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by Patrizia Pia

1. Introduction

The upheavals of the past decade which are taking place in the communist universe, especially those in China since 1979 and in the Soviet Union since 1985 attract a great deal of attention in the West. This is not only due to the consequences they trigger off abroad, but also to the novelty and specific nature of the problem they pose: how must an economic system be set up, based on market mechanisms?

The similarity of the conditions and causes at the origin of the reforms carried out in the USSR and in the People's Republic of China calls for a comparison between these two experiences so as to identify a possible transition theory.

In summary, the elements in common are the following:

a) two very large communist countries with planned economies, whose command system (1) has exhausted its potential;
b) both launch reforms, encouraged by an economic crisis which does not find a solution within communist postulates, in an attempt to trasform themselves into modern industrialized economies;
c) both are looking for a balance between Marxism, the official ideology of the party in power, and the market;
d) a nearly impenetrable bureaucracy and a sort of equalitarian psychology which results in a very scarce propensity vis-à-vis an entrepreneurial approach. This is further strengthened by an «everthing owed instead of earned» attitude (2) which makes changes unwelcome, not only for those experiencing these changes, but also for those conceiving them;
e) both countries must abandon autarky and open up to the external market, exposing themselves to «Western contamination» (this has had more evident effects in China, given its century-old adversion to «European barbarians»);
f) both require major investments, technologies and know-how and acquire them by turning to joint-venture agreements with foreign partners;
g) both attract foreign investors by offering great new markets for Western products and abundant, low-cost labour;
h) despite the above-mentioned elements in common, the situation in these two countries is certainly not similar. The comparison the

(1) The main characteristics of a command economy are:
a. State monopoly covering all economic resources, including the labour force;
b. strictly centralized resource allocation and management, coupled with a distorted system in which the State fixes the sale prices of industrial goods (raw materials, energy and transports) at a low level compared to production costs;
c. compulsory production objectives fixed for enterprises by high level administrative authorities;
d. non-redeemable budget allocations;
e. predominance of capitalization vis-à-vis consumption which leads to a high rate of labour exploitation and to a levelling distribution of material benefits.
S. MANEZHEV, «Tentativi di riforma economica in URRS e Cina: un approccio comparato», *Quaderni di Economia e Banca,* n. 10, 1990, p. 23-24.

(2) A. CARDANI, «Est Europeo: contributi su una realtà in trasformazione», *Economia & Management,* Sept.1990.

author wishes to carry out is not aimed at a quantitative assessment of the results achieved. Such a comparison would inevitably be unfair and not very reliable given the different starting off points in cultural, economic, demographic and historical terms. More simply,the author wishes to verify whether reforms adhere to the objectives singled out and to identify, whenever possible, the measures which have yielded the best results, quality-wise.

1.1. A comparison of philosophies

The inspiring philosophy of Soviet and Chinese reforms and the approach followed in the implementation of these undoubtedly represent the elements of greatest contradiction between the two experiences:

a) Perestrojka is essentially marked by its global nature, involving all the country's different aspects.
«Economic reforms imply changes in international political and economic relations, in the role and behaviour of individuals, in domestic political relations and in the organization of society. In the meanwhile however, the success of economic reforms is a necessary condition for the above-mentioned changes to occur» (3). The first measures, although assuming the appearance of traditional Soviet campaigns (the anti-alcohol campaign, the struggle against corruption in State entities, Glasnost and quality control) and not undermining the essence of the centralized economic system, end up by laying the basis for subsequent changes. The transformations take place in stages, both in order not to upset the functioning of the economy, and because of the lack of understanding between Soviet leaders concerning the need, the scope and the schedules of the changes to be introduced. Each innovation becomes even more daring than the previous one, at least in political terms, to such an extent that the August 1991 events trigger off more «revolutionary» consequences than those actually hoped for by Gorbachev in 1987. Lastly, in the Soviet world, pol-

(3) B. DALLAGO, «La riforma dell'economia Sovietica: risultati e prospettive», *Economia e Banca,* 1989-91, p. 73.

itical reforms abuse and sometimes hinder the uncertain and shaky economic reforms until they reach the extreme limit of disintegrating the empire itself.

b) In China the New Course follows the model successfully applied by the bordering Chinese communities in Hong Kong, Singapore and Taiwan, called «Confucian capitalism», a social capitalism based on the compromise and respect of the various specific cultural characteristics of Asia (4). A kind of «Third Path», which combines the advantages of capitalism and of socialism.

On a political level, no concession was ever granted nor forseen: «the State will regulate the market and the market will guide the economic activity of the enterprises» (5). This is the sentence which best describes the essence of Chinese reforms. The Tienammen events have shown that the communist party has not lost ground. Other elements which describe Chinese reforms are pragmatism on the place of command - paraphrasing a famous sentence by Mao Zedong - and a continuous testing. Each innovation is tested and tried out in restricted circles: it is then spread if considered valid or abandoned if it does not work. The first period of reforms (1979-1984) was indeed mainly devoted to the testing of capitalism in circumscribed geographical areas called Special Economic Zones.

1.2. A comparison of Soviet and Chinese economic reforms

Before entering the specific topic of this treatise - the comparative analysis of the two financial systems - it is interesting to assess, in general terms, the changes carried out by both countries in other economic sectors.

1.2.1 Agriculture

Differences

- Chinese reforms are launched in this very sector to struggle against the stagnation of agricultural production while the Soviet Union, although an importer of foodstuffs (roughly twenty billion dollars

(4) E. BETTIZA, *L'anno della tigre,* Mondadori, 1987.
(5) Reported in *The Independent,* 27th October 1987, p. 12.

a year) (6), once again sacrifices agriculture to industry. The few measures adopted in this field are translated in an initial increase of supply, but their impact turns out to be insufficient to incentivate peasants . «A radical reform of agriculture would have had the merit of being inexpensive in terms of resources and of yielding results in the short term, allowing an improved satisfaction of consumer demand, thereby relieving existing tensions» (7).

- The Soviet Union maintains State and collective farms intact. These production units are coupled with family-run farms which are, however, very few in number (8).

  The problem of a private sector in the USSR does not only concern its legal acceptability, but also the economic conditions on the basis of which it can function. «Until individual producers will not really have access to the inputs produced industrially, except through monopolistic State and State-controlled companies, or through large socialist-model farms, and until they will able to market their wholesale products only through these channels, their existence, which is legally independent, will remain precarious from an economic viewpoint.» (9)

  China is dismantelling its failing people's Comunes, replacing them with the production responsability system, according to which each family receives agricultural plots to manage, on the basis of fifteen year lease contracts. The families may farm these plots with the criteria they believe to be most advantageous. The duties of these

(6) For a more detailed analysis, see IMF/IBRD/OECD/EBRD, *A Study of the Soviet Economy,* Vol. 3 p. 137-170.

(7) B. DALLAGO, *op. cit.,* 1989-91, p. 75.

(8) «The decisions taken by the plenum of the central committee of the Party dating March 1989 and the following legislation on leases, land and property have rendered official the notion of "peasant farm". It forsees, among other forms of land use, the independant allocation for an unlimited period, to stimulate entrepreneurial initiatives ... At the end of March 1990, according to the first statistical report, there were 20,000 Soviet peasant farms, especially in the Baltic republics. The most frequent dimensions are of 15-30 hectares of arable land or otherwise cultivated, and roughly twenty milk cows, or 50-100 cattle or pigs for slaughter. Even if within the end of 1990 the number of these farms were indeed to increase to 30,000, they would represent, at a maximum, only 0,2-0,3% of the arable land of the Soviet Union and an even lower percentage of its global agricultural land...» (K.E. WADEKIN, «Il ruolo dei produttori individuali in una agricultura socializzata», *Quaderni di Economia e Banca,* 1990/10 p. 113-138).

(9) K.E. WADEKIN, *op. cit.,* p. 117.

tenants are limited to the payment of taxes and to the delivery of a share of produce at fixed prices.

- By 1984, the number of Chinese agricultural commodities subjected to compulsory State procurement had been reduced from 29 to 10, however, what is even more important is that the shares were always fixed in absolute terms, thereby creating a major incentive to an increase in production ([10]). In the Soviet Union two thirds of production are still under State procurement.
- The township and village community enterprises which are privately owned represent the most important consequence of the introduction of the production responsability system in agriculture and the response to the problems inherent to the survival of a rural, individual Chinese economy ([11]).

1.2.2 Enterprise Management

Similarities

- Reforms in the industrialized urban economy, as was forseen, encounter various difficulties both in Russia and in China. The sector, which is highly bureaucratized, demonetized and State controlled, puts up a great resistance against structural changes in the two really important fields, namely prices and property. In the People's Republic of China «the weakening of the instruments of central administrative common planning (accomplished in part through what appears to be excessive administrative decentralization of decision-making to provincial bureaucracies) without the adequate strengthening of the market and of information, coordination and incentive instruments has contributed to the worsening of the economy, of inflation, the widening of income differentials, and corruption» ([12]).

([10]) B. BALASSA, «China's Economic Reforms in a Comparative Perspective», *Journal of Comparative Economics,* 1987 n. 11.

([11]) For further details see W. BYRD - A. GELB, *Township, Village and Private Industry in China's Economic Reform,* Working Papers of Country Economics Department of the World Bank, April 1990.

([12]) JAN. S. PRYBYLA, «China's Economic Experiment: Back from the Market?», *Problems of Communism,* Jan-Feb 1989, p. 3.

- In both countries enterprises are entrusted, for the first time and in principle, with greater decision-making powers concerning their sphere of competence.
- Enterprises are made responsible from a financial standpoint through profit taxation which, in theory, makes profit management uniform and transparent. In Russia the law creates a wide range of preferential taxes (13) whereas in China the practise prevails of bargaining the tax rate according to entrepreneurial requirement criteria and according to «guanxi», ie,useful connections. Both countries run the risk of re-creating, with a new external appearance, an entrepreneurial system which is not very different from that they wish to change.
  An impediment to the success of enterprises being responsible financially is that enterprises are not yet considered responsible for losses. In the event of scarse revenue or prolonged deficits not only are taxes condoned, but the companies in this situation continue to receive State subsidies.
- The decentralization of the power of the Soviet and Chinese central governments transforms regional and local governments into entities which combine State administration and corporate management. In China provincies vie with each other in setting up their independent companies and industrial systems using administrative powers to monopolize low cost raw materials and to launch autonomous productions. The consequence of all this is a market segmentation worthy of concern and a deterioration of the resource allocation process. In the USSR «increasingly, the notion of an all union, integrated market - albeit the result of central planning rather than market forces - was being challenged. Barter transactions grew in importance and the attitude of the republics became increasingly autarkic» (14).

Differences

- «The law on State enterprises dated 30th June 1987 lays down "bottom - up planning" for Russian enterprises. It lays down and autonomously adopts the plan covering its own activities on the basis

(13) For more details, see IMF/IBRD/OECD/EBRD, *op. cit.*, Vol. 1, p. 237-248.
(14) For a more detailed analysis see: IMF/IBRD/OECD/EBRD, *op. cit.*, Vol. 1, p. 38.

of State orders and trade orders coming from other users, bearing in mind control figures and long term measures drawn up by central administrative bodies» (15). In practise, State orders still cover 90% of industrial production and the degree of autonomy of Russian enterprises is rather limited.

The Chinese government applies the same approach to industrial enterprises followed in the agricultural sector: it allows enterprises to sell at free prices the surplus production, on the basis of the fixed share. Gradually, the industrial output under mandatory planning decreases until it reaches only 20% of national production.

- Chinese managers are appointed by the Bureau and are committed on a contract basis for a threefive year period to achieve a certain amount of profit. The profit exceeding the fixed share can be withheld by the enterprise or taxed at a lower rate. In Russia a certain spontaneous privatization of enterprises is witnessed, however, no personal interest is being created in the maintenance and enhancement of corporate assets (16).
- While Russia has not yet adopted a law concerning bankruptcy - it is indeed a matter of undermining one of the most fundamental premises of a socialist society - China, in 1986, issued an Enterprise Bankruptcy Law of the People's Republic of China. Apart from the great «socialist» concessions covered by this law, which alter the very meaning of bankruptcy, its integral application would trigger off enormous difficulties for the Chinese economy, as roughly 300,000 on 400,000 enterprises (both collective and State-controlled) would be declared bankrupt (17).

1.2.3 Prices and Wages

Similarities

- The reforms of both countries attempt to enhance links between wages and productivity, with scarce success, as only the former increase.

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(15) For further details see: D.J. SOLINGER, «Capitalist Measures with Chinese Characteristics», *Problems of Communism*, Jan-Feb 1989, p. 19-33.

(16) IMF/IBRD/OECD/EBRD, *op. cit.*, Vol. 2, p. 21-22.

(17) D.J. SOLINGER, *op. cit.*

- The complex problem concerning the labour market (dismissals, social welfare and employee dislocation) is still being discussed.

Differences

- In Russia the need for a restructuring of the price system is widely recognized. This problem is a source of heated discussions between those in favour of reform and conservatives. «In the discussion of price liberalization, even among those who advocate radical reform, enphasis is frequently put on the need to wait before freeing prices until scarcities are eliminated, supplies are stabilized, and monopolies are broken up. The role of prices in influencing demand and as a signal to producers for resource allocation, which would indeed help to remove shortages, is often given less weight» ([18]). Since January 1992, in Eltsin's Russia, the more radical line prevails: the total liberalization of prices does not provide the wished-for effects and the authorities are forseeing measures to take some steps backwards.
  China tackles the price question by creating a two-track price system. The producer negociates with the government a certain production quota to be sold at regulated prices. Additional output can be sold at market prices or at negociated prices, within government guide-limits. This system has tended to reduce price distortions and increase efficiency. However, it has also constrained the efficient use of macroeconomic policy instruments, because the government has to influence the behaviour of producers facing different input and output prices, making it difficult to evaluate and predict the impact of specific policy measures ([19]). The existence of multiple prices for a same type of product develops the speculative capacities, instead of the entrepreneurial ones. It is more simple to achieve profits by obtaining low cost materials and low interest rate loans or re-selling rationing shares, certificates, and food tickets instead of improving management. Moreover activities where abuse of administrative power takes place prevail, and this is used to forward personal interests.

([18]) IMF/IBRD/OECD/EBRD, *op. cit.*, Vol. 2, p. 1.

([19]) M.I. BLEJER-G. SZAPARY, «The Changing Role of Macroeconomic, Policies in China», *Finance & Development*, June 1990, p. 32.

2. Banking system

In the period before 1979, the Chinese banking system was essentially identified with a monobank system, typical approach of socialist economies. The People's Bank of China (PBC) acts both as a central bank and as a commercial bank under the aegis of the Ministry for Finance (MOF) and, as in the Soviet case, it plays the role of government taxation board. It collects and transfers funds to enterprises, ensuring that their use takes place in line with the Plan's indications. To guarantee control, enterprises must centralize their deposit and withdrawal operations in one single credit institution indicated by the authorities.

All the principles illustrated in the previous chapters are in force, and indeed many of these have been inherited from the Soviet model:

- separation of financial circuits between the private sector and the State sector. In the latter every single transaction is controlled by the PBC and cannot take place if it is not in line with the Plan;
- credit policy decided centrally on the basis of the principle of the separation of, on the one hand, banking loans granted to cover sudden and transitionary cash requirements (to be paid back upon expiry and taxed with an interest rate) and State funds necessary to fund investments and a fixed share of the working capital (not to be paid back nor subject to any cost);
- interest rates which do not play a credit allocation role.

In order to create a financial structure more in tune with the autonomy and efficiency requirements of Chinese «new enterprises»,reforms proceed to cover the restructuring of the banking sector through: the separation of commercial functions from central bank functions, the consequent creation of specialized banks and the creation of new national and local banks.

The banking scenario is more articulated: four specialized banks (Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, People's Construction Bank of China), two national-level comprehensive banks (Bank of Communications, CITIC Industrial Bank), a development bank (China Investment Bank), a vast network of Rural Credit Cooperatives and Urban Credit Cooperatives.

Starting from 1987 other small banks are set up at a provincial-level

or for the Special Economic Zones: Guandong Development Bank, Bank of China Merchants and Shenzhen Development Bank. In any case, this is an event of very limited scope, which cannot be compared with the proliferation of commercial cooperative banks in the Soviet Union, to which Paola Schwizer refers to in the third chapter of this book.

With reference to this incredible expansion, resulting from the transformation of State banks into commercial banks, and from the dismantelling of these into minor units with an autonomous status, «the chairman of the Russian Central Bank believes the commercial banks are overwhelmingly dependent on funds deposited by the now banned Communist party or by organized crime. He said the banks were: «laundering "billions of roubles" owned by the Communist party or by organized crime. In his view, the transfer abroad of communist money is reminiscent of the Nazi's efforts to salt away cash at the end of the war to provide for a future resurrection of the National Socialist Idea...» ([20]).

The truth of such statements is still uncertain, however the funding capacity of a high number of cooperative banks created in such a short time span remains unexplained.

2.1. The Central Bank

In 1984 the People's Bank of China trasforms itself into a central bank, directly subordinated to the Council of State. The «Provisional Regulations of the People's Republic of China on the Control of Banks» promulgated by the State Council on 7th January 1986 indicates the functions of the PBC:

- «as the central bank, PBC formulates and implements financial policy; controls the issue of currency, determines interest rates and foreign exchange rates, and draws up and implements the credit plan;
- as the prudential regulatory agency it supervises and audits all financial institutions, approves the establishment, merger and closure

([20]) J. LLOYD, «Russian Commercial Banks Under Attack», *Times*, 28/9/1991.

of financial and non-bank financial institutions; and plans and regulates the issuance of negociable securities by enterprises and supervises money markets;
- as banker to the government, it manages the State treasury and issues government bonds; handles official foreign exchange reserves and the international transactions of the government;
- as the bank of banks, it grants ordinary and seasonal credit, and short-term liquidity (rediscount teller and refinancing facility) to the specialized and comprehensive banks; provides banking services to the financial system (clearing, remittance of funds, checking accounts, etc); offers conciliation and arbitration procedures; and provides services to specialized banks and other financial institutions in such areas as coordination of functions, provision of information, development and training of personnel and assistance in the development of their development capacity.

Finally, in its development functions, PBC lends directly to promote regional development (14 coastal cities and SEZs), gold and silver production, to key State owned enterprises, and to industries located in the poorest counties. In addition, PBC makes long-term loans through the specialized banks, for specific regional development projects and to sub-lend to the least developed areas.» ([21])

The declarations contained in the Temporary Regulations lay down new responsabilities and a greater degree of autonomy for the People's Bank of China: from a passive taxation agent of the government it becomes an active board for the formulation and execution of the monetary and credit policy of the country. A real autonomy from the central power is not however contemplated, not even «on paper». The People's Bank of China depends, from a hierarchy viewpoint, from the State Council to which it must submit all economic decisions to receive approval.

From this standpoint, Russian reforms have taken a major step forward compared to Chinese ones. Indeed, for the former, the recently enacted banking law lays down the independence of the central bank vis-à-vis executive and administrative bodies of State power.

([21]) WORLD BANK, *China Financial Sector Policies and Institutional Development*, p. 3.

Even if the separation between the two authorities is not complete in practise, it is remarkable indeed that a real law contemplates this principle. On the other hand in China, the very fact that the banking sector is still ruled by simple regulations instead of by a well defined legislative framework clearly indicates the will of the central powers to maintain control over events.

The control power of central banks over the entire financial sector too indicates a similarity between the two systems. The moves in favour of independence of the Soviet Republics, which have a marked political connotation and which clash with a central structure undermined by Perestrojka itself, have enjoyed a good margin of action. The consequences have logically been felt in the banking sector too. Various peripheral branches autonomously declared their independence from their parent bank. In China too the traditional strong provincial and local power, strengthened by the centralization which matched these reforms, limits the authority of the PBC, to the detriment of the capacity of ensuring the respect of credit and monetary directives at a local level. However, the Chinese central bank manages to overcome this situation by centralizing certain decisions and by taking into consideration the timeliness of launching major changes, aimed at reorganizing branches on the basis of an economic and geographical structure which does not coincide with the provincial one.

2.2. Specialized banks

The Chinese banking system, following the Soviet model, contemplates the possibility of specialized banks too, whose number and operative power undergoes more or less cyclic variations. Reforms introduce a certain degree of decentralization, enlarging the field of action of certain specialized banks and creating a few from scratch.

The Industrial and Commercial Bank of China (ICBC) is the largest bank in China, accounting for 32% of total bank assets, and 47% of domestic operations (excluding BOC) of the commercial banks. Its principal functions include: mobilization of individual and enterprise deposits, mainly in urban areas; provision of working capital to state-owned enterprises, collective and individual enterprises; technical transformation lending; pay-roll management and supervision and

cash management for state and large collective enterprises. ICBC also engages directly in trust business and, indirectly through a TIC affiliate, in entrusted business.

The Agricultural Bank of China (ABC) has the role of providing the working capital to state agricultural supply and marketing units in rural areas. Since 1985 it started to lend to industrial township enterprises and to extend medium-term technical transformation loans. ABC collects deposits mainly from agricultural marketing and supply units and individual deposits mainly in the countryside. A major source of its resources are mandatory redeposists of Rural Credit Cooperatives.

ABC has two distinctive arrangements which the other specialized banks do not have. One of them is that since January 1988 it is operating under the modality of the «contract responsability system». ABC's management agrees with the Ministry of Finance on a number of targets including the annual income tax to be paid. If ABC exceeds the agreed targets, it can retain any excess profits and pass part of them to its employees through higher bonuses. The second distinguishing characteristic is the old and special relationship which it has with the RCCs.

ABC receives RCCs redeposits (which represent about one third of ABC's total deposits) and in exchange ABC pays interest equivalent to 7.2% per year on their required reserves and about 10% on the remaining funds. In addition, ABC provides them with short-term loans, clearing services, cash management services and substantial-staff training and supervises their operations on behalf of PBC.

The People's Construction bank of China (PCBC) was established in 1954 and directly affiliated to the State Council. Its principal functions were to distribute funds from state budgetary appropriations to state-owned enterprises, to be used in «capital construction» (for example fixed investment in new enterprises or major expansion of existing enterprises) and to supervise the use of funds. PCBC was also in charge of supervising all construction units in the state sector. Funds for capital construction were provided until 1979 as non-repayable, interest-free grants. Since then, they have been gradually replaced by loans, albeit with interest rates. PCBC's network is rather limited as the bank was not a commercial retail institution.

The Bank of China (BOC) was the state monopoly handling all

foreign exchange and international payments. It served as the import-ecxport bank, implemented exchange control regulations, handled international loans and managed all foreign exchange-related operations and securities. Formally directly subordinated to the State Council, BOC is now under the supervision of PBC. Although BOC has no longer the foreign exchange monopoly, it still dominates foreign exchange transactions while its domestic operations are still relatively small.

In 1985 operative restrictions are dismantelled for the four specialized banks. Each is in competition with the others for the acquisition of new deposits and the granting of funding. Competition has, however, difficulty in developing. On the one hand, high «intra-industry» product line barriers prevail within the banking and non-banking sectors, resulting from the number of regulations. Differential administrative interest rates applied to different institutions, quantity restrictions placed on bank's deposit takings and priority lendings also apply. On the other hand, inadequate organizational structures prevail.

The conditions of the Soviet banking system appear, at a first glance, more favourable to the creation of a competitive environment: indeed cooperative commercial banks have undermined the monopoly of specialized banks awakening the latter from an atavistic wait-and-see policy. In fact, in China, any reformist initiative appears to be guided closely from the top or quickly enmeshed in the network of state power. The non-banking financial institutions which enjoy most freedom as they are not subjected to the credit plan are, however, owned by specialized banks or by local governments, which are contrary to competition by definition.

2.3. Interest rates

The policy of interest rates, despite a slackening of restrictions, continues to be managed by the PBC, after the approval of the State Council. To this end it must be underscored that within the framework of the Chinese economic system, as in the Soviet system, conditions for a complete liberalization of interest rates are not yet ripe. The scarse development of competition in the financial sector does not guarantee the fixing of adequate interest levels. The profitability

of investments is influenced by controlled prices and interest rates do not carry out an adequate allocation role for credit. Investment and debt decisions carried out by companies are only partially sensitive to interest rates, both because production units continue to receive state subsidies and because many do not look for the maximization of profits.

In China the differentiated and not so transparent structure of interest rates fulfils a complex range of objectives which reflect, above all, the preferences of the public authorities vis-à-vis the distribution of subsidies to the various production activities or to specific provinces instead of reflecting objective characteristics of the risks involved, inflation forecasts or cost-opportunity assessments of alternative investments.

Interest rates vary not only according to the production sector or to the aim of the loan granted, but, both for deposits and for loans, it also differs according to the banking institution involved. For example, the RCCs can practise a 70% and 90% increase on the rate fixed by the PBC for deposits and working capital loans respectively. On the other hand, specialized banks manage to impose a rate which is only 30% higher for working capital funding and must in any event apply official rates for large state-owned companies and for production units operating in key sectors. As far as deposits are concerned, it appears that the same specialized only in offering rates authorized by the PBC in the areas where they enjoy a monopolistic situation.

The differences in interest rate flexibility are justified also on the basis of the average cost of bank funds, of the recipient of the credit and of the loan risk. The last two factors are understood in a slightly twisted sense as they refer more to the legal form of the enterprise than to its economic assessment. The RCCs and the UCCs enjoy a greater degree of flexibility, both because the average cost of their deposits is higher than that of specialized banks, and because they grant loans mainly to collective enterprises that one presumes to be in a better position to sustain higher costs. Specialized banks, on the contrary, grant loans nearly exclusively to priority sectors, to agriculture and exports, and thereby have a lower discretionary power, which is sometimes nil.

In Russia, «until recently, different interest rate regimes applied to specialized banks and commercial and cooperative banks. The former

were not allowed to pay, on average, above 0.5% on enterprise deposits and 2-4% on household deposits (depending on maturity). Interest rates on loans from specialized banks could vary according to the financial position of the borrowers but remained, in practise, near or below the refinancing rate charged by Gosbank, which itself varied across sectors. The CCBs meanwhile, were allowed to freely set both deposit and lending rates. Since February 1990, interest rates on household deposits in the CCBs have been limited to the deposit rates offered by the Savings Bank» ([22]).

2.4. Autonomy and plan

The role of Chinese central authorities in the allocation of financial resources continues to be all except limited. The credit plan is indeed the dominant instrument in deciding which bank must finance each project.

The wish of the Chinese government to ensure the financial coverage of key projects matched with the limited discretionary power granted to banking institutions alters the spirit of reforms and qualify bank credits as an essentially "guided credit". There are two implicit contradictions in this policy: 1) administrative guidance is inconsistent with making banks autonomous; 2) priority loans at low interest rates conflict with the objective of making banks accountable for profits.

The same problem is witnessed in the Soviet Union when the law on banks and on banking activity, issued on December 11th, 1990 explicitely forsees the creation of "ad hoc" banking institutions for the funding of certain state projects, either at a republic or regional level. There is an attempt to eliminate, or at least to decrease the interference of the State in the distribution of credit, but this reappears in other instances under false pretences.

In conclusion, Chinese reforms in the banking sector have been blocked at their first development stage, that which led the system to a partial decentralization and a consequent operative specialization.

([22]) IMF/IBRD/OECD/EBRD, *op. cit.*, Vol. 2 p. 120.

It is the same path followed by the Soviet banking sector in an attempt to undertake some improvements without changing the rules of the game. After ten years of Chinese reforms, the transition stage has become cristallized and this is a major source of concern. The «great innovations» are instead revealed to be scantly camouflaged government control operations.

Frankly speaking, all the actions of the new course undertaken both in the financial and non-financial sectors have been carried out by the political powers which have never lost their dominion over the situation. This behaviour is undoubtedly a guarantee of relative stability and harmony for a country undergoing transition, but at the same time, it runs the risk of emptying reforms of their really innovative contents.

In the USSR, on the contrary, a first restructuring «for appearances sake» was followed by deeper changes which, although with much uncertainty and political instability, will probably yield more satisfactory results.

3. Capital market

The capital market, in coherence with Chinese pragmatism, develops on an experimental basis too: Shenyang, Shanghai and the Guandong province act as a test case and, in the absence of explicit government directives, lay down their own temporary regulations. After various years of empirical philosophy,in 1987 the State Council intervenes with two administrative bulletins which introduce certain limitations to prevent and reduce excesses:

a) «The issue of shares should be under the strict supervision and control of the authorities concerned, and only a limited number of collectively-owned enterprises, with special permission from the authorities, can issue shares;
b) The state-owned enterprises are not permitted to issue shares publicly and the authorities retain the power to repeal the right to issue shares from those enterprises previously granted permission;
c) PBC branches may authorize the issue of shares by enterprises only after strict investigation.

After the State Council issues these regulations, the cities with se-

curities markets will issue or revise their own securities regulations. PBC and MOF issue some circulars with the intention of regularizing the emerging capital markets. PBC is now drafting "the Provisional Regulations on Stock Issuance" and "the Provisional Regulations on Share Issuance" which will be the national unified code of regulations for the securities market. It is not yet known when these will be issued.» (23)

In the Soviet Union the capital market is moving its first steps within a legislative framework which is still full of shortcomings: the obvious lack of experience in this field is matched with the political and administrative problem linked to the jurisdiction of the republics. Whilst awaiting the Securities Law of Russia to which Vladimir Kuznetsov refers to in his paper, various decrees are in force, which, just like their Chinese counterparts, impose strict restrictions on those allowed to issue financial instruments, on those allowed to purchase them and on the negociability of securities.

These limits outline a kind of compromise capable of not embarassing, at an ideological level, a communist government, especially the Chinese one which has never repudiated its political matrix, when it revives a typically capitalist instrument, which is therefore judged negatively.

Following the wake of reforms, the governments of both countries recognize the usefulness of capital markets as mobilizers of financial resources and they perceive the advantages linked to the possibility of partially sharing the cost of supplying financial means without, in the meanwhile, threatening employment and thereby stirring up social tensions (24). However, they also glimpse the dangerous implications of this instrument vis-à-vis the principle of the state property of production means, which is the cornerstone of the socialist system.

This viewpoint explains the specific characteristics of the Chinese securities market, some of which are also present in the USSR:

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(23) WANG YUAN, *China: Recent Development in the Capital Market,* World Bank paper, September 1991, p. 2.

(24) D.J. SOLINGER, «Capitalist Measures with Chinese characteristic», *Problems of Communism,* Jan/Feb 1989, p. 32.

- strong dominance of state securities compared to corporate bonds and shares. In 1988 in China securities amounting to 90 billion yuan were in circulation of which only 2,2% were corporate shares and 22% corporate bonds. The rest were Treasury bonds and stocks linked to the funding of specific key projects fixed by the State. «The securitized claims in the Soviet system are a relatively small volume of government bonds, some bank deposit certificates and a limited number of shares issued by joint stock companies, the most prominent of which is the Agroprombank» ([25]);
- rules which oblige Chinese state companies not to issue shares at a value higher than 30% of the total capital stock;
- dividends on shares fixed in advance and calculated by the company as a cost. Not only does this exclude any risk for the holder, but this even distorts the essence of shares;
- traditional relations between companies and the political authorities, which in general are not harmed by the issue of shares;
- confusion or total lack of measures concerning the property rights and negotiable nature of securities.

The issue of securities also has a second objective: to absorb the money in excess held by the population, a function which acquires a certain importance in the presence of growing inflation, especially if the allocation of securities takes place under coercion. However, the mechanism stops working when the distribution of shares, to the exclusive benefit of employees, is used by enterprises in order to distribute further benefits.

In the Soviet Union the decree enacted by the Council of Ministers dated October 15th, 1988 ([26]) allows and justifies the issue of corporate shares and of other economic organizations, relying once again upon socialist rhetoric. «For the further deepening of the democratic principle in management, the development of the initiative of working collectives and of each worker who will therefore be shown to be the real owner of production....»

The emphasis placed on the incentivating role of share issues is

([25]) IMF/IBRD/OECD/EBRD, *op. cit.*, Vol. 2, p. 128.

([26]) «O vypuske predprijatijami i organizacijami cennych bumag», *Economiceskaja Gazeta*, n. 45, November 1988, p. 23.

however promptly denied by the procedures followed in dividend distribution. The old equalitarian heritage surfaces still, thereby imposing fixed dividend payment and not on the basis of the profits reaped by the enterprise.

3.1. Trading institutions

In China there are many securities trading companies and trading counters. By the end of May 1990, there were 1,563 intermediaries dealing in securities, of which 63 were securities companies, 743 were trading counters, and 757 were securities trading agencies. Among these intermediaries, 1,467 were owned by banks and financial institutions (TICS) and 96 were owned by the public finance system.

Trade in State bonds dominates the transactions in these markets and by these intermediaries. It is only in Shangai and Shenzhen that trade in shares is important. By May 1990, 83 enterprises in Shenzhen had been converted into standard joint-stock companies, with a total share value at issue of RMB 400 million. Many problems have emerged along with the development of the securities market in Shenzhen:

1) the market is not being regulated in an orderly manner, and there is a lot of off-floor trading, due to the inefficiency of the trading procedure. Normally it takes three or four days to transfer the account of one share holder to another;
2) the approval procedure has not been well defined and therefore it can take a considerable length of time for an enterprise to obtain approval for the listing of its shares.
3) Since the legislative framework is incomplete, there are a lot of loop-holes in the system, permitting such practices as insider trading and tax evasion.

The Shanghai Stock Exchange was officially opened on December 19th, 1990, and is part of the plan for developing and opening Shanghai's Pundong area and rejuvenating Shanghai's economy. As soon as the Shanghai Stock Exchange came into being, the related departments took steps to legalize its operations according to common international practise. Nevertheless it has its own characteristics as a socialist stock exchange.

It is not a business legal person, but a non-profit institution with

a membership status aiming at promoting the securities market in China to serve socialist modernization. It only deals in spots but not futures. All securities for trade in the exchange must be approved by the administration of the Stock Exchange and the government departments in charge. After the conclusion of a transaction, the clearing account between the buyer and seller will be handled by the Stock Exchange, which will transfer the stocks and quote the prices of the stocks on the large electronic TV screen in the hall, and at the same time pass on the information to all member firms in the city and related circles across the country through a computer ([27]).

3.2. Nature of instruments issued

State bonds are issued by the Ministry of Finance to both institutions and individuals, and there are six types of bonds at present: Treasury bonds, Treasury bills and price-indexed bonds which are issued for budgetary purposes; State key-construction bonds for priority construction projects in such sectors as energy, transportation and raw materials; State construction bonds to finance state-designated projects.

Bonds sold by MOF to enterprises have borne lower interest rates than those sold to individuals. Interest rates on Treasury bonds have risen from 4% and 8% respectively for bonds issued in 1981-84 to 5% and 9% in 1985, rising finally to 14% in 1989 for bonds allocated to individuals. Interest on all bonds is payed in full at redemption with no interim interest payments and the interest paid on Treasury bonds is simple interest. The bonds are thus not unlike zero-coupon bonds or discount securities, with the distinction that they are sold at par instead of at discount, and redeemed to yield cumulative simple interest.

Treasury bonds held by individuals are negotiable since April 1988. Trading was initially permitted experimentally in seven cities, but only of the 1985 and 1986 bond issues. Two months later trading

([27]) LU JIRONG, «The Shanghai Stock Exchange Comes True», *China Economic News*, n. 5, Feb. 1991.

was extended to 63 cities in total. Trading of Treasury bonds is segmented among localities, a natural consequence of the communications system and the small denominations of the debt being traded. Prices differ from city to city for the same issue, reflecting different supply-demand conditions and the expense involved in moving paper from one market to another.

Demand appears to be stronger in Shanghai than in other cities, the secondary market accounts for 25% of total activity. Some Shanghai securities firms have established channels for buying bonds at lower prices in other cities for resale in Shanghai.

Capital Construction Bonds are issued by State Investment Corporations and purchased only by specialized banks to finance basic construction projects. There is a three-year deadline and the first issue goes back to 1988.

Key Enterprise Bonds are issued to institutions by the State Investment Corporation to finance the power, oil, steel and metal industrial plants. They have relatively longer maturities, ranging from three to ten years, depending on the sector and the implementation of the product.

Financial Bonds are issued by specialized banks and non-bank financial institutions to individuals for specilized loans. These bonds have been issued since 1985. Maturities for these bonds range from 1 to 3 years. The bonds can be redeemed after one year, and the coupon rate for one or two year maturities is of 2% over the rate offered by the specialized banks on a deposit with similar maturity, and for a three year maturity the rate is 1% over the three year indexed deposit rate. The choice of redemption rate is up to the bond holder and is not determined at the time of purchase.

Local Enterprise Bonds are issued by enterprises to individuals and institutions for short term working capital, as well as fixed investment. Maturities are usually for more than one year.

A common characteristics of the two countries being examined for the allocation of bonds, is the adoption of material incentives. In the Soviet Union, the state offers a kind of securities called Zero-coupon lottery bonds which, after a drawing, confers to the winner a prize in money, whose value varies from 100 to 10,000 roubles. Large winnings (5,000 and 10,000 roubles) can be applied against the price of Zhiguli or Volga motorcars and place the winner at the head of

the queue for these cars. Another example is that of «Commodity bonds, a securitized form of advanced payment by "investors" seeking to secure access to 16 specific commodities, mostly consumer durables, identified by the Council of Ministers. The stated intention is to channel resources to expand production capacity for the specified goods, but it is not clear whether this is in fact happening» ([28]).

In China the very same approach is followed by certain enterprises. To promote the sale of their bonds, they offer additional prizes, such as lottery tickets or priority in purchasing their commodities.

The purchase of Chinese State Bonds is not on a voluntary basis. State bonds are allocated to both individuals and institutions, with allocation units usually responsible for arranging purchases by individuals. By the end of 1989, 29.38 billion RMB was held by individuals (53.7% of the total) and 21,6 billion was held by institutions (46.3% of the total).

Key construction bonds are issued to individuals and institutions on a voluntary basis, with 0,5 billion held by individuals and 4,9 billion by institutions. All Financial bonds are held by individuals. In contrast, Capital Construction bonds and Key Enterpise Bonds are allocated to specialized banks and enterprises on a compulsory basis.

4. Joint ventures and foreign investments

4.1. The forms of foreign investment

The possibility that foreign business concerns could participate in China's economic growth through direct and indirect equity investments was first announced during 1979. By the end of 1990, just eleven years later, more than 29,049 Chinese-foreign equity and contractual joint ventures had been approved by the Chinese government. Of this number 16,289 are equity joint ventures with investments totalling US $15.234 and 9,311 contractual joint ventures with

([28]) IMF/IBRD/OECD/EBRD, *op. cit.*, Vol. 2, p. 128.

a total planned investment of approximately US $14.812 billion.

Additionally China had authorized 3,385 wholly foreign-owned enterprises to commence operations in China ([29]). Such figures represent a remarkable success in attracting foreign investment, particularly when remembering that China had existed in self-reliant isolation for over thirty years and began the process with untrained officials and a legal system opposed to private ownership.

Foreign participation in Chinese investments is less piecemeal compared to that in the Soviet Union: Hong Kong and Macao account for more than half of the foreign presence in China while in Russia foreign participation is equally divided among the countries of the EEC.

4.2. The legal framework

The «Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment», adopted on July 1st 1979 creates a new entity with a different and separate status compared to traditional state enterprises. To define the role of this new kind of enterprise within the Chinese economic system, the government proceedes by adopting laws and regulations in a rather piecemeal fashion, correcting or bridging with a series of decisions both mistakes and previous gaps and testing out certain measures in the Special Economic Zones before they are actually introduced as national laws. The legislative framework which results from this apppears at first to be incomplete and muddled. An analysis of published laws, the only ones which are truly binding, induces the author to believe that there is more uncertainty and flexibility than what is really the case. In truth, the legal structure for the regulation of foreign investments also includes future laws whose approval is expected and which will become internal guidelines made available only to Chinese negociators, ie, legislation for Special Economic Zones, applied by analogy, plus the contractual forms of previous transactions approved by government agencies.

([29]) *Business China,* May 27th 1991, p. 76.

«The difficulty of understanding China's laws governing foreign investment is complicated by the fact that China has two separate legal systems, rather than one. In most countries that seek to encourage foreign investments, there is a set of regulations that sets forth the procedures under which a foreign company can apply to invest in the host country. Such legislation may grant incentives or impose terms restricting the form and types of investments that are permitted. But once approval is obtained, the foreign investor and the company he establishes are regulated by the general laws of the host country, such as corporate law , foreign exchange control law, tax laws and laws related to labour relations. In other words, the foreign investment enterprise established after approval of the foreign investment application is governed by the same laws as those applicable to domestic enterprises» (30).

In the USSR too joint ventures are subjected to the same law which regulates other Soviet enterprises although major exceptions are foreseen in specific areas such as taxation, foreign exchange, wages and management rights. In China, apart from the limitations which are found in Soviet legislation, there is a further complication: «when a joint venture contracts with a foreign company for the supply of goods, that supply contract will be governed by China's Foreign Economic Contracts Law, which is similar to generally accepted international contract law principles. However, when the same joint venture contracts with a Chinese enterprise, that domestic contract will be governed by the Economic Contracts Law of China .... The differences between the two laws are substantial. Under the Foreign Economic Contracts Law, if there is a breach of contract, the defaulting party should pay damages to the non-defaulting party so that the latter receives the benefit of the original bargain. Under the Economic Contracts law, however, if the default is caused by a change in the State Plan, such as an order to the Chinese enterprise to supply its goods to some other enterprise other than the joint venture, then no damages must be paid but the contract must be amended or cancelled. If the default is not due to change in the State Plan, but simple non-performance, then the non-defaulting party has

(30) L.G. HOUBEN PARTNER, *The Form of Foreign Investment in China with Case Studies*, paper presented to management and economics in China today, Maastricht, November 15th and 16th, 1990.

the right to insist upon contract performance and the courts may order the defaulting party to perform. In addition to specific performance of the contract, the penalty stated in the contract for non-performance must also be paid» (31).

Chinese legislation, differently from Russian legislation, contemplates a wider choice range for foreign investors. The most developed investment forms are: Equity Joint Venture, ie, a limited liability corporation jointly invested in and operated by the Chinese and foreign partners. Profits, risks and remaining assets upon expiry of the venture are shared according to the percentage of equity held by each party. The corporation has a legal person status. Each party may contribute cash, buildings, equipment, industrial materials and intellectual property rights and land use rights too. Labour is not an allowed contribution. Minimum investment contribution by the foreign party amounts to 20%. No maximum is specified.

The Equity Joint Venture's (EJV) advantages are:

- EJV Law and implementing regulations provide a relatively complete structure of rules and procedures for establishing and operating a venture in China.
- EJVs are preferred investment vehicles of the Chinese government and many incentives are offered.
- EJVs may provide a vehicle for selling to the domestic market.
- EJVs may be included - differently from what takes place in Russia - in the annual plans for raw material allocations and may procure goods at subsidized state prices.

EJV disadvantages are:

- Negotiations for EJV may stretch out for years, generating excessive expenses.
- Investors are restricted from withdrawing registered capital during the life of the contract.
- Termination and liquidation of equity joint ventures have not been fully addressed by laws or practice.

Contactual Joint Ventures can take two forms: 1) a limited liability entity with legal person status that closely resembles the equity joint

(31) L.G. HOUBEN PARTNER, *op. cit.*, p. 7.

venture in structure and operation; 2) a business partnership in which the parties cooperate as separate legal entities and bear liabilities independently. In either cases, profits and assets remaining after expiration are divided as specified in the contract and not necessarily according to investment shares. Unlike equity joint venture each party's investment contribution does not have to be expressed in monetary value. No maximum or minimum investment required.

CJV advantages are:

- Maximum flexibility in structuring the assets, organization and management of the venture.

The foreign investor can recover the registered capital during the life of the contract.

The CJV can be developed quickly to take advantage of short term business opportunities and then dissolved with minimum legal restrictions.

CJV disadvantages are:

- Detailed implementing regulations have not been promulgated.
- Higher corporate income tax rate than EJVs.

Wholly Foreign Owned Enterprises: a limited liability entity solely owned and operated by a foreign investor. It may or may not have legal person status. The foreign investor receives all profits and bears all risks.

WFOE advantages are:

- Foreign investor has tighter control of propietary interest.
- Exclusive management control for investor, no need to compromise with partners.
- Exempt from 10% tax on dividends.

WFOE disadvantages are:

- Implementing regulations have not been promulgated.
- Few precedents to rely on during negotiations and operations.
- No Chinese partner to tap for a trained work force and for established sourcing and distribution networks.
- Stricter foreign exchange balancing requirements.
- Higher corporate tax rate than EJVs ([32]).

([32]) U.S - CHINA BUSINESS COUNCIL, *U.S. Investment in China,* September 1990, p. 74-77

4.3. The basic motivation and problems behind the setting up of joint ventures

In general the motivations of foreign investors for creating joint ventures in China are similar to those in Russia:

- access to the local market, especially with an eye to future developments
- utilization of low labour costs, and improving access to some material supplies
- favourable treatment from the Chinese and Soviet governments (with respect to tax exemption, obtaining finance and direct and indirect support)

The reasons on the Chinese side have to be separated into two categories:

a. The aims of the government which broadly consist in obtaining foreign exchange, increasing industrial efficiency (in terms of productivity, quality and capacity), manufacturing products in order to replace imports and the creation of new jobs.
b. The aims of the companies can be summarized in general as: to obtain advanced technology, to obtain access to foreign markets, to advance in the local market, to enhance research and development capacities and to acquire management expertise ([33]).

The similarity between the Russian and Chinese experience in the field of foreign investments is of note even when considering the problems and obstacles they meet:

- the inconvertibility of respective currencies and the relative limit of exchange self-sufficiency. According to China's 1979 Joint Venture Law, all of China's foreign investment enterprises must generate the foreign exchange needed to meet their foreign exchange expenses. Hotels and other service-oriented investment projects, which earn foreign exchange from tourists and other expatriate clients, have had relatively little trouble with this requirement. But the majority of China's foreign investment enterprises - especially those manu-

([33]) For further details see E.de BRUIJN and J. XIANFENNG, *Managing Technology Transfer to China by Means of Joint Ventures,* Paper presented to Management and Economics in China Today, Maastricht, November 15th and 16th , 1990.

facturing for the Chinese market - have been unable to tap stable domestic sources of foreign exchange. These problems are magnified in the early years of production when local sourcing of raw materials and components have not yet been fully developed and joint ventures must rely on imported parts and materials to sustain production. The growing need to provide more ways for investors to obtain their currency to meet their foreign exchange requirements led China to promulgate two major laws in 1986 that allow foreign investment enterprises to: 1) purchase domestic goods with renminbi and export them directly for foreign exchange; 2) balance foreign exchange between multiple ventures using the foreign exchange surplus of one joint venture to make up the shortfall of another (this has promoted the formation of wholly foreign-owned holding companies to manage the overall foreign exchange requirements of multiple investment projects); 3) sell domestically for foreign exchange or for some mixed domestic and hard currencies. Even if these measures offer some new possibility of generating strong currency, the situation remains a difficult one ([34]).

- Scarceness and low qualification of managerial staff together with the new attitude adopted by the Chinese government aimed at hin-

([34]) «a) Selling Foreign Investment Enterprise (FIE) products in China for hard currency or some mix of hard and soft currency had become the most commonly used balancing option by 1989, but is inherently limited by the small size of the domestic foreign exchange market. In addition, many Chinese customers prefer to purchase imported goods rather than to rely on domestic products with the stigma of being "made in China" even if produced by FIEs.
b) Formal import substitution status , which many ventures had viewed as extremely promising, remained very difficult to obtain and is granted on a local basis only.
c) While the size and scope of swap markets has expanded rapidly, trading volume remained insufficient to meet all FIE balancing requirements. Moreover, all Chinese swap market transactions require approval of the local or provincial administrations of exchange control, which are reluctant to approve transactions transferring scarce foreign exchange out of their jurisdictions. Their reluctance effectively stifles the development of a national exchange market, delaying growth of trading volume and generating market distortions.
d) FIEs may purchase Chinese goods with renminbi and export them directly under some circumsatnces. But Chinese authorities limit FIEs to exporting goods that do not already have an export market. And once successful export markets are identified, the Chinese producer has a strong incentive to cut out the FIE middleman and export the goods directly - thus developing its own foreign exchange income. The advent of China's economic austerity program and the more restrictive interpretation of investment regulations since Tiananmen have combined to make the foreign exchange problem even more difficult for FIES». U.S. - CHINA BUSINESS COUNCIL, *op. cit.*

dering the wage policy of joint ventures. FIEs have always paid higher wages to attract good workers to less secure jobs that require harder work. Internal guidelines issued in late 1989 apparently authorize local officials to play a more active role in determining the wages that FIEs pay their local employees and to control «unjustified» wages.

- A more selective bureaucracy and policy vis-à-vis foreign investments. Prior to June 1989, China provided incentives for «preferred» projects such as technologically advanced or export- oriented ventures, but did little to discourage other types of investment projects. In the stricter post-Tiananmen environment, China not only continues to favour certain types of projects, but is actively discouraging others.