China's changing shape: From socialism to capitalism

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CHINA'S CHANGING SHAPE -- FROM SOCIALISM TO CAPITALISM

By

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B.S., Business Administration
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Despite two hundred years of foreign relations problems, division at home and extreme poverty within its population, China is fast becoming the world's largest economy as it makes a switch from communism to quasi-capitalism.

Other communist countries, such as Russia, have shown that the transition from a communist state to one that embraces capitalism does not always go smoothly. But the Chinese have been much more successful than other communist countries in shifting to a free market system. So far they have proven that a socialist economic system really can be transformed into a market system without total social disaster. Part of their success can be attributed to not trying to switch to capitalism all at once, but instead introducing economic reforms by dividing them into manageable phases.

The primary differences between Chinese and Soviet performances are linked to a profoundly different economic and political strategy on the part of China. Instead of using other communist countries as a model, China's strategy of development has been uniquely Asian.

China's economic turnaround began when its leadership abandoned Marxism and formed Special Economic Zones (SEZs) around the country. In these areas, the government has relaxed its grip and allowed entrepreneurs the independence to operate in a capitalistic way without interference from Beijing. Also in these zones, many state-owned enterprises are being privatized, local managers are ignoring regulations from central authority and Chinese millionaires are being created overnight.

All this rapid economic growth, accompanied by an open door policy is attracting both Western and Asian nations with major investment and trading opportunities. To accommodate these new trading partners, China reopened its stock exchanges and began developing other financial markets.

But this economic boom, while boosting living standards and creating enormous opportunities, is also generating a multitude of problems. The country is constantly battling rising inflation, increasing unemployment, growing peasant unrest and widespread corruption and greed. Because of these difficulties and continued ideological differences among China's leaders, there is still a significant possibility that China will not manage a successful economic change as experts first believed. Given these enormous implications, instituting dramatic changes within China's borders may be more difficult than Deng Xiaoping first imagined.

To give the reader a clear understanding of China's transition, this paper concentrates on, the techniques China is using to convert to a "market system", how these changes are impacting its social, economic and political structures, and why this rising nation may be heading toward catastrophe.
CHAPTER I
INTRODUCTION

Problem Statement

For the past two centuries China has experienced weakness abroad and fragmentation at home, and its people have lived in unspeakable poverty.

Since the Communist Party's liberation of China from the Nationalist government in 1949, party leaders have never let membership rise above 5% of China's population. Today, party membership represents only 4.3% of the China's population ("The road from Tiananmen", 1994).

Under the communist regime, the Chinese people were not allowed a life without scrutiny from the government. For instance, individuals could not choose where they lived or worked. Neighborhood committees watched and reported every move. Traveling was inconceivable without a mountain of paperwork and authorizations. All forms of media were government controlled and used essentially for propaganda. All jobs were regulated by the communist party and private businesses were seized and converted to state-owned enterprises. In the rural areas, the government bought all produce and confiscated private land. Clearly, a person belonged in every way to his or her "work unit", which assigned housing, education and health care. It was through these mechanisms that the communists controlled China's more than one billion inhabitants.

Deng Xiaoping rose to power in 1978 and decided that China must begin a program of economic reforms. Deng's dramatic reversal in ideology was the catalyst that swung China's door open to foreign trade and investment and with it began an
age of incredible economic growth ("The road from Tiananmen", 1994).

But even with economic reforms, as late as 1985, more than one hundred million Chinese still subsisted on an annual income under US $30, less than the cost of a good dinner in New York City. Today about 40 million people live in caves in northeast China, and the people in 520 of China's 1903 counties have incomes below US $35 per person annually. In some areas, the average value of the total possessions of a peasant household is under US $3. Such extreme poverty created a phenomenon known as the "one-pants family" in many rural areas of China. The one-pants family has been studied by Chinese sociologists (but never published in the West), it is a family owning only adequate clothing for one member of the family. Since the man must work during the day, he typically gets to wear pants to the fields, while the wife hides her shame. Then in the evening the wife gets to wear the pants. In another instance, villagers too poor to own any clothing blacken themselves with charcoal to create the illusion of black clothing (Overholt, 1993).

Statement of Purpose

Paramount to China's transition to capitalism is the strategies its leadership is using to make the shift as successful as possible. Therefore, the overall purpose of this paper is to illustrate the techniques China's leadership is using in its quest to function as a "socialist market system", examine how these changes are affecting the country's social, economic and political structures, and how this rising nation could be heading for disaster.
In chapter two, the transition methods used by China as opposed to the former Soviet Union's techniques are examined and compared. The main differences are dramatically different economic and political strategies and that the Chinese have introduced change in manageable phases rather than all at once.

Highlighted in chapter three will be China's use of Special Economic Zones which are designed to promote "Western" style capitalism. This chapter will also examine China's move to privatization and how township and village enterprises (TVEs) are an important contributing factor in making reformation possible in the rural areas of China.

Chapters four and five cover China's reopening of a stock market system and the establishment of its financial markets. Both of these financial systems are vitally important to China's economic reforms and will potentially accelerate privatization and facilitate converting state ownership to individual ownership.

The concluding chapters focus on China's growing internal problems and how they could spell serious trouble for the country. For example, although China continues to show signs of economic success, it still faces significant problems with peasant discontent, worker unrest and serious widespread corruption. It seems the Communists have forgotten who helped them gain power in 1949 during the Cultural Revolution -- the peasants. The very faction they helped into power is now oppressing them much like the previous leadership.

Although the growing peasant discontent and worker unhappiness are important issues that need to be addressed, corruption is the most serious concern and is
affecting China's internal efficiency. Corruption is rampant and on the rise in China. While corruption is not uncommon in developing countries, it only serves to amplify the general state of discontent among China's population. While many experts agree China's growth is unstoppable with few obstacles to prevent it from becoming the world's largest economy -- corruption could threaten future success. Others believe that if corruption is not brought under control it could provide the impetus for another incident like Tiananmen Square that could result in nationwide chaos and possible governmental collapse.

**China's Changing Shape**

All this poverty and extreme hardship is becoming a thing of the past. Today, the vast majority of Chinese are more interested in boosting their living standard than in organizing movements (like the June 1989 Tiananmen Incident) against their communist run government. The household savings rate, which remained relatively stable for more than 25 years, experienced a sharp increase after economic reforms in 1979. Chinese households typically save 40% of their disposable income -- one of the world's highest rates -- and have generated a pool of private savings that is worth at least 1 trillion yuan (US $180 billion) ("A new day", 1992).

Traditionally, a country's economy is measured by determining a per capita income which is calculated by converting the value of its gross domestic product into US dollars at the official exchange rate. But, a big problem with this method is that if a country's currency weakens against the dollar, its economy automatically shrinks,
which can be very misleading. That is precisely what happened between 1978 and 1992 in China, as the yuan (China's currency) fell from 1.7 to the dollar to 5.5 to the dollar. Therefore, the traditional measurement effectively negates China's real economic growth during this period. By this calculation, China's economy is the 10th largest, and its people among the poorest.

In 1993, the International Monetary Fund (IMF) devised a different method to calculate a country's economy. The IMF measured each country's national output by what goods and services its currency will buy at home compared with the purchasing power of other countries' currencies. This method known as the purchasing power parity (PPP) found China to be a producer of US $1.7 trillion in goods and services in 1992, far greater than the US $400 billion previously estimated, and that its per capita income was US $1600, not US $370 - thereby, ranking China's economy no. 3 in world ("Agency ranks China's economy", 1993).

With very few outlets for this capital, the result has been a boom of domestic and foreign investment in Chinese companies and especially its new stock exchange system. According to Robert Broadfoot, managing director of Political and Economic Risk Consultancy Ltd. in Hong Kong, "there is a lot of money sloshing around in China -- it is estimated that there are people driving around with as much as $65,000 on the back of their bicycles" ("A new day"). By all appearances, there is no shortage of Chinese or outsiders willing to take advantage of China's very healthy economy.

This economic boom will have other effects. It is already changing the politics
of China, and promises to reshape the politics of all of Asia and perhaps the world. Economic success has given reformers the initiative and put both bureaucratic and radical factions on the defensive. It has given coastal areas the initiative over the interior, including Beijing, and has given economics priority over politics in a country whose central post-revolutionary slogan was "politics in command". The government has relaxed its grip over provinces, state-owned enterprises and the individual. China has opened itself to the degree that a cosmopolitan culture is developing in coastal cities and in many major inland cities and almost all universities and research centers. In these areas it appears that Marxism is dead. It has created a differing perspective among China's leadership, the octogenarians (the generation in their mid-sixties), the fifty-year olds, and those under forty-five.

Internationally, China has removed itself from conflicts and geopolitical objectives to concentrate on the pursuit of total economic success. Further, it has stopped promoting revolution around the world, opened friendly relations with its neighbors, and not only slashed military spending, but also has reduced its overall size.
CHAPTER II
COMPARING THE SOVIET UNION
AND CHINA'S TRANSITION STRATEGIES

The Chinese have tried Communism, and haven't liked it any better than anyone else. Other countries, such as Russia, have shown that the transition from a communist state to one of capitalism does not always go smoothly. Conversely, the Chinese have been much more successful than other communist countries in shifting to a free market system. They have proven that a socialist economic system really can be transformed into a market system without social catastrophe. Instead of trying to switch to capitalism all at once, the Chinese have introduced economic reform by dividing it into manageable stages.

The differences between Chinese and Soviet performance are primarily linked to a profoundly different economic and political strategy. Instead of using other communist countries as a model, China's strategy of development has been uniquely Asian. Using the lessons learned by its four neighbors, South Korea, Taiwan, Hong Kong and Singapore, China has derived strategies in four areas: economics, politics, administration and financial markets (Overholt).

Economics

In the area of economics, China gave priority to industries and sectors where limited government investments would produce rapid growth. Initially, they privatized farming which generated enormous increases in productivity, income and output without financial involvement by the government. Next, China encouraged
foreign direct investment which resulted in huge increases in output and exports and the costs to do so were inconsequential to the government. China also turned its attention to light and medium industry where small investments usually return handsome outputs. Following two of its neighbors, Hong Kong and Taiwan, China flooded the market with textiles, garments, shoes, toys and consumer electronics and quickly became a global force. The result was an explosion of growth, consumer goods production, personal income, exports and foreign exchange earnings (Overholt).

By comparison, the Soviets ignored agriculture, discouraged foreign investment and turned its attention to, the capital intensive, heavy industries. When the issue of privatization was approached, the Soviets again concentrated on industries with huge capital investments and long lead-times, rather than segments of low costs and rapid payback. Overall, the Soviet strategy resulted in a disintegration of production concurrent with severe inflation (Overholt).

The differences in each country's revolution may also explain why China has been more successful than the Soviet Union. The Chinese revolution, unlike the Soviet Union's, had deep roots in peasant society. Whereas, the Soviet revolution was a brutally imposed coup launched from the upper echelons. As a result, China's peasants became energized and later when reforms came they still had their entrepreneurial spirit and were able to immediately channel this energy into a drive for wealth. China's growth curve compared to the Soviet Union's can be likened to a jet ascending as opposed to a rock descending.

Another important strategy employed by China was the creation of millions of
jobs for the people who needed them most. Under this strategy, income and growth are focused on the ordinary farmer and ordinary workers. In the Soviet Union, the concentration is on heavy industry which creates a much smaller number of higher-paid jobs and leaves the majority of the work force unemployed (Overholt).

Politics

China's leader, Deng Xiaoping, believes that reform is a domestic political process and in order to succeed, it must be divided into manageable phases, building in each phase a politically overwhelming coalition of groups who support and view reform as serving their own self interests. Gorbachev, the Soviet Union's former leader, while a notable international figure, tried to overhaul his country's system all at once. Throughout history, those reformers who also attempted to implement a sweeping range of reforms have mobilized opposition and met with failure and defeat.

Deng's introductory reforms in China more than doubled the incomes of its farmers (peasants), thereby winning support of a group of over eight hundred million people, his first coalition. Next, Deng stimulated the expansion of small and medium industry and consequently gained the support of tens of millions of workers and managers throughout China. To gain the support of China's intellectuals and students, Deng loosened the constraints on travel and the exchange of ideas. Even after the Tiananmen Square incident, these groups remained solid supporters of economic reforms (Overholt).

In spite of a huge reduction in military spending to finance economic improvement, the Chinese leader even managed to win over the military leadership.
Deng convinced the military that in order to become a world class power it needed to acquire advanced Western weaponry. According to Deng to obtain these weapons, China must improve its economic condition through drastic military budget cuts and manpower reductions to help finance its domestic economic success (Overholt).

The Chinese top leadership knew that something extreme must be initiated to save both the country and themselves and therefore were staunch advocates of Deng's reform plans. The liberals strongly agreed that a market economy was right for China, while the conservative party recognized that the only way to preserve their constituencies was through providing economic benefits and the only way to provide these benefits was through reform. Further support came from the families of both groups when they discovered that reform also brought special advantages to them, in terms of making money in the marketplace (Overholt).

Conversely, in the Soviet Union, Gorbachev's approach immediately distanced essentially all important social groups for his reform plan. He continued to ignore the farmers and placed stronger work demands for less wages on Soviet workers. The once managerial elite was stripped of its power and advantages, while losing income. After more than thirty years of alienating the masses, the Communist Party was told to campaign for election to public office. The Soviet military lost much of its budget and access to technological advances as their major allies were aligning themselves with the West. This chaos and overnight reform caused these groups to oppose and further resist Gorbachev's move to a market economy. The only allies to Gorbachev's reform plan seemed to be foreigners and intellectuals because he was instrumental in ending the cold war and freedom of speech had become a reality
Most experts on China's reforms and political future focus on the various personalities of the individual players in the regime and who will outmaneuver whom. However, some believe that China's future will be determined largely by group interactions, not by individuals jockeying for position. Currently, all the potential successors to Deng support the basic tenets of his reform program. Although there is a wide range of views and some degree of division among Deng's heirs, their concern is essentially how quickly and to what extent should reform go and not in what direction (Overholt).

Administration

China's approach to reform has been carefully planned and introduced in manageable phases. However, the former Soviet Union has sporadically and quickly liberalized prices and privatized business. This sudden liberalization created enormous inflation and a worthless currency, while overnight privatization created economic anarchy. Inflation rates in 1991 were around 91 per cent and in 1992 inflation soared to more than 2000 per cent, thus causing a catastrophic collapse in the ruble. This severe inflation has not only damaged the Soviet Union's infrastructure, but has discouraged both domestic and foreign investment, destroying the chance for economic growth (Overholt).

China's strategy has been to liberalize prices slowly over a period of time and like its neighbors it has been cautious to prevent rice prices from becoming explosive and endangering its rural population. While liberalizing prices, China created credit
controls and bond markets to help control and maintain a reasonable level of inflation. This scheme has allowed speedy growth and with a workable inflation sequence never exceeding 20% in its major cities and even less in rural areas (Overholt).

Although in the beginning China's strategies to control inflation seemed to work, in a statement issued during August 1994, China's State Statistical Bureau (SSB) was quoted as saying, "the ratcheting up of industrial production, market sales, cash payment by banks and inflation has already put the macroeconomy on the rim of the 'red light zone' and this merits close attention." The report indicated that China's consumer price index (the leading inflationary indicator) rose by 25.8% nationwide and is sending a clear signal that the economy is dangerously close to overheating (Jia, 1994).

With respect to privatization, China has been especially guarded. Its policy is to delay privatization until it has resolved several major hurdles. First, China must successfully liberalize prices so that it does not bankrupt companies. Secondly, a national pension system must be created to protect its retirees from losing their pensions. Next, China must provide medical and educational programs for its enormous population. Also, communist leaders must implement banking reforms to adjust for private enterprise. In addition, China must develop a working stock market to assess the efficiency of companies, analyze trends, communicate findings widely and efficiently and manage stock transactions.

China's policy of gradual privatization has received much criticism, but it has been key to its overall success. The Soviet Union's spontaneous privatization, while
praised by many, has caused major industries to fail and discouraged domestic and foreign investment in the country. China's strategy has promoted huge investments by foreign and private investors, has served to reduce the population's poverty and helped finance solutions to China's problems (Overholt).

China's Distinct Advantages

China has other distinct advantages over the Soviet Union. For example, China enjoys the synergy of being close to other fast-growing and emerging markets, but more importantly, there exists a network of Chinese businesspeople who no longer live in China. Living in Indonesia, Malaysia, India, Taiwan, Hong Kong, and elsewhere, these businesspeople are part of the world's largest tribe and have strong emotional ties to the motherland (WuDunn & Kristoff, 1994).

Also, China's economy has always been decentralized and distributed widely throughout the country. The communists centralized political control, but out of fear of neighboring Japan, the leadership placed manufacturing plants all over the country so if part of China was lost in war, it would not lose a key manufacturer of strategic goods to continue the war effort. Stalin, however, divided the Soviet Union into manufacturing sectors: tanks were made in one place, tractors in another. Whereas Russia has only a few enormous industrial operations in each manufacturing sector, China has many small manufacturing plants scattered throughout the country. In China's shift to a market economy, these thousands of small operations adapted themselves easily to entrepreneurship and privatization. Russia is plagued with large,
cumbersome, inefficient facilities.

In addition, China has a huge entrepreneurial advantage. While Chinese farmers eagerly embraced the opportunity to decide their own economic future and to make a profit, the Russian farmers openly defied the liberalization of the economy with great cynicism.

Southeast Asia is filled with ethnic Chinese already running things. Probably the single most significant factor in China's success is the power and pride of the Chinese. It has been estimated that there are 55 million Chinese living outside mainland China. Many of these overseas Chinese are successful businesspeople and are beginning to migrate back to the motherland to invest and teach others.

As opposed to the Chinese, Russians have no memory or history of entrepreneurship or free markets and no outside ethnic members to help them create a market economy ("Why the Chinese are making it", 1993).

China and the Soviet Union clearly used different methods in their move to capitalism. However, China's regional approach of designating certain rural areas as "Special Economic Zones" is probably the most unique and has resulted in a much more efficient transition strategy.
A distinctive feature of China's move towards privatization is its regional approach. In 1979 China began to practice an odd sort of communism by allowing some rural areas of China to operate in a capitalistic way, while others remained locked in the grips of communism. It first opened its coastal areas. With Hong Kong playing an important role in the regional orientation of this open door policy, Guangdong and Fujian Provinces were selected as the sites for the location of four Special Economic Zones (SEZs). The underlying premise for the creation and existence of the SEZ was to provide a workshop to which employees from state and municipal corporations all over China would be sent to study Western management and technology in joint ventures with foreign companies. The goal for these individuals after having learned these skills in the SEZ, was to return to their respective provinces and transmit their new expertise to their colleagues and employees. And as a result, modern methods of management and technology would gradually filter back into inner China (Dorn & Xi, 1990).

Guangdong, the closest province to Hong Kong, was the first area authorized to engage in this quasi-communism (by freeing it from state planning and ownership regulations). In the city of Shenzhen, businesses were allowed to operate, employing the ideals, philosophy and techniques of a capitalistic and market-based society, without intervention or interference by the Chinese government. By the early 1990's, the experiment proved to be highly successful, as Shenzhen has grown at a rate
exceeding 40% per year and has become a mini-Hong Kong. On a recent trip to Shenzhen, the author found the skyline filled with skyscrapers and the streets full of Mercedes and Audis -- factories were mass producing products that would saturate the US market with clothes, toys and shoes -- and local inhabitants were wearing designer labels and using cellular phones. This boom is also producing its share of Chinese millionaires. Zhou Jiangning of Wenzhou is typical of China's new millionaires; last year he made a profit of US $750,000. This would certainly place him in the upper-bracket in any country in the world (Evans, 1993). Interestingly, some 80% of the investment in Guangdong came from Hong Kong. And half of Guangdong's industrial workforce (over three million out of six million) was employed by Hong Kong companies. Three out of four Hong Kong companies have operations in China, representing some twenty-three thousand ventures.

For the peasant population of Guangdong, the staggering growth brought an overnight emersion into consumerism. Once an underemployed population with virtually no mobility suddenly had plenty of work and unlimited opportunities. By 1990 approximately fifty per cent of Guangdong's rural households had a radio, a television and a tape recorder (Overholt).

Township and Village Enterprises

Another important factor contributing to and making reformation possible, especially in the rural areas of China, is a hybrid company that is not really private, and not state-owned either. This mixture of a private and state-owned firm is known
as township and village enterprises (TVEs). Although these TVEs are essentially controlled by units of local government, these companies are inflicting cutthroat competition to communities once dedicated to socialist precepts. Under basic socialist principles state-owned enterprises operated employing the following four conditions. First, goods were made available through administrative allocation, TVEs use the marketplace. Second, pricing is dictated by government, TVEs allow the supply and demand to determine prices. Third, state-owned companies operated as monopolies, TVEs create and grow based on competition and survival of the fittest. And the last condition under socialist principles forced managers to follow the rules of central government (Naisbitt, 1994).

In an effort to change ownership and management of state-owned enterprises and bring about a market-oriented structure, China's State Economic and Trade Commission is further reducing its administrative interference. It also plans to form a shareholding system and independent management system for all state-owned companies.

In contrast to state-owned enterprises, TVEs function in accordance with the rules of the marketplace. Managers of TVEs answer to local officials and to the householders who either started or invested in the enterprise. In many areas of China, these TVEs are simply superficially disguised private companies, in other areas, they are owned by local governments. In any event, private or government owned, they keep a close eye on the bottom line and profitability. It is estimated that there are currently 20 million such ventures throughout China.
These TVEs are contributing substantially to a local area's economy, including roads, schools, and hospitals. So local governments are forcing managers to act like businesspeople, not bureaucrats. Bankruptcies, virtually unknown during the Communist regime, are now a fact of life for badly managed TVEs. During 1989, losses of state-owned companies reached enormous levels, but none went bankrupt. But at the same time 3 million TVEs went under or were absorbed by other TVEs (Naisbitt).

The typical rural Chinese attitude toward central authority, fueled by strong profit/money motives, has dramatically changed since the days of communism. They recognize that the central government has limited resources, is located far away, and the huge numbers of people and business units are far too large to regulate.

Additionally, these enterprises have no enacted laws or regulations to govern their activities, so local governments and private owners are making up the rules as needed. And, should the TVEs not agree with new rules or laws set forth by Beijing, they simply ignore them or develop a creative way to circumvent them.

Not only are TVEs competing with one another, but through exporting, they are competing with companies around the globe. Experts believe that more that seventy percent of China's industrial output comes from these TVEs, with only a meager ten percent being contributed by the state-owned firms. These TVEs continue to pop up all over China and clearly have become instrumental in China's continued growth and transition to a market economy (Naisbitt).
Unemployment

Although the dynamism of China's economy is visibly improving living standards virtually everywhere in the country, China's unemployment rate continues to be a serious problem. Officially, the government has announced that it is currently a little over 2 per cent, but recent reports (not substantiated) place unemployment at about 200 million people, or about 30 per cent of the workforce (Overholt).

Generally, the unemployment problem is conceived in terms of the loss of jobs created by reform or by businesses closing as a result of foreign competition. This is not the problem. The problem is that the system of socialism and protectionism almost guarantees the proliferation of huge firms and bureaucracies which are not serving market needs and are therefore not providing jobs for their employees. As a result, there is a buildup of disguised unemployment. Each company essentially becomes a small welfare system, whose size and costs grow until they eventually collapse the firm and the country.

Certainly reform creates millions of new jobs, as the industries that emerge as a result are job-intensive. Making shirts, toys, shoes and cameras requires lots of workers. But reform has removed the cover that has disguised unemployment. The paradox: most of the jobs generating China's US $80 billion of exports are new jobs, but at the same time unemployment has become a source of heightened concern.

This invisible unemployment is becoming more visible as millions of people move from one area to another seeking employment. Not only does this unemployment become more and more apparent, but also changes occur more rapidly
and more disruptively. These accelerated shifts in employment and unemployment are politically more dangerous (Overholt).

As more and more enterprises close, more and more people will find it easy to organize, potentially becoming a threat to the government and slowing reforms. The government's objective must be to keep the economy growing fast enough to keep the job creation rate high, implement reform in phases, to spread the pain geographically, and to explain the process so that discontent does not reach critical proportions of mass anger and organization. In a country as large as China, this could become a huge problem if appropriate actions are not taken.

Although many things have improved since economic reform began, unfortunately the country's infrastructure is not one of them. For instance, China lacks an adequate telephone network, a coast-to-coast highway system, suitable transportation sources, and enough utility installations to deal with the ever-growing market. However, infrastructure weaknesses, as opposed to inflation and enterprise problems, are results of a country's success. Most observers believe that China's phenomenal growth will most certainly produce the capital required to pay for new infrastructures (Overholt).

China's efforts to privatize state-owned enterprises and the growth of its TVEs have certainly played an important role in economic reforms. However, the most interesting event, and vital to economic reform, was the reopening of its stock market system. China shocked the world by becoming the first Communist country with stock exchanges -- two of them, located in Shanghai and Shenzhen. The next chapter
analyzes China's stock markets and their impact.
CHAPTER IV
CHINA'S STOCK MARKETS

Over the past decade, China has experienced rapid economic growth characterized by economic reforms and an "open door" policy. In the coming decade, China's main goal is to complete the second stage of its modernization, that is, to quadruple the GDP of 1980 by the year 2000 and raise the Chinese people's standard of living to a level which is described as "comfortable" in the West. The goal has been to develop socialism with Chinese characteristics through economic reform. But the ultimate question plaguing the world remains: To what extent will the leadership, which plans to maintain the socialist path, continue with this economic overhaul? But one good sign is their tolerance of the existence of a stock market, which is the paramount symbol of capitalism because it allows individuals the opportunity to invest and own shares of Chinese companies (Yebi, 1993).

Despite a long list of technical and ideological barriers -- in late 1990 the government began experimenting with a stock market, first in Shanghai, then in Shenzhen. Because China was considered the eighth largest economy in the world, this experiment was of vital importance to its future development and the world.

Securities and stock markets are not new to China. China's first stock exchange was established in Shanghai in the 1890s and ten years later an active bond market was set up in Beijing. At the time living standards were generally low and shares were too expensive relative to income. Because of this, most investors came from the upper-middle class. Not only were these people more knowledgeable about
securities than their poorer counterparts, they also had the capital to speculate (Yebi).

By 1948, hyperinflation hit Shanghai. The subsequent reaction suspended the operations of both the Shanghai Stock Exchange and the Chinese Merchant’s Stock Exchange even before the Communists took over in 1949. However, in 1949 when communism was the central theme of the new government, stock exchanges were viewed as the most prominent symbol of an oppressive capitalistic society and were banned (Yebi).

In 1986, the first securities trading market surfaced. However, public response was weak.

**Goal of the Stock Market**

While China continues its economic reform and "open door" policies, it must be remembered that the general direction of change is socialistic and this must be kept in mind in order to assess developments in the Chinese stock market. The ultimate purpose of the stock market is not to privatize state-owned firms and change their fundamental nature, but rather to reduce the government’s budget deficits by improving their efficiency and cost-effectiveness. This will also reduce their dependence on state subsidies and loans. Also, without government involvement, public companies will have the freedom to generate the necessary funds for expansion without limitations or restrictions on amount or use of funds. The stock market is also an effective way to convert private savings into capital investment.

Low productivity and efficiency have been the mainstay of China's state-owned
businesses, because the responsibility of making a profit was not placed on any one person. Upon issuing public stock, these enterprises now have both a legal and financial responsibility to the shareholders (Yebi).

Although China's leader, Deng Xiaoping continues to support change, the official attitude of China remains socialist and any change in the future must be viewed in the context of the prevailing socialistic system. So, the problem facing China's leadership is how to successfully integrate a Westernized stock market -- which means adopting capitalism -- into a socialist system.

In the near term, potential problems are not apparent because the number of state-owned companies currently outnumber the companies listed on the stock exchange, with 155 state-owned to 28 private firms. And for those players in the market, the government retains a predetermined number of shares, making state-owned enterprises the dominant factor (Yebi).

Current and Future Sites

Continuing enthusiasm for economic reform and a change in national attitude is evidenced by the reopening of the Shanghai stock exchange, the opening of a second in Shenzhen and a third in Beijing. Guangzhou, the Capital of Guangdong Province, recently requested permission to launch a stock exchange and may soon receive approval ("A new day"). In addition to Guangzhou, the provinces or cities of Beijing, Tianjin, Wuhan, Shenyang, Xiamen, Hainan and Shandong have all expressed a desire to establish a stock exchange. Each site has distinct advantages. For example,
Beijing has strong political and financial foundations with a technically trained workforce. Tianjin is a popular commercial and cultural center and had its own stock exchange before 1949. Shenyang is home to China's largest state enterprises. Guangzhou had over 100 renminbi (RMB) million in stocks in circulation in 1982. Hainan has an internal stock exchange center and China's largest free trade zone. Xiamen is backed up by Taiwanese capital and investors. Wuhan is the proposed site for the Central China Free Trade Zone. And Shandong is an open coastal city with a large amount of Japanese capital invested.

China's leaders are reluctant to expand the stock markets too quickly and want to learn from Shanghai and Shenzhen before opening additional locations. In the meantime, Vice Premier Zhu Rouggi is encouraging other provinces with strong economic records to list their stocks in Shanghai or Shenzhen thereby developing them as regional stock centers (Yebi).

At the Shenzhen exchange, would-be investors crowd around a storefront video monitor displaying the day's stock prices or stand in line along a sidewalk and wait their turn to place an order for stock and invest in such companies as China Bicycles and Shenzhen Konka, China's largest color-TV manufacturer (Cook, 1992).

The action on the exchange itself, some 15 floors up, stands in stark contrast to the carnival below: 33 clerks sit calmly at computer terminals, punching in buy and sell orders. In August 1992, a total of 26 securities were trading on the exchange and volume was averaging about 10 million shares a day (versus 200 million shares on the New York Stock Exchange (NYSE)). However, unlike the NYSE, there
are no floor brokers, no specialists and no discarded order slips. And it is not uncommon for a particular stock to rise or fall 20% in a given day (compared to NYSE where a rise or fall would average 2-4%) (Cook).

Public interest in China's stockmarkets has spread beyond just the Shenzhen and Shanghai exchanges to cities such as Changsha, the capital of Hunan province. Every week thousands of new investors are purchasing stocks with the number of investors living outside Shenzhen and Shanghai now greater than the number living inside. Because of the superior returns on China's stocks, many ordinary Chinese citizens are electing to invest their considerable savings in the stock market (Mooney, 1993).

Types of Shares

There are other differences between the Chinese stock exchange and Western exchanges. For example, there are two stock exchanges: in Shanghai and in Shenzhen. At first, this may not seem particularly unusual; after all, the US has several regional stock-market exchanges besides the NYSE and the American Exchange on Wall Street. But the difference in China is that the two exchanges are not linked. They are separate. Also, there are two classes of shares in China, A and B shares. The A shares -- which are considered the most promising and profitable stocks -- are being reserved only for Chinese investors. Since foreigners are not permitted to buy A shares very little is known about them and how they are traded. The B share is exclusively reserved for foreigners and is the vehicle used to introduce
foreign investment into China through the stock market.

According to the rules governing the issuing and trading of B shares published by the Chinese authorities, B shares are RMB-denominated and registered, and exclusively for overseas investors, including; foreign, legal and natural persons; legal and natural persons in Hong Kong, Macau and Taiwan; and other persons approved by the authority in charge.

Companies issuing B shares are required to have a steady and adequate source of foreign currency, and such currency should be sufficient to fund at least the payment of the final dividend on B shares every year.

All trading of B shares must be carried out in either the Shanghai Securities Exchange or the Shenzhen Stock Exchange and may only be traded among those persons who were authorized to purchase them originally.

The Beijing government permitted a few companies to issue B shares up to 49 per cent of their total issued capital. In Shanghai, the Shanghai Vacuum Electronic Device Company -- the biggest counter on the local stock exchange -- issued a total of one million new B shares to the public (about one-third of the expansion capital). These B shares were jointly underwritten by Swiss Bank Corporation, Sun Hung Kai & Co., and Soloman Brothers, with the investors coming mainly from Hong Kong. The issuing price was RMB 420, representing a discount of approximately 40 per cent to the share's average price of RMB 700 in the "A" shares market, i.e., the normal market (Yebi).

At the same time, two companies in Shenzhen went public by issuing new
shares to investors (part of which were B shares). These companies were; China Southern Glass a Sino-Hong Kong joint venture principally engaged in producing glass products, and Shenzhen Property Development Company, a leading property developer in Shenzhen. The B’s, unlike the A stocks, must meet tougher accounting standards for listing.

As previously mentioned, the B shares are denominated in Chinese currency, but are issued and traded in foreign currencies based on the exchange rates in China’s foreign exchange swap centers. All trading is conducted on the local stock exchanges, however a separate market is being formed because the foreign contingent is essentially a different group of investors (Yebi).

Further evidence of China’s economic prosperity is reflected in the growth of stock prices. During the first forty-five days of 1993, the price of China "B" shares had risen by 49%, (based on figures provided by Credit Lyonnais Securities Asia). The price of "A" shares had risen by more than 67%. Compare that to China’s neighboring countries, such as Taiwan where prices (in approximately the same length of time) have risen only a meager 19%, and have fallen in Malaysia and South Korea ("Taming the tiger", 1993).

These increases have left China markets looking very expensive to the average investor with regard to earnings per share to cost per share. The "B" shares in Shanghai are selling at an average of 17 times earnings per share. In Shenzhen shares are selling at roughly 26 times earnings (calculated by dividing the market price per share of stock by its earnings per share). That compares with 11 times earnings in
Hong Kong and 12 in the U.S markets ("Taming the tiger"). The B shares have attracted the attention of international investors, such as foreign trust funds. Several Hong Kong, Taiwan and other international funds have established trust funds to invest in B shares. These trust funds not only invest in China's stock markets but also in potential firms in China. This is done because under Chinese tax regulations, any company with 25% of its shares held by foreigners is allowed tax concessions for joint ventures. That is, their company's applicable tax rate will decrease from 50% to 33%. As a result, many Chinese companies are eager to issue B shares to lure international investors (Yebi).

Generally, investing in any stock market is risky, however, investing in Chinese B shares not only bear the usual hazards, but some additional ones as well. For example, political shifts could place the stock markets in jeopardy, or a reversal or changes in policy could cause fluctuations in stock value. Additionally, by trading in renminbi, when RMB depreciates or increases, investors will either suffer or benefit (Yebi).

There is a danger that inflation will continue to dramatically affect China's seemingly unstoppable economy. Real output rose by 12.8% last year and trouble may be as very close. Foreign investors are particularly concerned because local currency declined 10% against the dollar in 1993. This decline has caused paper losses related to exchange rate fluctuations ("Taming the tiger").
Difficulties Encountered

The opening of these stockmarkets has not been without difficulties. Rioting broke out in Shenzhen on August 8, 1992, when 1 million people from all over China poured into the city (usual population 2 million) to stand in line for an application to purchase shares of stock. For the next three days "would-be shareholders" smashed windows and cars and attacked each other and the police. Many people were injured, and some reports indicated that several were killed. On August 11th, the stock exchange was closed for the afternoon, and China's cabinet met in Beijing to discuss what should be done to prevent further incidents. The only comfort for China's leadership was that the worst disturbance since Tiananmen Square had nothing to do with politics, the motive was money ("Open outcry", 1992).

The main question troubling authorities was how to distribute shares when the demand far outweighed the supply available. To help alleviate the problem, officials set up a lottery system to allocate 500 million yuan (Chinese currency) worth of new shares that were expected to be issued.

The government printed 5 million lottery forms available at 100 yuan apiece. Each purchaser was allowed to purchase up to 10 forms each, on a first come first serve basis. The lucky winners were entitled to buy up to 1000 shares per form in 14 companies offering shares on the market.

Although this lottery system worked well, demand by Chinese citizens for shares was so great that even worthless photocopies of stock certificates were bought and sold on the streets to unsuspecting customers ("Open outcry").
Although since their reopening, China's stock markets have experienced phenomenal growth, many financial experts caution investors. They say the big risk is that any correction in the Chinese economy will dramatically affect stocks and will probably last a long time. Seems investors are beginning to share that word of caution. According to Credit Lyonnais All China index, both the Shanghai and Shenzhen exchanges by August 1993 lost over 50% of their value since peaking in February 1993. The reason for this decline is because most stocks when initially offered are overpriced. For example, Brilliance China's stock nearly doubled after its initial offering before declining to near its list price. But at $19, it still sold for 17 times the 1994 earnings estimate of $1.10 a share projected by Bryan Sudweeks manager of Montgomery Emerging Markets fund in San Francisco. Another example is China Tire. The company's initial price of $17 settled down to $13, but that is still 15 times the 1994 estimate of its earnings. Sudweeks feels these stocks should sell at multiples closer to seven or eight, or $7 a share for China Tire and $9 for Brilliance China (Neumeier, 1993).

Because of the volatility of China's stock markets, experts recommend that a less risky approach might be to invest in the three funds listed on the NYSE: the China Fund, the Jardine Fleming China Region fund and the Greater China fund (Neumeier).

Aside from the risk of inflation, overpriced stocks and declining exchange rates, foreign investors can be assured that the chances of insider trading and other abuses of the stock market, will greatly diminish due to the formation of a Securities
Commission to oversee the Chinese stock exchange and its activities. Although no problems have yet emerged, this monitoring body will coordinate the control and regulation of stock markets, and it requires that all state-owned businesses adopt international accounting standards. These firms are now required to use balance sheets, income statements and cash-flow statements in the operation of their business ("Taming the tiger"). This does not guarantee everything will be squeaky clean, any more than the US Securities and Exchange Commission can on Wall Street, but at least some of the worst abuses will be prevented.

Stock Market Stalls

Although China's stock market started as a raging bull, it began to demonstrate signs of weakness by mid-1994. For instance, the market for the "A" shares, which only mainland Chinese may buy, fell by almost two-thirds by May 1994. In addition, the price to earnings ratio that leaped above 100 in 1993, has since fallen, on average, to 30. Although by Western standards this is still incredibly strong, in China this is considered weak. This situation caused a postponement of $630 million worth of new stock issues to be released in late 1994.

In the meantime, foreign investors moved their money to those Chinese companies listed in Hong Kong (with eight mainland listings) and New York (with three) ("Bears in a China shop", 1994).

By July 1994, trading on China's stock markets slowed severely with stock prices falling sharply to record lows. The decline was attributed to lower company
profits that resulted from restrictions on bank loans and the government's drive against inflation. Worried investors then decided to invest their funds in bank deposits and government bonds (Kahn, 1994).

However, after several months of dormancy, China's stock markets began to rally. By August 1994, the trading volume on the Shanghai Exchange broke records. Both the "A" and "B" shares increased which led observers to speculate that another sharp correction was on the horizon. But the rally continued. To further boost confidence, the China Securities Regulatory Commission made an announcement that they were considering the possibility of allowing foreign investors into the "A" share market for the first time (Kahn).

Observers are recognizing that the rise and fall of China's stock market is a direct result of government intervention in the volume of stocks it will allow to be traded. As a result, poor quality stocks rise in price simply because they are in short supply. These kinds of manipulations are contrary to the forces that drive a stock market and are raising serious concerns over the long-term prosperity of China's stock exchanges (Kaye, 1994).

It is apparent that the market does not function like Western stock markets. It is not driven by fundamentals or by logical operations based on price-earnings ratios or earnings per share. Some experts have compared China's stock market to a racetrack where investors demonstrate "casino-like madness" and act more like gamblers playing craps than serious, knowledgeable investors. But carnival atmosphere or not, it is difficult to argue with success. Since the stock markets birth
in December 1990, capitalization has topped US $28.9 billion and some experts believe that the Shanghai Exchange will become one of the top 10 stocks markets in the world by the year 2000 (Shale, 1994a).

This attitude is further supported by seven key experts in Chinese finance. China International Trust and Investment Corporation's Chang Zhenming feels that there will be a sharp increase in the number of Chinese firms seeking overseas listings because they desperately need foreign capital. Liu Bo, vice president of the Shanghai Exchange agrees with this observation, but also believes that Shanghai will eventually become the center of all Chinese listings. Ian Boyce, of Schroders Asia, is also convinced that the Shanghai and Shenzhen exchanges will continue their pattern of growth. He also envisions new stock markets in Beijing, Tienjin and Harbin. And finally, In-Hong Chung of China Enterprise Investment Management suggests that the Shanghai exchange will ultimately become an international financial center much like Hong Kong and Singapore (Shale, 1994b).

**Long-Range Challenges**

As these stock markets continue to develop and expand, observers feel state-owned companies will become a minority and those public companies partially controlled by the government will continue issuing more stock thereby diluting the government's percentage of ownership. The end result will be that private ownership will be the dominant form of ownership. Other than a repeat of recent crashes in the stock market, the basic problems confronting China in further developing their stock
market are ideological, macro-economic and environmental, legal and simply understanding the mechanics of a stock market system.

**Ideological Issues**

From the beginning of the reform movement, the Chinese leadership was plagued by several highly academic and intellectual questions concerning a stock market. For instance, will a capitalist market actually change state-owned enterprises? Another concern is whether the existence of shareholders will accelerate China's privatization efforts? Also, are stockholders exploiting the workers because they share in the company's profits while the workers do not? The answers to these questions are still undecided and as a result, China's leadership continues to take a very tentative attitude towards the development of stock markets (Yebi).

Typically, stock markets are viewed as secondary markets and therefore, no real wealth is created. However, supporters contend that a stock market helps channel savings and risk capital into viable, productive businesses. Opponents argue that the high turnover rate is more consistent with speculation than with the idea of long-term investments. Others believe that betting in a casino or racetrack is a better way to shift wealth. The real truth lies somewhere between these ideals.

The stock market is a tool, and like most tools has no ideology, though it functions better in some environments than in others. It can also be an excellent device to reallocate capital because investors are driven by speculation and greed.

Developing a stock market in China is consistent with the goals of the Chinese leadership. The stock market could be the mechanism, the means by which state
ownership can be smoothly transferred to the people. However, to prevent the loss of the factors of production (buildings, land, machinery, tools etc) the government could simply lease the right to operate a business for a specified period of time. Also, in order to limit the public control over these enterprises, no more than 50 per cent of the voting share would be available for purchase (Yebi).

China's economic foundations are built predominately on state-owned companies and these companies have real financial power and investment potential. Introducing a stock market system will force these enterprises to be privatized, which is contradictory to socialist thinking. However, arguments that support a stock market, contend that such a mechanism will provide an alternate source of capital for enterprises in the economy (Yebi).

**Macro-Economic and Environmental Problems**

Even though China's economic reforms are showing signs of success, there are still problems that need to be resolved. Officials need to improve and expand the mobilization and allocation of domestic financial resources. Government involvement is still a major factor. The central government continues to use its influence to manipulate local, provincial and central officials, as well as through taxes, import allocations, pricing decisions and designating managers. But even with these problems, many of the macro-economic factors generally considered harmful in the development of a securities market, do not exist.

The continuing existence of barriers to competition and the perpetuation of the government-controlled financial resources allocation system, is a crucial problem.
Price controls continue to distort market mechanisms and the tax system is used as a way to correct deviations on an as needed basis. Price reforms need to be predicated on pressures due to inflation. Bankruptcy is yet another problem since Chinese law does not currently recognize the concept even though some TVEs have closed their doors claiming insolvency, in essence bankruptcy. Another issue is whether enterprises will be financially capable of assuming the burden of social overhead and worker welfare.

Interest rates usually play an important role in allocating resources and mobilizing savings. However, thus far, interest rates (which are set by the central bank) have not been a factor. One major problem is the low rate paid on enterprise time deposits and on treasury bonds held by enterprises (about 5 per cent). As a result, enterprises are using available capital for internal investment or inventory accumulation rather than savings (Yebi).

*Legal Structure Problems*

In order for an economic system to succeed, it must have a stable legal structure with limited government involvement. The absence of this would cause extreme uncertainty and fear in the market.

Unfortunately, to date, there is not a clearly defined national framework of laws, rules or regulations to govern a stock market in China. The listing requirements are unclear and enterprise asset valuations are even more vague.

Aside from regulations, rules and definable laws, China does not use an internationally recognized accounting method. Basically, Chinese companies use a
national accounting system, by which the nation is one big company and the profit or loss of an individual business is the nation's gain or loss, therefore, the importance of a single business is insignificant. Coupled with the lack of accounting procedures is the lack of an acceptable auditing system. Both of these problems will make it virtually impossible for foreign investors to have any degree of confidence in the declared financial position of any business.

The absence of a cohesive accounting system also complicates how an enterprise computes its profits. For instance, in Shenzhen, independent companies are not obligated to sell their hard currency to the state. Therefore, if they enter their income according to existing rules (converting currency at current rates) they will show an operational loss on paper. However, if they use swap center rates, a potential profit may be entered. And if a black market rate is used, they may show a considerable profit. While the latter two methods are sometimes used, they are not considered legal in China. How public companies are to handle this issue is not yet clear. Since there is not a proper method of accounting and auditing, a company will very often undervalue its assets to issue shares to employees at a discounted value (Yebi).

_Understanding the Mechanics of a Stock Market_

A sound, stable stock market is based on the public having a clear perception of how it works and exactly what it is. The Chinese investor's understanding of a stock market and investing in a company's shares is at best vague. Typically, an investor will direct his attention to the potential dividends of a stock rather than its
long-term appreciation and value. Recognizing this, companies have offered excessive dividend rates to shareholders which most of these companies cannot afford. As a result, many of the companies that went public quickly realized that the interest paid on stocks was about three times higher than local banks were offering. In the future, this situation may prevent potential public companies from engaging in this expensive way of raising capital.

Obtaining detailed information on China’s stock market is extremely difficult as listed companies have no obligation to provide any significant data. Their only obligation is to hold a yearly stockholder meeting and to disclose a profit and loss statement.

Another gap in China’s stock market is the lack of a sufficient number of listed companies, independent jobbers and underwriters. And a key ingredient in the success of any venture is qualified, trained personnel. China currently has very few knowledgeable brokers and no official training program (Yebi).

With a changing attitude and obvious movement toward capitalism, China has been phenomenally successful at attracting foreign investors as they are eager to get into the Chinese market. Although precise figures are unavailable, it appears that in 1992, foreigners and Chinese invested as much as US $11 billion in China and signed agreements that pledged an additional US $55.5 billion over the life of the agreements. Contrary to popular belief, these funds are not just coming from America, most of the money is coming from China’s neighbors such as Taiwan, South Korea, Japan and Hong Kong (Evans).
Yet it is still unclear just how far the Chinese government is willing to go to embrace capitalism. Deng Xiaoping, China's leader, who led this new wave of economic reforms, has said bold experiments should be initiated to develop the stock markets. But he also warns that the stock markets could be closed if something goes wrong. No one is quite sure exactly what that statement means ("Taming the tiger"). However, things did go very wrong in 1994 when the stock market crashed, but it seems that wasn't serious enough in Deng's opinion to close the stock markets.

However, reformists maintain that developing a securities market is the best way to raise much needed capital, and probably the only way for ailing state industries to become accountable to shareholders and more productive. Government statistics illustrate that more that two-thirds of state-owned businesses are losing money and require subsidies.

Conservatives fear that allowing the public and foreigners to purchase shares will crack the very roots of socialism -- state ownership -- and further weaken the Communist Party's control of the economy. In that, they are right. It is an ongoing clash between economic prosperity and political control ("Taming the tiger").

But equally important to China's economic success and shift to a market-based system is the need to restructure its financial markets. This development is vitally important to China's economic reforms and responds to the central problems facing the country.
CHAPTER V
DEVELOPMENT OF OTHER FINANCIAL MARKETS

The development of China's financial markets was in response to specific problems and the needs of the economy rather than some ideological plan. The debate over development of the financial markets brings all the central ideological struggles together: command vs. market, central control vs. efficiency, state ownership vs. private ownership, egalitarianism vs. growth, and party control vs. government control. China's expansion of its financial markets will be one of the dominant trends of the 1990's and its success or failure will be determined by whether these mechanisms of capitalism can be used to shape future socialist reforms (Overholt).

Bond Market

The government's broad strategy of reform permitted and encouraged extensive local initiative, many times approving plans that clearly contradicted central directives. They let institutions like the bond market develop without direction or interference and stepped in only when they felt they understood the needs of the economy and the options for regulation.

The Chinese government began issuing bonds in 1981 and volume increased to more than RMB 54 million by 1989. In the beginning, bonds had long maturities and low interest rates, but by the 1980's a new market was forming and interest rates began to move in response to market forces. Ten-year bonds gave way to three and
five-year maturities and interest rates reacted to inflation and increased from 8 to 14 percent by 1988. By the end of the decade, the government was issuing treasury bonds, government bonds, special project bonds and value-guaranteed bonds with interest rates indexed to inflation.

Although selling bonds posed no ideological problems for the state, investors needed to trade them at prices that reflected market conditions as well as their face value. In a capitalist market, the principal value of bonds fall when interest rates rise and the opposite when interest rates fall. To meet investor needs, the state permitted the creation of secondary market trading, initially in seven cities, eventually expanding to fifty-four. Trading was limited to government bonds, negotiable certificates of deposit and other instruments approved by the state bank. In addition, trading could only be handled by securities companies, trust and investment companies, and others specifically approved by the government (Overholt).

In the mid 1980's, tight government controls on sources of capital to enterprises, forced many companies to issue their own bonds to the public. These "enterprise bonds" as they became known, created some profound problems. The Chinese population confused bonds with shares. And because the government had not sanctioned or factored this new bond into its overall plan, officials felt the instrument undermined the state plan. Responding to potential problems with these enterprise bonds, the state eventually implemented the Temporary Regulation of Enterprise Shares and Bonds plan designed to regulate and control issuance of securities (Overholt).
As the bond market continues to develop and expand, new methods to legitimize them have emerged. For example, initially the government determined the credit worthiness of a firm by simply requiring it to show that the total value of its bonds does not exceed its asset value. However, in Shanghai and Guangdong, a new credit rating system uses third party assessments to verify a firm's financial strength and assure investors of its solvency (Overholt).

As the bond market became more and more regulated, it also served to give it a certain degree of legitimacy and thereby created national bond markets. Although the bonds are trading with relative freedom, the government continues to overregulate the market by prohibiting bonds that exceed the state's interest rate, bonds that finance fixed assets not defined in the national plan and trading that would result in a yield of more than 15 percent (Overholt).

In the period 1989-90, the government once again recognized the importance of the bond market when inflation and credit had to be tightly regulated. During this period, the government issued new instruments. Commercial institutions that issued bonds to the public now expanded into three kinds of state enterprise bonds, bank financial bonds, negotiable certificates of deposit, and enterprise bonds with short, medium and long maturities. Additionally, some private companies elected to issue these enterprise bonds to their employees instead of paying them wages (Overholt).

Over the nine year period of 1981-90, the Chinese government issued more than RMB 100 billion in securities. Of those securities, stocks represented only 4 percent.
While bond growth continued to increase, the government began to improve and update its bond issuing mechanisms. During the 1980's it was customary for the government to forcibly impose the purchase of bonds on workers by simply deducting it from their pay, commonly known as "administrative floatation". This tactic created bitterness and resentment among the public toward the central government (Overholt).

Recognizing this hostility, the state devised a new method of selling bonds by utilizing securities firms as underwriters. Each firm was given an allocation and committed to sell a specific quantity of bonds and to purchase any amount not sold. This new system prevented public resentment and absorbed public capital that would have potentially ended up being spent on consumer goods and causing serious inflation. To motivate these securities firms and the public, the government set interest rates very high, thereby, creating a serious demand for bonds. The demand became so enormous that Beijing eventually began allocating bonds by auction, with the price being established by the resulting market. However, during 1992-93 the system temporarily fell apart due to a wave of inflation that was higher than the interest rate being paid on bonds.

During this period, in order to reduce the possibility of future problems in raising foreign capital, the government began issuing US dollar and Hong Kong dollar bonds. This action raised foreign currency from its own population as well as from foreigners. This move also resulted in China's debts to be rated by Western standards and a listing in Standard and Poor's directory (Overholt).

China's transition to financing investments using bank loans rather than state
grants, and the formation of the securities markets, gave clear indications that inflation could be controlled by managing the money supply instead of pricing regulation. China realized that controlling inflation was possible if the money supply could be regulated through a bond market. Officials theorized that bonds would attract the excess money that would typically feed inflation. During the 1988-89 period of severe inflationary rates, China was able to control inflation by using the bond market, by imposing strict regulations on bonds, and by using high interest rates. As a result, Beijing is recognized as having one of the world’s most modern computerized bond-trading systems (Overholt).

Again it must be kept in mind that China’s securities market is developing under the prerequisites of public ownership and adherence to socialist orientation. It is therefore a product of a planned economy at the primary stage of socialism.

In China, the principal floaters, or issuers of bonds, are the central government, the state banks and the state-owned enterprises. Shareholders are individuals and state-owned organizations. The share-holding system as practiced in Chinese enterprises is principally based on public ownership, with the government and state-owned enterprises holding the majority of the shares. In this way, the nature of Chinese enterprises has not been changed radically by the issuing of shares. The situation whereby a few financial institutions can monopolize the market is not likely to appear.

The State Planning Commission has developed a plan that covers the issuance of all State Treasury Bonds, bank bonds, corporate bonds and corporate equities in
China. The plan is viewed as a macro-economic device that controls and oversees the issuance of all securities by the government. Under the Ministry of Finance falls the responsibility of organizing State Treasury Bonds, however, it is based on a proposal approved by the State Planning Commission. Bank bonds and corporate equities are handled by the People's Bank of China, but once again under a scheme developed by the State Planning Commission. Unlike the West, where the issuing of bonds and transferring of stocks and bonds are dictated by the market, all bonds in China must be issued for the proposed investment only.

The central government has very clear objectives in issuing securities. In order to balance investments in different industries, securities will be divided among several. For instance, State Treasury Bonds are primarily issued for general finance, while construction bonds are intended for raising capital for energy projects, transportation, raw materials and other infrastructural industries. And bank bonds are mainly used to generate more working capital for state-owned enterprises, while corporate bonds are sold by issuing firms to finance or expand technology (Overholt).

The central bank's role, The People's Bank of China, is in the development of the securities market, i.e., the actual issuing and trading of securities. In the West, central banks regulate and control public finances mainly through trading state bonds in the market, with the administration and supervision of securities markets being normally undertaken by special regulatory commissions or agencies. Currently, everything in the Chinese securities markets is under the unified control of the central bank. The reason for this is that the country has been in need of capital for quite
awhile and the single control by the central bank is conducive to both preventing local governments and enterprises from blindly expanding the scale of their investments, and to a more effective control of the money supply (Yebi).

**Foreign Exchange**

The foreign exchange markets of China are also evolving from a highly controlled, artificially priced system in the direction of a modern, national, market-priced system. Early foreign exchange transactions focused on the import of technology and capital equipment in return for commodity exports -- artificial, wildly overvalued RMB was viewed as useful for making imports cheap. If exports were over stimulated, the control system could be used to block them.

Also, foreign investment consisted mostly of joint ventures; the artificially high RMB overvalued the partner's contribution and thereby seemed to give China the better deal. With the few exceptions for high technology, infrastructure and other high-priority projects, all joint ventures have been required to balance their foreign exchange earning by exporting enough to pay for their imports of raw materials and technology.

By the end of 1992, foreign debt had grown to more the US $69 billion. In order to keep this debt under control, China knew it needed to encourage exports and discourage imports. However, the overvalued RMB did just the opposite. China's control on imports caused lengthy delays on needed imports and caused vast corruption and trade conflicts with Western countries (Overholt).
Learning again from Asian neighbors, China discovered that to encourage development, a country must promote exports and discourage imports through a cheaper currency. And as a result, China devalued the RMB by 20 percent several times, each time moving it closer and closer to the market rate. Thereafter, it used a system of mini-devaluations crafted to adjust the currency to the market rate.

Due to China's success in exporting, it began accumulating large foreign reserves. The ensuing demand for imports raised the demand for foreign currency and devalued the RMB. While this was happening the Chinese people discovered that they could gain access to foreign currencies and began to hoard them in large amounts, causing the value of the RMB to fall dramatically, which caught the government by complete surprise.

Facing an apparent scarcity of foreign exchange, China sought to make more efficient use of its current foreign exchange. It began by allowing enterprises to retain a percentage of their own foreign exchange earnings instead of turning them all over to the government. To facilitate this program, the government introduced small foreign exchange markets that were essentially free to find their own levels. These exchange markets became known as "foreign adjustment centers", or swap centers for short, these markets allowed ventures with surplus foreign exchange to trade with ventures that needed additional foreign exchange -- at whatever rate the parties deemed acceptable. Although the rate of exchange was a market rate, the trades occurred under government scrutiny, the acquisition of funds was restricted to enterprises needing them for high-priority projects, and the selling of foreign exchange
was restricted to US dollars acquired through legal retention by enterprises. However, the government does not allow its banks to engage in this type of trade (Overholt).

Futures

In October 1990, China, with the technical support of the Chicago Board of Trade, opened a futures market for wheat in Zhengzhou. Based on its success, China opened futures markets in Wuhan, Anhui, Jiangxi for rice, in Changchun for corn and in Shandong for peanuts and peanut oil. The goals of the markets were to give farmers a hedge against future price changes, prevent the farmer from selling low to merchants who would in turn sell high at a future opportune date, to help reduce seasonal price fluctuations and assist the government in making advance decisions based on clear signals from the marketplace (Overholt).

The futures market that is not being addressed by the government, however, is currency. In 1992, China's trade exceeded US $165 billion and due to fluctuations in currency, the traders faced enormous risks. Foreign banks have attempted to establish a futures market for China's currency, but Chinese law prohibits foreign banks from trading in RMB. However, Chinese banks have conducted experiments regarding a futures market for currency, but so far have not been successful. In an effort to solve this dilemma, some trading companies have put together small scale markets by matching importers with exporters. But to date, no true currency forward or futures market exists for Chinese currency (Overholt).
Whether China can continue to surge ahead in its economic reforms and development largely hinges on how rapidly and successfully the government structures the financial markets. But nevertheless, China seems destined to develop into a powerful economic presence, with its economy performing well in the next decade as in the last.

Although China's economic reforms are creating millionaires and are providing more funds for public works projects, the country is still facing significant issues. The most apparent problems involve rising worker unrest, peasant discontent and severe corruption. China watchers believe these serious problems, left unresolved, could result in the eventual collapse of the current dynasty in power (i.e., the Communist Party).
CHAPTER VI
IS CHINA HEADING FOR COLLAPSE?

"For the last four millennia, the dynastic cycle has been the dominant pattern of Chinese history" (WuDunn & Kristof, 1994, p. 131). The "dynastic cycle" was a theory first introduced by Duke Zhou who lived during the twelfth century B.C. His family having defeated the current dynasty needed justification for their extreme actions. Apparently the Duke dreamed up a very clever rationalization concerning why a dynasty must be replaced by another ruling family. He reasoned that all new dynasties have the divine blessing of the gods, but are charged with certain responsibilities and duties regarding the people. When the ruling dynasty failed to meet those obligations, heaven rescinds their "Mandate of Heaven" and transfers it to a new leadership. Therefore, when a dynasty is overthrown or falls apart, people should recognize it as a sign that the current leadership has lost its mandate because they have failed to honor the people with esteem and respect (WuDunn & Kristof, 1994).

Historians believe the whole notion of the Mandate of Heaven is much older than the Magna Carta and has had an important impact on worldwide political ideology. It has basically provided the rationale for resistance and coups against oppressive leaders. "The philosopher Mencius, who lived in the third and fourth centuries B.C., further defined the notion of the Mandate of Heaven and of an explicit right of rebellion. All this imposes is a check on the absolute rule of the emperors: They have an obligation to be decent." (WuDunn & Kristof, 1994, p. 132).
Lord Acton said: "Absolute power corrupts absolutely". Chinese rulers have traditionally ruled absolutely, each one recognized as the Son of Heaven. Therefore, no mortal person would even consider questioning their actions or pointing out their mistakes. Chinese history has shown that dynasties fell not because of unscrupulous minor mistakes, but their downfall was due to monumental blunders like the Opium War with Great Britain or the Taiping Rebellion that lasted fourteen years and killed millions of people.

Because China currently lacks a free press, church leaders or strong educational network to water down its absolute control, the Communist Party has been the primary faction behind all actions. Unfortunately, the Communist Party leaders, like past emperors, live in virtual isolation from the population and have very little understanding of what is really going on outside the walls of the Forbidden City. This isolation has been the major cause of their poor decisions that are based on misinformation and rumors passed to the leaders through other misguided Party members. As a result, the Party leadership has made serious mistakes and monumental blunders, like the Tiananmen Incident (WuDunn & Kristof). Many observers believe that the Communist dynasty has lost the "Mandate of Heaven" and is in jeopardy of collapsing.

This belief is evidenced by a variety of problems that are surfacing everyday. For example, as in the Qing Dynasty, the official faith is slowly dying. In this case, the official faith is Communism. Experts feel that today there are very few who actually support or believe in Communism. Superstition also has a great deal to do
with collapsing dynasties. Traditionally, the gods send signs that a dynasty is failing by creating natural disasters and other strange happenings. As a result, the Chinese people have become very superstitious and rumors often run rampant throughout the country. Current rumors such as crab landings, earthquakes, and an American made robotic monster that devours little children are examples of the kind of stories being circulated. The increase of superstition has been historically linked to a breakdown of traditional beliefs. The Chinese economy and its societal norms are rapidly changing, and the people are confused about their values and traditional morality. Belief in Mao and Communism continues to shrink, but so far nothing has surfaced to replace it.

Whenever a dynasty is disintegrating, it begins to lose its hold on the country. There is evidence of this happening all over China. In small villages and in major areas such as Tibet and Xinjiang the people are challenging the Communist Party's control and authority and virtually no one supports or believes in Communism (WuDunn & Kristof).

Although many would like to see the Communist Party fall, they are seriously concerned about what would replace it. China watchers have warned that major chaos in China could cause massive migrations, resulting in catastrophic events occurring in neighboring countries. So most observers, aware that collapsing dynasties are historically followed by years of turmoil and war, are more concerned with chaos than the continued hard line stance by Communist leaders -- which at least provides a modicum stability.
Traditionally, China has been held together by ideology and fear, but both are continuing to erode, while corruption continues to wear away what is left of the infrastructure of the old Chinese government (WuDunn & Kristof).

Peasant Discontent

The Communists have forgotten their original source of support -- the peasants. During the 1949 revolution to unseat the Nationalist government, the peasants viewed the Communists as their saviors and energetically helped overthrow the current regime. Now it seems that the very faction they helped into power is oppressing them much in the same manner as the previous leadership. As a result, many peasants are now finding themselves being exploited by the Communist Party. Whereas the Communists were originally viewed as saviors to the peasants, they are now quickly becoming the instruments of growing oppression.

China's leaders are keenly aware of the tremendous leverage the workers have and the possibility of a general strike. They recognize that a charismatic leader could easily appear and mobilize the workers to strike and shut down the economy. This concern was clearly evidenced when the decision to send in tanks during the Tiananmen protests were prompted by the growing participation by workers (WuDunn & Kristof).

But the Communist Party continues to ignore the most important faction in China -- the peasants. The Party Leaders have principally focused their worries on unhappy students, and workers because protests are usually held in large cities. But
lately Chinese officials and foreign experts believe that the ongoing discontent in the villages could signal serious trouble for the Communist Party.

Throughout the history of China, peasants uprisings have filled the history books. The most recent uprising was about fifty years ago that installed the present Communist leadership. From that time forward the Chinese leadership has focused its primary efforts in urban centers on workers and restless students.

Although China's peasants represent the vast majority of the country's 1.2 billion inhabitants (over 800 million), relatively little is known about them. Most Chinese officials pay little, if any, attention to them and believe they are a fairly happy and content group. Over the years peasants have rebelled because of one issue or another, but most uprisings are small scale and receive little notice because usually their goal is not to overthrow the government, but just to settle some small injustice. However, Chinese leaders and China watchers are beginning to wonder if a peasant revolt might occur in the near future -- which could be the demise of the Communist Party (WuDunn & Kristof).

Clearly, whenever there is a conflict between city dwellers and peasants, the peasants always end up on the short end under Communism. For instance, the government in an effort to appease city people and prevent protests, uses the money generated from the peasants to provide subsidies to the city residents. Also, the government used peasant money to support universities and other educational facilities, while the countryside does not even have a school system. As a result, nearly the entire peasant population is illiterate. Also when floods threatened cities,
the government opened dikes and flooded villages causing more economic damage that would have been inflicted on the cities. Millions were left homeless and thousands died.

It is obvious that the Chinese government does not recognize the peasant population as an important factor in its administration. When you examine the participants in the Tiananmen Square incident, only intellectuals, university students and workers were involved. The peasants role was as soldiers firing on the protesters.

A government that chooses to ignore a segment that represents more than 80% of its population is risking its own peril. The peasants are becoming increasingly aware of this inequity and are searching for ways to even the playing field and get control of their futures. Their unhappiness is causing them to grow bolder and more aggressive by staging larger protests, attacking government offices, refusing to pay outrageous taxes and fines and actually firing on government officials (WuDunn & Kristof).

**Widespread Corruption and Greed**

A serious problem that only serves to amplify the general state of discontent and unrest among China's population is corruption. Corruption is rampant throughout the country and this corruption has a tremendous corrosive effect on the Chinese political and social structure -- and on the Chinese people. Corruption has not only eroded community values but it is also seriously affecting the efficiency of China's
The problem stems from the fact that everyone seems to be absorbed by one thought -- getting rich. For example, Chinese journalists who once rallied for freedom of the press, now write favorable articles in hopes of receiving a payoff. Private business owners may complain about the taking of bribes by public officials, but are increasingly devising ways to defraud the public. Even the peasants have been affected by the corruption and greed. Some have opened brothels using kidnapped women and girls who work as sex slaves while others are selling these women to small villages throughout the country (WuDunn & Kristof).

While corruption is ubiquitous and considered a part of Chinese culture, there are two reasons why the ordinary Chinese is infuriated by it. First, because income is so low, bribes have a dramatic impact on living standards. For example, an official taking bribes in the United States might double his income, but in China a corrupt leader can earn twenty times his salary. Next, the people who benefit from corruption are typically public servants, and their children or relatives (Overholt).

Whereas corruption and graft are not uncommon in undeveloped countries, they are more threatening in China. Unlike other countries that realize their officials are "on the take", at least they put them in office through democratic means. Conversely, in China, the leadership just seized power rather than legitimately being elected into office.

Although an increasing number of Chinese are initiating measures to undermine and change the Communist Party, the past has shown that killing off a
reigning dynasty is not a quick or easy process — it can take years or even decades to die (Overholt).

Nevertheless, today, most outsiders believe that China's growth is unstoppable with few obstacles to prevent it from becoming the world's largest economy. But others theorize that because China's current social and economic infrastructure is so fragile, and its ideological platform so delicate, it may not be able to sustain much more internal turbulence. They sense that the country's growing corruption, peasant unrest, increasing unemployment and rising inflation could potentially spark another incident like Tiananmen Square and escalate into total overthrow of the government thereby propelling the nation into total chaos and possible collapse (Overholt).
CONCLUSION

Although the average Chinese has experienced an improvement in living standards, China is still a repressive country with widespread abuses of basic human rights. It still has a very long way to go, but no other country has progressed more rapidly in the improvement of people's lives during the past 10 years. China's situation today is comparable to South Korea a generation ago; the repression is real, but the success and stability and glimmerings of freedom are real too (Overholt).

An ongoing debate concerning economic reforms and to what extent they should be allowed to develop continues among China's top leaders. The outcome of these debates will influence the course and future of the whole reform program, as well as, Deng's successor. Opposition from conservatives is causing future development to slow. Reform-minded officials, however, are quietly nurturing the markets without seeking permission from the central government. Yet the conservatives continue to block any market developments they consider especially threatening. Government officials remain split: first one faction gets the upper hand, then the other ("Taming the tiger").

In obvious contrast to previous sessions where the topic was "sustained, swift and sound" economic development, the Fourth Party Plenum's meeting on September 28, 1994, involved politics, caution and a resurgence of central government control, or limited democracy. Party members stressed "safeguarding central authority" and "forcefully implementing the party line, principles and policies" (Chen, 1994b).

This change in attitude stems in part from growing problems concerning
economic reforms that have been responsible for double digit inflation, high unemployment and an ever widening wealth gap. The party's answer is to shift the focus from making money back to a more communistic ideology and conservative posture. In addition, members are concerned about maintaining stability and firmly establishing the party ahead of the eventual death of Deng Xiaoping (Chen, 1994a).

The prosperous Chinese economy and profitable stock market have certainly refocused Chinese citizens on capitalism rather than rebellion. In addition, they have sparked a boom in foreign direct investment in Chinese companies and the purchase of corporate stock. But with all its success the stock market still needs tighter regulations, valid financial reporting system and increased controls or it will risk future crashes (Overholt).

Future of China's Reforms

For the first time in China's history large numbers of foreigners and trading partners have chosen to connect their future fortunes to China's. And China is still moving toward solutions based on market approaches in its economic reforms concerning state-owned enterprises, prices, foreign trade, financial markets, fiscal policies and administrative reorganization.

Although it looks likely that China will successfully continue its reforms, the country still faces many internal problems. Experts believe the biggest threat comes from an overheating of the economy resulting in higher inflation. This will definitely cause a slowdown, especially in the financial sector and in price liberalization. But if
China implements measures to slow expansion -- such as raising interest rates -- it could sufficiently cool growth and reduce inflation (Overholt).

Another serious danger to China's continued success is corruption. Corruption is seemingly widespread and it has blossomed with the radical economic changes. If and when the Chinese Communist Party fails, experts believe that corruption will be a major factor. Add to the concerns of hyperinflation and corruption -- massive unemployment, ongoing ideological questions, possible peasant revolt and conditions appear right for internal fragmentation or another revolution.

Internal fragmentation could be economic, with the resource rich coastal cities breaking off from the rest of the country. This could result in trade obstacles between provinces and taxation would then be handled by local government. This also might spark a succession by Tibet and parts of Xinjiang.

Another potential area of fragmentation could include China's seven military regions. If these regions break-off, they could each turn into a military as well as a political stronghold with Beijing becoming only a facade of central government. But because some areas have richer resources than others, this situation could cause conflicts and potential civil wars between provinces ("China survey", 1995).

But assuming Beijing can introduce effective measures to successfully manage these dilemmas and keep the country together -- an underlying problem still remains. The incompleteness of economic reform and the absence of political reform have created tensions between China's economic and political systems. So, the overriding question is -- will the Communist Party dismiss the old measures that reinforce the
role of central government which are anti-reform and openly embrace decentralization and development which encourage reform?

If the Chinese leadership cannot resolve this highly important issue it will continue to stand in the way of China's future. Any impediment to economic reform could be perceived as a liability, in which case political change -- of a controlled or an uncontrolled kind -- may be fast approaching.
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