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https://hdl.handle.net/2144/29889

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MEMORANDUM RE
PROPOSED MODEL FINANCIAL SYSTEM FOR HAINAN

INTRODUCTION:

The report claims to advance the basis for formulating the new laws required to establish a new "socialist" model for Hainan's financial system. Before those laws are written, however, it would seem appropriate to assess the proposal in light of available evidence.

Two kinds of investigations could have been conducted to assess the proposed model's utility in the Hainan circumstance: 1) an analysis of the evidence designed to reveal the historically-shaped causes of inadequacy of Hainan's present financial system to lay a basis for consideration of the range of possible proposals that might help to overcome them; and 2) a thorough-going review of the experiences of the many third world countries which have already adopted a financial system like that here proposed.

Unfortunately, although they spent 35 days in Hainan, the report shows no indication that its authors undertook either kind of investigation. Instead, they adopted the conventional capitalist wisdom -- propagated throughout the third world by the International Montary Fund (IMF) -- which ASSUMES that the causes of underdevelopment in Hainan (and other third world countries) lie in the lack of a financial system with the characteristics they propose. They apparently conclude that Hainan should adopt this model on the basis of this untested asumption. Far from being a new "socialist" form, however, it represents the old model which the International Monetary Fund (IMF) has sought to impose on all developing countries -- one which economists of all but the most monetarist persuasion tend to reject!

Having never been in Hainan, I make no pretense to having made the first kind of investigation. I consider such an investigation absolutely essential, however, before anyone can usefully propose a new financial system. Even without ever having been there, I would like to emphasize that Hainan's history and institutions in no way resemble those of Hong Kong which the authors of the report suggest as an important source of the ideas in their proposal. More usefully, perhaps, I can provide evidence of the experience of other developing countries (1)

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1 For 25 years, I taught and conducted research in Ghana, Tanzania, Zambia and Zimbabwe (as head of the Economics Department of the Universities in the last two); and, working with graduate students in Clark University in the United States, have conducted investigations into Asian and Latin American countries' financial systems. I have written a number of articles on relevant issues, and a textbook, Money, Banking and

which may shed light on the difficulties the proposed financial system may impose on the people of Hainan.

The remainder of this memorandum first outlines the model proposed by the authors of the report; and then considers the consequences of its adoption in other developing countries.

THE MODEL PROPOSED IN THE REPORT:(2)

The Central Bank:

Strictly in accord with "western" monetary theory, the report proposes that Hainan establish a Central Bank, separate and apart from the Peoples Bank of China, with branches and subbranches in Hainan's economic regions responsible only to it. The Central Bank's three main functions would include: 1) issuing a currency (separate and apart from that of the rest of China, called the "Qiong Bi"); 2) performing the functions of the bank of Hainan's government, ie handling its finances; and 3) serving as a bank for the commercial banks. While the Central Bank should cooperate with the Hainan government, it should be as independent of government as possible in making, supervising and enforcing monetary policy. The Central Bank's primary instruments for influencing monetary policy should be the indirect techniques typically used in developed capitalist economies, namely, the interest rate, the reserve ratio, and open market operations.

The commercial banks:

As recommended by orthodox western textbooks, the report proposes that the commercial banks be established as enterprises, owned by shareholders, entirely outside of government control. Shareholders may include individuals and other enterprises or banks, whether domestic, foreign, or jointly held. These commercial banks would function like commercial banks in most capitalist countries, taking in domestically-generated savings and lending funds to finance projects which their managers

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Public Finance in Africa (London: Zed Press, 1986), which, in light of the African experience, specifically considers alternative theoretical and practical approaches to finance for development.

2 This section summarizes the proposal as interpreted into English by students of mr. Chi Hai Bin at Pekig University. I wish to express my deep gratitude to them for the wonderful job they did in a brief time period. If I understand the proposal correctly, it coincides almost in its entirety with the typical model proposed elsewhere by the IMF and other monetarist theorists.

calculate will produce an adequate rate of profit. The report explicitly argues that foreign banks, working as potential sources of foreign funds together with foreign enterprises, will likely play a leading role. The authors view this as essential to fuel what they anticipate will be a foreign investment boom.

Non-bank financial institutions:

The report recommends the establishment of other financial institutions, also as share-held enterprises separate from the government. These should include insurance companies, rural credit cooperatives, investment corporations, and leasing firms. Foreign as well as domestic individuals, banks and enterprises may own shares in these, and bank representatives may serve on their boards of directors.

Stock exchange:

As a key feature of Hainan's new money market, the report recommends creation of a stock exchange where individuals and institutions can buy and sell shares of ownership in the proposed new financial institutions as well as productive and trading enterprises.

Foreign exchange market:

The report proposes that all enterprises, including banks and financial institutions, whether domestic or foreign-owned, should be allowed to participate in a newly-created market for foreign exchange. These enterprises' demand for foreign currencies, in relation to the available supply, should determine the rate of exchange (the "market price") of Hainan's new currency, the Qiong Bi. The report recommends that representatives of the commercial banks meet weekly with the Central Bank to determine the Qiong Bi's exchange rate. Hoping to create another channel to bring in foreign exchange, the report proposes to enlarge the foreign exchange market to include foreign currency debentures and stock.

THE EVIDENCE FROM OTHER DEVELOPING COUNTRIES:

Except for the proposed foreign exchange market, this proposed model is not new. With variations reflecting different historical circumstances, it constitutes the financial system functioning in most third world countries that have not seriously attempted to implement a transition to socialism. Under IMF pressure, a few countries, like Zambia and Ghana, have even adopted an auction system, a market for foreign exchange not unlike that recommended by the report. Hence extensive evidence exists as to this model's likely consequences for a developing country like Hainan. Here, a few examples may serve to illustrate the experiences that, in many parts of the third world, have led to widespread criticisms of the proposed

model(3).

The role of private commercial banks:

The report anticipates that, both directly and indirectly, the private commercial banks will play a crucial role in the proposed financial system. The banks' own policies, as well as their role in financial institutions that provide long-term capital, will directly affect the amount, cost, and direction of credit. In addition, they will indirectly help to shape macroeconomic measures through their influence on the central bank and monetary policies, including those affecting the foreign exchange value of the Qiong bi.

Like the conventional western monetary theory on which it is based, the report assumes that commercial banks play an

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3 Given the shortage of space, the analysis below will focus primarily on evidence drawn from Zimbabwe where together with a number of students I spent 3 years (1980-83) investigating the details of the way the financial institutions functioned. Zimbabwe, like Hong Kong, was formerly a British colony called Southern Rhodesia. For two decades after World War II, the British viewed Zimbabwe as a potential regional subcenter (not unlike Hong Kong, except that Zimbabwe is not an island, but a landlocked country with close links to South Africa) for its southern African colonies. In 1980, Zimbabwe won independence. Its population of almost eight million (compared to Hainan's six million), inhabits a land area of 150,000 square miles, more than ten times the size of Hainan. It enjoys a range of mineral and agricultural resources. At independence its average per capita income was US$780, but the average per capita income of the peasants (60% of the population) was less than US$70.

During 15 years before independence, the previous regime (ruled by a 3% <white> minority) created a financial system with most of the characteristics of the model the report proposes for Hainan. The primary exception was that, under conditions of United Nations sanctions (designed to hasten Zimbabwe's liberation), the government intervened directly to prevent the transnational corporate affiliates (that control an estimated 70% of the nation's modern capital assets) from remitting profits to their home countries. For the first 10 years, the financial institutions together with the transnational corporations managed to accumulate and reinvest LOCALLY GENERATED INVESTABLE SURPLUSES to achieve a an industrial growth rate of 8-10%. In the context of the regime's apartheid policies, this "development" benefitted only the (white) minority and the transnational corporate affiliates that own 70% of the assets in the so-called "modern" sector. The declining real living standards of the mass of the workers and peasants fueled the guerilla struggle that finally led to liberation.

essentially technical role in the financial system. In the course of competing with each other, they supposedly create and allocate funds in an optimal pattern. The evidence from developing countries, however, proves that, on the contrary, their policies typically have serious negative consequences for small developing countries like Hainan.

First, seeking to maximize profits, private commercial banks make loans to the sectors that promise the highest short-term profits. In almost every country in Africa, for example, private commercial banks lend funds primarily to firms engaged in foreign and internal wholesale trade, speculative real estate (eg. office buildings and hotels), and a limited array of last-stage assembly and processing industries. Thus they help finance the growth of urban centers that primarily service the export of crude agricultural, mineral products, and light manufactures produced with the cheap labor generated by underdevelopment; and the import of high cost luxury and semi-luxury manufactures for the narrow high income groups who can afford them. They lend little to African farmers, small African businesses, or integrated manufacturing industries. As a result, their lending practices aggravate uneven, externally-dependent development that tends to impoverish the majority of the population, especially the poorest segments in the neglected hinterlands, while leaving the national economy increasingly vulnerable to external economic fluctuations.

Second, as the report itself admits, foreign banks tend to dominate the domestic developing country's banking scene. Transnational corporate banks may hold a majority of shares, have representatives on the board of directors, and control the local banks' management. Through the local bank, as well as through additional shareholdings and their exercise of management functions, foreign banks may also control the non-bank financial institutions.

Contrary to the report's naive assumption, foreign domination of domestic commercial banks typically does NOT ensure an increased flow of foreign funds into the country. Rather it eanbles transational banks to use domestic banking and financial institutions to accumulate domestically-generated funds to finance foreign firms' locally-incorporated affiliates. In Zimbabwe, the head of the Anglo American Group(4) explained to

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4 The Anglo American Group is a large transnational holding company, estimated to be the 25th largest in the world. Based on South Africa's rich diamond and gold mines, with holdings in firms that dominate most of that country's industries, it has extensive US and British ties. Besides controlling mines, industries and trading firms in almost every southern African country, it has close links with their commercial banks; in Zimbabwe, for example, the Group has representatives on the boards of directors of both Barclays and Standard Banks (two British banks that together control about 2/3 of Zimbabwe's

our student researchers that the Group almost never brought capital into the country; it relied, instead, on its contacts with financial institutions in the country to mobilize and direct locally-generated investable surpluses to finance its Zimbabwean business.

Third, because the foreign commercial banks and financial institutions aim primarily to maximize their global profits, they assist, rather than thwart, transnational corporate efforts to transfer profits out of the country. Zimbabwe's post-independence government changed the previous regime's prohibition and permitted foreign firms to remit 50% of their after-tax-profits(5). Nevertheless, transnational corporations continued to extract an additional outflow, estimated at 10% to 15% of the total value of the nation's foreign trade, through transfer pricing. Authorized to implement the country's foreign exchange regulations, the commercial banks made no effort to monitor and halt this illegal activity. This should not come as a surprise, however, since the transnationals constituted the banks' main clients.(6)

But the proposed banking reforms for Hainan go even further. They would give the commercial banks the right to preside over a currency exchange market which would set the exchange rate for the Qiong Bi in light of their clients' demands in relation to supply. Yet the foreign banks' clients' interest in a given exchange rate must inevitably diverge from Hainan's. Transnational corporations buying Hainan's raw material or light industrial exports would prefer a lower value for the Qiong Bi

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commercial bank assets), and owns its own merchant bank and discount house. Directly and through the banks it owns the controlling shares, has representatives on the boards of directors, and controls the leading insurance firms that do about 80% of Zimbabwe's insurance business, as well as pension funds. These relationships give the Group access to the accumulated insurance and pension funds saved over the years by Zimbabwean citizens, providing the finances wich enabled the Group to purchase controlling shares in almost every sector of the Zimbabwean economy.

5 Designed in accord with conventional western wisdom that Zimbabwe must create a hospitable investment climate to attract foreign capital, this relaxation led to an increase in reported profit outflows from about $80 million in 1979 to about $250 million in 1981. In return, new foreign capital investments in Zimbabwe reached only about $25million, 10% of the expanded outflow.

6 By paying very high reinsurance premiums to their parent firms (mainly in South Africa) for which Zimbabwe never received any benefit, foreign insurance companies, alone, transferred out an estimated $30 million annually.

which, in effect, would lower the price they would have to pay for those exports. But a low Qiong Bi exchange rate would raise the cost of all the machinery, equipment and material imports required to implement Hainan's industrial program. Furthermore, the foreign banks' transnational clients would more likely be able to purchase most of Hainan's scarce foreign exchange to import profitable (luxury or semi-luxury) items. they would leave little foreign exchange for to Hainan's smaller (private or public) firms to buy the imported inputs they woud require to compete effectively. this was Zambia's experience when, under IMF pressure, it attempted to create a market for foreign exchange. Its currency's value dropped to a fraction of its former level. At the same time, only a handful of the largest importing firms could afford to purchase foreign exchange. As a result, many small Zambian firms went out of business.

The report's proposal that the Hainan foreign exchange market should deal in future exchange rates neglects the added danger of speculation. It fails to consider the fact that the banks might use their proposed insider status in the exchange market to engage in that speculation, fostering greater, not less,currency instability.

The limited Central Bank role:

By granting the commercial banks the key role in the proposed model, the reforms would simultaneously reduce the central bank's potential influence over the banking system and monetary policy.

Unlike a socialist banking system, the privatization of the commercial banks will eliminate the central bank's capacity to monitor the financial activities of enterprises by examining their bank transactions. Throughout the third world private banks insist on protecting their clients' anonymity. Furthermore, the central bank's power to influence the direction of credit will greatly diminish as private (especially foreign private) banks may refuse to lend at all, rather than lend to the areas defined by central bank criteria.

The central bank's powers to ensure the stabiity of the Qiong Bi will also be reduced. Presumably, the purpose of keeping Qiong Bi separate and distinct from the mainland currency is to prevent any instability introduced by the Hainan experiment from affecting the mainland economy(7). Establishment of the proposed

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7 It might be noted that by restricting the currency to Hainan, alone, the proposal also restricts access from Hainan to the mainland market. Given that Hainan alone is economically too small to permit economies of scale required for vertically integrated industries, this restriction will likely cause foreign investors to focus primarily on raw material exports or last-stage assembly and processing industries which will contribute little to the desired pattern of industrial development.