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The Role of the Black Market in China's International Financial System

I. INTRODUCTION

In a joint communiqué simultaneously issued in Beijing and Washington, D.C. on December 15, 1978,¹ President Jimmy Carter announced the United States' diplomatic recognition of the People's Republic of China ("China" or "PRC") after nearly thirty years of nonrecognition. In the eight years which have elapsed since the normalization of relations, cultural, economic, and political ties between China and the United States have continued to improve. The United States and the rest of the occidental world represent China's primary source of hard currency required to finance its plans of industrialization. To encourage the inflow of these foreign assets, China has opened its doors to foreign investors, foreign traders, and foreign tourists.

The problems which China suffers in its attempt to industrialize are not dissimilar to those experienced by other developing nations. The government must weigh its desire to maintain centralized control of the economy against its need to bring foreigners and foreign currency into the country. The Chinese have recognized this problem, noting that "whenever the government tries to increase its control of the economy, rigidity results, and when restrictions are eased, confusion reigns."²

Understanding the extent of China's problems of industrialization requires a knowledge of the character of the country. As Frank Ching, a China observer for the *Wall Street Journal* commented:

Part of the problem is China's size. No other government in history has had to look after one billion people. In a way, running China is like carrying a tray brimming with water: a rapid movement makes the water spill, steady hands and small steps are required. But the desire not to go too far too fast has given Chinese policy a zigzag character. Each new plan cries out for modification after a while, giving the impression of a country that takes one step backward for each step forward.³

The Chinese government thus attempts to forge a steady growth course

¹ See The Joint Communiqué on the Establishment of Diplomatic Relations between the United States of America and the People's Republic of China, 18 INT'L LEGAL MATERIALS 274 (1979).

² Ching, *China Attempts to Steer a Steady Course But Policy Reversals Seem to be the Norm*, Wall St. J., Jan. 28, 1983, at 34, col. 1.

³ *Id.*

for its economy, burdened by seemingly insurmountable problems. The government's desire to maintain control without hampering economic growth, coupled with China's size and underdevelopment, has created many flaws in the system which the government is unable or unwilling to remedy.

Historically, China has impressed the West by the semblance of order and organization reflected in the Chinese bureaucracy. However, behind the facade presented to the foreigner, there always have been other systems and organizations controlling the society.⁴ China has perfected the art of presenting order on paper; but reality often bears little resemblance to the system the government officially promulgates.

The dichotomy between China's political theory and its administrative reality is nowhere more apparent than in the system China has developed to manage the inflow of foreign reserves into the country. In order to avoid disturbing the domestic economy, the government developed an elaborate two-tiered currency system.⁵ In addition, the government issued a set of Foreign Control Regulations⁶ which placed restrictions on the use of foreign exchange. The regulations purported to place the use of foreign exchange under a "unified national plan."⁷ In reality, however, beyond the reaches of the officially promulgated regulations, a thriving black market for foreign currency, foreign goods, and Foreign Exchange Certificates ("FECs") has developed, over which the PRC government does not exercise any control.

This Comment will examine the realities of the Chinese international financial system by going beyond the theoretical operation of the Chinese two-tiered banking system. The Comment will focus on the function of the black market in facilitating international trade by examining the reasons for the black market's existence and the mechanics of its operation. It is hypothesized that the Chinese government tolerates the operation of the black market because it provides the Chinese consumer with a channel through which to acquire foreign durable goods, without the Chinese government having to expend foreign reserves to finance the transaction. Finally, it will be argued that, despite China's current use of the black market as a means of acquiring many foreign imports, the fu-

⁴ See E. BALAZS, *POLITICAL THEORY AND ADMINISTRATIVE REALITY IN TRADITIONAL CHINA* (1965).

⁵ See *infra* note 29.

⁶ Foreign Exchange Provisions (Dec. 18, 1980). Text cited in E. ASIAN EXEC. REPORTS, Feb. 15, 1981, at 21[hereinafter Foreign Exchange Provisions].

⁷ Randt, *China's Provisional Foreign Exchange Control Regulations*, 1 CHINA L. REV. 117, 118 (1981) (quoting Ji Chongwei, Board Member of China's Import-Export Control Commission).

ture market in China for United States manufacturers and exporters holds great potential.

II. THE CHINESE BANKING SYSTEM

A. The Structure and Theoretical Operation of the Banking System

China has orchestrated a dramatic transformation of its banking system since 1979.⁸ Following questionable management by the government after 1949, the banking situation became even more chaotic during the ten years of the Cultural Revolution.⁹ To remedy many of the problems caused by the Cultural Revolution, China's plans for industrialization called for a reorganization of the banking sector. As a result, there now are five banks in China: the Bank of China, the People's Bank of China, the Savings Bank, the People's Agricultural Bank, and the New Development Bank.¹⁰ Each bank has a unique role.

The Bank of China ("BOC"), originally established in the early-nineteenth century during the Qing dynasty, was reestablished by the new government in 1949.¹¹ The BOC was created as a joint state-private enterprise and dealt, in part, with foreign exchange.¹² Before 1979, the BOC was subordinate to the People's Bank of China. However, in 1979 the Chinese government demonstrated the new emphasis it was putting on the BOC as part of a new economic policy. The government took the BOC out of its subordinate position to the People's Bank and placed the BOC directly under the State Council.¹³ The BOC is now assured a powerful position in China, due in part to the following official monetary regulations.

1. The BOC is the only full-service bank allowed for foreign use; other nations are permitted only representative offices.
2. Any group doing business in China must have an account with the BOC.
3. Any individual or enterprise, whether PRC or foreign, wanting foreign

⁸ Russell, *Bank Issues Currency, Sets Rates, Administers Planning International Banking Handled by Ministry of Finance Through Three Banks*, AM. BANK., Dec. 21, 1982, at 8.

⁹ *Id.* During the Cultural Revolution, which lasted from 1966 to 1976, banking activities were dismissed as bourgeois. The Ministry of Finance merged with the People's Bank, and the bank effectively became the Ministry's cashier. Funds were distributed arbitrarily and used irrationally. Many recipient enterprises did not have to pay interest or repay their loans. *Id.*

¹⁰ *Balancing Accounts in Country of a Billion*, AM. BANK., June 19, 1984, at 22 [hereinafter *Balancing Accounts*].

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

exchange must apply for it through the BOC. (The majority of private foreign exchange was, by law, previously sold to the BOC.)

4. The above regulations apply also to financial activity in the special economic zones ("SEZs"). In addition, all salaries and profits of non-PRC groups involved in the SEZs must be remitted through the BOC.¹⁴

Of the five banks, the People's Bank serves primarily as a central bank.¹⁵ It issues currency, sets interest rates, and administers income and spending of the national treasury among other functions. The Savings Bank handles individual deposits and remittances.¹⁶ The People's Agricultural Bank serves agricultural projects and unions.¹⁷ The Development Bank, funded by a World Bank loan of \$70 million, is being set up to finance the modernization of the Chinese infrastructure in telecommunications and transportation.¹⁸ Of these five banks, however, the BOC clearly plays the most influential role in China's system of international banking.

B. The Role of Foreign Exchange

The Chinese government established the BOC's central role in its international banking system under China's Provisional Foreign Exchange Control Regulations ("Regulations").¹⁹ Published December 18, 1980, and put into effect March 1, 1981, these Regulations consist of seven chapters and thirty-four articles. As stated in Article I of the Regulations, their purpose is to strengthen exchange controls, to increase national foreign exchange income, and to economize on foreign exchange expenditures "so as to expedite the national economic growth and safeguard the rights and interests of the country."²⁰

The Regulations distinguish between four categories of domestic economic entities: 1) Chinese domestic entities; 2) individuals; 3) foreign organizations resident in China and their personnel; and 4) enterprises employing overseas Chinese capital or foreign capital or taking the form of Chinese-foreign joint ventures and the personnel of such enterprises.²¹ According to Article 4 of the Regulations, general procedure requires all entities in the PRC to surrender their foreign currency to the BOC. Article 4 states that:

All Chinese and foreign organizations and individuals in the People's Re-

¹⁴ *Id.*

¹⁵ Russell, *supra* note 8, at 8.

¹⁶ *Balancing Accounts*, *supra* note 10.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Foreign Exchange Provisions, *supra* note 6, art. 3.

²⁰ Foreign Exchange Provisions, *supra* note 6, art. 1.

²¹ Randt, *supra* note 7, at 118.

public of China must, unless otherwise stipulated by law or decree or in these regulations, sell their foreign exchange proceeds to the Bank of China. Any foreign exchange required is to be sold to them by the Bank of China in accordance with the quota approved by the state or with relevant regulations. The circulation, use, and mortgage of foreign currency in the People's Republic of China are prohibited. Unauthorized sales and purchases of foreign exchange and unlawful seizure of foreign exchange in whatever ways and by whatever means are also prohibited.²²

Thus, the holding of foreign reserves by entities other than the Bank of China within the PRC is illegal, unless approved by the state.

The enforcement sanctions regarding the holding of foreign currency are outlined in Article 31 of the Regulations. This Article states that: "According to the seriousness of the offense, the penalties may take the form of compulsory exchange of the foreign currency for renminbi,²³ or fine or confiscation of the properties, or both, or punishment by judicial authorities according to law."²⁴ More recently, however, on April 5, 1985, the State Administration of Exchange Control announced the Penal Provisions for Violation of Exchange Control Regulations.²⁵ These penal provisions were formulated to implement Article 31 of the Provisional Regulations.²⁶

In addition to establishing specific penalties for those not abiding by the exchange control provisions, the penal provisions also list specific illegal economic activities offensive to the national plans of financial stability.²⁷ Among the activities addressed, the list includes the utilization of foreign currency as a medium of exchange and the buying and selling of foreign exchange for speculative purposes.²⁸ The penal provisions also establish leniency for minor offenders who confess and "show sincere repentance."²⁹ The authority of the Administration of Exchange Control to distinguish between minor and serious offenders appears to indicate an official recognition that exchange control violations are common and violators are many.

Perhaps more significant than the promulgation of the Foreign Ex-

²² Foreign Exchange Provisions, *supra* note 6, art. 4.

²³ Renminbi, literally "people's money," is the form of domestic exchange within China. The largest denomination in Chinese currency is the yuan, which currently is worth about 2.79 renminbi to US\$1.00. See Bennett, *As Peking Wrestles With Devaluation, Currency Market Dealers Thrive*, Wall St. J., Dec. 19, 1984, at 32, col. 1.

²⁴ Foreign Exchange Provisions, *supra* note 6, art. 31.

²⁵ Penal Provisions for Violation of Exchange Control Regulations (Apr. 5, 1985). Text cited in 24 INT'L LEGAL MATERIALS 804-05 (1985).

²⁶ *Id.*, art. 1.

²⁷ *Id.*, art. 6.

²⁸ *Id.*

²⁹ *Id.*, art. 9.

change Control Regulations on foreign exchange transactions, China established the requirement that foreigners within the PRC use a special scrip. Known as Foreign Exchange Certificates ("FECs"), China introduced the scrip in 1980 in an attempt to curb foreign currency speculation and black market trading.³⁰ A second purpose of the scrip was to prevent foreign merchandise from flooding the domestic market and increasing national foreign exchange holdings.³¹ This action implemented a state council decision to ban the circulation of foreign currency within China.³² FECs are required for the payment of all government services, (e.g., planes and trains), meals and lodging in luxury hotels, and the purchase of merchandise in "Friendship" stores.³³ (Friendship stores supply resident tourists with foreign and local goods and only will accept foreign exchange and FECs for purchases.)³⁴ Nonetheless, instead of eliminating the black market for foreign currency, the addition of FECs has resulted in a thriving black market,³⁵ as the scrip may be used to purchase imported televisions, recorders, and refrigerators from the Friendship stores and from other stores selling foreign goods.

Another reason the government introduced FECs was to facilitate the renminbi's entrance into the international market without disrupting the domestic economy.³⁶ Until 1984, the renminbi was overvalued.³⁷ At that time the government discovered that, at the official exchange rate of approximately 1.5 yuan to the United States dollar, China's inefficient factories could not compete internationally.³⁸ Consequently, the Chinese government "effected a *de facto* devaluation" of the renminbi by creating a two-tiered exchange rate system.³⁹ A new rate was established at 2.8 renminbi to the United States dollar as the official exchange; this rate was to be used by all Chinese entities engaged in foreign trade.⁴⁰ However, tourists to China still exchanged currency at the official rate of 1.5 renminbi to the United States dollar.⁴¹ This scheme enabled the domestic exchange rate to remain unchanged while allowing the renminbi to

³⁰ See Randt, *supra* note 7, at 129.

³¹ See also Bennett, *supra* note 23, and Baker, *China's Growing Black Market*, Fin. Times, Dec. 28, 1984, at 206.

³² Randt, *supra* note 7, at 129-30 (citing Kramer, *China Will Soon Prohibit Use of Foreign Currencies in Bid to Stop Circulation*, Asian Wall St. J., Jan. 28, 1980).

³³ See Baker, *supra* note 31.

³⁴ *Id.*

³⁵ See Randt, *supra* note 7, at 130.

³⁶ Bennett, *supra* note 23.

³⁷ *Id.*

³⁸ *Id.*

³⁹ Randt, *supra* note 7, at 130.

⁴⁰ *Id.*

⁴¹ *Id.*

compete on the international market. Furthermore, this two-tiered system served to encourage exports and to discourage imports.⁴²

III. THE BLACK MARKET: THE REAL SUPPLIER OF FOREIGN GOODS AND FOREIGN EXCHANGE

A. Development of the Black Market

The black market for foreign goods, foreign currency, and FECs is thriving in China. The sudden appearance of the black market stems from the rapid growth of the Chinese economy recently and its sudden entrance into the world market after three decades of relative isolation.⁴³ Since 1979, economic reform policies have more than doubled personal income for the average Chinese.⁴⁴ In the 1984 figures reported, the PRC government claimed the biggest one-year increase in living standards since 1949.⁴⁵ According to a report given at the National People's Congress, per capita income jumped 12.5% in the cities — to \$216 — and 14.7% in rural areas — to \$126.⁴⁶ In addition, the 1981-1985 five-year plan surpassed its set goals one year ahead of schedule.⁴⁷

This new prosperity in China has spawned increasing consumer demands, primarily from newly prosperous farmers, urban traders, and skilled workers.⁴⁸ Although the government has imported some consumer durables — primarily Japanese color televisions, washing machines, and refrigerators⁴⁹ — the official statistical bureau of the PRC acknowledged that workers making more money have had trouble finding consumer goods to purchase.⁵⁰ Thus, the black market helps to supply some of the foreign goods which the new Chinese consumer is unable to obtain through other channels. Items reportedly obtainable through the black market include household appliances, color televisions, fashionable clothes, imported liquor and cigarettes, cassette players, and watches.⁵¹

As discussed above, FECs are required to purchase foreign durables

⁴² *Id.*

⁴³ See Bennett, *supra* note 23, and Baker, *supra* note 31.

⁴⁴ See Baker, *supra* note 31.

⁴⁵ See Burns, *Some Take Liberties in China's Free Market*, N.Y. Times, Mar. 31, 1985, at D4, col. 3.

⁴⁶ *Id.* There is no indication that these increases were adjusted for inflation.

⁴⁷ *Id.*

⁴⁸ See Baker, *supra* note 31.

⁴⁹ Burns, *supra* note 45. Foreign imports of consumer goods to China have increased substantially since 1979, when the only goods imported were Coca-Cola and Schenleys'. Clarke, *Commercial Implication of Normalization*, 5 INT'L TRADE L.J. 93, 96 (1979-80).

⁵⁰ N.Y. Times, July 27, 1984, at D2, col. 4.

⁵¹ See Baker, *supra* note 31.

from Friendship stores. Formally, only foreigners had access to the foreign goods in these stores. As recently as the summer of 1984, however, some cities such as Harbin permitted Chinese citizens with FECs to purchase foreign goods in Friendship stores. In Shanghai, "Overseas Chinese" stores sold foreign goods to anyone who came armed with scrip.

Some Chinese citizens purchase foreign currency with the intent of profiting on currency speculation.⁵² Many Chinese look to invest in foreign currency as they believe it to be more stable and reliable than the renminbi.⁵³ Apparently, in its meager attempt to control the growing black market, the Chinese government may have fueled a bigger market. As mentioned previously, the government revalued the official exchange rate in 1984, devaluing the Chinese currency against foreign currencies. The government devalued the currency and phased out the two-tiered currency system in hopes of discouraging black market deals.⁵⁴ Devaluation, however, is historically a sign of instability.⁵⁵ Fear that the renminbi may not be stable in comparison with foreign currencies may be prompting some Chinese to seek foreign currency as a means to hold their savings.⁵⁶

For a five-month period, between November 1984 and March 1985, factory managers also joined in the scramble for available foreign exchange.⁵⁷ Economic liberalizations gave factory managers more independent authority to purchase goods from abroad.⁵⁸ But due in part to corruption among some local officials, the government announced plans to tighten bureaucratic controls to prevent such abuse.⁵⁹ China presently plans to reimpose some state control over the purchase of foreign goods;

⁵² This author has been told that, historically, the Chinese have not placed much confidence in the ability of the Chinese currency to maintain its value. As China was often plagued with famines and political upheavals, which sometimes required a move of the capital city, the Chinese valued pure gold and pure gold jewelry because it maintained its value and could be transported easily. It has been suggested that the United States dollar has become a substitute for pure gold. *But see infra* note 61.

⁵³ Interview with Henry Yang, Advisor for Chinese Foreign Trade at Mayer, Brown, and Platt, Chicago, Illinois (Sept. 29, 1985)[hereinafter Yang interview].

⁵⁴ See Bennett, *supra* note 23.

⁵⁵ *Id.*

⁵⁶ The Communist government is hesitant to devalue the renminbi. Hyperinflation contributed to the fall of the Nationalist government in the 1940s. As one fifty-year-old recalled, "[y]our money would be worth \$40 in the morning, and \$5 in the afternoon." Bennett, *supra* note 23. Thus, the present government is particularly sensitive to the possibility of inflation.

⁵⁷ Burns, *China Reimposing Curbs it Relaxed 5 Months Ago*, N.Y. Times, Mar. 28, 1985, at A6, col. 1.

⁵⁸ See Bennett, *supra* note 23.

⁵⁹ See Burns, *supra* note 57. See also *infra* note 76.

consequently, the participation of managers and local officials in the black market may have stopped.

Finally, the recent surge in the number of students, academicians, business exchange groups, and government servants who are afforded at least temporary permits to live or travel abroad account for some of the demand for foreign currency.⁶⁰ The Chinese government restricts the Chinese citizen to a maximum of \$75 worth of renminbi when exiting the country. Thus, the Chinese citizen is forced to supplement this amount with foreign currencies.⁶¹

B. The Mechanics of Black Market Operation

In the last few years, the Chinese government has eased travel restrictions for those who wish to travel through China. Tourists now are permitted to travel independently to areas formerly restricted to officially sponsored tour groups. Travelling through the PRC in the summer of 1984, the author was curious as to whether she would be given the opportunity to observe or engage in an illegal exchange of foreign currency. "Young shoestring tourists" supply much of the foreign currency available on the black market because they stay in cheap hotels and eat at ordinary restaurants where FECs are not required. Such tourists can finance much of their travels through money changing.⁶² Fellow travelers had described the money changing transaction to the author in detail, so that she felt fairly confident that she would know where to go and whom to approach in order to change money. To the author's surprise, the opportunities to observe exchanges on the black market were abundant. In fact, no sooner had the author entered the country than did someone in Guangzhou approach the author desiring to acquire United States dollars, Hong Kong dollars, and FECs.

The most conspicuous market for trading appears to be in the PRC's capital city of Beijing. Trading is also evident in the southern cities of Guilin and Guangzhou and in the southwestern city of Xian. To exchange money in Beijing, one need only go in front of the Peking Ho-

⁶⁰ In recently released figures, 25,961 immigrants were admitted to the United States in 1983. U.S. IMMIGRATION AND NATURALIZATION SERVICE STATISTICAL YEARBOOK, (AMERICAN STATISTICAL INDEX (1985)).

⁶¹ It also appears that gold is used by Chinese who are attempting to skirt the restrictions placed on the amount of renminbi which may be carried out of China. Article 27 of the Foreign Exchange Regulations generally prohibits precious metals from being carried out of China but, of the two restricted items, gold is easier to transport. In a recent article in the *Los Angeles Times*, an overseas Chinese woman was quoted as saying, "[p]eople were asking me about the price of gold. They said they were buying gold to get it out of the country and help pay for their children's education." Mann, *Canton Goes Own Way as China's New Boom Town*, L.A. Times, Oct. 27, 1985, at 14.

⁶² See Baker, *supra* note 31.

tel, which serves both as a large tourist hotel and a business center for many of the foreign offices located in China. One sees many street-wise characters, both of Han Chinese and non-Han Chinese extraction, meandering around the street corner in front of the hotel. The money changer will glance at the tourist in a knowing way, or discreetly will say, "Change money!" If the tourist nods knowingly back, the money changer will begin to follow quietly and discreetly. After a minute or two, the money changer will overtake and lead the tourist into an inconspicuous alley or backstreet.

Once away from the main thoroughfare, the current foreign currency exchange rate will be quoted and the tourist must indicate how much foreign currency the tourist is interested in exchanging. The Chinese money changer will walk away and count out the appropriate amount of money from the supply being carried in a satchel. Within minutes, the money changer returns with the money carefully counted and neatly bundled. Should the tourist wish to count the money, the money changer will wait patiently. Upon completing the exchange the Chinese money changer quickly vanishes, only to appear moments later occupying a former spot in front of the Peking Hotel, awaiting another deal.⁶³

There are four primary methods to acquire and funnel foreign currency and FECs into the black market. These methods include straight currency swaps (described above), special exchanges, grey market acquisitions, and foreign remittances. The market for foreign currency and FECs in a straight currency swap is very competitive. In the summer of 1984, when China was full of young tourists, one could only exchange FECs for renminbi at a rate of 1:1.3. In the winter however, when tourism is down, the foreigner can double the currency exchanged.⁶⁴ Chinese will ordinarily offer exchange rates of up to 3:1 in order to obtain FECs.⁶⁵

Foreign exchange and FECs also enter the black market through special trades. In this transaction, money changers offer merchandise for a certain price in renminbi, or for nothing if the foreigner agrees to make a currency swap.⁶⁶ In the summer of 1982, foreigners reportedly were able to acquire "new, full-length padded coat[s] of export quality" free,

⁶³ In June 1984, this author changed money three times within a two-week period with various money changers in Beijing. All transactions followed the same procedure. Discussions with more recent visitors to the PRC have indicated that the procedure remains the same.

⁶⁴ See Baker, *supra* note 31.

⁶⁵ *Id.*

⁶⁶ *Id.*

by exchanging 100 yuan in FECs for 100 yuan in renminbi.⁶⁷ The author observed a similar transaction in Xian involving a two-tiered price system directed at foreigners. Articles could be purchased at one price in renminbi and at a much cheaper price in FECs. In addition, vendors tended to be much more generous and anxious to bargain with foreigners willing to spend FECs.

The grey market acquisition of FECs involves the common street vendor and merchant, not the professional money changer. Here, the vendor sells goods to foreigners who pay with FECs, then gives the foreigners change in renminbi.⁶⁸ It is apparent that government regulation of such transactions in small, privately-owned shops is unworkable. However, even in government-owned shops, other than Friendship stores, the author observed clerks accepting FECs from foreign customers and then exchanging FECs with their own renminbi before depositing the money into the register.

The fourth way in which foreign currency is acquired and funneled into the black market is through foreign remittances. Particularly in the last several years, the Chinese government has encouraged Chinese to write to overseas relatives soliciting money and goods. Previously these remittances had to be deposited in state bank accounts and withdrawals could be made only in renminbi.⁶⁹ Recently, however, China has eased restrictions on the possession of foreign currency by Chinese residents in certain provinces who receive these remittances.⁷⁰ According to the *Jingji Ribao* (*China Economic Daily*), persons receiving foreign remittances will now be able, for the first time, to withdraw the foreign exchange from the bank.⁷¹ Reportedly, the relaxation soon will be nationwide.⁷²

Persons who change money on the black market are a diverse lot. Among foreigners, young tourists are the main contributors of foreign exchange and FECs. Among the Chinese, however, the participants are more varied. In Beijing the most predominant and conspicuous money changers were the Uighurs, a Chinese minority of Turkish extraction who originate from Inner Mongolia. Other common money changers include those whose professions require them to have contact with foreigners, particularly taxi drivers⁷³ and train station attendants.⁷⁴ Those who

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ Wall St. J., Mar. 8, 1985, at 35, col. 2.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ See Bennett, *supra* note 23.

work in SEZs also have access to foreign exchange and FECs.⁷⁵

IV. THE GOVERNMENT'S TACIT ACCEPTANCE OF THE BLACK MARKET

A. Nonenforcement of Currency Regulations

Apart from the promulgation of the penal provisions for violations of the Exchange Control Regulations, the Chinese government has made no real effort to eliminate or control the black market. There have been no reports of any action taken against either Chinese or foreigners who exchange money. There have been a few recent reports of criminal action against Chinese who have attempted to participate in the black market for foreign goods, however these incidents involved serious schemes of racketeering and embezzlement.⁷⁶

While not openly promoting the black market, the Chinese government tacitly accepts and tolerates its existence. In Beijing, a policeman turned a blind eye and continued walking as two money changers quarreled over who saw the author first and thus who had priority to change money. Some street vendors brazenly accost visitors, crying "Change money! Change money!,"⁷⁷ even chanting it at passing foreigners' cars.⁷⁸ In Guangzhou, one reporter saw youths bearing hand-lettered cards an-

⁷⁴ See Mann, *supra* note 61, at 14.

⁷⁵ The government established four Special Economic Zones ("SEZs") in 1979 and added Hainan Island in 1983 as special areas to attract foreign investment and encourage export trade, while concentrating and isolating these foreign influences. See Guo-cang Huan, *The SEZs: Problems, Successes, Outlooks — I*, E. ASIAN EXEC. REPORTS, May 15, 1985, at 11. Unfortunately, these zones have not performed as well as expected. See *The Second Revolution*, TIME, Sept. 23, 1985, at 42, 45.

⁷⁶ In one story reported recently, a minor Chinese official named Liu Bauqin told villagers that he could import 200,000 Japanese television sets through contacts in Hong Kong. Liu sketched a deal to fellow officials under which the television sets would be imported and resold for a profit of 30 million yuan, or about \$10.7 million. Evidently, the whole deal was a fraud. After taking 12.6 million yuan in advance payments for the nonexistent sets, he placed two million yuan in his own bank account. He was arrested in a luxury hotel in Shenzhen, across the border from Hong Kong. He and his fellow swindlers are awaiting trial on charges that carry a maximum death penalty. Burns, *Proletarian 'Rectitude' Runs Amok under China's New Economic Policy*, N.Y. Times, Feb. 23, 1985, at 2, col. 1.

In another story reported by China's news agency, Hainan's top officials engaged in a major fourteen-month embezzlement scheme. Taking advantage of Hainan's tax and duty exemptions, which were instituted to help industrialize the impoverished island and to promote investment, local officials began importing luxury goods. These goods could be resold for more than 300% of the original import price, all at the government's expense, to China's inland provinces. The scandal involved \$1.5 billion, in which 89,000 cars and light trucks, nearly 2,900,000 color television sets, more than 250,000 videotape recorders, 122,000 motorcycles, cosmetics, food, and toys were imported for resale. See Burns, *Scandal Blights Hainan Hope*, N.Y. Times, Nov. 12, 1985, at 41, col. 1. See also *The Second Revolution*, *supra* note 75.

⁷⁷ Bennett, *supra* note 23.

⁷⁸ Baker, *supra* note 31.

nouncing the day's unofficial exchange rate.⁷⁹ The relative openness of the exchange transactions and the lack of enforcement of the penal provisions suggest that the government does not seek to eliminate the market. Its existence appears to be an accepted reality by the state, in which the government offers token accolades to those who refrain from black market trading, rather than criticizing those who engage in such transactions.⁸⁰ In addition, by relaxing restrictions on Chinese citizens' acquisition of remittances, the government is essentially sanctioning the flow of more foreign exchange into the black market.

B. Government Permissiveness

It is questionable why the government promulgates rules against participation in the black market, refuses to enforce such rules, and even condones the market's existence. It is submitted that this apparent paradox is part of the Chinese political tradition which involved a great dichotomy between political theory and administrative reality. Traditionally, to demonstrate the order and control it envisions, the government often formulates laws based upon theories it cannot or will not apply. It sometimes appears that the government believes order has been attained merely by passing the proper legislation. Instead, societal order is achieved in ways contrary to the officially-sanctioned system. In this manner, the black market has replaced much of China's officially-sanctioned financial and goods markets.

In addition to this systemic paradox rooted in China's political tradition, the government permits the continuance of the black market because of the benefits realized by its continued existence. The black market provides a means by which Chinese consumers may acquire FECs and foreign goods without the need for the Chinese government to spend its foreign exchange reserves importing these items. Stockpiling foreign reserves is fundamental to China's spending policy. Since 1979, China has maintained a very conservative policy regarding foreign trade expenditures. As of 1983, China held the seventh largest gold and foreign exchange reserves in the world.⁸¹ China's reserves stood at a record

⁷⁹ Bennett, *supra* note 23.

⁸⁰ *The Peking Daily* reported the story of a chief of the dining car crew on a train named He Baoxien. The story said that, despite suggestions by his friends and co-workers that he was being foolish, he repeatedly refused to trade his renminbi for FECs, to which he had special access on the train. "I don't want anything except more foreign exchange for the state," he said." Mann, *supra* note 61, at 14.

⁸¹ Those countries which list more reserves are: the United States, the Federal Republic of Germany, France, Italy, Switzerland, and Japan. Cass, *More Flesh on Skeleton of Change*, *Fin. Times*, Oct. 29, 1984, at 2, col. 1.

high \$16.67 billion in September 1984, after rising rapidly from \$226 million in 1980.⁸² Despite its large reserves, the government's economic policy prohibits a large amount of foreign exchange to be used to import foreign consumer goods.⁸³

The characterization of China's policies as "one step backward for each step forward"⁸⁴ is particularly appropriate in describing its spending policy for foreign exchange reserves. Following a nearly disastrous spending spree in 1978, China displayed, for several years, the utmost frugality in its spending habits. Then in May and June 1984, China began reporting its intention to spend more of its foreign reserves.⁸⁵ For nearly one year, China loosened its control over foreign reserves and increased imports.⁸⁶ In addition to the imports needed for multibillion-dollar projects including nuclear power plants, coal and oil developments, and transportation and communications networks (projects in which the government plans to invest over the next several years),⁸⁷ China began to increase its imports of consumer durables. Leading the import surge were color television sets, radio-recorders, washing machines, and refrigerators in amounts double those of the previous quarter.⁸⁸ In March 1985, the government explained the increase of these imports as a means of easing shortages and "mop[ping] up currency."⁸⁹

By July 1985, however, Beijing voiced its concern over dwindling foreign reserves⁹⁰ and called for measures to halt the decline. Programs were implemented to decrease imports, particularly those deemed unnecessary (such as consumer goods and automobiles), and to cut back on

⁸² Wall St. J., July 9, 1985, at 33, col. 6.

⁸³ Cass, *supra* note 81.

⁸⁴ See Ching, *supra* note 2.

⁸⁵ In May 1984, when China's foreign exchange holdings stood at \$15.69 billion, Dai Qiading, general manager of the Institute of International Finance under the government's Bank of China, told a Chinese seminar, "such a large reserve isn't necessary for China." He then recommended spending \$5 to \$6 billion. In addition, at the National People's Congress in May 1984, Planning Minister Song Ping promised "greater access to foreign exchange in China's coastal foreign investment zones." China was reportedly striving to increase imports. Bennett, *China's Cash Hoard Symbolizes Its Problems*, Wall St. J., July 12, 1984, at 41, col. 2.

⁸⁶ In a report issued by the Chinese Foreign Trade Ministry, imports jumped 54% from the year earlier, resulting in a reported \$890 million trade deficit for the first quarter. In contrast is the \$1.09 billion trade surplus in the first quarter of 1984. Imports reached \$6.04 billion while exports, although 2.7% more than the year previous, only totaled \$5.15 billion. Wall St. J., Apr. 16, 1985, at 34, col. 3 [hereinafter Trade Report].

⁸⁷ Bennett, *supra* note 85.

⁸⁸ See Trade Report, *supra* note 86 (quoting China's Foreign Trade Ministry).

⁸⁹ Burns, *supra* note 45.

⁹⁰ The country's reserves fell to \$11.72 billion in March from \$14.42 billion in December. See *supra* note 82.

trade exhibitions overseas.⁹¹ China's current conservative fiscal policy is, in part, a reaction to the country's harrowing financial experience in 1978.⁹² In an enthusiastic attempt to industrialize, Chinese planners overextended the country's financial resources by purchasing entire factories from Japan, the United States, and the Federal Republic of Germany.⁹³ Such rapid spending resulted in soaring interest rates of up to 18% on billions of dollars in debt.⁹⁴ The government eventually cancelled many contracts in an attempt to limit its financial liability. The current Chinese approach to industrialization is much more cautious and frugal; for example, the government now purchases limited amounts of imported technology as opposed to ordering complete industrial complexes.⁹⁵ Not surprisingly, consumer goods rank last on the government's list of import priorities.

Although China occasionally indulges in the importation of consumer goods, the government quickly reverts to conservative fiscal policies at the first sign that foreign exchange reserves are being affected seriously. Some provinces have already taken measures following Beijing's announcement of tighter controls. These measures include more carefully monitoring the importation of capital goods, approving only those imports which will clearly raise output, and limiting some projects with foreign participation which could cost the country foreign exchange.⁹⁶

As reflected in recent events, the Chinese government wants to maintain a positive flow of foreign exchange into the country. To accomplish this goal, the government will continue to emphasize exports over imports. Of those items which are imported, China will continue to place the greatest priority on expenditures for large-scale investment projects to build up its infrastructure. In China's import scheme, consumer goods are an afterthought.⁹⁷

⁹¹ *Id.*

⁹² See Bennett, *supra* note 85.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ Wall St. J., May 24, 1985, at 28, col. 5.

⁹⁷ The leading United States exports to China include logs and lumber, fertilizers, synthetic resins and rubber, coal-cutting machinery, mining and well-drilling machinery, commercial aircraft, office machinery, computers, and scientific instruments. Unclassified State Department Release on United States China Trade, No. 377-3583 (Sept. 5, 1985).

V. THE IMPLICATIONS OF THE BLACK MARKET ON
UNITED STATES-CHINA TRADE

Despite rhetoric that Beijing intends to use some of its foreign reserves to import more goods, there remains a clear emphasis to import materials for long-range and large-scale construction projects rather than luxury items. In addition, it appears that Beijing would like to amass large amounts of foreign reserves and that it will act to restrict capital outflow when reserves are being affected seriously. Such restrictive measures include eliminating consumer imports.

Currently, however, Chairman Deng Xiaoping and the Chinese government are extolling the new prosperity and increased consumerism which are products of the successful economic liberalization plans. Indeed, *The People's Daily*, the Communist Party newspaper, has written that "getting rich and buying consumer goods is not decadent — especially if it makes life more pleasant."⁹⁸ Hence, China's internal economic conflict exists because the successful economic policies pursued by the government have created new consumer demand by the Chinese citizenry, but the government is unwilling to commit sufficient foreign reserves for the importation of consumer items to satisfy the demand.

The black market for foreign goods and foreign currency provides a means by which the private Chinese citizen may acquire consumer durables while permitting the government to continue its emphasis on the purchase of goods for large construction projects. Thus, whether gifts sent by Chinese friends or relatives overseas supply the black market, or whether foreign currency is acquired through the black market and subsequently used to purchase foreign goods in Hong Kong, the Chinese government can applaud increased consumerism without financing it. In addition, by encouraging its citizens to solicit foreign goods and foreign currency from abroad and by easing restrictions on the holding of foreign currency, the Chinese government is fanning the flames of the black market, not stamping out the fire.

The most common way for Chinese to purchase foreign goods is through the use of FECs at Friendship stores and Overseas Chinese stores. Therefore, it is no coincidence that the black market for FECs is the most active of the black markets. Financing imports in this manner permits the domestic economy and the balance of payments to remain relatively unaffected. By requiring FECs backed by foreign currency for the purchase of foreign goods, the government is assured of receiving an adequate amount of foreign funds to pay for the imports. Moreover, the

⁹⁸ *The Second Revolution*, *supra* note 75, at 42.

government knows that it will not have to purchase foreign currency elsewhere or draw upon its foreign reserves to settle a balance of payments. Finally, selling foreign goods for FECs augments the government's foreign exchange holdings. The government includes a hefty profit in the price of the foreign goods it sells, thereby acquiring all the foreign exchange exceeding the import price.

With respect to FECs and the goods which they purchase, the government has taken a practical, if not expedient, approach to this market transaction. As a Chinese man whom the author interviewed stated, "Once the government has acquired your dollar, it is not so concerned about who spends the FECs."⁹⁹ The tourist who initially exchanges foreign currency for FECs and then exchanges FECs for renminbi still has deposited foreign exchange into China's foreign exchange reserves.¹⁰⁰ Moreover, the government places no prohibitions on the acquisition or possession of FECs by Chinese and also permits Chinese to use the scrip. Such a political posture may be interpreted as tacit approval of the black market for FECs.

Reflected in its past policy and recent events, the PRC is not embarking on an expansive plan to import foreign goods. For the foreseeable future, the black market will remain China's stop-gap measure for providing consumer goods to its citizens without affecting its foreign reserves. As the bulk of United States exports to China have been materials for development projects, China's recent import restrictions have had minimal impact on United States-China trade.¹⁰¹ Judging from China's recent action, the United States exporter should realize that, while China's market for goods such as lumber and machinery remains stable, its current import market for consumer goods is limited.

VI. CONCLUSION

The business executive wishing to break into the Chinese market should be advised to proceed with limited expectations for the present

⁹⁹ Yang Interview, *supra* note 53.

¹⁰⁰ Foreign tourists must spend renminbi within the country as it cannot be taken out of China legally. Foreign Exchange Provisions, *supra* note 6, art. 30. Generally, only Chinese customs officials will convert FECs back into foreign currency. However, they are reticent to convert large quantities of renminbi back into foreign exchange.

¹⁰¹ In 1984, Japan controlled 26% of China's nearly \$50 billion of international trade while the United States only accounted for 12% of this trade. Japan, however, has suffered more because of China's recent import cutbacks as China generally imports consumer goods from Japan. As one United States business official observed, because the United States provides China with equipment and materials used for China's development, "It's easy for China to cut back on Japanese products, but less easy for them to do without the American products." Kramer, *Japanese Dominate Market with Savvy Trading*, Wall St. J., Nov. 18, 1985, at 1, col. 1.

and to maintain a sense of optimism for the future. There is great potential for a healthy consumer market in China as evidenced by its stable banking structure and its rapidly growing gross national product and consumer demand. Currently, however, as a result of a conservative fiscal policy and the desire to avoid depleting foreign currency reserves, the government has limited its imports of foreign goods.

The black market has evolved as a mechanism for Chinese consumers to acquire much of their foreign durables. The government sees the practical benefits in permitting the continued functioning of the black market. While the black market is in direct conflict with most of the currency and import regulations the government promulgates, the government also realizes that the black market can supply the Chinese consumer with demanded goods without the government financing such import transactions. Consequently, United States exporters should not expect large contracts for consumer goods in the near future; such needs will continue to be satisfied through the unofficial channels of the black market.

While cutbacks and limitations on the importation of consumer durables have dampened the prospects of increased foreign sales for many United States manufacturers, the effects on United States trade have been relatively minor. Most United States exports to China have consisted of industrial rather than consumer goods. Hence, the black market has affected United States export trade far less than the trade of countries exporting consumer goods to the PRC.

Regarding future trading opportunities with China, the United States manufacturer may look to two scenarios. First, trade restrictions eventually will be eased which will allow easier entry into the Chinese consumer market. Second, exporters might consider a joint venture with China if they wish to embark on long-range manufacturing projects. It must be recognized that there are many regulations and restrictions imposed upon such ventures. If sufficient capital is involved, however, the joint venture project has the advantage of circumventing China's import restrictions and possibly providing a means of reaching the Chinese consumer. The outlook for the future of United States-China trade is far from grim. Considering China's growth record in the past five years, China should provide a vast and demanding consumer market in the not-too-distant future.

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