

Chapter 2

Informal and Formal Contracts

2.1 Introduction

The strategic policy of economic reform started in the late 1970s to the early 1990s to build a “socialist market economy” that has brought about remarkable economic growth in China (*Statistical Yearbook of China* 2006: 57).¹ This has attracted considerable attention in the law and development literature mainly because the high growth rate is achieved within the context of “weak formal legal system” both in terms of provision and enforcement in the eyes of development scholars. Despite a general lack of the shadow of the law, a huge amount of foreign direct investment (FDI) (*Statistical Yearbook of China* 1990: 653, 2006: 52; Long 2007)² and a great deal of domestic investment (*Statistical Yearbook of China* 1981: 295, 2006: 187)³ were made. In addition, there has been a considerable improvement in productivity, which reflects significant investments in human capital (*Statistical Yearbook of China* 1981: 107, 442, 2006: 798).⁴ From an institutional perspective, Che and Qian (1998) argue that local government ownership of enterprises (which face a hard budget constraint) may have credibly limited state predation when legal constraints were lacking and there was no formal protection of property rights. Investment of local governments was closely related to China’s fiscal policy of decentralization

Zhang Hao made a contribution during the conclusion stage on an early version of this chapter.

¹Gross Domestic Product (GDP) grew from 489 billion yuan in 1980 to 18,308 billion yuan in 2005.

²FDI grew from US\$ 1.98 billion in 1983 to US\$ 63.8 billion in 2005. The accumulated amount of FDI by the end of September 2006 is greater than US\$ 665 billion.

³The total amount of investment in fixed assets grew from 42.78 billion yuan in 1981 to 8,877 billion yuan in 2005.

⁴The total number of university students grew from 1.28 million in 1981 to 20.95 million in 2005. Employment by administrative allocation has been replaced by employment through market allocation. The number of employed in urban areas has increased from 109.4 million in 1981 to 273.3 million in 2005.

in the 1980s and 1990s. Lin and Liu (2000: 3) find that fiscal decentralization has made a positive contribution to the growth process. They also find that rural reform, the non-state sector, and capital accumulation along with fiscal reform are the key driving forces of China's impressive growth over the past 30 or so years. Along similar lines, Zhang (2007: 584) argues that, under a weak rule of law system, local governments, which are able to provide assistance in, for example, acquiring land-use rights at a fraction of its market value from private individuals and then selling them to business investors and in providing tax breaks to these investors, may well have functioned as an imperfect substitute for the weak formal property rights and legal system at this stage of economic development in China. While the focus on property rights in these studies is used to illustrate that the protection of property and investment, though unorthodox, can nonetheless be construed as acceptable, it would appear that these authors have not paid sufficient attention to contractual arrangements and enforcement in China. Downgrading the importance of formal contractual enforcement, Clarke chooses to emphasize the importance of property rights protection in China in the form of local governments' ownership and involvement. He suggests that economic growth in China appears to take place in those sectors that are free of the fear of arbitrary government confiscation (Clarke 2003: 109). While Clarke does not regard the issue of formal contractual enforcement as crucially important at the current stage of economic development for China, Trebilcock and Leng (2006: 1519, 1675) are less sanguine. Although Trebilcock and Leng, as well as Clarke, directly deal with North's claim that the lack of low-cost, effective contract enforcement mechanisms is the most important contributor to economic inefficiency and low growth rates in the developing world (North 1990: 54), they have not examined North's point on adaptive efficiency.

North (1990: 80) states:

Adaptive efficiency . . . is concerned with the kinds of rules that shake the way an economy evolves through time. It is also concerned with the willingness of a society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity of all sorts, as well as to resolve problems and bottlenecks of the society through time.

He (North 1990: 81) further provides later:

In a world of uncertainty, no one knows the correct answer to the problems that we confront and no one therefore can, in effect, maximize profits. The society that permits the maximum generation of trials will be most likely to solve problems through time Adaptive efficiency, therefore, provides the incentives to encourage the development of decentralized decision-making processes that will allow societies to maximize the efforts required to explore alternative ways of solving problems

This chapter seeks to use the development of informal contractual arrangements and the adaptation of three formal contractual arrangements in China to examine the notion of adaptive efficiency in the context of economic development in China. This author argues that this process of economic development (and the resultant economic growth) may be construed as adaptive efficiency in action. Adaptive efficiency, in the Chinese context, is a process by which economic reform creates incentives for economic actors to develop informal contractual arrangements when

these can serve as acceptable (however imperfect) substitutes and gradually adapt to formal contractual arrangements used in other countries or newly created locally when adaptation becomes feasible. This research, therefore, has the potential of not only examining North's notion of adaptive efficiency in the specific context of China but also providing additional insights in explaining China's economic growth.

Section 2.2 examines the informal contractual arrangements in Wenzhou to show that the general policy of economic reform has created incentives for people to develop informal arrangements by which to exploit contractual gains. Section 2.3 treats three formal contractual mechanisms widely used in China, namely, bill of exchange, letter of credit, and secured debt to examine financial contracts that require formal and third-party legal enforcement regimes. This section seeks to show that formal contractual mechanisms have played an important role in China's economic growth and will become more important for China in the future. Unlike others (Clarke 2003: 109; Trebilcock and Leng 2006: 1554), this author argues in Sect. 2.4, along the line of Johnson et al. (2002a: 260), that commercial parties and the courts, albeit imperfectly, are able to utilize these formal legal enforcement mechanisms to provide contractual protection. Conclusions follow in Sect. 2.5.

2.2 The Informal Contractual Arrangements in Wenzhou

The policy of economic reform in China since the end of 1970s has provided the necessary conditions as well as political/economic context for a private sector to grow out of a centrally planned economy. During the unorthodox development of this private sector, however, the financing of projects of private firms by formal financial institutions accounted for a very small proportion. Among the gross industrial products of 1985, 1990, and 1995, the state-owned sector accounted for 64.8 %, 54.6 %, and 33.97 %, respectively, whereas the contribution of the non-state sector was 35.14 %, 45.4 %, and 66.03 %, respectively (Wang 1999: 459–461). Despite the fact that the non-state sector was becoming more important in the economy, the private sector firms in the above 3 years only received 5.44, 5.48, and 2.7 % of the loans from state-owned banks (Wang 1999). The scarcity of capital for good, viable investment projects was a serious and hard constraint on private firms and on the macro economy as a whole. To address the issue of capital shortage, informal financial markets emerged. Specifically, the informal financial market in Wenzhou provides the best example of the vitality and ingenuity of the private sector in the early years of economic reform.

Wenzhou is located in the southeastern part of Zhejiang province. It has jurisdiction over nine counties and is well known for its dense population and the lack of arable land (Fei 1987: 46). Since Wenzhou also does not possess sufficient natural resources (e.g., oil, coal, and other minerals) for a viable extractive industry, light industry would be more suited. Partly as a result, the people of Wenzhou tend to engage in commerce. However, not unlike other regions in China, the development of light industry in Wenzhou was seriously constrained, while the economy was

still a planned economy. Moreover, Wenzhou is also very close to Taiwan and thus a potential “war zone.” Because of the historic tensions between Taiwan and the Chinese mainland, the state made very little investment in this region. From 1949 to 1978, the state only invested 560 million yuan in Wenzhou (Li 1996: 3). As a result, the state-owned sector was very weak there.

The economy of Wenzhou developed very rapidly in the reform period, which started in 1978. Compared with the Pearl River Delta, where there is heavy foreign direct investment, and the southern part of Jiangsu province, where considerable economic contribution is made by township and rural enterprises, the development of the Wenzhou economy relies more on entrepreneurs and private firms. In spite of the relative neglect by the state between 1978 and 1994, the Wenzhou economy developed at an annual rate of 16 % on average (Li 1996: 4). The economic development of Wenzhou during early years of the reform period reflects the crucial role the private sector played in economic development. The mode of economic development in Wenzhou is also popularly known as the Wenzhou Model.

The Wenzhou Model has the following characteristics: (1) Active and specialized family enterprises. By the end of 1984, more than 130,000 family enterprises with 330,000 entrepreneurs and laborers had produced 60 % of the gross industrial products in the rural areas of Wenzhou (Zhang 1987: 123–125; Lin 1987: 125–130). Most of the family enterprises were engaged in the production and marketing of light industrial products such as buttons, electronic products, shoes, textile products, etc. (2) Well-developed specialized markets for light industrial goods. By the end of 1984, there existed 135 specialized markets in Wenzhou (Lin 1987: 127–130). Among these, ten specialized markets are well known in China. Examples include the specialized market in Yongjia County for the production and sale of buttons, the specialized market in Cangnan for the production and sale of textile products, and the specialized market in Le Qing for the production and sale of hardware and electronic products (Lin 1987). (3) A large number of sales persons. These former farmers or residents of small towns started to adjust their jobs and played important roles in the acquisition of raw materials, signing contracts, promoting goods from their areas, and in the process, facilitating the flow of information. When the transfer of information was not very smooth during the very early days of economic reform, the large team of sales people became important. (4) Various market factors. They included the labor market and the financial market. These markets have facilitated the efficient utilization of resources.

The labor market played an important role in the economic development in Wenzhou. Since the economic reform program in 1978, individuals have had the right to determine whether to work as owners or employees. While there existed some restrictions on the number of helpers or employees sole proprietors could hire in the 1980s, these restrictions were removed in the 1990s. The greater autonomy of individuals made it easier for firms to hire all types of employees. In addition, intermediaries were also developed to facilitate the matching between employers and employees. All these were unthinkable under the planned economy before 1978 when the choice of employment was terribly limited or restricted.

In particular, the informal financial market in Wenzhou made a significant contribution to the development of the regional economy. According to statistics, the demand of funds by individuals, family enterprises, and township and rural enterprises in 1985 was between 600 and 700 million yuan (Zhang and Li 1990: 128). 30 % of that demand was met by loans from banks and credit cooperatives, 36 % was supplied by the informal financial market developed by the private sector, and the rest was retained earnings of the enterprises themselves (Zhang and Li 1990). In more developed coastal areas, the supply of fund by the private sector was even more significant. A survey of 10 wholesalers, 26 retailers, and 9 manufacturing enterprises revealed that the demand of funds in 1985 by these enterprises was 366 million yuan (Zhang and Li 1990). Retained earnings and loans from credit cooperatives could meet only 38 % of the demand for funds, while the remaining gap (62 %) was filled by the informal financial market (Zhang and Li 1990). Similarly, 50 % of the demand of working capital from family enterprises, township, and rural enterprises was met by the informal financial market (Zhang and Li 1990). As I illustrate below, the methods of financing were innovative as bank financing was restricted or unavailable. It is worth noting that the stock market in China was not set up until 1990, and when it did, it was used to raise funds to reform state-owned enterprises.

2.2.1 Direct Private Borrowing

This is the most primitive borrowing method under which interest varies according to market conditions. Borrowers and lenders using this method are parties who are from the same local community or village, know each other well, and are a part of the same closely knit social network. The close relations between borrowers and lenders reduce the moral hazard problem under imperfect information at the time of borrowing. This type of borrowing existed underground prior to economic reform. However, the role of private lenders changed after the start of reform, from lending for personal use to financing investment projects by various enterprises. It is worth pointing out that the legal status of these lenders was at best ill-defined and the money they lend could count on no protection from the government or its courts. Nonetheless, according to statistics, direct private borrowing between individuals and enterprises in Dai Tou Village of Ruian County reached 779,000 yuan, accounting for 86.2 % of the total lending in that place (Zhang 1999: 442).

2.2.2 Borrowing Through the Intermediary of Yinbei

This is an indirect borrowing method through an individual called *yinbei* or *qianzhong*. *Yinbeis* in the rural area of Wenzhou were already engaged in the facilitation of underground borrowing between borrowers and lenders before the

economic reform. After the economic reform, the activities of *yinbeis* became more open and the number has increased significantly (Zhang and Li 1990: 129). *Yinbeis* do not own large amounts of money themselves, but they know the potential lenders very well and have established good relations with lenders as well as borrowers. *Yinbeis* charge borrowers and lenders different types of fees such as brokerage fee, service fee, and guarantee fee. A survey in Xincheng District of Ruian County in 1992 showed that there existed on average one *yinbei* in each village among the 30 administrative villages (Zhang 1999: 440). Roughly each *yinbei* had the credit amount of one million yuan, with a total of 30–40 million yuan (Zhang and Li 1990: 130).

2.2.3 Juhui

Juhui is organized by a promoter called *huitou* (leader of the organization). The promoter usually invites friends and/or relatives called *huijia* (member) to join the group. Members of the group hold meetings every month, quarter, or year depending on the availability of the members and the need of funds by the members. In meetings, each member contributes a specific amount of money for the use of a particular member. This goes on so that other members also get the opportunity of borrowing money – this method serves the *juhui's* purpose of mutual assistance (Zhang and Li 1990: 130). The interest rate is normally higher than the official bank lending rate. The number of members of *juhuis* varies from group to group, ranging from two to hundreds. Investigation reveals that some *juhuis* only exist for a year, while others have lasted for 8 or 9 years (Zhang and Li 1990: 130). Participants of *juhuis* may include farmers, individual industrial and commercial households, city residents, workers, teachers, and cadres. In some cases, *juhuis* also include people from outside the region (Zhang and Li 1990: 130). It has been estimated that the financial scale of the *juhuis* reached the amount of several hundred million yuan, with the number of members around several hundred thousands (Zhang and Li 1990). There are examples of collapse of *juhuis*, particularly when the monthly interest rate reached 4–5 % and a large number of members are from outside the region. The often cited case of collapse of a *juhui* happened in Leqing County within half a year from the establishment in 1986, involving hundreds of thousands of members from 14 counties (Zhang and Li 1990).

2.2.4 Direct Fund Raising by Enterprises

According to incomplete statistics made by the Agricultural Bank of China in Wenzhou, 2,301 enterprises raised 136 million yuan in 1985, representing 79.45 % of the enterprises (Zhang and Li 1990: 133). The amount of funds raised accounted for 84.59 % of the total funds raised by township and rural enterprises (Zhang 1999: 442).

The main methods of raising capital by large enterprises on the informal financing market are the following (Zhang 1999: 442): (1) Cooperatives. Investors use this method of financing to establish new enterprises. There are two different ways under this method. First, investors assume senior level positions and hire non-investors to carry out the production work. Employees are normally paid by a per hour rate or per piece rate. Second, all investors are also employees of the enterprise. (2) Employee investment. This method is usually used when existing enterprises urgently need capital, but banks and credit cooperatives are not able to satisfy the need for capital of the enterprises. The enterprises generally pay interest according to the proportion of investment of employees. Some enterprises also pay dividends from after tax profits. This method of financing is also very significant in Wenzhou. (3) Raising capital from outside the region. This method is used for newly established enterprises when the lending from employees is not adequate.

One common characteristic of these informal methods of financing is that the terms of lending are normally short, varying between 1 and 3 years (Zhang 1999: 442). Another is that most borrowers performed according to their contractual arrangements although these arrangements enjoyed non formal protection from the law. In other words, these contracts are self-enforcing. Interests or dividends are normally very high, reaching a monthly rate of 2–3 % in most cases (Zhang 1999: 442).

The Wenzhou informal financial market emerged in the 1980s when the official financial system was very rigid and the official interest rate of banks and credit cooperatives was too low to reflect the risks of small family and rural enterprises. The information asymmetry between state-owned banks or rural credit cooperatives and family business and private enterprises is another possible reason why the banks and credit cooperatives did not have a comparative advantage in financing family or private enterprises. Information about the ability, business plan, and efforts of entrepreneurs could not be revealed costlessly to banks and credit cooperatives in the market. Williamson's concepts of bounded rationality and opportunism shed light on this type of problem (Williamson 1985: 44–49). Bounded rationality implies that uncertainty exists as it is difficult to assess an often untested idea of the entrepreneur. This is particularly the case when the entrepreneur's ability is acquired in a way of learning by doing or his knowledge is partly acquired by practice and can only be particularly communicated (North 1990: 74). Opportunism is present as in any debtor-creditor relations after the credit is obtained by the borrower. The borrower may use the money at the expense of the lender through asset substitution or selfish consumption. It was and remains difficult to perform background check on private firms in China.

While this author focuses on the potential abuse of information asymmetry by borrowers, it cannot be denied that lenders may also have opportunistic behavior once a new idea or entrepreneurial project is disclosed by a borrower. Lenders may also have the incentives to take up and pursue the idea or project themselves when there are no contractual or legal constraints. I do not, however, plan to further pursue this issue here.

Considering these serious problems, the adaptive ability of the economic actors to find alternative financing methods (i.e., adaptive efficiency) through the informal

financial market of Wenzhou was remarkable. I use the phrase “informal financial market” based on three reasons. First, this market developed outside the formal financing channels of banks and urban or rural credit cooperatives. Second, in the informal financing market, participants were in “breach” of formal laws and regulations. For instance, the interest rate of borrowing and lending followed by banks and credit cooperatives in China at the beginning of the 1980s was fixed by the People’s Bank of China. In 1980, the monthly interest rate of banks and credit cooperatives was around 0.4 % (Zhang and Li 1990: 136). At the same time, the monthly interest rate at the informal financial market was around 2 % or greater (Zhang and Li 1990: 135). Since setting interest rates above the official rate was in violation of formal laws, administrative regulations, or administrative rules, contracts based on illegal interest rates naturally could not be expected to be enforceable formally. It was not after 1987 that rural credit cooperatives were allowed to adjust the interest rate within a range of 20 % based on the interest rate fixed by the People’s Bank of China (Provisional Measures on the Credit Fund Administration by Rural Credit Cooperatives 1949–1989, Article. 13). In 1991, the Supreme People’s Court made it clear that interest rate on the informal financial market shall be no greater than four times the regulated bank lending rate (Certain Opinions Concerning the Handling of Lending Cases 1990–1992, Article. 6). Interest rate exceeding this range is not subject to legal protection. Most of the time, however, the lending interest rate at the informal financial market has been far greater than this legally permitted range. The Peoples Bank of China did not abolish the ceiling rate in lending used by financial institutions (other than credit cooperative) until 2004 when it raised the maximum lending rate of urban and rural credit cooperatives to 2.3 times of the prime lending rate (Notice of the People’s Bank of China on the Adjustment of Deposit and Lending Interest Rate of Financial Institutions 2004, Article 2(1)). Take the example of the 5.58 % of the 1-year prime lending rate, urban and rural credit cooperatives after 2004 may adopt lending rates within the range of 5.58–12.83 % (Articles 1(2) and 2(2)).

Violation of the interest regulation is obviously a minor risk that the participants have to face. The 1986 Provisional Regulation on the Administration of Banks prohibits the running of financial business by nonfinancial institutions or individuals (Articles 4 and 28). In 1998 the State Council decided to abolish illegal financial institutions and to prohibit illegal financial activities. Pursuant to the State Council Measures, any organization which, without the approval of the People’s Bank, engage in taking deposit, raising fund from the general public, providing credit, providing discount for bills, etc. shall be abolished (Measures of the State Council on the Abolishment of Illegal Financial Institutions and Illegal Financial Operation 1998, Articles 1–4). Under the Measures, the People’s Bank of China has the power to confiscate the illegal gain and to impose a fine between one and five times of the illegal gain (Article 22). When there is no illegal gain, the People’s Bank may still impose a fine between 100,000 and 500,000 yuan (Article 22).

Had the law been strictly enforced, a wide range of activities on the informal financial market of Wenzhou and elsewhere would have been caught by the said Measures. This did not happen. As the informal financial market played

an important role in the economic development of Wenzhou, local governmental agencies did not strictly enforce either this 1998 regulation or other earlier laws or regulations. In addition, the cost of discovering “illegal” or informal financial activities can be very costly. When there were budget constraints, local governments were more likely to spent resources on projects with clear positive impact on economic development.

Third, the enforcement of these financial contracts could only be informal. The contracting parties have either relations with blood or family ties or are from the same village or small towns. Disputes are rarely submitted to courts in part because this would expose the illegal nature of the contracts. The evidence from the informal financial market in Wenzhou is consistent with North’s observation that self-enforcement is the primary feature of contracts used in tribes, primitive societies, and close-knit small communities settings in which personal knowledge of transacting parties about one another is extensive and repeat dealings are pervasive (North 1990: 54). As discussed in the case of *juhui*, the existence of some *juhuis* sometimes lasts for more than 8 years. Members in these *juhuis* can be considered as repeating players. In the case of direct lending or *yinbei*, participants know each other very well. These informal financial methods mitigate the information asymmetry problem between borrowers and lenders well. The local and dispersed information on the borrowers gives the lenders, sometimes through *yinbei*, the comparative advantage over banks and credit cooperatives. Powerful incentives possessed by lenders or *yinbeis* compared with employees in banks or credit cooperatives also suggest the reasons why the amount of deposit in banks and credit cooperatives in Wenzhou declined enormously in the 1980s and 1990s (Zhang and Li 1990: 135).

Evidence from the informal financial markets shows that informal contractual arrangements have played a vital role in China’s economic development this far. While this chapter does not collect information of the overall annual lending amount in Wenzhou, other surveys estimate that the size of lending on the informal financial market in China varied from 200 to 1,400 billion yuan in 2003 (Feng 2007). In addition to the expansion of financing, the informal financial market has also contributed to China’s institutional change. Stimulated by the vitality of the informal financial market and pressured by the loss of business, the credit cooperatives in Jinxiang Town of Cangnan County, Wenzhou, under the support of local government and some relevant governmental agencies adopted in 1980 a floating rate policy so that interest rates reflect the scarcity of financial resources (Zhang and Li 1990: 135). Within 3 months, this cooperative became profitable and changed its history of loss-making during the past 26 years (Zhang and Li 1990: 135). During the period from 1981 to 1984, the amount of credit provided by this cooperative was 36.5 times the cumulative amount extended during the 26 years before 1980 (Zhang and Li 1990: 135). Reform of the interest rate policy of cooperatives considerably increased the flexibility of adopting interest rate by credit cooperatives. As credit cooperatives were able to adopt relatively higher deposit rate from depositors, the amount of deposit flowing to people or firms on the informal financial market went down. Since people or firms on the informal financial market had to compete with more credit cooperatives in lending, policy reform on interest reduced the lending rate prevailing

on the informal financial market from 4 to 7 % per month to 2 % per month (Zhang and Li 1990: 135). This partly solved the monopoly problem enjoyed by people or firms on the informal financial market and increased the competitiveness of the overall financial market. Excellent reform results in this town led to the adoption of the floating interest rate policy by rural and urban credit cooperatives in the City of Wenzhou in 1986 (Zhang and Li 1990: 136). The 20 % floating range of interest rate adopted in 1987 at the national level is closely related to the experiment of the interest rate reform in Wenzhou.

Interest rate reform was not the only private-sector-led institutional reform experiment in Wenzhou. In October 1987, two urban credit cooperatives took the leading role of distributing shares to the public (Zhang and Li 1990: 137). While the amount raised by these two credit cooperatives was very small, direct financing by enterprises stimulated financing reform of state-owned enterprises (SOEs) in China in the late 1980s and eventually resulted in the establishment of the two stock exchanges in China at the beginning of 1990s (Resolution by the Board of Directors of the Shanghai Vacuum Electronic Components Ltd 1993).

The evidence from the informal financial market in Wenzhou suggests the important role of informal contractual arrangements resulting from an era of decentralized experimentation and trying new methods brought about by the policy of economic reform. The reform policy unleashed strong economic incentives to adapt, to try alternative methods, and to find substitutes. However, the evidence also reveals the shortcomings of informal arrangements. The enforcement of informal contractual arrangements worked well in Wenzhou among people with blood or family ties or within very small villages or towns. When the relations between participants go beyond a county, city, or province, both *ex ante* adverse selection problem and *ex post* moral hazard problem become more serious. The collapse of a *taihui* in Leqing discussed previously is a good example. In a world of impersonal, nonsimultaneous, and/or one-shot exchanges, formal regimes of third-party enforcement, advocated by North (1990: 59), become increasingly relevant.

The economic theory on self-enforcing contracts suggests that a contract is self-enforcing either because the expected future gains from adhering to the contract exceed the current gain from a violation of the contract or because there are extra-legal means of enforcement (such as norms established between relatives and closely knit social networks) (Telser 1980: 42). In the case of Wenzhou, the existence of some *juhui* was supported by blood or family ties or close relations in the context of a small community. In some other cases in rural China, nonfulfillment of contractual obligations is followed by acceptable substitutional performance in the form of labor services (Ye 2004). Substitutional performance, however, is not very efficient as the *ex post* alternative labor service may not meet the needs of the other contractual party.

Self-enforcing contracts in spontaneous cooperation between two trading partners also require them to be in a bilateral monopoly. This may be possible in small communities where there are few alternative contractual partners. As the economy develops, McMillan and Woodruff (2000: 2426) suggest that parties may have the incentives to break existing relations and enter into new contractual relations to seek

greater gain. An implication to Wenzhou is when business people or enterprises move beyond its small community and reach other cities, provinces in China, or other countries, formal contractual arrangements and enforcement will become more important. China's greater integration with the world obviously requires formal contractual mechanisms and enforcement.

Dixit (2004: 80) has pointed out that relational contracting may also create high costs for corporate finance since capital markets tend to be compartmentalized among linked firms through potentially inefficient related borrowing and lending. In a more general context, McMillan and Woodruff (2000: 2423) point out that private ordering "sometimes harms efficiency by excluding new entrants from trading or by achieving price collusion." This implies that formal contractual mechanisms in domestic or international trade are essential when the economy develops.

Still another shortcoming of informal contractual arrangements and enforcement is the reluctance of private sector agents to participate in nonsimultaneous economic transactions with significant investment carrying sunk cost (such as projects involving products of high technical content requiring long periods of costly research and development). With respect to this type of transactions, Williamson (1996: 332) contemplates some degree of external enforcement. Schwartz and Scott (2003: 544) argue that "contract law should facilitate the efforts of contracting parties to maximize the joint gains from transactions." According to them, more formal enforcement is required to maximize joint surplus when one or both parties made relation-specific investment (Schwartz and Scott 2003: 546). This is so because in the absence of formal legal enforcement, the non-investing party has an incentive to renegotiate the contract price downward. Contemplating this possibility, the party with potential firm-specific investment may not enter into the contract in the first place. Obviously, the best option for them is for a third party (court) to enforce the law, when the parties themselves are not able to choose this option, to assure that the firm-specific investment is made and parties will not breach or renegotiate a contract for purely redistributive purpose (Schwartz and Scott 2003: 567).

Informal contractual arrangements may also give rise to criminal violence. The Sicilian and Russian Mafias, as pointed out by several researchers (Gambetta 1993: 28–33; Grief and Kandel 1995: 307), are a good example. Milhaupt and West's research (2000: 43) in the context of Japan also shows the dark side of informal contractual enforcement. According to them, organized crime "is the dark side of private ordering – an entrepreneurial response to inefficiencies in the property rights and enforcement framework supplied by the State." In the case of collapse of the *taihui* in Leqing discussed previously, some lenders vandalized property, kidnapped people as hostages for repayment, robbed members' money, and beat others (Zhang and Li 1990: 132; Current Status of and Management Strategy for Capital Circulated Outside the Formal Financial System 2006).

As the analysis above suggests, to sustain a good rate of economic growth in a country, the development, adaptation, and experimentation of more formal contractual mechanisms would be needed at some stage. In the next section, I will examine a few formal contractual mechanisms that are already in wide use in China with the aim to assess the possible correlations between formal contractual arrangements and enforcement and economic development in China.

2.3 Formal Contractual Arrangements

2.3.1 *Bills of Exchange*

Most research on negotiable instruments law (NIL) focuses on negotiability (Nyquist 1995; Rogers 1989–1990: 283)⁵ or the doctrine of holder in due course (Maggs 1998; Sinclair 1990: 628).⁶ The use of negotiable instruments to save screening or monitoring costs has not been adequately discussed. And there has been no discussion on the enforcement properties of these instruments. The large body of law and development literature rarely touches on NIL (Mayeda 2006; Ginsburg 2000). In this section, I will discuss the development of NIL in China and the increasing use of the most important negotiable instruments, bills of exchange (draft) in Chinese commercial practice to show that adaptive efficiency in the form of developing NIL, and using of this very formal contractual mechanism is very conducive to China's economic growth.

From 1949 until 1979, China practiced a very rigid socialist central planning economic system. Under that system, commercial credit was prohibited (Qiang 1997: 376). Scarce financial resources were administratively allocated. The use of negotiable instruments was severely restricted. Promissory notes were not allowed. Bills of exchange were only used in international commercial transactions. Checks were only used by enterprises, mainly for the transfer of funds (Qiang 1997). Under such a planning system, there is not much need for a sophisticated law to govern drafts, promissory notes, and checks. The economic reform program adopted at the end of the 1970s, however, has gradually moved the Chinese economy from a planned economy to a market-oriented economy. As a result, there has been a gradual expansion of commercial credit and an increase in the use of negotiable instruments (*China Financial Yearbook 2003–2007*). The increased use of negotiable instruments calls for more formal legal rules.

Like other national laws, the harbinger of the NIL in China is local rules and administrative rules normally adopted after a period of trial and experimentation in certain selected regions. In 1982, the Shanghai Branch of the People's Bank of China (PBOC) issued the Measures Concerning the Acceptance and Discount of Negotiable Instruments (Liu Xin-wen 1997: 39). Based on the experiment in Shanghai, the PBOC, the bank exercising the function of a central bank, adopted the Provisional Measures on the Acceptance and Discount of Commercial Bills of Exchange in 1985. In 1986, Shanghai promulgated the Provisional Measures

⁵James Rogers observed that the twentieth century books all proceed on the assumption that the concept of negotiability and the rules permitting holders in due course to take free from defenses have always been the central, defining characteristics of the law of bills and notes.

⁶Gregory Maggs asserted that the holder in due course doctrine reduces transaction costs; M. Sinclair focused on the doctrine of holder in due course to illustrate that legislation is largely responsible for the lack of change of the negotiable instruments law.

Regarding the Use of Negotiable Instruments in the City of Shanghai. These local law and administrative rules have facilitated the use of commercial credit and the transferability of credit. The increased use of negotiable instruments, in turn, led to the first systematic effort to formalize the banking practice relating to drafts, promissory notes, and checks in 1988. In that year, the PROC promulgated the Bank Settlement Measures to further promote the use of negotiable instruments. In 1993, the PBOC promulgated the Measures on Commercial Bills of Exchange. The Negotiable Instrument Law of China (NIL) enacted in 1995 has further improved the law in this area.

To examine the role of formal contractual arrangements of drafts, which may be the most important instruments among drafts, promissory notes, and checks in China's economic development, I use two cases to demonstrate that the adoption of NIL in China is consistent with North's notion of adaptive efficiency. I will then use statistics and survey results to show the increasingly wide use of drafts in the commercial world including the interbank market and the informal market participated by individuals and small firms.

2.3.1.1 The *Danchengru Sub-branch Case* (2001)

In 1997, Jincheng City Radio and Equipment Co (Jincheng) signed several agreements with Chang Hong Electronic Ltd (Chang Hong), Hefei Rongshida Washing Machine Ltd (Rongshida), and Xinkewei Electronic Ltd (Xinkewei) for the purchase of electronic products in the amount of 7.3 million yuan, 0.34 million yuan, and 11.5 million yuan, respectively. While the facts of the case were not explicit, payment through the use of bills of exchange was likely to be dictated by the sellers who were not parties in the litigation and were located in other provinces. The dispute in this case is between the pledgee, the bank who agreed to issue bills of exchange under the request of Jincheng for the benefit of the sellers, and the Danchengru Sub-branch. Danchengru Sub-branch is the bank branch which accepted the deposit of 18.08 million yuan from Jincheng and issued three certificates of time deposit to Jincheng.

In May 1997, Jincheng approached the Nan Street Sub-branch of China Construction Bank (Nan Sub-branch), requesting the bank to issue four drafts payable to Chang Hong, one draft payable to Rongshida, and five drafts payable to Xinkewei. Pursuant to the agreement between Jincheng and China Construction Bank related to the provision of drafts, the bank bears payment liability for the amount stated on these drafts when the relevant creditors of Jincheng or their endorsees present the respective drafts for payment. Jincheng was, however, required by the said agreement to deposit into the account with Nan Sub-branch adequate money relevant to each of the draft to be paid by Nan Sub-branch before the payment date. Should Jincheng fail to put adequate amount of money into the account, penalty interest will be charged by the bank over any unpaid amount. The agreement further provides that the bank has the right to demand payment from the guarantors of Jincheng for any amount liable by Jincheng to the bank. The bank similarly has the

right to dispose of any mortgaged property or pledged property offered by Jincheng to satisfy its claim against Jincheng. Relevant to this case, Jincheng pledged three certificates of time deposit in the total amount of 18.08 million yuan.

After the Nan Sub-branch honored its obligation arising under the four drafts, it approached Jincheng for payment related to the drafts. At that time, Jincheng was insolvent. It was under that circumstance that Nan Sub-branch presented the three certificates of time deposit to Danchengru Sub-branch to exercise its right as pledgee. The litigation arose as Danchengru Sub-branch refused to pay Nan Sub-branch.

One interesting fact about this case is that contracting parties, in effect, chose to rely on a bank to act as a third party to administer and enforce the relevant contracts through the use of drafts.

2.3.1.2 The Lijin Sub-branch Case (2000)

On 13 March 1998, Aokema Sales Ltd (Aokema) entered into an agreement with Materials and Equipment Ltd (MEL) in Lijin whereby Aokema shall supply a series of its products to MEL in the amount of 100 million yuan. Payment by MEL shall be made through bills of exchange promised to be paid by a bank at the place where MEL is located. For the purpose of payment, MEL approached the Lijin Branch of the Bank of China, applying for the issuing of 20 bills of exchange. The amount on each draft is five million yuan. Under this draft agreement, MEL shall put into its account with the Bank of China the right amount corresponding to each of the draft 7 days before the payment date. If MEL fails to deposit adequate amount of money related to the drafts before the payment date, the bank shall have the right to impose penalty interest on the shortfall amount. To protect itself from the potential liability of issuing the bills and honoring payment, Lijin Branch obtained guarantee from a guarantor for the money owed by MEL to Lijin.

Again, the contracting parties rely on the Bank of China to act as a third party to administer and enforce the contract.

The facts of these two cases give rise to the following generalizations. When sales transactions are between distant parties and when the sales amount is very substantial, the formal contractual device of drafts is needed and was used in China. The choice of bank drafts rather than commercial drafts is also significant. It may be argued that the use of bank drafts is an attempt to explore and experiment with more formal contractual arrangements as well as methods of enforcement and is North's notion of adaptive efficiency in action. First, the device utilizes the comparative monitoring/information advantage of the drawing bank. Compared with a seller in a far distant place, the bank at the buyer's place is more likely to know the buyer better. Normally, the buyer is a customer of the drawing bank. By serving the customer, the bank has information about the buyer's assets, cash flow through its capital spending, and accounts payable and receivables. As the number of banks is much smaller than the number of buyers (especially true in China where there are only a handful of state-owned or state-controlled banks), the seller's reliance on the

device of bank drafts saves the cost on the part of the seller to search information about all the possible buyers. This is so because once the device of drafts is used, the drawing bank's payment liability based on the draft is normally independent of the underlying sales transaction between the seller and the buyer. So long as the formality of the draft complies with the NIL, the bank cannot deny its liability to the payee or endorsee of the draft. Moreover, banks (especially Chinese banks, which are few in number and owned/controlled by the government) are much less likely to go bankrupt compared with other commercial companies. While the seller may sometimes also have long-term relations with the buyer as the bank does with the buyer, this may not prevent opportunistic behavior on the part of the buyer in transactions with very substantial amount of money. In some of these cases, the short-term gain from breach may be greater than the overall benefits derived from a series of future transactions. Besides, the parties may enter into a period of end game. Furthermore, the seller in a very dynamic business world may frequently enter into new relations with new buyers. This is very likely in China during its economic transition from the past planned economy to a market economy. New relations have to be established in such a transition period. It is also very likely in China during the period of high rate of economic growth when firms are likely to deal with newly established companies for the purpose of expansion and profit maximization.

Second, the device of drafts makes the best use of the comparative advantage of the drawing bank in monitoring the assets of the buyer. Located far away, the seller cannot efficiently monitor the assets of the buyer. The drawing bank controls the accounts of the buyer customer. As the bank has better information about the other assets of the buyer and the local suppliers and customers of the buyer, the bank can ask the buyer to obtain credible guarantors or take mortgage or pledge. This explains why in distant substantial domestic sales transactions payment is normally through bank drafts. While other devices to secure business transactions like mortgage or pledge do exist under Chinese law and practice, they are more likely to be used by banks in lending transactions to be discussed in Sect. 2.3.3, documentary credit transactions, or bill of exchange transactions (*Administration Yearbook of China Administration for Industry and Commerce* 2005: 639, 2006: 650).

Third, state-owned or state-controlled banks may be more able to enforce the formal contracts in China for several reasons. One is that a bank is a third party who nonetheless has the pecuniary incentive to see the successful execution of the contracts. Another reason is that a bank has established a long-term commercial relation with at least one of the contracting parties, which reduces the likelihood of opportunistic behavior.

The comparative advantage of banks in gathering information about buyers and in monitoring buyers as well as enforcing contracts provides a plausible explanation as to why bank drafts, rather than commercial drafts, are widely used in domestic sales transactions. The two cases discussed in this section are certainly not isolated transactions. Factual patterns in many other cases similar to these two cases can be found elsewhere (Sommers and Philips 1998: 340). Empirical evidence also provides some support that bank drafts overwhelmingly outnumber commercial drafts in China. According to a 2002 survey in Beijing, bank drafts paid by drawing

banks accounted for 93 % of the total balance of drafts, while commercial drafts paid by banks only took the remaining 7 % (*China Financial Yearbook* 2003: 735). Bank drafts are preferred to commercial drafts because banks are more efficient than firms to administer and enforce formal financial contracts and are less likely to go bankrupt.

As the device of drafts plays important roles in facilitating large distant sales transactions, it is expected that the value correlates with the higher rate of economic growth. Limited statistics basically confirm that prediction. The data collected by the Post and Savings Office shows considerable expansion of the amount of drafts from 16 billion yuan in 1986 to 295.8 billion yuan in 1999 and stabilized at that level with some slightly decreasing use in this century (*China Financial Yearbook*, online). Since the statistics collected by the Post and Savings Office is not comprehensive, it cannot be concluded that the overall use of bank drafts has also declined recently. A regional survey in Beijing shows that the amount of bank drafts on the interbank market increased from 1.3 billion yuan in 1999 to 14.3 billion yuan in 2000 and to 27.5 billion yuan in 2001 (*China Financial Yearbook* 2003: 734). Another survey of the informal market in Cixi City of Zhejiang Province also shows the active use of discount market of drafts by private firms as well as by banks (*China Financial Yearbook* 2003: 737–739).

My own survey of one bank at the national level and seven regional branches or regional banks in Xian reveals that bank drafts have been widely used (four responses) or very widely used (four responses).⁷ The survey results also indicate that the willingness of banks in issuing bills of exchange plays important roles (five responses) or very important roles (two responses) in facilitating the signing of sales contract. Only one reply indicated that the willingness of banks in issuing drafts does not play important roles in facilitating the signing of sales contracts. When being asked to indicate whether disputes related to drafts are very common, only one response has suggested that disputes are common. All the other banks or branches have indicated that disputes are not common. In responding to the question on the percentage of disputes requiring court adjudication, five replied that 75–100 % of the disputes need to be dealt with by courts. This shows that courts do play important roles in solving disputes related to this type of formal contractual device. Two replied that only 0–25 % of the disputes require court adjudication. This may suggest that either the person does not understand the question well by confusing with the previous question or parties use other dispute resolution method. The last question asks whether smooth resolution of the disputes by court will influence the bank's willingness to issue drafts in the future. Responses to this question are divided. Three responses suggest that smooth resolution of disputes by court will significantly influence the bank's future issuing of drafts. Another three responses indicated that it may not significantly influence the bank's future action. The remaining two responses indicate that smooth resolution of disputes by court does

⁷The reply to my questionnaire is supplied by the manager or director for legal affairs in these banks or branches. For the purpose of confidentiality, the names of banks and the individuals filling the questionnaires are not disclosed. The survey (Yu's Survey 2007) was conducted in May 2007.

influence the bank's future action. Overall, proper resolution of disputes by court is more likely to influence the bank's willingness to issue drafts in future transactions.

There are several implications from this survey of limited number of banks. First, the device of bank drafts (but not yet commercial drafts) is widely used in distant sales transactions. The statistics at the national level and the two surveys of the market for drafts in Beijing and Cixi City discussed previously provide some collaborative evidence. Second, courts do play positive roles in solving disputes related to drafts. Third, the use of this formal contractual arrangement plays a positive role in China's economic growth in the sense of facilitating distant sales transactions when sellers provide large quantity of products to purchasers who may not buy such significant quantity of products in the future or who may be new contractual parties to the seller and is not certain whether they will enter into other relational transactions in the future. This partly supports North's claim that a credible, low-cost, and formal regime of third-party enforcement is essential when the economy develops.

2.3.2 *Documentary Credit*

Since China adopted the reform policy to open up its economy in 1978, foreign trade has played a very important role in China's economic growth. The promotion of import and export has been an explicit and important policy objective of the Chinese government and an important part of its economic reform strategy for the last 30 years. The percentage of foreign trade in the GDP has been high. In 1980, foreign trade already accounted for roughly 21 % of China's GDP (*Statistical Yearbook of China* 2006: 57, 734). In 2005, foreign trade further reached 64 % of the GDP (*Statistical Yearbook of China* 2006: 57, 734). In 2012, China became the largest country in the world in terms of total amount of foreign trade (*China Overtakes the United States as World's Largest Trading Country* 2013). The high proportion of foreign trade in the Chinese economy suggests that Chinese firms must adopt and conform to practices of international trade, which are demanded by trade partners internationally. One of these practices is the use of letter of credit.

International sales transactions are characterized by the nature of nonsimultaneous transactions. When buyers and sellers do not know each other well and/or do not have long-term business relations, opportunistic behaviors are likely to happen. A seller may not be willing to ship the goods first as he may not trust the credit of an unknown buyer located far away. A buyer in turn may not wish to pay for the goods prior to their delivery. The commercial world developed the device of letters of credit to solve potential problems arising from such nonsimultaneous transactions more than 100 years ago (*Curtis v. Leavitt* 1857; *Fletcher v. Tayeur* 1855).⁸

⁸As for international practice, the Uniform Customs and Practice for Documentary Credits (UCP) are an outstanding successful codification of banking practice in relation to letters of credit. First published in 1933, the UCP 600 is the current text.

During the formation of an international sales agreement, the seller normally requires the buyer to make the payment through the device of letter of credit. A letter of credit is a payment mechanism whereby an obligation of payment by a known buyer is substituted by a more credible bank. The buyer applies for the letter of credit with the bank (issuer), specifies the terms and conditions of the letter (*Anglo-South Am Trust Co v. Uhe* 1933), and promises to reimburse the issuer upon payment by the issuer. Once the bank issues the letter of credit, it is irrevocably bound to honor (UCP 600, 2006, Article 7(b)). A credit by its nature is an independent transaction from the sales contract on which it may be based (UCP 600, 2006, Article 4(a)). In this way, banks are in no way concerned with or bound by such a sales contract. In addition, banks deal with documents and not with goods, services, or performance to which the documents may relate (UCP 600, 2006, Article 5). When the seller submits to the bank complying documents such as bills of lading, invoice, and insurance policy, the bank must honor its obligation (UCP 600, 2006, Article 7). Under the contract between the applicant buyer and the bank, the bank is entitled to recover the payment it has made from the buyer so long as the seller's documents comply with the conditions stated on the letter of credit. As a security measure, the bank holds security or mortgage from the buyer through a separate agreement.

The efficient nature discussed in the context of drafts is equally relevant to the device of letter of credit. Compared with the seller, the bank can monitor the purchaser far more efficiently. The letter of credit device also makes it possible for the seller to rely upon the commercial credibility of banks. This is particularly the case in a dynamic business world when the seller needs to establish new relations with new buyers in other countries.

Since one of the main drivers of China's economic growth (especially in early years) has been the vibrant import and export sector, it is logical that the device of letters of credit played an important role in China's economic growth. While there does not exist any publicly available statistics on the use of letters of credit in China, Yu's Survey of one national bank in Beijing and seven regional branches and regional banks in Xian provides some limited evidence. When being asked on the frequency of relying upon letters of credit in international sales transactions, four banks replied that letters of credit are very widely used and the other four banks replied that letters of credit are widely used (Yu's Survey conducted in 2007 as explained in Sect. 2.3.1.2). Collaborative evidence tends to support the wide use of letters of credit. In the Inner Mongolia Autonomous Region in 2003, 51.9 % of the imports were paid by utilizing the device of letters of credit (Imports and Exports in Inner Mongolia in 2003 Continued to Grow and Grew at a Faster Rate 2004). This proportion is very low compared with other provinces because there is considerable cross-board trade taking place in that region.

The widely used letters of credit by banks in China explain the role of such device in China's imports. Similarly, when Chinese firms export goods, they ask foreign purchasers to apply from banks in their own country for issuing letters of credit so that payment liability is also borne by foreign banks.

The more interesting question is that given the weak formal legal system in China, whether the use of letter of credit (a formal contractual arrangement) has

experienced any difficulty in China. For many decades since the founding of the People's Republic of China, there were no domestic legal provisions governing the use of letters of credit in international trade. When parties adopted the Uniform Customs and Practice for Documentary Credit (UCP) in their sales or purchase agreement, courts in China normally respected their choice. One explanation concerning the lack of legislative attention to letters of credit is the low percentage of disputes related to letters of credit in international sales transactions, particularly during the 1970s and 1980s. When the author asked the banks on the frequency of disputes related to letter of credit transactions, six banks replied that there are very few legal disputes and two replied that there is no legal dispute (Yu's Survey 2007).

Another explanation why there were no legal provisions governing letter of credit transactions was the lack of attention to law between 1949 and 1978. Party and governmental policies were used instead in dealing with civil and economic relations. At a time when there was no contract law or corporate law, the lack of domestic legal provisions on letters of credit was not surprising.

In the middle of 1980s when foreign trade increased and law started to play a greater role in economic activities 10 years after the ending of the Cultural Revolution in 1976, China enacted the General Principles of the Civil Law (1986). According to Article 142, "international practices" may be applied to matters for which neither the law of China nor any international treaty concluded or acceded to by China has any relevant provisions. In other words, the Chinese government supported a near-wholesale adoption of international practices in the area of foreign trade. Many cases involving disputes of letters of credit after 1986 were decided by courts with reference to Article 142 in that law.

When foreign trade continued to expand and when more cases related to letters of credit have to be dealt with by the Supreme People's Court (Judicial Interpretation on Finance 2006), judicial actions were taken. In 2005, the Supreme People's Court issued the Provisions on Several Issues Concerning the Trial of Letter of Credit Disputes (2005, 2006). The Provisions are necessary as UCP 600 (2006), albeit very comprehensive in scope, leaves the fraud exception to the independence principle of Article 4 to domestic law (Williams 2004).

The adoption of letter of credit in China provides interesting observations about the development of formal contracts and contractual enforcement in China. The use of letter of credit is a practice widely used in international trade. Letter of credit, as a formal contractual arrangement, is proven to promote international trade by alleviating problems of opportunistic behavior in nonsimultaneous transactions. As a result, international partners *demand* their Chinese counterparts to adopt this practice despite the relatively weak formal enforcement regime in China (this is especially true in the early years of economic reform). Because this demand is consistent with and important to the promotion of international trade, the Chinese government supported the near-wholesale adoption of this practice. While the use of letters of credit by Chinese banks promotes imports, the request for the use of letters of credit by exporting sellers in China promotes exports. Evidence on the use by foreign banks and purchasers is even more difficult to obtain. Court cases in China do show that foreign purchasers apply from their banks letters of credit when

they buy goods from Chinese firms. The use of letter of credit, a formal financial contract, encountered little or no enforcement problems in China. As informal contractual substitutes for letter of credit were not feasible, economic actors adopt feasible formal contractual arrangements and adapt to international practices. This adoption/adaptation was largely successful despite the weak formal legal system in China because it was consistent with reform policy objectives and thus enjoyed the support of the state. The use of letter of credit is consistent with North's notion of adaptive efficiency made possible in China by the policy of reform. It also partly supports North's claim that a credible, low-cost, and formal regime of third-party enforcement is essential when the economy further develops.

2.3.3 *Secured Lending*

In the last 20 years or so, as economic reform reaches a more mature stage in China, secured lending, a more formal form of financial contract has become more widespread. In a recent study, Haselmann and his colleagues (2006) conducted an empirical study to examine the relationship between reform of bankruptcy law and collateral law and behavioral changes by banks in their lending activities. One of the findings of their study is that "collateral law designed to protect individual creditors" claims is of greater importance for expanding bank lending than is bankruptcy law, which is aimed at establishing a collective enforcement regime (Haselmann and his Colleagues 2006: 2). One implication of this study is that if secured lending contracts are legally enforceable, the adoption of them will increase bank credits as well as the quality of these credits. The remaining subsections will examine two cases concerning the use of secured lending, review statistical evidence in China on the increasing use of secured lending, and analyze our survey on the use of secured lending to show that secured debts will be much more widely used as the Chinese economy becomes more mature and more integrated with the world economy.

2.3.3.1 *Two Cases*

Hongye (Group) Co, Ltd (2002)

On 2 September 1998, Guohua Bank (Guohua), which was incorporated in Hong Kong and later reorganized into the Bank of China (HK) Ltd, issued to Dalifeng Group Ltd (Dalifeng) a letter, granting various types of credit. The total amount of credit reached HKD 342 million. These types of credit were subject to terms and conditions under the letter. In addition, Guohua took a mortgage, burdening an office property and a residential property provided by the borrower. Furthermore, Guohua requested the borrower to provide guarantee. For this purpose, several guarantors were used to guarantee the repayment liability of Dalifeng. Shen Shaoying, Fang Runping, and Lin Zhaoxu as a group assumed guarantee liability to the extent of

HKD 396 million. Hongye Ltd (Hongye) and Xinye Ltd (Xinye) each assumed guarantee liability for the repayment obligation of Dalifeng to the extent of HKD 313 million, respectively. Both Hongye and Xinye are incorporated in mainland China. Similar to the lending agreement, very formal and elaborate documents were prepared and used for the mortgage agreement and the guarantee agreement.

Jingguang Industrial Ltd (2007)

On 23 June 1995, Huashan Finance Ltd (Huashan), a company incorporated in Hong Kong, and New International Ltd (NIL), a company established in China, entered into a loan agreement whereby Huashan would extend to NIL a loan in the amount of HKD 619.2 million. This loan was to be used for the development of commercial and residential buildings in Guangzhou. The loan agreement contained very formal provisions, governing the conditions for using the loan, interest, repayment period, default, jurisdiction, and arbitration. As a security measure, Huashan took a mortgage from Jingguang Industrial Ltd (Jingguang), the parent company incorporated in Hong Kong with a holding of 100 % of the shares in NIL. The mortgage property included the land-use right concerning four parcels of land in Guangzhou. The original loan agreement described both Jingguang and NIL as borrowers, but NIL eventually was the only user of the loan. To rectify this problem, Jingguang and Huashan entered into an agreement, modifying the mortgage agreement to the effect that Jingguang provided the mortgage for NIL. Among other things, the mortgage agreement contained provisions related to ownership of the mortgagor, obligations for the registration of the mortgage, duty of insurance, proper law, and jurisdiction.

The above two cases involve the supply and provision of a significant amount of goods or a large amount of credit. In both cases, very formal contractual arrangements were used. With respect to the Hongye case, the provision of numerous types of credit was secured by a mortgage of real property and by three separate guarantees. The case reveals that people or companies in Hong Kong are more likely to use formal contractual means in their business transactions with people or company in the mainland China. This is likely to be true as people or firms in Hong Kong are more familiar with formal contractual methods than people or companies in mainland China because of the greater sophistication of their legal system compare with that of the emerging legal system in China. In the Jingguang case, the grant of the significant amount of credit was secured by a mortgage agreement, covering the land-use right of four parcels of land. It goes without saying that provided those contracts were enforced, the devices of mortgage and guarantee have significantly enhanced the probability of entering into the main credit agreement between banks and credit users. The fact that these contracts emerged demonstrates the confidence in the formal law enforcement regimes related to mortgages and other forms of secured lending in China. Assuming there are gains from the main lending agreement in terms of greater investment, the formal contractual arrangements of mortgage and guarantee do contribute to the net gains in these transactions.

Table 2.1 Mortgage of movable and immovable property

Year	Mortgage of movable property (contract numbers)	Mortgage of movable property (contract amount) [unit: 10,000 yuan]	Mortgage of immovable property (contract numbers)	Mortgage of immovable property (contract amount) [unit: 10,000 yuan]	Amount in the main contract secured by the mortgage of immovable property [unit: 10,000 yuan]
1997	92817	36,685,713	32105	7,484,213	N/A
1998	114609	40,903,577	40896	8,389,756	N/A
1999	117459	48,210,788	43680	9,271,251	5,757,650
2000	98762	44,129,477	33542	7,074,396	4,345,922
2001	91239	46,672,150	24501	5,275,039	3,223,664
2002	86161	49,811,313	25463	4,667,205	2,920,889
2003	86119	58,757,389	22196	3,896,255	2,376,149
2004	73997	69,958,379	16842	5,349,816	2,997,347
2005	69580	94,098,771	10891	5,735,390	3,549,290

Source: Various years from the *Administration Yearbook of China Administration for Industry and Commerce* (1998–2006)

2.3.3.2 Statistical Evidence

Table 2.1 provides some statistical evidence concerning the use of mortgage of movable property and immovable property in China from 1997 to 2005.

Table 2.1 shows the increasing use of movable property as collateral for the purpose of securing loans. Although the number of contracts has declined since 1999, the value of contracts for the mortgage of movable property has been increasing except for the minor decrease in the year 2000. Without adjusting for relevant macroeconomic conditions, it is more difficult to explain the mortgage of immovable property in secured lending. The number of contracts increased from 32,105 in 1997 to 43,680 in 1999. Since then, the number of mortgage contracts of immovable property has been declining. The value of mortgage contracts of immovable property increased from 74.8 billion yuan in 1997 to 92.7 billion yuan in 1999 and then decreased to 38.9 billion yuan in 2003. While the number of contracts continued to decline from 2003, the value of mortgage contracts of immovable property increased again from 38.9 billion yuan in 2003 to 57.3 billion yuan in 2005. An expert of financial law provides the following explanation.⁹ Since 1999, four asset management companies have been established to take over the bad loans of many state-owned banks. As many bad loans were sold at a discount to these asset management companies during that process, many mortgage contracts with

⁹Interview with Professor Qiang Li, Faculty of Law, Northwest University of Political Science and Law on 5 November 2007.

banks failed to get into the statistics (Interview with Qiang 2007). Overall, the value of mortgage of movable property and immovable property together has been large.

The statistical data in 2004 and 2005 also reveal that mortgage of movable property is much more widely used in loan transactions than in sales transactions (*Administration Yearbook of China Administration for Industry and Commerce* 2005: 639, 2006: 650). This information provides important evidence that banks do have comparative advantage in monitoring buyers and the assets of buyers than sellers. Hence, the claim that the use of bills of exchange serves efficient purpose as discussed in Sect. 2.3.1 is strongly supported by empirical evidence.

2.3.3.3 Questionnaire Survey

One bank at the national level and seven bank branches or regional banks in Xian responded to the author's questionnaire survey. When they were asked to explain the proportion of lending requiring security or guarantee, seven responded that 75–100 % of the loans were secured; only one response suggested that 50–75 % of the loans were secured. When they were requested to explain whether the use of security or guarantee will affect the provision of credit by banks, six responded that the use of security or guarantee will very significantly increase the probability of lending; two replied that the use of security or guarantee will significantly affect their lending decision. The questionnaire survey provides collaborative evidence that formal contractual arrangements of mortgage or guarantee have been widely used in business transactions in China. Without the device of secured debts, many bank loans probably would not have occurred. This is especially true during China's high rate of economic growth when firms have to supply goods to new trading partners. With respect to new trading partners, it is far more uncertain whether the suppliers will enter into contracts with these new trading partners in the future. It is equally true in cases where loans are used for infrastructure projects as it is not certain that borrowers will repeatedly undertake similar projects in the future and repeat transactions are likely.

The results of the questionnaire survey suggest the finding that secured lending is already an important part of overall lending by banks today. This is not surprising given the current economic development in China regarding economic actors. It is difficult for banks to establish the appropriate credit rating for borrowers and borrowing firms. Financial reporting procedures are not well established by firms. Most firms are brand new or relatively new firms. There is insufficient formal information about prospects of proposed investment projects. To protect themselves, banks demand collaterals, without which there would be no lending. However, the collaterals are of no value if the contracts governing them cannot be enforced. Thus, the increased use of secured lending, a more formal financial of contract, is to meet the demand for credit from borrowers without putting lenders at unacceptable risk. The development of secured lending in the last 30 years in China appears to be consistent with North's notion of adaptive efficiency.

2.4 Contract Law Enforcement and Economic Development

The Asian Development Bank commissioned a comparative study on the relationship between law and economic development in Asia during a 35-year period of dynamic economic growth from 1960 to 1995 (Pristor and Wellons 1999). One of the issues examined in the study was the role of dispute settlement institutions in resolving commercial disputes and facilitating contract enforcement. A major finding of their research on this issue was that “over the long term, rates for litigation concerning civil and commercial disputes increased in all economies.” The available empirical data to them on the sample economies show a positive and statistically significant correlation between per capita litigation rates and indicators for the division of labor.

The finding from the sample Asian countries appears to support North’s proposition that there is a positive link between formal contract dispute settlement and economic development. In this section, I will analyze the statistical evidence of the litigation rate in China from 1987 to 2005 to see whether evidence from China is consistent with North’s proposition.

Litigation most relevant to contracts and their enforcement includes civil disputes and economic disputes. Two types of litigation dominate civil disputes in China (*Law Yearbook of China* 1988–2006). They include marriage disputes and disputes related to obligations. With respect to economic disputes, domestic economic contract disputes significantly outnumber all other economic disputes. As economic contracts are separated from the category of obligations, it is most likely that obligations under the category of civil disputes mainly cover obligations arising from torts or unjustifiable enrichment. As such, statistical analysis of the litigation number of domestic economic contracts can roughly establish the correlation between the reliance upon formal contractual arrangements and economic development. Table 2.2 shows the relationship between the number of economic disputes accepted by courts of first instance and the GDP from 1987 to 2005.

Table 2.2, by and large, establishes a positive link between formal contract dispute settlement and economic development. While there is no obvious correlation between the rate of growth and contract disputes, the correlation coefficient between GDP and contract dispute is a positive 0.928. With some exceptions, the number of economic contract disputes increased from 332,496 in 1987 to 2,265,362 in 2005, having an annual growth rate of litigation around 30 %. During the same period, the average growth rate of GDP is around 9.6 %. The decrease of litigation from 1989 to 1991 may be explained by the Tiananmen Event occurred in 1989 when many Western countries imposed sanctions against China. As the growth rate of GDP declined from 1988 to 1991, litigation related to contracts also decreased. Similarly, when the growth rate of GDP fell from 1996 to 1998, litigation also decreased. This may be partly explained by the impact of the Asian financial crisis. What is more difficult to explain is the fall of litigation in 2000 when the GDP growth rate increased. The statistics in Chap. 2 may provide a possible explanation on the decrease of judges. Since 2002, the number of contract disputes has stabilized at the

Table 2.2 Relationship between the growth rate of GDP and the litigation rate of economic contract disputes

Year	Gross domestic products (GDP) (100 million yuan)	Growth rate of GDP	Numbers of economic contract disputes accepted by courts of first instance
1987	12,058.6	11.6	332,496
1988	15,042.8	11.3	467,872
1989	16,992.3	4.1	636,941
1990	18,667.8	3.8	543,613
1991	21,781.5	9.2	516,607
1992	26,923.5	14.2	598,610
1993	35,333.9	14	824,448
1994	48,197.9	13.1	971,432
1995	60,793.7	10.9	1,184,377
1996	71,176.6	10	1,404,921
1997	78,973.0	9.3	1,373,355
1998	84,402.3	7.8	1,329,020
1999	89,677.1	7.6	1,410,107
2000	99,214.6	8.4	1,184,613
2001	109,655.2	8.3	1,062,302
2002	120,332.7	9.1	2,266,695
2003	135,822.8	10	2,266,476
2004	159,878.3	10.1	2,247,841
2005	183,084.8	10.2	2,265,362

Sources: The data on GDP come from the *Statistical Yearbook of China* (2006) on page 57; the growth rate of GDP is from the same source on page 59; the numbers of economic disputes accepted by courts of first instance is derived from various years of the *Law Yearbook of China* 1988–2006

number of 2.26 million. Obviously, the correlation between the growth rate of GDP and the litigation rate is a very rough one. There are possibly some other variables, affecting formal contract dispute resolution. At least, a general observation can be drawn that formal contract enforcement becomes more widely used when China's economy grows further. This is true because more people rely on formal contractual arrangement when they enter into exchange relations with new partners or when people have to make investment with sunk costs. Without the protection of law, gains from trade or exchange have to be foregone. From this perspective, participants on the market and the Chinese legal system possess adaptive efficiency in solving bottleneck problems faced by the Chinese society in its transition from a planned economy towards a market economy.

Discussion of contract dispute settlement is not complete without a treatment of the role of courts. A finding of the study conducted by Simon Johnson et al. is that "firms' investment is affected by the perceived security of property rights' (Johnson et al. 2002b: 1354). The entrepreneurs who perceive their property rights to be the least secure reinvest much less. While they recognize that using courts to enforce

contracts is a distinct activity from protecting property rights, they consider that the effects of contract enforcement and property rights protection on investment are similar (Johnson et al. 2002b: 1339).

Naturally, inadequate contractual enforcement could put firms' profits at risk and make them reluctant to invest (Johnson et al. 2002b). From this perspective, contract enforcement is important in the sense of protecting the expectation of contractual parties. If contract enforcement is important, a great reliance upon the courts is an indication that contractual parties derive utility from using the court system for contractual dispute settlement. If that is true, the increasing numbers of litigation of contractual disputes in China are an indication of adaptive efficiency of the Chinese legal system in solving bottlenecks in economic development and facilitate the realization of gains from exchange.

Trebilcock and Leng (2006: 1563) observe that, similar to the use of courts in Russia, the use of courts in contractual dispute settlement in China is to signal that "managers are not in a conspiracy with defaulting debtors to expropriate state funds or assets." They, however, did not provide any empirical evidence to support their observation. As is pointed by Graham Mayeda (2006: 586), it is certainly true that a large proportion "of investment by non-resident Chinese indicates that foreign investors in China can take advantage of the familiarity of ethnically Chinese business-people with the informal norms of Chinese business." Noel Tracy and Constance Lever-Tracy (2002: 71–72) are of the view that "Chinese business tends to be conducted through a series of personalized networks based on friendship and trust, which are given substance by long-term relationships and reputation for trustworthiness and reliability, rather than in the open marketplace or in an institutional framework." While these authors are partly right in emphasizing informal networks for doing business in China, I am of the view that researchers emphasizing informal contractual arrangements may have understated the role of courts and more formal contracts in China.¹⁰ My view is partly supported by the large number of cases dealt with by courts in China. Statistics from a very conservative standpoint show that the number of civil and economic disputes from Hong Kong, Taiwan, and overseas Chinese is increasing every year. Table 2.3 provides the trend.

What is clear from Table 2.3 is that the number of civil and economic disputes involving both foreign traders and investors and overseas Chinese traders and investors accepted by courts of first instance has been increasing when China's foreign trade and foreign direct investment into China rise. The statistical data on China's foreign trade and foreign direct investment into China is contained in Table 2.4.

Tables 2.3 and 2.4 show a relatively close correlation between the increasing amount of foreign trade and investment and the increasing number of civil and

¹⁰The *Hongye* case and the *Jingguang* case discussed in subsection three of the previous part show that firms owned by Chinese outside mainland China are more likely to rely upon formal contractual mechanisms.

Table 2.3 The increasing number of contract disputes involving foreign firms and overseas Chinese

Year	Number of civil and economic disputes involving foreign traders and investors accepted by courts of first instance
1987	156
1988	200
1989	378
1990	533
1991	644
1992	712
1993	985
1994	2,815
1995	1,381
1996	1,530
1997	1,256
1998	2,276
1999	4,764
2000	4,878
2001	6,891
2002	17,838
2003	5,176
2004	17,066

Source: Various years of the *Law Yearbook of China* 1988–2006

economic disputes involving overseas Chinese traders and investors. The correlation coefficient between the number of disputes involving foreign parties and total import/export (FDI) is a positive 0.8257 (0.670). To be sure, the number of civil and economic disputes collected above may actually understate the true number because once an overseas Chinese or a company controlled by an overseas Chinese has incorporated a company in China, the said company becomes a Chinese legal entity. Any dispute between this company and any other company in China is considered as a domestic dispute even if the two companies are both foreign owned.

In discussing the dramatic increase in commercial litigation from 1980 to 2005, it is also necessary to pay attention to the chronic problem in China of nonenforcement of judgments. According to an estimate of the director of the judgment enforcement division of the Supreme People's Court, the average rate for enforcing civil and economic judgments in China is 60 % at the basic-level court, 50 % at the intermediate-level court, and 40 % at the higher-level court (Clarke et al. 2006: 42), suggesting that around half of Chinese court judgments exist only on paper. Despite the problem reflected by the statistics, it is not easy to come to any clear conclusion. First, Clarke (1996: 27–34) has doubted the usefulness of such statistics in passing any judgment. He has also pointed out that many studies do not have any scientific method in assessing the enforcement problem in China. Secondly, he has also cited the enforcement problem in the United States as a

Table 2.4 China's foreign trade and inflow foreign direct investment

Year	Total imports and exports (US\$ 100 million)	Total amount of foreign direct investment actually utilized (US\$ 100 million)
1987	3,084.2	23.14
1988	3,821.8	31.94
1989	4,155.9	33.92
1990	5,560.1	34.87
1991	7,225.8	43.66
1992	9,119.6	110.07
1993	11,271.0	275.15
1994	20,381.9	337.67
1995	23,499.9	375.21
1996	24,133.8	417.25
1997	26,967.2	452.57
1998	26,857.7	454.63
1999	29,896.3	403.19
2000	39,273.2	407.15
2001	42,183.6	468.78
2002	51,378.2	527.43
2003	70,483.5	535.05
2004	95,539.1	606.30

Source: *China Statistical Yearbook* (2000: 588, 604, 2005:626, 643)

reference point to question the relative level of severity of the enforcement problem in China (Clarke 1996: 33–34). According to Clarke (1996: 34), a 1993 study in the United States “found that in eleven New Jersey counties surveyed for the year 1987, only 25 % of writs of execution in civil cases (this category excludes small claims and landlord-tenant cases) were returned fully satisfied”; in small claims cases, the number was 37 %. This raises the question whether the data in China and in the United States can be meaningfully compared. While it is generally recognized that the enforcement of judgments is a serious problem (Clarke 1996; Trebilcock and Leng 2006: 1561), there has been no empirical study examining the consequences upon defaulting parties. Presumably, there will be some negative impact such as termination of business relations, loss of reputation in the region or specific industrial or commercial sector, etc. So far, there has been no evidence at all, suggesting that the relative growth rate of alternative dispute resolution including mediation or arbitration is greater than the relative growth rate of litigation.

I certainly would not argue that more disputes cause economic development just as Trebilcock and Leng (2006: 1569) do not. However, the view that it is the economic success that has fostered the development of law (but not the other way round) might have been too sweeping (Clarke et al. 2006). My view is that economic success and development of formal legal regimes may be part of an interactive and adaptive process in search of greater efficiency and economic

gains. It may be true that initially the development of formal law responds to the demands of economic development (e.g., the use of letter of credit). Once in place, formal legal regimes, if they promote further economic development, may induce further development of more formal legal regimes. The relationship between law and economic development moves in both directions in China as the economy experiments with and adapts to different contractual (and other) arrangements, formal and informal, to enhance efficiency by reducing risk and transaction costs. This process of experimentation and adaptation, made possible by the more open era brought about by the policy of economic reform, is consistent with North's notion of adaptive efficiency. My view that the development of formal law and law enforcement in China is one of experimentation and adaptation to meet the objectives of economic reform is also in agreement with Pitman Potter. In a recent article, Potter (2004: 468) suggests that "performance of the Chinese legal regime in areas of economic regulation and dispute resolution might be understood by reference to a dynamic of selective adaptation" as China's legal institutions function largely according to policy priorities imposed upon them by the party regime (Potter 2004: 472). Of course, the policy-motivated legal institutions beg the question of whether these institutions can truly be independent. Nonetheless, if viewed as a gradual process, formal law has indeed played an important role in Chinese economic development and will continue to do so (Peerenboom 2002: 463–464, 496–498). Empirical research in Russia and several Eastern European countries led Simon Johnson et al. to the conclusion that "a legal system that, while imperfect, has beneficial effects can be set up much more quickly" in contrast with the claim that an efficient legal system cannot be built in less than a generation (Johnson et al. 2002a: 261).

2.5 Conclusion

The existing literature on China's economic development focuses more on economic reform, decentralization, and the clarification and protection of property rights. There is inadequate attention being paid to the adaptive efficiency of economic actors in general and in experimenting with informal and formal contractual arrangements in particular. In this chapter, I have documented and analyzed the informal financial contracts developed in the region of Wenzhou and three formal contractual arrangements increasingly in wide use in China. Like many others (Lazzarini et al. 2004; Trebilcock and Leng 2006), I argue that both informal and formal contractual mechanisms play important roles in China's economic development. The general pattern appears to be that economic actors rely on self-enforcing informal contractual arrangements first and adopt more formal arrangements when these become feasible. By focusing my analysis on the development and adaptation of selected contractual arrangements, I submit that the process of legal development in China is consistent with the notion of adaptive efficiency (North 1990: 107). The implication from my study is that the development of a formal contract regime will

become more important as economic development reaches a more advanced stage. When economic actors are able to rely on more formal contractual arrangements, more complex, risky transactions with higher technological content will be pursued. After nearly 30 years of economic reform, the Chinese economy is at a stage where it seeks to transform itself from a labor- and resource-intensive, developing economy to a capital and technological-intensive, advanced economy. As a result, there will have to be a greater reliance on more formal regimes of law and law enforcement. As economic reform deepens, it can be predicted that adaptive efficiency in action in China will usher in more workable formal law and law enforcement regimes.

References

- Administration Yearbook of China Administration for Industry and Commerce*. (1998–2006). Beijing: Press of the Industry and Commerce.
- Anglo-South Am. Trust Co. v. Uhe*, 261 N.Y. 150, 156, 184 N. E. 741, 742–43 (1933).
- Certain Opinions Concerning the Handling of Lending Cases. (1990–1992). *Collection of the laws of the PRC*. Jilin: Jilin People's Press.
- Che, J., & Qian, Y. (1998). Insecure property rights and government ownership of firms. *Quarterly Journal*, 113, 467–496.
- China Financial Yearbook*. (2003). Beijing: China Financial Yearbook Press.
- China Financial Yearbook*. Online. <http://www.chinainfobank.cn>. Accessed 20 Aug 2007.
- China Overtakes US as World's Largest Trading Country. (2013). <http://rt.com/business/china-us-largest-trading-country-908>. Accessed 22 Nov 2013.
- Clarke, D. (1996). Power and politics in the Chinese court system: The enforcement of civil judgments. *Columbia Journal of Asian Law*, 10, 1–92.
- Clarke, D. C. (2003). Economic development and the rights hypothesis: The China problem. *American Journal of Comparative Law*, 51, 89–111.
- Clarke, D., et al. (2006). *The role of law in China's economic development* (George Washington University School of Law, Public Law & Legal Theory Working Paper No. 187). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=878672
- Current Status of and Management Strategy for Capital Circulated Outside the Formal Financial System. (2006). Report of the research team of urban financing at the China industrial and commercial bank. *Financial Forum*, 3, 3–10.
- Curtis v. Leavitt*, 15 N.Y. 9 (1857).
- Danchengru Sub-branch Case*. (2001). <http://www.chinainfobank>, Supreme People's Court file. Accessed 20 Aug 2007.
- Dixit, A. (2004). *Lawlessness and economics*. Princeton: Princeton University Press.
- Fei, X. (1987). The trip to Wenzhou. In Lin Bai et al. (Eds.), *A theoretical enquiry of the Wenzhou model* (pp. 45–62). Nanning: Guangxi People's Press.
- Feng, X. (2007). *Informal financial development report in rural China*. http://www.aordo.org/html/investor_attitude/2007-2/2/02145534.html. Accessed 20 Aug 2007.
- Fletcher v. Tayleur*, 17 CB 21 (1855).
- Gambetta, D. (1993). *The Sicilian mafia*. Cambridge: Harvard University Press.
- General Principles of the Civil Law. (1986). *Collection of the laws of the PRC*. 1980–1989. Jilin: Jilin People's Press.
- Ginsburg, T. (2000). Does law matter for economic development? Evidence from East Asia. *Law and Society Review*, 34, 829–856.

- Greif, A., & Kandel, E. (1995). Contract enforcement institutions: Historical perspective and current status in Russia. In E. P. Lazear (Ed.), *Economic transition in Eastern Europe and Russia: Realities of reform* (pp. 291–321). Stanford: Hoover Institution Press.
- Haselmann, R., et al. (2006). *How law affects lending?* (Columbia Law and Economics Working Paper No. 285). <http://ssrn.com/abstract=846665>
- Hongye (Group) Co, Ltd. (2002). <http://www.lawinfochina.com>. Accessed 18 Sept 2007.
- Imports and Exports in Inner Mongolia in 2003 Continued to Grow and Grew at a Faster Rate. (2004). <http://www.bailingnews.com>. Accessed 18 Sept 2007.
- Jingguang Industrial Ltd. (2007). <http://www.lawinfochina.com>. Accessed 18 Sept 2007.
- Johnson, S., et al. (2002a). Courts and relational contracts. *Journal of Law, Economics, and Organization*, 18, 221–277.
- Johnson, S., et al. (2002b). Property rights and finance. *American Economic Review*, 92, 1335–1356.
- Judicial Interpretation of Finance. (2006). Edited by the selection team of the Supreme People's Court. Beijing: People's Court Press.
- Law Yearbook of China*. (1988–2006). Beijing: Press of Law Yearbook.
- Lazzarini, S. G., et al. (2004). Order with some law: Complementarity versus substitution of formal and informal arrangements. *Journal of Law, Economics and Organization*, 20, 230–261.
- Li, H. (1996). *The new rise of Wenzhou*. Shanghai: Shanghai Social Sciences Press.
- Lijin Sub-branch Case. (2000). Supreme People's Court Gazette.
- Lin, R. (1987). Five trends. In Lin Bai et al. (Eds.), *A theoretical enquiry of the Wenzhou model* (pp. 126–130). Nanning: Guangxi People's Press.
- Lin, J. Y., & Liu, Z. (2000). Fiscal decentralization and economic growth in China. *Economic Development and Cultural Change*, 49, 1–21.
- Liu Xin-wen. (1997). *The negotiable instruments law*. Beijing: China University of Politics and Law.
- Long, Y. (2007). *The mergers and acquisition of Chinese firms by foreign investors do not cause serious economic security problems*. <http://www.people.com.cn>. Accessed 20 Jan 2007.
- Maggs, G. (1998). The holder in due course doctrine as a default rule. *Georgia Law Review*, 32, 783–824.
- Mayeda, G. (2006). Appreciate the difference: The role of different domestic norms in law and development reform; lessons from China and Japan. *McGill Law Journal*, 51, 547–598.
- McMillan, J., & Woodruff, C. (2000). Private order under dysfunctional public order. *Michigan Law Review*, 98, 2421–2458.
- Measures of the State Council on the Abolishment of Illegal Financial Institutions and Illegal Financial Operation. (1998). The Measures appear in the *Collection of the Laws of the PRC*. Jilin: Jilin People's Press.
- Milhaupt, C. J., & West, M. (2000). The dark side of private ordering: An institutional and empirical analysis of organized crime. *University of Chicago Law Review*, 67, 41–98.
- Negotiable Instruments Law. (1995). This Law was adopted at the Thirteenth Session of the Eighth Standing Committee of the National People's Congress on 5 October 1995. The official Chinese version appears in the *Collection of the Law of the PRC*. Jilin: Jilin People's Press.
- North, D. (1990). *Institutions, institutional change and economic performance*. New York: Cambridge University Press.
- Notice of the People's Bank of China on the Adjustment of Deposit and Lending Interest Rate of Financial Institutions. (2004). <http://www.chinainfobank>, Legal database. Accessed 12 Aug 2007.
- Nyquist, C. (1995). A spectrum theory of negotiability. *Marquette Law Review*, 78, 897–971.
- Peerenboom, R. (2002). *China's long march toward rule of law*. Cambridge: Cambridge University Press.
- Pistor, K., & Wellons, P. A. (1999). *The role of law and legal institutions in Asian economic development, 1960–1995*. New York: Oxford University Press.
- Potter, P. B. (2004). Legal reform in China: Institutions, culture, and selective adaptation. *Law and Social Inquiry*, 29, 465–495.

- Provisional Measures on the Credit Fund Administration by Rural Credit Cooperatives. (1949–1989). The Measures appear in the *Collection of the Laws of the PRC*. Jilin: Jilin People's Press.
- Provisions on Several Issues Concerning the Trial of Letter of Credit Disputes. (2005). (2006, September). *China Law and Practice*.
- Qiang, L. (1997). *Financial law*. Beijing: Law Press.
- Resolution by the Board of Directors of the Shanghai Vacuum Electronic Components Ltd. Authorizing the Distributing Shares to the Public. (1993). *Collection of the laws and regulations on securities and share systems in China*. Beijing: Law Press.
- Rogers, J. (1990). The myth of negotiability. *Boston College Law Review*, 31, 265–334.
- Schwartz, A., & Scott, R. (2003). Contract theory and the limits of contract law. *Yale Law Journal*, 113, 541–619.
- Sinclair, M. (1990). Codification of negotiable instruments law: A tale of reiterated anachronism. *University Toledo Law Review*, 21, 625–684.
- Sommers, A., & Philips, K. (1998). The PRC's negotiable instruments law: An instrument for facilitating private economic activity or monetary control? *Houston Journal of International Law*, 20, 317–351.
- Statistical Yearbook of China*. (1981). Hong Kong: Hong Kong Economic Daily Press.
- Statistical Yearbook of China*. (1990). Beijing: China Statistics Press.
- Statistical Yearbook of China*. (2000). Beijing: China Statistics Press.
- Statistical Yearbook of China*. (2006). Beijing: China Statistics Press.
- Telser, L. (1980). A theory of self-enforcing agreements. *Journal of Business*, 53, 27–44.
- Tracy, N., & Lever-Tracy, C. (2002). A new alliance for profit: China's local industries and the Chinese Diaspora. In T. Menkhoff & S. Gerke (Eds.), *Chinese entrepreneurship and Asian business networks* (pp. 184–216). London: Routledge Curzen.
- Trebilcock, M., & Leng, J. (2006). The role of formal contract law and enforcement in economic development. *Virginia Law Review*, 92, 1517–1580.
- Uniform Customs and Practice for Documentary Credits (UCP 600). (2006). The text is available at <http://letterofcreditforum.com/node/3/print>.
- Wang, G. (1999). Reforming informal financing to promote economic growth. In Zhang Shuguang (Ed.), *Case studies of China's institutional change* (pp. 459–461). Beijing: The Finance and Economic Press of China.
- Williams, M. (2004). Documentary credits and fraud: English and Chinese law compared. *Journal of Business Law*, 155–170.
- Williamson, O. (1985). *The economic institutions of capitalism*. New York: The Free Press.
- Williamson, O. (1996). *The mechanisms of governance*. New York: Oxford University Press.
- Ye, J., et al. (2004). Farmers' financial demand and rural financial supply: A sociology perspective. *Rural Economy in China*, 8, 31–37.
- Zhang, R. (1987). Three principles. In Lin Bai (Ed.), *A theoretical enquiry of the Wenzhou model*. Nanning: Guangxi People's Press.
- Zhang, J. (1999). The informal financial institutions in a post reform rural area: The case of Wenzhou. In Zhang Shuguang (Ed.), *Case studies of China's institutional change* (pp. 432–459). Beijing: The Finance and Economics Press of China.
- Zhang, X. (2007). Asymmetric property rights in China's economic growth. *William Mitchell Law Review*, 33, 567–589.
- Zhang, R., & Li, H. (1990). *A study of the Wenzhou model*. Beijing: China Social Sciences Publishing House.

The Roles of Law and Politics in China's Development

Yu, G.

2014, XIII, 212 p., Hardcover

ISBN: 978-981-287-001-8