

CAPITAL FREEDOM IN CHINA AS VIEWED FROM THE EVOLUTION OF THE STOCK MARKET

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Since reforms started in 1978, China has made commendable progress in achieving capital freedom and individual liberty. Prior to 1978, private enterprises with more than eight employees were prohibited and there were no capital markets. Private entrepreneurs were labeled “capitalist tails,” and political movements were launched frequently to “cut the capitalist tails.” For several decades, Chinese citizens could only obtain employment and economic means from government organizations and state-owned enterprises, which strictly limited individual liberty. Today there are more than 10 million privately owned enterprises, making up more than 80 percent of each year’s employment growth. As a result of less regulation and more room for entrepreneurship, it is relatively easy to register and start a business. Public equity offering opportunities and bank financing are also increasingly available to private firms as well. Chinese, young and old, can choose among jobs provided by government organizations, SOEs, private businesses, and foreign-owned firms. As capital freedom has increased, the rise of the individual and liberty is one of the highlights achieved in China’s development over the past 35 years.

There are, however, many challenges ahead to further increases in capital freedom in China. These challenges are inevitably due to

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China's gradualist reform approach in which pragmatic economic reforms have been allowed and adopted without correcting the philosophical foundation of the country's political, economic, and legal system. SOEs, government, and Marxist ideology still dominate the economy, politics, and business—although market forces and private ownership are a significant part of the Chinese society and still on the rise. In particular, political power is not formally checked or balanced and neither is the monopoly position of SOEs, which has allowed government agencies and SOEs to reenergize and expand their power to cut into capital freedom as they desire. There has not been a formal debate or reform to define and limit the scope of government. Taxation has been increasing at more than twice the speed of GDP growth. Thus, unless and until political reforms take place and functioning check-and-balance institutions are put in place formally, SOEs and government power present immediate threats to the precious but still limited degree of capital freedom and individual liberty in China.

In this article, I use China's capital markets, more specifically its stock market, to illustrate why the lack of a formal rejection of Marxist economics, as well as the lack of political reforms, has internalized forces and contradictions in the Chinese society that have the potential to reverse the many positive achievements of the last 35 years. At a minimum, such forces will continue to make it difficult for the rule of law and for justice and equity to progress further.

Today China has a sizable capital market, with more than 2,400 listed companies on the two stock exchanges with a total market capitalization of more than RMB 21 trillion (almost 50 percent of China's GDP).¹ More than 300 securities and trust companies are licensed to provide investment banking and stock brokerage services through more than 2,500 branch offices in cities large and small. This extensive network of brokers has attracted more than 200 million stock and mutual fund accounts. China today has among the most robust securities market infrastructures in the world, when measured in terms of both trading capacity afforded by the electronic systems and potential investor reach facilitated by the vast physical distribution channels. The physical infrastructure and distribution

¹The statistics cited are all as of mid-year 2012 and come from the Chinese Securities Regulatory Commission (www.csrc.gov.cn).

network present the Chinese economy with a potentially great financing capacity.

The gap between stock market potential and reality is, however, still quite wide. While China's physical infrastructure for capital markets is impressive by many measures, the institutional infrastructure necessary for investors to be willing to part with their money is largely missing or not functioning in its intended way. As a result, recent efforts by the government to push up stock prices have led to continuous disappointment. Investors are not rushing back to buy stocks, and the stock market is not showing enthusiasm.

China's stock market development started during the 1860s, was interrupted several times by wars and ideology, and reemerged in the late 1980s. In this article, I compare the stock market under the current regime with its past under the Qing dynasty and during the Republican years before 1949. Discussion centers around several key questions: (1) In the absence of necessary impersonal legal and regulatory institutions, what arrangements did China come up with to induce public investors to join stock trading? (2) What was done to overcome the confidence and trust barriers? (3) With the government being the largest shareholder in most publicly listed companies today, how does that impede legal development and limit capital freedom? Answering these questions will help us understand the cultural roots of the Chinese government's large role in the economy, in addition to the Marxist political economy roots. What we will see is a constant struggle between the traditional Chinese preferences for informal or relationship-based rules of business transactions and the stock market's dependence on formal structures of contracting and governance. That struggle in the capital market mirrors closely the struggle by the larger Chinese society with the process of modernization.

The Origin of China's Stock Market: 1860s to 1911

China is known to have invented paper money during the Song dynasty, 960–1279 (see von Glahn 2005). However, China did not venture into innovations in securities trading until the late 19th century. The move to adopt joint-stock companies with limited liability and initiate a stock market was largely a consequence of the "Self-Strengthening Movement" following the defeat to Britain and France in the Opium Wars (1839–42 and 1858–60). The wars revealed that China was far behind in military technology and that in

order to win over the West and regain national pride, China must catch up with Western military and industrial technologies (Feuerwerker 1958). However, adopting such technologies and developing the necessary manufacturing infrastructure required large sums of capital. Yet, at the time, the Qing government was financially constrained. The state would not have the needed resources to take on the projects directly. The financing challenge was therefore daunting.

As one of the leading voices at the time, Xue Fucheng (1838–94) commented,

The essence of the joint-stock corporation is to make a nation rich and powerful. . . . If a country does not pursue joint-stock companies, its industry cannot prosper nor can its commerce. . . . Where foreign firms are present, there are corporations raising capital from hundreds or even thousands of shareholders. Backed by plenty of financial resources, no wonder they are so powerful and hard to compete with. . . . This is truly an unprecedented historical change in business [Li 2002: 271].

In 1868, Yung Wing, the first Chinese student to graduate from an American university (Yale, 1854) proposed to Zeng Guofan, the governor-general of Liangjiang, to adopt the joint-stock corporate form and start a Chinese-owned navigation company. That idea was well received by the Qing mandarins. China was thus on its way to experiment with the modern corporation and make its shares tradable. But how could this be done?

The modern corporation has three defining characters. First, it is a legal person, with the same ability to do business and engage in contracting as a real person. Second, it can issue tradable shares to any number of investors. Third, the investors face limited liability (i.e., they could lose no more than their initial investment). At the heart of the modern corporation is the separation between ownership and control. Thousands of outside investors (owners) entrust their capital with the management who has actual and full control over the use of shareholder assets. To provide outside shareholders with the needed confidence, this separation has to be supported by a corresponding set of legal institutions, including investor-friendly substantive laws, an independent judiciary, and a reliable enforcement infrastructure (Black 2001, Coffee 2001). In addition, as what is exchanged between

the outside shareholders and the corporation is a financial contract (instead of tangible physical goods), there need to be informational institutions, such as a free press and other mass media, to facilitate the uninhibited and fast flow of information. Substantial and truthful information about the stock-issuing corporation is essential for the accurate pricing of its shares and for the keeping of investors' trust.

Business organizations and economic transactions in China had relied on personal relationships for centuries. Relationships served as a signaling and commitment framework, or as informal bedrocks for trust and a basis for enforcement of contracts (implicit or explicit). Partnerships of unlimited liability were the typical form of joint ownership, with partners from a single family, a lineage, a small number of lineages, or the same locality, usually not going beyond township boundaries. Before the railroad network was built in the late 19th century and afterwards, the lack of mass transportation means prevented for centuries the inland local economies from expanding across regions, generating no pressure for business organizational changes. Capital was free but constrained to one's locality or circles of friends and kinship networks. The waterways in southeast China and along the coast could have pressured the unlimited-liability partnership structure and called for more impersonal forms of business organization. However, the emperors' orders forbidding overseas trading since the 13th century and the general anti-commercial Chinese culture stifled the possibility of inter-regional market expansion afforded by the waterways, which served to limit the development of formal institutions that are necessary for capital to be impersonal.

According to Jensen and Meckling (1976) and Easterbrook and Fischel (1989), the modern corporation is simply a "nexus of contracts" or a legal creation. For this "nexus of contracts" to work, there have to be supportive laws and impartial enforcement institutions with enough force. But, as of the late 19th century, China did not have the necessary legal or informational institutions for arm's-length or impersonal financial contracting, let alone an institutional infrastructure for public trading in financial contracts. In China's tradition, the legal system is never separated from, or independent of, the administrative system. In addition, China's tradition put its emphasis on administrative and criminal sanctions, with a lack of formal development in contract, civil liability and procedural laws. Rules and practices did not develop to enforce impersonal contracts or

commercial transactions, or to protect property rights, across regions and beyond local circles. This is in sharp contrast with the Roman law tradition, from which Western laws are derived, and has restrained capital freedom in China.

A related barrier to China's adoption of the modern corporation was its traditional practice of unlimited liability. Chinese literature classics are often full of stories in which children were held responsible for their parents' or even grandparents' unpaid debt, stories of debt being passed down generation after generation. This culture of unlimited liability is even dominant in today's Chinese society. But limited liability is a fundamental character of the modern corporation, without which passive outside shareholders would not be willing to part with the control of their assets and without which the inside managers would not want to engage in the control because they would not be willing to risk the future of their children and children's children. That is why a sage of the Progressive Era, Nicholas Murray Butler, proclaimed that "the limited liability corporation is the greatest single discovery of modern times" (Micklethwait and Wooldridge 2003: xxi). Therefore, the modern corporation would imply a direct clash with one of the defining features of the Chinese tradition.

Developing the necessary legal and informational institutions would by no means be a short-term task, even if the elite at the time had known how to do it. Given the urgency of China's modernization movement, the state had to come in and sponsor the new enterprises. In the absence of a corporate law and a bankruptcy law, the government's sponsorship had to include implicit guarantees, limiting the liabilities for outside shareholders and for the corporation. This also marked the beginning of the state's role in corporate management and direct corporate ownership in modern Chinese history. Of course, other factors were important as well in the government's decision to become involved in the early experiment with joint-stock companies, including its traditional distrust in private merchants' motives (so the government had to be in, lest the businessmen would exploit the public). Also, the reformer officials were personally interested in ensuring the experiment's success by providing the new enterprises with privileged trade monopolies.

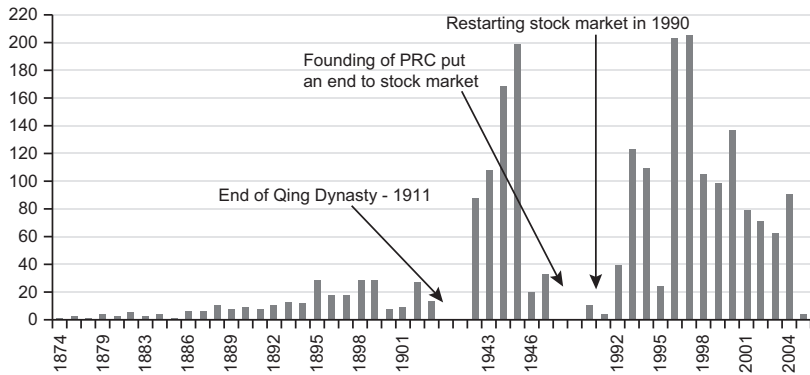
The first modern corporation—China Merchants' Steam Navigation Company (CMC)—was founded in 1872 by Li Hongzhang in his official capacity as the governor-general of Zhili province and a

key reformer official in the Qing court. In October 1872, Li appropriated 135,000 taels of Zhili military funds as a government loan to CMC. Despite the government's assurance that outside shareholders would receive a 10 percent government-guaranteed dividend yield, private merchants pledged share capital of more than 100,000 taels but actually paid up only 10,000 in cash. Between 1873 and 1883, the government provided annual loan amounts between 80,000 and 1,000,000 taels to CMC (Lai 1991). The total of these government loans was 2.2 times the maximum paid-up share capital during this period.

Overall, the first decade after the founding of CMC brought 15 joint-stock companies to the market (see Figure 1 for the evolution of new joint-stock companies), from mining, manufacturing, and transportation industries. Their shares were traded on the streets and in the teahouses in Shanghai.

By the end of the Qing dynasty in 1911, China had had more than 40 years of experimentation with joint-stock corporations and a stock market. More than 480 stocks had been issued for public trading, with many more businesses indirectly benefiting from the stock market. These modern corporations represented a cross section of industries from manufacturing, electrical power, mining, textile, railway, and steamship transportation to banking and

FIGURE 1
NUMBER OF NEW CHINESE STOCKS ISSUED
FROM 1873 TO THE PRESENT



SOURCES: Goetzmann, Ukhov, and Zhu (2001) for the late Qing; Zhu (2005) for the late 1940s; and CRSC website for post-1990.

financial services. This period of trial and error made the country's elite recognize the necessity for a government structure that separates officialdom from the judiciary and business. In the words of another scholar-official and governor-general of Liangjiang, Zhen Guanyin, "The essence of corporate and commercial laws is to protect business and commerce from the threat of political power" (Li 2002: 100). At the beginning of the 20th century, China started to accept the notion of government powers checked and balanced by a constitutional structure.

Stock Market Development in the 20th Century

The founding of the Republic of China in 1911 led to the adoption of a government structure based on the principle of checks and balances among functional branches and with independent institutions such as the executive (*Xin Zhen Yuan*), the legislative (*Li Fa Yuan*), and the judiciary (*Fa Yuan*). It marked a new beginning in China's process toward a modern institutional structure that is friendly to capital market development.

Indeed, the 1912–28 period was a golden age for China's securities market development. According to an estimate by Xu and Chen (1995), during this period, more than 1,984 modern industrial and mining enterprises were established each with a capital base of more than 10,000 yuan, with a total investment of 45.89 million yuan; 311 modern joint-stock banks were founded, with a total share capital of 119.43 million yuan. These developments lifted China's industrial structure to a new level in terms of both scale and scope. Free enterprise under self-regulating professional organizations was the dominating theme of business practice. Professional organizations, such as the Shanghai Native Bankers Association, the Shanghai Securities Broker/Dealers Association, and various other industry associations, and government institutions provided reasonably secure contract enforcement, market conduct, and property rights. As a result, a sizable network of financial intermediation emerged with fund-raising capabilities extending beyond geographical boundaries.

The 1930s was marked by bond trading. Then, in 1937 the Japanese occupation troops marched south from Manchuria and China was forced into the eight-year anti-Japanese war (1937–45). Trading in Chinese stocks was soon halted by the government. Between 1937 and 1940, stock trading was confined to the foreign

settlement areas in Shanghai and only foreign-registered company stocks were traded. Trading in Chinese domestic stocks resumed in 1940. Figure 1 shows that the year-by-year numbers of new stocks issued were quite high during the post-1940 period. The prewar Shanghai Chinese Stock Exchange was reopened for trading in September 1943.

After the Japanese troops withdrew from China at the end of World War II, the Shanghai Chinese Stock Exchange was closed again in August 1945 and then reopened in September 1946, this time with just 20 stocks listed. The exchange introduced stock futures and allowed arbitrage trading by the end of 1946. The good time however did not last long, as the stock exchanges in Shanghai and Tianjin were once more halted by the Republican government in August 1948. This time the reason was to give the government enough time to reform its monetary system. After that, the Tianjin Stock Exchange was never reopened as the communist troops moved into the city in January 1949. The Shanghai Chinese Stock Exchange resumed operation in March 1949 but was closed in May when the communist troops marched into Shanghai.

The post-1927 Republican years were therefore punctuated with wars and political-financial crises. As a result, the Chinese stock market went through rounds of stop-and-go cycles, making it difficult to develop any sustainable equity culture or a functioning institutional infrastructure that was stable enough for reliable shareholder protection.

The People's Republic of China was founded on October 1, 1949. A new economic philosophy of public ownership was to replace centuries-old private ownership. Initially, the PRC reestablished a Tianjin Stock Exchange in 1949 and a Beijing Stock Exchange in 1950, with ten and six stocks traded, respectively. But it was soon concluded that the market was too speculative, something that diametrically contradicted Marxist economic principles. Both stock exchanges were shut down in 1952, and the expropriation of private properties entered its high tide thereafter. By 1958, China was under state ownership, with the private sector making up less than 3 percent of national output.

Economic reform started in 1978, soon after the end of the disastrous Cultural Revolution (1966–76). However, until the mid-1980s the focus of the reform efforts was on the agricultural sector, allowing peasant families to each have a plot of land to grow grain and

retain whatever profits they were able to generate after sending to the government the required production quota. As a result, there was a large increase in income and living standards among peasants.

The success in agriculture then started to affect the debate on how to reform the industrial sector where state ownership dominated. The first industrial-reform experiment in the mid-1980s was to apply the individual-responsibility model of farming to SOEs. However, this responsibility model did not work out because it promoted mostly short-term behavior by management. It was then realized that without clearly defined private ownership, there would not be an incentive structure to induce managers to take a long-term view.

In the late 1980s, joint-stock corporations with limited liability became the new experiment, with some SOEs converted into joint-share corporations. These shares were traded on unofficial street markets in Shanghai and elsewhere, much like in the late Qing years. More formally, the new Shanghai Stock Exchange emerged in December 1990, followed by the Shenzhen Stock Exchange two months later. The ownership structure for a typical public company was broken into several share classes: state shares, legal-person shares (owned by legal-person corporations), and floating common shares (A-shares for domestic citizens and B-shares for foreign investors). In particular, prior to 2006, the state shares and legal-person shares were not publicly tradable.² Regardless of share type, the holder of a share is entitled to the same cash flow and voting rights. Until recently, a typical public corporation had about one third of its shares in each ownership category.³

Political and Legal Background in the Recent Experience

Having reviewed China's stock market history, we now seek to understand its political and institutional context from which the stock

²A reform policy started in 2005 allowing the listed companies to convert their state and legal-person shares into tradable ones (hence, identical to A-shares). By 2010, the conversion reform was completed for all public companies.

³See Chen and Xiong (2001) for a study on the underpricing structure of legal-person shares. Because these shares are not tradable, they are priced at an average discount of 86 percent to the otherwise identical floating common A-shares. This pricing and liquidity distortion is also a source for corporate governance problems.

market reemerged in the late 1980s. Such an analysis allows us to see whether 150 years later China has finally gotten the stock market right and allowed capital to be really free. Recall that when the Qing reformers started experimenting with joint-stock companies, they began with an economy in which business enterprises were almost all privately owned. During the late Qing, the state's sponsorship was to promote new industries that might otherwise be difficult to launch because of the lack of trust-enhancing legal institutions.

In contrast, when stock trading and joint-stock corporations reemerged in the late 1980s, almost all enterprises converted into this corporate form were SOEs. The reemergence was because the SOEs had accumulated large financial losses and not because China abandoned the anti-capitalist political economy of Karl Marx. The government's intention was not to privatize the SOEs, but to solve the SOEs' financial problems through raising funds from, and selling equity shares to, the public. Neither was it meant to offer the general public a way to participate in wealth creation, diversify investment portfolios, or hedge future consumption/income risks.⁴ The PRC was effectively the stock issuer and controlling shareholder. Shareholder rights were more of an afterthought, which was not a concern until several years after stock trading was widespread.

As an example to illustrate the inherent conflict of interest between the state's regulatory/law enforcement roles and its shareholder role, note that from 1990 to 2000, the government practiced an IPO quota system for each year, so as to make the IPO flow low enough to keep the IPO price high, setting a perfect environment for more SOEs to issue shares. To achieve this, the government has also needed to maintain a positive and encouraging market through policy announcements and newspaper editorials. The fact that the stock market was designed to promote the state's interest in the SOEs means that the regulator's and even the court's roles are to maintain a high stock price level, instead of ensuring a level playing field for every market participant. In China, neither the court nor the regulators are independent from the government or Chinese Communist Party. Thus, market regulation is equated with the management of the stock market index.

⁴Walter and Howie (2003) argue extensively that the Chinese government's determined interest has really been, and will continue to be, to use the equity capital markets as a tool of enterprise reform, while other byproducts of the capital markets have been more of a side purpose.

Note that when the late Qing began its stock market experiment in the 1870s, there was no institutional structure that separated the judiciary from the executive branch and from the legislative branch (judicial independence and regulatory independence would have been foreign concepts back then). Against that background, the Qing government almost had to come in to provide implicit guarantees to the investing public, but the Qing state in most cases did not have a direct equity stake in the new enterprises. In contrast, by the late 1980s China appeared to have in place all the modern political institutions, from the legislative (the National People's Congress) to the executive branch (the State Council), to the judiciary (the People's Court system), to the newly adopted Constitution of the PRC. Thus, one would expect the PRC to be much more ready to develop the modern corporation and a stock market in the 1980s. But, as discussed above, the state's stock-issuer role has greatly compromised the functioning of the PRC institutional structure for contract enforcement and shareholder rights protection.

The political philosophy and government structure of the PRC have impaired market development and capital freedom in other ways. Back in the late 1980s, preparation was under way to reintroduce an official stock exchange. But, while stock trading was already taking place on the streets, private ownership and privatization was still politically taboo. Against that background, the reformers had to settle for a political compromise—that is, each publicly traded corporation would have several classes of shares: state shares, legal-person shares, and floating common shares (A- and B-shares). Not making the state and legal-person shares publicly tradable served two purposes: (1) to prevent the loss of state ownership and (2) to ensure that investors in such shares would not engage in speculation (something the communist ideology is totally against). Given that most legal-persons are state-owned or state-controlled, about two thirds of most corporations' shares are owned by the state, directly or indirectly. This ownership structure has not only misaligned the interest of different shareholder types (e.g., holders of floating shares can benefit from stock price gains whereas holders of nontradable shares cannot), but also made it difficult for private securities litigation to proceed independently, because granting damage awards in private litigation would amount to the loss of state assets (to the extent that the state owns a majority of the shares outstanding), which puts the court in a conflicted situation.

Another ideological obstacle to corporate governance in the PRC is the traditional communist values that only income through labor is rightly acceptable. Though stock trading appeared in the 1980s, this official line on justifiable income remained in the CCP charter until November 2002, when the 16th Party Congress changed the charter to formally acknowledge that acceptable income can be earned through both labor and capital (i.e., monetary capital, intellectual capital, and managerial capital). Therefore, until late 2002, CCP members were not supposed to buy or trade stocks. This ideology is of course contrary to the notion of shareholder rights and the protection thereof, which has been partly responsible for the slow implementation of the PRC Securities Law and the Company Law. It has been detrimental to the growth of confidence in the stock market.

Future Prospects

China has not officially announced any plan to privatize land or the remaining SOEs. According to my estimate using official data, the government still owns about two-thirds of all productive assets in China. It is unlikely that the new leadership will undertake privatization and adopt a free-market private-ownership economic philosophy. Neither will the new leadership likely conduct fundamental political reforms to hold in check the ever expanding government power both in economic regulation and control and in taxation. The scope of government is more likely to broaden than not. Against this trend, capital freedom is expected to retreat in China.

Based on World Bank data for about 60 countries, I find countries with higher SOE investment (relative to total investment) between 1978 and 1991 to have less capital freedom, a lower rule-of-law rating, lower private credit as a percentage of GDP, and tighter regulations on business in general and on banks in particular. These findings are understandable because the state is totally conflicted when it wears too many hats—namely, the only or largest shareholder in business, the rule/law maker, the law enforcer, the judiciary, and the market/business regulator. With all these roles and interests, it is impossible for the judiciary, the regulators, and the law enforcer to be independent and impartial. For example, since the state is the largest shareholder in most public corporations in China, it is hard for the judges and the securities regulator to be impartial in adjudication and regulations (Chen 2003). As a result, legal and

regulatory rules apply unequally, depending on whether a party is an SOE, a private business, a private person, or a powerful individual. When the state is not just a referee but also a dominating stakeholder in business, capital cannot be free, and the resulting playing field in industry will be arbitrary.

Therefore, privatizing the remaining state-owned assets and collectively owned land is a first necessary step to allow for judicial and regulatory independence and hence for capital freedom in China. Reforming political institutions to have functioning checks and balance on government power is another necessary step. Otherwise, before we know it, capital freedom and individual liberty will experience a setback.

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