The Formation of Hainan Airlines: The Inside Story of How the Pre-body of HNA Group Came to Be.

by

Simon David Page & Jane Li *

January 16th, 2018   V1.1

This report attempts to describe in as much detail as possible the key people involved in - and the events leading up to - the formation of Hainan Provincial Airlines in the late eighties and early nineties.

It sheds light on how the chairman of HNA Group, Chen Feng, came to be in Hainan and shows that, far from being the visionary entrepreneur he portrays himself as, Chen rode on the coattails of others who were pursuing a World Bank loan project that was originally offered to Wang Qishan.

The report is the result of fieldwork conducted in 2016 and 2017 and is primarily based upon interviews that the contributing researcher held with individuals in Beijing and Hainan who were close to the matters described. The researcher was also granted access to previously unreleased correspondence material between key individuals during the time of these events.

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Jane Li is a Senior Research Analyst at the World Civilization Forum.
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Key findings

• In 1989, Wang Qishan was invited to join a Beijing-approved project to raise a 1 billion dollar loan from the World Bank. He would decline and remain in Beijing.
• A princeling named Chen Dongping took up the opportunity instead and got agreement from the Hainan provincial government to set up the project there.
• A group of six, including Chen Feng, transferred to Hainan in 1990 to work for a Hainan SOE called China Xingnan Group which would act on behalf of the Hainan government’s World Bank Loan Administration Office.
• China Xingnan Group also pursued other opportunities, including a questionable bid to run Hainan Provincial Airlines which formed in 1991.
• Chen Feng was made the general manager of Hainan Airlines by China Xingnan Group head Wang Gang. The state-owned airline corporatized in 1993.

Key individuals

1. Wang Qishan 王岐山: Chief Executive, China Agricultural Development Trust & Investment Co. (CADTIC).
2. Chen Dongping 陈东平: CADTIC employee; a princeling.
3. Qin Gang 秦钢: General Manager, Hainan Construction Co.; a princeling.
5. Liu Jianfeng 刘剑锋: Governor, Hainan Province.
7. Wu Peilan 吴佩兰: Vice-director, Beijing Civil Aviation Department.
8. Chen Feng 陈峰: General Manager, Hainan Provincial Airlines.
Figure 1 – Correspondence to key individuals. From top: Xinhua News Agency; Research Division of the Office of the State Council; Hainan World Bank Loan Administration Office; Hainan Party Personnel Department.
A CHINESE PROVINCE AS A REFORM EXPERIMENT:  
THE CASE OF HAINAN

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This report is based on a mission to China in November 1990 by Paul Cadario (Principal Country Officer, Task Manager, EA2CO), Kazuko Ogawa (EA2CO) and Yin-Kann Wen (EDIE), Economists. The mission's work was greatly helped by a Chinese counterpart team led by Wang Gang, Assistant to the Governor for Financial Affairs, Hainan Province. It included Chen Feng, Chi Polin, Liang Xun, Zhang Chonglei, Deng Yingtao and Tan Xingdong. Jiang Hei, David Zhuang and Wang Xiaohua ably provided interpretation and translation of this report, a draft of which was discussed with the Hainan and central governments in July 1991. Charles Wolf and K. C. Yeh of the Rand Corporation (Santa Monica, California) and Rosa Lee of Hong Kong China Services, Ltd. (Hong Kong) also gave comments on the mission's work. Anthony Ody (EA2CO), N. Kay Hill (EA2AG) and Peter Harrold (EA2CO) provided other inputs. The report draws upon background material from studies prepared by The Japanese International Cooperation Agency (JICA) in 1986/87, the Chinese Academy of Social Sciences in early 1988, and the RAND Corporation in 1989/90.

Figure 2 – A World Bank discussion paper, "A Chinese Province as a Reform Experiment: The Case of Hainan," (Cadario, Ogawa & Wen, 1992, p. xi) credits team leader Wang Gang and Chen Feng, among others, for their assistance with a World bank mission to Hainan in 1990. See Appendix for an extract of the paper.
Figure 3 - Key individuals involved in the formation of Hainan Airlines.
Part one: chaos and opportunity at the China Agricultural Development Trust and Investment Co.

In September 1988 under political pressure, Beijing launched comprehensive financial investigations into five high-profile national-level companies. One of those companies was China Agricultural Development Trust & Investment Co. (中农信) which was headed up by Wang Qishan. The company was a newly formed state-owned enterprise (SOE) and was responsible for controlling money lent to China from the World Bank. However, under Beijing’s investigation drive, CADTIC’s over 400 employees, including Wang Qishan, were now facing redundancy.

Sometime in early 1989, a well-connected princeling and CADTIC employee by the name of Chen Dongping brought a letter to Wang Qishan from a close mutual associate inviting Wang to participate in a Beijing-approved project to set up a new provincial government loan office to raise 1 billion dollars (US $1 billion) in development finance from the World Bank. The plan outlined how Wang would be promoted to a vice-governor role within that province in return for bringing the project and funding. Although a position as vice-governor would have represented a two-level promotion, Wang Qishan decided to it best to remain in Beijing to pursue his career.

Upon hearing Wang’s response and facing redundancy himself, Chen Dongping asked Wang for permission to pursue the opportunity instead. Wang agreed, and Chen set off to report the “good news” back to their mutual associate. Chen would later get permission to bring four other colleagues and associates into the project, namely: Jiangxi provincial government deputy-secretary Wang Hongchang, 5th ranked CADTIC vice-executive Wang Gang, CADTIC food manufacturing office director Wang Weiming, and CADTIC office colleague Chen Feng.

With the blessing of Wang Qishan and a proposal report in hand, Chen Dongping contacted Qin Gang who was a fellow princeling by way of his father Qin Bangxian (better known as Bo Gu) and the general manager of Hainan Construction Co. at the time. Hainan -- an economic backwater under the administration of the Canton provincial government -- had just become an independent province and special economic zone the year before.

Qin Gang would help broker the deal between the “six gentlemen” and the new Hainan provincial government; he was close with Hainan executive vice-governor Bao Keming as the two had studied together at the Moscow Aviation Institute during their college years.

Bao Keming managed to convince Hainan governor Liu Jianfeng and Hainan Party secretary Xu Shijie to take the project on, however, absorbing six predominantly non-government outsiders to work on a provincial government project presented a bureaucratic challenge.

After careful consideration, Hainan suggested setting up a new SOE to employ the six to act on behalf of the proposed provincial government World Bank Loan Office. The six agreed and after background checks and personnel files were transferred from their previous employers, the group set off to Hainan.
Part two: China Xingnan Group and the Hainan World Bank Loan Administration Office

By February 1990 the six had arrived in Hainan. The Hainan government had already decided to call the new SOE Xingnan Group (兴南集团) and to place Wang Gang in charge.

At the welcome banquet for the six, Hainan Party secretary Xu Shijie thanked the group for coming to Hainan and explained how the company name “Xingnan” was short for “zheng xing Hainan” (振兴海南), meaning, “bring prosperity to Hainan.” Xu, a known calligraphist, gave the group a hand-written scroll with the phrase inscribed as a welcome gift.

During discussions, the idea to upgrade the company status to a national-level SOE by adding “China” to the company name was raised. Governor Liu agreed to assist and made a phone call to the director of the State Administration for Industry and Commerce Liu Minxue to gain approval for the national-level status. Liu informed Wang Gang who sent Wang Weiming to Beijing to complete the task. In Beijing, Wang Weiming formally met Liu Minxue, presenting a silk tie as a token gift from Hainan. Director Liu rubberstamped the approval documents and Wang returned to Hainan with the paperwork completed.

China Xingnan Group (中国兴南集团) had been formed and the credibility boost of a national-level status would later make it much easier for the SOE to raise finance and attract business opportunities.

Under Hainan regulation at the time, all government funding had to be personally authorised by the governor. To support the newly formed China Xingnan Group, Governor Liu authorised 500,000 yuan (CNY ¥500K) of government funds to invest in the SOE which was the maximum allowable at the time. But, there were strict rules on the flow of government funds: if an SOE received funding directly from a government department of finance, then the money could only be used for operational expenditure. To get around this restriction, the Hainan government would have to funnel the money to China Xingnan Group via another SOE.

Hainan Provincial Development and Construction Co (海南省开发建设总公司) (HDC) was the only provincial SOE in Hainan at the time so Governor Liu would have the ¥500K of taxpayer money transferred to HDC’s accounts and instruct HDC general manager Qin Gang to then pass it on to China Xingnan Group. But Qin Gang was cynical, however, and was not about to transfer the ¥500K windfall to China Xingnan Group easily. In one conversation Qin Gang told Wang Gang that he and his group were not the first from all over China to come to Hainan “promising big dreams” adding that he had seen “round after round of big talkers come and go.” Qin Gang would withhold the funding for months whilst claiming expenses against the budget for multiple rounds of validation meetings and expensive dinners with HDC employees and Xingnan Group.
Wang Gang was increasingly frustrated as the funding was being slowly frittered away by Qin Gang’s stalling validation tactics. In desperation, Wang would call on a close associate to help negotiate with Qin Gang – a move that eventually saw Qin Gang release the funds and reimburse Xingnan Group for the full ¥500K.

By mid-1990 and with the Hainan provincial government funds finally in-hand, China Xingnan Group had become operational. The Hainan government would establish the Hainan Provincial World Bank Loan Administration Office shortly after, and in 1992 the World Bank would hold its annual meeting on Hainan Island to discuss investment opportunities to aid “comprehensive system reform” across the agricultural province.

Part three: Wang, Chen and the governor’s “assistants”

For China Xingnan Group members the jump in standing from their mid-to-lower tier roles at CADTIC represented a significant upgrade in their careers.

Within the group, however, Wang Gang harboured anxiety as an “outsider” in Hainan and lamented a lack of importance and security which could only come through having a government title there. But Wang’s dream was virtually impossible to realise as transferring an SOE employee to a role within the government would require an inordinate amount of effort and political capital that Governor Liu would not be willing or able to expend.

It wasn’t until a group conversation amongst Xingnan’s members, however, that the idea of skirting the system was raised: could an unofficial title be just as good as an official one?

The idea of fake government titles was not a new one in China, but it was a very difficult act to pull off as one’s identity could be easily verified with a quick phone call to the relevant department or official. Yet, within the balmy, sub-tropical backwater of Hainan, anything seemed possible.

Wang Gang came up with the idea of asking Governor Liu Jianfeng to approve each member of Xingnan Group to call themselves “special assistant to Governor Liu Jianfeng” (刘剑锋省长专项助理) for the duration of his tenure in Hainan. Chen Feng, who by now had become a loyal subordinate to Wang Gang, was keen on the idea, while Wang Weiming offered to help. The rest of the group would pass as they imagined the “awkward and inappropriate” conversation that Wang was proposing to have with the governor of Hainan.

Governor Liu Jianfeng, though, was against it from the beginning – after all, what kind of self-respecting provincial governor would have such low ranking SOE employees as his special assistants? Despite Liu’s heavy resistance, Wang, Chen, and Wang would hound Governor Liu relentlessly over the course of 1990 as they sought official approval for their unofficial roles, and whether through sheer persistence on their part or eagerness on Liu’s
to see the World Bank money, the Governor reluctantly agreed to Wang and Chen’s new self-appointed titles.

It was settled: Wang Gang’s background was in finance, so he would call himself “special financial assistant to Governor Liu Jianfeng” (刘剑锋省长金融助理); Chen Feng had worked in Air China before his time at CADTIC, so he would call himself “special aviation assistant to Governor Liu Jianfeng” (刘剑锋省长航空助理).

For Wang and Chen, it seemed, the sky was the limit.

**Part four: the bid for Hainan Provincial Airlines**

Outside of their efforts to bring development finance from the World Bank to Hainan, China Xingnan Group’s members were on constant look-out for other projects to land.

With a government title to his name, Wang Gang travelled to Shanghai and gained a two-year exclusive licence to establish the first branch of China’s Bank of Communications in Hainan; Chen Dongping joined one of Hainan’s early finance companies, while Wang Hongchang – the only actual government official of the group – left China Xingnan for a horticultural endeavour as head of the Hainan Province Agricultural Comprehensive Development and Experiment Zone (海南省农业综合开发试验区).

By now, Wang Gang had also managed to effectively ingratiate himself with Governor Liu Jianfeng and now had his sights on another opportunity: Hainan Provincial Airlines.

Around the time of the announcement to restructure the monopolistic Civil Aviation Administration of China (CAAC) in 1985, reform experiments had already taken place to create “independent” airline carriers in joint ventures between provincial or municipal governments and business enterprises. Xiamen Airlines, for instance, had been established in the Xiamen special economic zone in 1984 and likewise Shanghai Airlines in 1985 by the Shanghai city government and local enterprises to help the city regain its importance as a commercial centre. Although the CAAC would still maintain regulatory authority over China’s airlines, local governments were now free to manage their own operations and business as they saw fit.

The air travel market was booming, and the Hainan government had already floated the idea of establishing an independent provincial airline to capitalise on the trend and promote economic development across the province.

Wang Gang was able to persuade the Hainan government that China Xingnan Group was up to the task, but forming an airline from scratch was no small matter and Wang would still need to satisfy the government approval process by showing – at least on paper – that the group had the credentials for the job.
The usual process for such a significant project would involve a number of rounds of validation. First, a proposal would need to be heard by a standing member of the Party Committee at a validation meeting. Second, the proposal would either be recommended or rejected at a meeting of the Provincial Party Standing Committee. Third, if recommended and unanimously agreed, each member would sign off on the proposal. In the final fourth step, the proposal would require approval from the Provincial People’s Congress.

Chen Feng had long ago convinced Wang to make him general manager of Hainan Airlines if the group ever won the bid, however, Chen’s credentials did not at all stack up: he had vocational training from the Chengdu 14th Aviation School (成都 14 航空学校) in his teens, and his relevant work experience as deputy head of division, or fu chuji (副处级), within the accounts department at Air China made him the least senior member of the group.

Hainan was afforded a lot of flexibility in its governing as a special economic zone and it was already an open secret that Wang intended to put Chen in charge of the airline. Nonetheless, some bureaucratic procedures still needed to be played out and there was just no way that Chen was a plausible candidate to present at an official validation meeting – even as the governor’s “special aviation assistant.”

Executive vice-governor Bao Keming had been appointed to validate the proposal owing to his university education in aviation and experience as vice-minister for the Ministry of Aerospace (now China Aerospace Science and Technology Corporation). Wang realised that he would need to enlist a qualified aviation expert who also held a high enough government ranking, or civil service grade, to back China Xingnan Group at the validation meeting if Bao was going to be able to recommend the group’s proposal.

As luck would have it, Wang got word from an associate that an official from the Beijing Civil Aviation Department was to be holidaying in Hainan. Wang wasted no time and through his associate arranged a meeting with vacationing vice-director Wu Peilan to persuade him to attend the validation meeting on behalf of China Xingnan Group.

Weighing up the offer, Wu realised that voicing his support for Xingnan Group would not cost him anything but would provide an opportunity to add an important meeting with an executive vice-governor to his political CV. He could also call in a favour from Wang Gang at some point – a real boon if Hainan Airlines ever became successful.

Wu Peilan agreed to the idea and over the next couple of days the pair discussed how to pitch the proposal to industry expert Bao Keming.

At the validation meeting, vice-director Wu spoke of his “grand vision” for Hainan Airlines to become a major player in China’s airline industry in just a few short years, bringing millions of tourists to the island and prosperity to its inhabitants. Though heavy on ambition and light on specifics, that needn’t have mattered as Wu was a sufficiently qualified and experienced aviation official with a just high enough ranking for Bao to feel comfortable putting his name on the proposal and sending it up.
With a satisfactory validation show completed and Wu Peilan on his way back to Beijing, the approval process was then largely a formality, as, on Bao Keming’s recommendation the Hainan Provincial Party Standing Committee signed the group’s bid into effect. It is unclear if the proposal ever gained the blessing of the “old guard” at the Hainan Provincial People’s Congress, but it mattered not as the project was now official: China Xingnan Group would run Hainan Provincial Airlines and Chen Feng would be its general manager.
Epilogue

It was 1991 by the time Hainan Airlines was formed by the Hainan government and Chen Feng appointed general manager by Wang Gang. For Chen, the leap from redundancy at China Agricultural Development Trust and Investment Co., to general manager of a provincial airline reporting to the Aviation Division of the Hainan Transportation Bureau, represented a remarkable advancement in his career and status.

In 1993, the state-owned airline was corporatized and restructured, selling both A and B shares on the domestic stock market with the corporate staff “financing” 20% of the shares, according the company’s claims. It would begin operations in May that same year.

In 1994, the CAAC and the Ministry of Foreign Trade and Cooperation would issue policy allowing foreign investors to buy shares in existing airlines, limited to 35 percent of the registered capital and 25 percent of the voting rights. Chen Feng would travel to the US to meet American investor George Soros as general manager of Hainan Airlines and “special aviation assistant to Governor Liu Jianfeng.” In 1995 the Hainan government would sell 25 percent of its shares in Hainan Airlines to a Soros controlled company for 25 million dollars ($US 25 million).

Wang Gang’s ventures into property development would prove unsuccessful and he would ultimately lose control of Hainan Airlines. Wang Gang’s widow, Er Ming (尔明), would go on record to say that her husband had told her that losing the airline had “felt like his own son being taken away” and was his life’s deepest sorrow.

In 1997, Wang Qishan would become executive vice-governor of Guangdong province and would on occasion receive phone calls directly from Chen Feng, according to a close associate of Wang’s.

In 2000, following further restructuring, Hainan Airlines would become the core business unit of privately held HNA Group which would go on to become a global conglomerate.

In 2015, HNA Group would embark on an aggressive, debt-fuelled global acquisition spree, attracting the attention of lenders, regulators and media alike due to concerns over the company’s opaque ownership.
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The Case of Hainan

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A Chinese Province as a Reform Experiment:
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World Bank Discussion Papers
China and Mongolia Department Series

A Chinese Province as a Reform Experiment:
The Case of Hainan

Paul M. Cadario
Kazuko Ogawa
Yin-Kann Wen

The World Bank
Washington, D.C.
FOREWORD

The World Bank's economic and sector work program in China is a very active one, ranging over a wide spectrum of topics from macroeconomics to health and education. Each year we publish a handful of our formal studies, but thus far most of the background papers and informal reports, many of them containing valuable analysis and information, have remained outside the public domain. Through the China and Mongolia Department Working Paper Series, we hope to make available to a broad readership among China watchers and development communities a few of the papers which can contribute to a better understanding of China's modernization.

The study by Mr. Cadario, Ms. Ogawa and Mr. Wen of provincial development in Hainan reviews the context of and prospects for China's only Special Economic Zone that covers an entire province. When Hainan became a province in 1988, the central government wanted to make it a special zone that would go far beyond even the other SEZs in system reform. It was to have a "small government and large society," implying very little state-operated enterprises and minimal government. Despite its essential backwardness, pockets of absolute poverty, inadequate infrastructure and other difficulties, Hainan has made progress in economic development, attracting investment from both the mainland and overseas. Its economy, previously dominated by state-owned rubber and iron ore industries, has diversified through substantial growth in services and small-scale enterprises, including export-oriented joint ventures. However, the pace of reform and investment slowed during the national austerity program from early 1989 to late 1991, calling into question the ambitiousness of some of Hainan's plans to lead the way in reform experiments in agriculture, industry and human resource development. Recently, though, the reform agenda seems to have regained momentum, as Hainan deals in greater depth with the trade, investment and fiscal modernization that could propel it into prosperity.

This limited, policy-oriented study of Hainan's prospects for achieving export-oriented growth, drawing on materials prepared by researchers in Hainan and abroad, was undertaken at the request of the provincial government. It not only analyzes Hainan's experience to mid-1991, but also suggests ways in which the province's reform agenda might be accelerated as the next key steps are identified and opportunities seized by both Beijing and Haikou.

Shahid Javed Burki
Director
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THE FORMATION OF HAINAN AIRLINES: THE INSIDE STORY OF HOW THE PRE-BODY OF HNA GROUP CAME TO BE

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CURRENCY EQUIVALENTS

Currency Unit = Yuan (Y)

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FISCAL YEAR

January 1 - December 31

WEIGHT AND MEASURES

Metric system unless otherwise noted

ACRONYMS

ABC - Agricultural Bank of China
BFT - Bureau of Finance and Taxation
CASS - Chinese Academy of Social Sciences
CG - Central Government
CNOOC - China National Offshore Oil Corporation
DFI - Direct Foreign Investment
DFT - Department of Finance and Taxation
FEC - Foreign Exchange Certificate
FIE - Foreign Investment Enterprise
GDP - Gross Domestic Product
GVIAO - Gross Value of Industrial and Agricultural Output
HPG - Hainan Provincial Government
HSY - Hainan Statistical Yearbook
ICT - Industrial and Commercial Tax
JICA - Japan International Cooperation Agency
LNG - Liquefied Natural Gas
MOF - Ministry of Finance
MOPERT - Ministry of Foreign Economic Relations and Trade
PBOC - People's Bank of China
PIF - Public Investment Program
RCC - Rural Credit Cooperative
SASC - State Administration for Exchange Control
SEE - Special Economic Zone
SPC - State Planning Commission
TIC - Trust and Investment Company
TVE - Township and Village Enterprise
UCO - Urban Credit Cooperative
WBLO - World Bank Loan Administration Office
WOV - (Foreign) Wholly-Owned Venture
Preface

I. Located in the South China Sea off the southwest coast of (and formerly part of) Guangdong Province, Hainan is a tropical island with a population of 6.5 million. In early 1988, it was designated both a province and a Special Economic Zone (SEZ), the latter status permitting it to offer foreign investors an attractive package including tax exemptions and duty-free status for production inputs. In addition, Beijing declared its intention to make Hainan a special area that would go beyond the other SEZs and become a "laboratory for system reform." It was to have a "small government and large society," implying little state-operated enterprise and minimal detailed government intervention in the economy. More specifically, the island was permitted to offer investors land-use rights on a leasehold basis for up to 70 years, to operate a free market in foreign exchange, and in general to function primarily by market principles, with no discrimination among enterprises on the basis of their ownership.

II. In many ways the island is richly endowed with natural resources, some of them unique or rare within China. But past comparative neglect has left it until recently relatively underdeveloped, and with pockets of absolute poverty. Stimulating domestic and foreign private sector activity holds the promise to make more efficient use of the province's comparative advantage and to improve the livelihood of its population, as well as that of increasing numbers of migrants from the mainland. Beyond this, Hainan has the potential—as both local and national officials have emphasized—to serve as a testing ground for many of the comprehensive, market-based reforms whose implementation throughout China is planned over the medium term.

III. Today, Hainan's economy has three prominent features: 19 cities and counties that present a mixture of urban and rural, state-owned enterprise (SOE) and township and village enterprise (TVE) activities and (relative) poverty and (relative) affluence similar to much of southern, coastal China; an outward-oriented sector with some foreign investment in joint ventures, mainly for assembly and tourism, but so far dominated mainly by domestic trading companies motivated by advantageous foreign exchange retention opportunities; and, a state farm sector producing rubber and other tropical crops. The challenge is to shape this current structure to suit its future goals using the latitude permitted by the reform laboratory concept, while mitigating the hardships of the transition in ways that would make Hainan's experience a model for the rest of China.

IV. It was against this background that the Hainan authorities approached the World Bank in late 1989 with a request for substantial long-term financial and technical assistance. As one of China's five SEZs (which the Bank has not so far studied) and, since mid-1989, a so-called laboratory for reform, Beijing's ambitious goals for Hainan merited renewed interest from at least these two perspectives. In the circumstances and given the availability of three recent studies of the province—by the Japanese International Cooperation Agency (JICA) in 1986/87, by the Chinese Academy of Social Sciences in early 1988, and by the RAND Corporation in 1989/90—this limited
policy-oriented study of Hainan's prospects for market-oriented development, drawing heavily on these materials, was undertaken.

v. A market economy in Hainan would have two benefits: first, to develop the island's resources and thereby stimulate employment and prosperity there, and, second, to serve as a testing ground for "the planned socialist commodity economy with Chinese characteristics," through a series of reform experiments. As Chapter 2 indicates, a fundamental issue is the demonstration value of these experiments for other areas of Hainan, and their applicability to other parts of China. On paper, Hainan's climate for investment is quite attractive and very similar to that in other SEZs. But there appear to be practical obstacles to encouraging foreign investment and even investment from the mainland. As Chapters 3 and 4 describe, some are erected by central ministries in Beijing, through their control over China's trade and investment approval process. Others can be tackled through simplified provincial procedures and as officials gain experience with the requirements of the market economy and how best to encourage prospective foreign investors. Hainan needs to eliminate barriers to foreign and domestic productive investment in the province, by making its investment climate and banking system transparent and predictable, and quite different from the mainland. An important signal would be an early start on the Yangpu Development Area, and relative autonomy to the developer to make the needed infrastructure investment and sell leases. Competition from foreign-owned enterprises would also be the best way to encourage international levels of quality and productivity for industrial products that Hainan's (and China's) SOEs wish to produce, whether for export or the domestic market.

vi. The "soft" environment for investment is not sufficient: Hainan will also need to continue to establish the basic transport, energy and urban infrastructure needed to remove the real sector constraints. The status of the productive projects listed in Hainan's Eighth Five-Year Plan is unclear: whether they are indicative for foreign investor interest or whether they are priorities that must be set ahead of others. In 1988 Hainan's leaders envisaged a limited role for government in the productive sectors. As Chapter 4 argues, even in a market-oriented economy, the public sector plays the predominant role in infrastructure investment. Hainan's infrastructure is not at the level in Shenzhen or China's other SEZs that have had a nearly 10-year headstart. But infrastructure is not so deficient that it would be a serious barrier to suitable investment from abroad or from the mainland. To retrieve its own decision-making autonomy, Hainan may wish to be in the vanguard of moving to a different planning system, based on a new relationship between government and the productive sectors. It may wish to move to a more flexible and periodically updated public investment program, where priorities are revised in light of achievements and resources and the evolving needs of the local economy.

vii. In its reflections over the role of government in the province, Hainan has also considered some administrative reforms that might accompany the market-oriented economy. In addition to examining what government should do, and how, Hainan may wish to take action on several other fronts. It might examine its approach toward creating new offices and bureaus, an observed practice of Hainan becoming a province, with the risk of ever-expanding the public payroll. It might examine the rationale and desirability of the
province taking up partnerships with foreign investors, with uncertain risk to
the government. The main instrument for reform is the decontrol of prices and
markets, in a secure transparent and predictable legal and regulatory frame-
work.

viii. As Chapter 5 indicates, Hainan now relies on generous central gov-
ernment financial support to cover recurrent deficits and its capital invest-
ment program. With expected private sector growth, Hainan may wish to sim-
plify its tax system and broaden the tax base. Even with new revenue sources,
the issue of how much additional revenue Hainan needs for its reform and
development cannot be separated from the issue of how existing public
resources are mobilized and spent. A full public expenditure review could
examine these issues and the priorities for public sector outlays. Consistent
with China’s efforts to further national financial sector reforms and inte-
grate the country’s financial markets, Hainan’s banking sector should remain
independent of provincial government control and subject to national monetary
policy.

ix. To address these priorities, Hainan will have to see that its civil
servants and those in Beijing operate according to the rules envisaged in the
State Council documents establishing the province. Being an island with pro-
vincial status could give Hainan certain freedom. But it also leads to real
sector constraints that would have to be removed before policies to promote
investment and trade will have the desired impact. This may require a wider
field of provincial power than Hainan currently seems to enjoy.
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