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Nicolas Schlotthauer\*

## Will the People's Republic of China Trigger Off the Next Asian Crisis?

*During the first phase of the Asian crisis, there were no signs of it having any serious influence on the People's Republic of China, but the country does now appear to have been drawn into the crisis. In which areas of the Chinese economy are there serious problems likely to occur? What measures ought to be taken to counteract them?*

Since the Asian crisis first came out into the open in July 1997, many countries with 'emerging markets' have developed serious financial and currency crises, including a number of economies that had not previously been regarded as being under threat. In the early period of the upheavals, many observers had felt that China might act as a stabilizing factor for the East Asian region as a whole. The growth achieved there since the start of the economic reform process, coupled with moderate inflation and a number of other positive fundamentals (see Table 1) earned the economy substantial respect, and it was regarded as a model for other transition countries. Moreover, when Zhu Rongji took over the office of prime minister in March 1998, this nurtured hopes of further progress to come. The proposals announced at that time for reforming state-owned enterprises, banks and the civil service created a new mood of optimism.

In the meantime, the groundswell of positive sentiment has evaporated, and parallels tend to be drawn between China and other Asian countries currently riding out their crises. The initial focus of concern in public discussions of China's problems was the likelihood of a devaluation in the interests of restoring competitiveness, but since the problems have come to a head in the financial sector, the most worrying example being the bankruptcy of GITIC, there have been growing warnings of an impending financial crisis.

Because competition has intensified from the Asian

countries already hit by economic crisis as a consequence of their major currency devaluations, many are now calling for a devaluation of the Chinese yuan. The justification for these demands, based on changes in key indicators, will be discussed in the first part of this article. Particular attention will be paid to China's ability to prevent devaluation if major outflows of capital were to occur following a loss of confidence. Given the deceleration of economic growth forecast for 1999, the structural problems in China's economy are now coming under greater scrutiny. Many analyses of the current economic situation examine only the financial and general business sectors. This article will also include the agricultural sector within its scope, since this is a sector where the Chinese government still has numerous means of intervention at its disposal.

### The Impact of the Asian Crisis

During the first phase of the Asian crisis (up to mid-1998), there were no signs of it having any serious impact on the People's Republic of China. However, in the meantime the view has tended to prevail that China, too, has been sucked into the region's economic troubles.<sup>1</sup> There are three fields in which problems may arise for the People's Republic: (1) the economy may become less competitive in international terms, leading to a fall in exports; (2) foreign

<sup>1</sup> Cf. e.g. James Harding: China throws a lifeline, in: Financial Times, 28th January 1999, p. 13; Frank Sieren: Viel Verständnis: China geht stabil in das zweite Jahr der Asienkrise, hat jedoch das Vertrauen westlicher Investoren verloren, in: Wirtschaftswoche, 10, 1999, pp. 51 f.

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Table 1  
China's Economic Indicators, up to 1997

	GDP growth <sup>1</sup>	Inflation rate <sup>1</sup>	Current acct. balance <sup>2</sup>	Net budget deficit <sup>2</sup>	Savings-to-income ratio <sup>2</sup>	Investm.-to-income ratio <sup>2</sup>	Conv. currency reserves <sup>3</sup>	Nominal exch. rate <sup>4</sup>
1983-89	10.7	9.0	-1.0	-1.7	-	-	18.0 <sup>4</sup>	4.72 <sup>4</sup>
1990	3.8	2.1	3.4	-2.0	37.77	34.74	29.6	5.22
1991	9.2	2.7	3.5	-2.2	37.84	34.77	43.7	5.43
1992	14.2	5.4	1.5	-2.3	37.26	36.17	20.6	5.75
1993	13.5	13.0	-2.7	-2.0	41.29	43.47	22.4	5.80
1994	12.6	21.7	1.4	-1.6	42.04	40.88	52.9	8.45
1995	10.5	14.8	0.2	-1.7	40.22	40.20	75.4	8.32
1996	9.6	6.1	0.9	-1.5	39.25	38.73	107.0	8.30
1997	7.8	1.5	2.5	-1.5	41.15	37.55	142.8	8.28

<sup>1</sup> In %; <sup>2</sup> in % of GDP; <sup>3</sup> in US\$ billion; <sup>4</sup> 1989 figure; <sup>5</sup> RMB yuan to the US dollar.

Sources: G. Corsetti, P. Pesenti, N. Roubini: What caused the Asian currency and financial crises? Part I: macroeconomic overview, NBER Working Paper No. 6833, 1998; IMF: World Economic Outlook - Interim Assessment, December 1997, p. 49; IMF: International Financial Statistics, January 1999.

investment may decline sharply; (3) it may not be possible to implement the programme to privatize state-owned enterprises via the Hong Kong stock exchange on the desired scale.

### Reduced Competitiveness

The main reason for the expectation that China's competitiveness will fall is that many other Asian countries' exchange rates have plummeted. As a result, China's exports to these crisis countries have been cut whereas exports to Europe and North America have increased once again.<sup>2</sup> Trends in the country's aggregate exports may offer some evidence of the adverse impact of the crisis on the People's Republic of China.<sup>3</sup> Figure 1 shows that, after dipping substantially in early 1998, China's exports recovered

somewhat as the year went on and regained their 1997 level. However, given that a similar fall in exports had also occurred at the start of 1997 and of other years, the dip may be attributable to other factors. At the same time, imports changed little in volume, so China was able to maintain its trade surplus in 1998 (the surplus was US\$43.6 billion, or approx. 4% of GDP).<sup>4</sup>

A better indicator to use as a judge of an economy's competitiveness is its real exchange rate.<sup>5</sup> This takes account of price and wage inflation in addition to changes in the nominal exchange rate, while the 'real effective exchange rate' goes one step further as it is measured on a trade-weighted basis for the country in question.

The devaluations occurring in the crisis-ridden countries of East Asia did not result in a real appreciation of the Chinese yuan. In fact the currency shows a real depreciation (see Figure 2).<sup>6</sup> Moreover, many of these countries have export profiles which differ substantially from that of the People's Republic. Textiles are an exception, where there is some overlap with Indonesia's exports, but even they account for just one sixth of China's total exports, so are not hugely significant.<sup>7</sup> The relative stability of China's real exchange rate supports the proposition that the collapsing exchange rates in other Asian countries have not unduly weakened its competitive position.<sup>8</sup>

Thus there is no macroeconomic basis for the devaluation of the Chinese currency that has often been called for.<sup>9</sup> Moreover, some key industries are

<sup>2</sup> Cf. AHST (= Foreign Trade Office at the Austrian Embassy, Beijing): China Nachrichten, 3/98, p. 26. According to the MOFTEC, exports to the EU grew by 18.1% and those to the USA by 16.1%.

<sup>3</sup> 'Singapurs Banken rechnen mit einer Abwertung des Yuan', in: Frankfurter Allgemeine Zeitung, 16th March 1999, p. 33.

<sup>4</sup> Cf. Frank Sieren, op. cit., p. 51.

<sup>5</sup> Cf. Peter Bofinger: Die internationale Wettbewerbsfähigkeit ganzer Volkswirtschaften: ein Phänomen auf der Suche nach einer Theorie, in: Kredit und Kapital, Vol. 28 (1995), pp. 484 ff.

<sup>6</sup> McKinnon attributes this to the relatively larger weighting of goods rather than services in China's retail price index relative to that of the USA, meaning that the worldwide decline in goods prices shows through in China's real exchange rate; cf. Ronald I. McKinnon: Exchange rate coordination for surmounting the East Asian currency crises, paper presented at the conference on 'Financial Crises: Facts, Theories and Policies' at the IMF, Washington, D.C. 1998, p. 9.

<sup>7</sup> Cf. Markus Taube: Volksrepublik China: Krise im Anzug?, in: ifo-Schnelldienst, 9/98, pp. 16-23.

heavily dependent on imported raw materials, so devaluation would push up their production costs. A further problem is that a yuan devaluation would risk setting off a new round of exchange-rate corrections throughout the region, which would ultimately fail to benefit any of the countries involved (including China itself).<sup>10</sup> Lastly, a devaluation and any other uncertainty in expectations of future exchange-rate policy would undermine the future planning of the foreign investors

on whom China is relying to help modernize its economy. That might make such investors more reticent than they are already.

**Trends in Foreign Direct Investment**

Almost 80% of the People's Republic of China's inward investment has come from Chinese people resident in other Asian countries.<sup>11</sup> The crises in Malaysia, Thailand, Indonesia and South Korea have considerably reduced the flow of FDI. A lot of the investors involved are currently grappling with liquidity problems, so they have cut back their involvement in China. Another reason for greater reticence among investors, in this case particularly among those from Western industrial countries, has been falling domestic demand in China. The deflation currently prevailing<sup>12</sup> coupled with increased saving suggest that growing uncertainty is leading China's households to postpone larger purchasing decisions. That has impaired foreign firms' sales prospects.<sup>13</sup>

According to official statistics, contracted investment in 1998 grew slightly overall in comparison to the previous year (see Table 2).<sup>14</sup> However, while the agreed sums remained on a comparable level there

<sup>8</sup> Rather, the countries in crisis have suffered massive falls in aggregate demand which have impacted import demand and cannot be eliminated by a devaluation of the currency. The Economist Intelligence Unit has estimated a cut in the demand for consumer goods around Asia of \$515 billion in 1998 alone, and also that it will take until the year 2002 to bring consumption levels back to where they were in 1996; cf. AHST, op. cit., p. 26.

<sup>9</sup> This is apparent from the lines of argumentation used to justify a devaluation in which, for example, the constancy of China's Renminbi (RMB) is regarded as being dependent on the Japanese yen, without making any closer reference to the currencies' real exchange rates or to the areas in which the two countries' exports overlap. The alternative arguments used centre around trends in the domestic financial obligations of Chinese banks or the rising unemployment rate; cf. 'Singapurs Banken rechnen mit einer Abwertung des Yuan', op. cit., p. 33. But here again, it is impossible to see any direct connection with the exchange rate.

<sup>10</sup> Cf. Liu Ming kang: Commitment to financial stability and greater efforts to introduce foreign investment, Speech by the deputy director of the People's Bank of China in Xiamen, September 1998, pp. 3 f.; 'Zhu's struggle', in: Financial Times, 8th March 1999, p. 15.

<sup>11</sup> Cf. MOFTEC: Utilization of Foreign Capital, <http://www.moftec.gov.cn>.

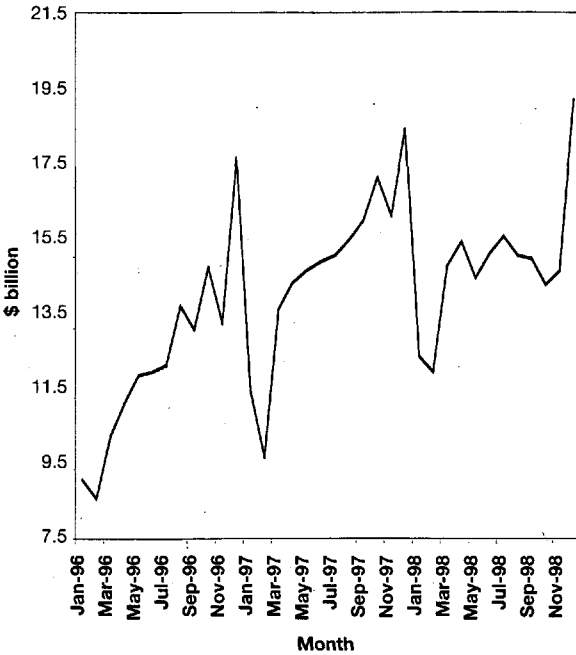
<sup>12</sup> During the first three quarters of 1998 the consumer price index fell by an average of 0.8%; cf. IMF: International Financial Statistics, Washington, D.C., April 1999.

<sup>13</sup> And the results of surveys of foreign businesses show that tapping China's domestic market is the main reason for investing in the country; see, e.g., the joint study by Roland Berger and the Delegiertenbüro der Deutschen Wirtschaft (German Industry and Commerce): Erfolgsanalyse deutscher Direktinvestitionen in der VR China, Beijing 1998.

<sup>14</sup> However, a rather surprising feature of these statistics is that both contracted and realized investments declined in the first three quarters of 1998, yet the contracted figure rose so strongly in the last quarter that the full-year figures outstripped those of 1997.

**Figure 1**

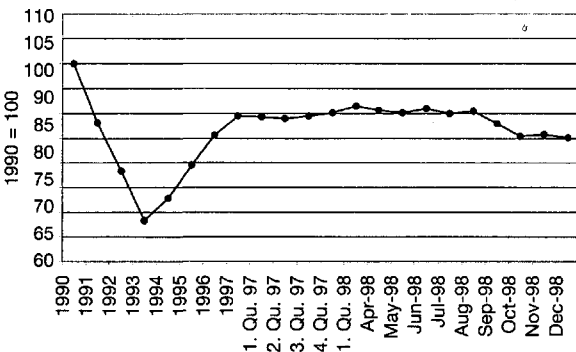
**Exports by the People's Republic of China during the Asian Crisis**



Source: Datastream; IMF: International Financial Statistics, April 1999.

**Figure 2**

**The Real Effective Exchange Rate for China**



Source: IMF: International Financial Statistics, January and April 1999.

was a marked reduction in investments, actually realized (down 7.88%), chiefly due to the more limited supply of credit.

Any further decline in direct investment volumes would curtail China's economic growth, for foreign investment makes a substantial development contribution in a number of industries (especially those with a high technical component).<sup>15</sup> China's leadership is unlikely to find it easy to prevent this happening, as many investors are holding back, or are recalling their loans on a substantial scale, either because of the unresolved structural problems or because they expect the currency to be devalued. However, in regaining the confidence of investors, the People's Republic of China has the advantage that its government gets to grips with its difficulties 'instead of taking a resigned stance, or trying to win some breathing space by swinging the axe spectacularly'.<sup>16</sup>

If the government wants to ensure that direct investment is maintained at its existing high level, it will have to create a more transparent environment to make life easier for China's foreign investors. Imposing restrictions (e.g. on payments denominated in foreign currencies or on investment in 'key industries') will not encourage foreign investors to step up their involvement. The first positive steps have now been taken in the right direction: Shi Guangsheng, the Minister of Foreign Trade and

Economic Cooperation, has announced that more areas of the economy will be opened up to foreign investors. The new areas include the oil and construction industries and the service sector. However, there remains a great deal to be done in many fields, including those of legislation covering the financing of trade and investment, labour law<sup>17</sup> or the protection of intellectual property rights.<sup>18</sup>

### Privatization of State-owned Enterprises

China had been planning to issue shares in state-owned enterprises on the Hong Kong stock market in the autumn of 1998. Unfortunately though, the market still had not recovered by that time from the impact of the Asian crisis in the second half of 1997, when Hong Kong-quoted stocks lost more than 30% of their value.<sup>19</sup> The stock market failed to recover even in spite of the Hong Kong government's historically unprecedented intervention by dipping into the state's convertible currency reserves to support domestic shares.<sup>20</sup>

The severe drop in Hong Kong share prices impeded the privatization programme as a whole: the value of shares issued by Chinese enterprises in the January–August 1998 period was 81.8% lower than in the corresponding period a year earlier, totalling just \$622 million.<sup>21</sup> Consequently, there is a shortage of finance, especially from abroad, to support China's reform measures. In February 1999, a second attempt to issue shares in Chinese enterprises on the Hong Kong stock exchange also came to nothing, due to insufficient interest and a lack of liquidity in the H-share market segment.<sup>22</sup> The new issue was postponed, and no repeat attempt will be made to relaunch it until at least the second half of 1999.<sup>23</sup>

<sup>15</sup> Cf. Armin Böhnet: Sozialistische Marktwirtschaft im Kommunismus – eine Bestandsaufnahme der chinesischen Wirtschaftsreform, Berichte zur Wirtschafts- und Gesellschaftspolitik Chinas (= reports on China's economic and social policy), 25, 1997, p. 12.

<sup>16</sup> Frank Sieren, op. cit., p. 52.

<sup>17</sup> As the law currently stands, foreign investors taking on employees of a former state-owned enterprise when they set up a joint venture are required to assume all severance-pay obligations arising from the person's previous employment (i.e., also covering the years before the joint venture was actually established).

<sup>18</sup> Despite a large number of laws enacted, the problems associated with the protection of intellectual property appear to be getting worse rather than better. This is borne out by a survey of German managers conducted by the business mission, German Industry and Commerce, in Beijing; see <http://www.ahkbj.org.cn>.

<sup>19</sup> Cf. Nicolas Schlotthauer: Die VR China in der asiatischen Währungs- und Finanzkrise, discussion paper, University of Würzburg 1998.

<sup>20</sup> This marked a change of course in the economic policy pursued by the former Crown Colony, away from its traditionally liberal approach towards state interventionism, very similar to the policy of the People's Republic itself. The policy change resulted in a depletion of convertible currency reserves by \$8 billion in the July–September 1998 period; cf. IMF, op. cit.

<sup>21</sup> 'China accumulated FDI hits \$249 bln end-August', in: Lateline-News, 23rd September 1998, Internet.

<sup>22</sup> 'H shares' are shares in Chinese enterprises issued and traded on the Hong Kong stock exchange.

<sup>23</sup> Cf. Donny Kwok: China firms may delay share listings in Hong Kong, in: Reuters, 8th February 1999, <http://infoseek.go.com>.

**Table 2**  
**Direct Investment in China**  
(\$ billion)

		Foreign loans	FDI	Other forms	Total
<b>Investments contracted</b>	1998	8.39	52.13	2.81	63.33
	1997	5.87	51.0	4.1	60.97
	Change in %	42.8	2.2	-31.35	3.87
<b>Investments realized</b>	1998	11.0	45.58	2.33	58.92
	1997	12.02	45.28	6.66	63.95
	Change in %	-8.49	0.67	-64.93	-7.88

Sources: Ministry of Foreign Trade and Economic Cooperation, Internet.

### Is China under Threat of a Currency Crisis?

The devaluation of their domestic currencies created all sorts of problems for banks and the corporate sector in the countries hit by the Asian crisis. Their overall level of debt rose sharply without any change in borrowing. Foreign-currency debt already accounted for more than 20% of GDP in Indonesia, Thailand, South Korea and Malaysia by the end of 1996.<sup>24</sup>

As things stand at present, the People's Republic of China is not in any danger of suffering the same fate as its Asian neighbours as far as the state of its currency is concerned.<sup>25</sup> China has taken precautions against currency crises by enforcing various kinds of exchange controls, which were also toughened up in 1998 to stem the outflow of convertible currency funds. Because the currency is not convertible for the purposes of capital transactions, the RMB yuan is not open to speculative attack.<sup>26</sup>

Apart from that, China's convertible currency reserves (worth \$145 billion) are the world's third largest after Japan's and the EU's, and these have now been supplemented by a further \$88.6 billion from Hong Kong. Less than 20% of China's debt denominated in foreign currencies is short-term; or, to put it the other way round, 80% of its debt is safe from immediate withdrawal by creditors.<sup>27</sup> It also differs from the Asian-crisis countries in that the total volume of its foreign-currency debt to banks participating in the BIS system is far lower as a proportion of its GDP (see Figure 3).

The numerous avenues of intervention open to them mean that China's authorities can attain a stable exchange rate even if there is a marked outflow of

capital without having to raise interest rates unduly. That allows them to avoid the vicious circle of interest rate rises (to stabilize the currency) leading to falling investment and/or increasing debt. The development of such a vicious circle would mean that the fixed exchange rate was untenable in the medium term, and that devaluation was inevitable at some stage.

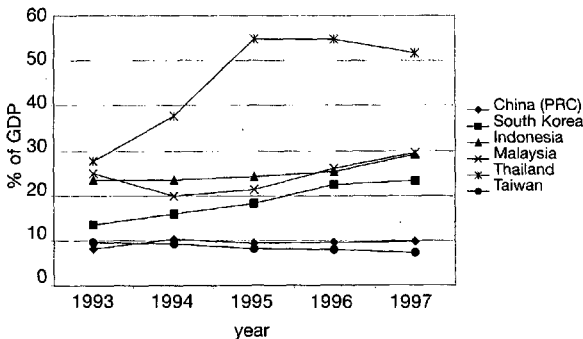
In Asia's crisis countries, not only their large current account deficits but also microeconomic distortions fuelled devaluation expectations and the associated capital flight. The article will therefore examine below what structural problems China faces, and what might be done to alleviate them.

### Corporate-Sector Reform

Even though China's economic transition has been in progress for some time, the number of state-owned enterprises (SOEs) has not fallen by very many. There are still 300,000 SOEs operating, and although they increased their output by 5.7% in 1997, half of them are loss-making.<sup>28</sup>

The scale of the problems faced by China's SOEs has recently grown more evident. Their total debt is estimated to be in the region of \$200 billion. Even in 1996, one third of SOEs were already technically bankrupt, and another one third suffered from serious liquidity problems.<sup>29</sup> The situation has deteriorated further since that time. In the first three quarters of 1998, earnings fell by 36% relative to the corresponding period in 1997, while their unsold inventories rose by 8%.<sup>30</sup> Nevertheless, the Chinese government is endeavouring to keep alive as many enterprises as

**Figure 3**  
Foreign-currency Liabilities to BIS Banks  
in Asian Countries



Source: G. Corsetti, P. Pesenti, N. Roubini: What caused the Asian currency and financial crisis? Part I: macroeconomic overview, NBER Working Paper No. 6833, 1998.

<sup>24</sup> Cf. Kathrin Berensmann, Nicolas Schlotthauer: Asiatische Währungs- und Finanzkrise: Ursachen, Auswirkungen, Lösungsansätze, Institut der Deutschen Wirtschaft, Beiträge zur Wirtschafts- und Sozialpolitik 245, Cologne 1998, pp. 18 ff.

<sup>25</sup> South Korea, Thailand, Malaysia and Indonesia all experienced currency and financial crises leading to negative economic growth, increasing inflation rates and extreme currency devaluations; for a more detailed account, see e.g. Kathrin Berensmann, Nicolas Schlotthauer, op. cit.; G. Corsetti, P. Pesenti, N. Roubini: What caused the Asian currency and financial crisis? Part I: Macroeconomic overview, NBER Working Paper 6833, 1998.

<sup>26</sup> Cf. Nicolas Schlotthauer, Peter Nestmann: Unternehmensfinanzierung in der VR China, topics on China (China-Themen), German Industry and Commerce Beijing 1998, pp. 24 ff.

<sup>27</sup> Cf. G. Corsetti et al., op. cit.

<sup>28</sup> Cf. Christian Schmidkonz: Reform chinesischer Staatsbetriebe, in: Wirtschaftswelt China, 10/98, pp. 8 f.

<sup>29</sup> Cf. World Bank: The Chinese Economy: fighting inflation, deepening reforms, Country Study, Washington, D.C. 1996. Defining a 'state-owned enterprise' causes problems: is it one in which the state owns a simple majority of the equity or, as sometimes defined by China's authorities, a wholly-owned enterprise?

<sup>30</sup> Cf. 'Gebremste Reformen - massive staatliche Stimulierung', in: Neue Zürcher Zeitung, 20th October 1998.

it can. To do this, it has returned to its practice of directing the lending of state-owned commercial banks, which it had theoretically ceased to do in 1997, in order to inject more liquidity into the SOEs. The commercial banks have been directed to make a further RMB100 billion (approx. \$12 billion) available for construction projects, mainly to improve infrastructure.<sup>31</sup>

On the other hand, attention is now being devoted, even officially, to potential solutions to these problems. In a study published in October 1998, the State Economic and Trade Commission looked at the cost of corporate restructuring over the next three years; the study estimates the cost of restructuring and privatization at between RMB600 and RMB800 billion (\$72-96 billion) in that period. This is the requirement over and above the RMB200 billion (approx. \$24 billion) already spent on reforming small to medium-sized SOEs in 1997.<sup>32</sup> The reform proposals envisage the flotation of another 150 major enterprises on the Hong Kong and other Chinese stock markets. 1,500 government enterprises will be called upon to operate more efficiently while 4,000 will be declared bankrupt. Particularly by arranging mergers, the programme also intends to bring smaller enterprises together to form larger units with more economic muscle.<sup>33</sup> Moreover, small to medium-sized SOEs will be required to manage without any financial support from the State or directed loans in the years ahead.<sup>34</sup>

China's future development will greatly depend upon how successfully these corporate reform measures can be implemented. It is also important to realize that the health of business enterprises has a major influence on the state of the banks and of the social welfare system.<sup>35</sup> In future, additional growth impetus may come from greater support for small to medium-sized enterprises (SMEs). In Taiwan, the existence of large numbers of SMEs has helped to create a diversified pattern of businesses, making the country's economy less vulnerable to crisis. In the People's Republic too, companies of this kind could create new jobs, thus absorbing some of the unemployment. However, this will not happen until the SMEs receive greater support both from government authorities and from the banks. It is impossible for a broad spread of SMEs to develop if the bulk of the finance is still being provided to the 'industry giants and dinosaurs'.<sup>36</sup> An encouraging point to note here is that China has had very positive experience since the early days of its transition process with the township and village enterprises (TVEs) which have contributed substantially to the country's economic growth.

### Developments in the Financial Sector

As pointed out earlier, the risk now more often cited as facing the People's Republic of China is that of a potential banking or financial crisis. In the debate as to how such crises are generated, the following factors are among those felt potentially likely to act as a trigger:<sup>37</sup>

- the strong influence exerted by government authorities and inadequate financial monitoring of directed lending;
- pronounced credit expansion, especially in boom phases, and collapses in asset prices;
- insufficient preparation for the complete liberalization of the financial sector (especially as regards banking supervision, accounting rules, training of bank personnel, and decision-making structures);
- marked mismatches between the terms and/or currencies of assets and liabilities;
- volatility in macroeconomic parameters (especially fluctuating real exchange rates and worldwide interest-rate differentials).

### The Banking System

The banking system in China is still tightly controlled by government authorities (see Figure 6). Especially the four major state-owned commercial banks,<sup>38</sup> but also a large number of regional banks established by provincial governments, are 'directed'

<sup>31</sup> Cf. AHST, *op. cit.*, pp. 32 f.; Nicolas Schlotthauer, Peter Nestmann, *op. cit.*, p. 7.

<sup>32</sup> Cf. China Economic Information Network: State enterprise reform costs 800bn Yuan, 27th October 1998, Internet (<http://www.cei.gov.cn>).

<sup>33</sup> Cf. Bayerische Vereins- und Hypothekenbank: China: auf schmalen Grat zwischen Reformen und Stabilität, Reihe Internationale Analyse, 1998, p. 5; Christian Schmidkonz, *op. cit.*, p. 8; the latter outlines the problems inherent in this approach in the light of negative experience with the South Korean 'chaebols'.

<sup>34</sup> Cf. 'Backwards and forwards in China', in: *The Economist*, 13th March 1999, pp. 71 f.

<sup>35</sup> A positive point to note with regard to the reform of SOEs is that the state itself is now taking on more and more of the tasks previously fulfilled by these enterprises in the 'iron rice-bowl' approach. The programme includes the systematic disposal of company-owned living accommodation to employees at very low prices. That will allow workers to subsist without being dependent on their enterprises if they are threatened with redundancy.

<sup>36</sup> The PBC has already announced that it intends to apply greater pressure on banks to provide more financial support to SMEs; cf. Liu Mingkang: Commitment to financial stability and greater efforts to introduce foreign investment, Speech of the Deputy Director of the People's Bank of China, September 1998, p. 2.

<sup>37</sup> Cf. Morris Goldstein, Philip Turner: Banking crises in emerging economies: origins and policy options, BIS Economic Paper, 46, Basle 1996, pp. 8 ff.

<sup>38</sup> Agricultural Bank of China, Bank of China, China Construction Bank, Industrial and Commercial Bank of China.

in their lending by political considerations and not by economic viability. Their lending is set by a credit plan, which allows a large number of uneconomic SOEs to continue in operation, thus guaranteeing jobs for a while longer.<sup>39</sup> Real credit growth has continued to increase as the state direction of lending has continued even in the 1990s (see Table 3). At the same time, China's banks need not fear any pressure from foreign competitors. These are subject to both regional and quantitative restraints in their RMB-denominated business: only a certain number of banks are allowed to conduct this business, and then only from Shanghai and Shenzhen.<sup>40</sup>

However, another feature apparent from Table 3 is that the Chinese leadership also uses the directed lending process as a means of restraining credit growth during periods of increasing inflation (e.g., the 1993–95 period), to take some of the heat out of the economy, and it has evidently had some success in exercising this control.

As the financial situation of the SOEs has gone from bad to worse, the difficulties of the banks have grown more acute as well, due to a rising proportion of irrecoverable loans. It is estimated that bad loans will make up 30% of the banks' total assets in 1999 – a figure exceeded only by the banks in Thailand (40%) and Indonesia (60%).<sup>41</sup> These estimates are far in excess of the official figure published at the start of the year by the central bank, the People's Bank of China (PBC), citing 'absolutely irrecoverable receivables' at 5–6% of the total.<sup>42</sup> Clearly, then, China's own authorities apply different standards when evaluating these risks. Fitch IBCA, the first international rating agency to operate in China, is working on the assumption that the total cost of recapitalizing the banking sector will come to 10% of the country's

<sup>39</sup> For a more detailed account of the regulatory system in the financial sector, see e.g. Nicolas Schlotthauer, *op. cit.*, or Kai M. Kunnasmaa: *Banking and Financial Institutions in China*, Finnish Lawyers' Publishing, Helsinki 1996.

<sup>40</sup> Cf. Nicolas Schlotthauer, Peter Nestmann, *op. cit.*, pp. 9f.

<sup>41</sup> Cf. 'Das Zittern geht weiter – Asiens Kreditinstitute müssen sich gleichzeitig erneuern und Schulden abbauen', in: *ASIA Bridge*, 10/98, p. 1.

<sup>42</sup> Cf. Lihong Wang: 'Bad loans only 5% of bank credits', in: *China Daily*, 17th January 1999.

<sup>43</sup> Cf. 'Das Zittern geht weiter...', *op. cit.*, p. 1.

<sup>44</sup> Cf. William Kazer: 'China bank debt woes could cost \$60 bln', in: *Reuters*, 8th March 1999, Internet (<http://infoseek.go.com>).

<sup>45</sup> Cf. Frank Sieren, *op. cit.*, p. 52.

<sup>46</sup> James Harding, *op. cit.*, p. 13.

<sup>47</sup> Cf. G. Corsetti et al., *op. cit.*

<sup>48</sup> Cf. Morris Goldstein, Philip Turner, *op. cit.*, pp. 10 f.

**Table 3**  
**Rate of Growth in Lending by Chinese Banks**  
(in %)

	1983-89	1990	1991	1992	1993	1994	1995	1996
Nominal growth	17.0	23.6	20.0	22.3	42.1	23.8	22.9	25.3
Real growth <sup>1</sup>	8.0	21.5	17.3	16.9	29.1	2.1	8.1	19.2

<sup>1</sup> = Nominal growth – inflation rate.

Source: IMF: *World Economic Outlook – Interim Assessment*, December 1997, p. 49.

GDP.<sup>43</sup> According to one of the top managers at the China Construction Bank, \$60 billion (approx. 6% of GDP) will be needed to carry out this task at the big four state-owned commercial banks alone.<sup>44</sup>

For the time being, the commercial banks are still benefiting from the high propensity to save among the Chinese public. By the end of 1998, people had accumulated total savings worth \$645 billion.<sup>45</sup> On the other hand, that means the financial sector would run into problems if Chinese savers and investors were to lose their confidence in domestic banks – indeed, that could pave the way for a severe financial crisis. As James Harding has put it, 'At the end of the day, Chinese depositors believe their deposits are safe in Chinese banks, (...) But if the time were ever to come when Chinese depositors started to have their doubts, China could end up wishing it were more like, well, south-east Asia, Russia or Brazil.'<sup>46</sup>

One of the advantages in China's situation is that a larger proportion of foreign debt than in other Asian countries is borne by the state, and a correspondingly smaller one by banks and by private-sector non-banking businesses.<sup>47</sup> Marked fluctuations in, for example, the real exchange rate coupled with a high proportion of foreign-currency debt can act to trigger off a banking crisis, either directly (via the banks' positions) or indirectly (as the balance sheets of manufacturing and trading companies deteriorate).<sup>48</sup> The People's Republic of China is not exposed to any such risk of a banking and financial crisis being set off by deteriorating macroeconomic data.

As a means of establishing more efficient supervisory structures and curtailing the influence of local politicians, further reforms of the PBC are being implemented. In particular, its branch structure is being reshaped to consist of nine regional entities, all of which will include several provinces in their ambit. In addition, a central financial institution along the lines of the Resolution Trust Corporation in the USA is



being established to deal with the commercial banks' irrecoverable loans.<sup>49</sup>

### The 'Non-Bank Financial Institutions'

The 'non-bank financial institutions' are proving an obstacle to reforms in the financial sector. The Trust and Investment Corporations (TICs), in particular, also conduct business with foreign partners. They often constitute the financing wing of an industrial conglomerate or provincial government,<sup>50</sup> and their lenders have profited in the past from the poor supervision of this area by the PBC.<sup>51</sup> The state-owned commercial banks were also able to use the TICs as a means of circumventing the government quotas imposed upon them; this practice was not brought to a halt until the Commercial Banking Law came into force in 1995.<sup>52</sup>

The TICs were originally established as lenders to and providers of funding for both Chinese and Sino-foreign enterprises; they are not permitted to operate as deposit-taking institutions.<sup>53</sup> As can be seen in Table 4, the number of non-bank financial institutions in operation has varied quite a lot at different times. Their share of the total assets in the financial system has increased somewhat over time, but has remained small in total.

The higher returns TICs offer to their lenders are a reflection of the riskier forms of business they finance (such as real-estate transactions). The TICs have benefited from the fact that the bulk of the funds lent out by the commercial banks have been supplied to state-owned enterprises as determined by the official credit plan. That has meant that other potential borrowers have been paid insufficient attention, and have turned instead to the non-bank institutions.<sup>54</sup>

The collapse of the Guangdong International Trust and Investment Corporation (GITIC) in October 1998 exemplifies the problems arising from the inadequate supervision of the TICs. GITIC was no longer capable of servicing its short-term foreign-currency debts. As a result of the collapse, foreign-currency debts

totalling \$2 billion threaten to be irrecoverably lost (as against total foreign-currency debts of just \$10 billion incurred by all 239 non-bank institutions combined).<sup>55</sup> The financial burden on the Chinese state is limited in the event of bankruptcy, as there is no provision for the central government to assume liability for institutions operating at a regional level.

The PBC has stated that it, or the Bank of China which is responsible for carrying out its policy in this area, will only provide guarantees for transactions that it has also authorized. Although this approach is heavily criticized by foreign lenders; it does nevertheless make sense. If the central bank or central government are not prepared to stump up for debts accumulated by regional financial institutions, this has the effect, first of all, of thwarting the usual practice (especially among regional authorities) of using the TICs to finance risky or prestigious projects. Secondly, the position makes it clear to creditors, both domestic and foreign, that their tendency to be insufficiently prudent will not receive any support from the central government in the form of bail-outs.<sup>56</sup>

The shake-out which can now be expected among the TICs has already occurred a number of times in the past, with a view to restraining unsupervised activities. For example, the number of licensed TICs was cut back substantially in 1982, 1986 and 1988, in response to 'overheating' in the system. In each case, the measure formed part of a package intended to rein in credit expansion.<sup>57</sup>

### The Real-Estate Sector

As in neighbouring Asian countries, property prices have recently lost ground heavily in China. In

Table 4

#### "Non-Bank Financial Institutions" in China

Year	1986	1988	1991	1993	1994	1997
No. of institutions	561	745	375	388	393	239
Share of financial-sector assets, in %	1.7	-	3.2	3.2	3.5	-

Source: Anjali Kumar et al.: China's Non-Bank Financial Institutions, World Bank Discussion Paper No. 358, Washington, D.C. 1997.

<sup>49</sup> Cf. 'Backwards and forwards in China', op. cit., p. 71.

<sup>50</sup> Of the 393 'authorized' TICs operating in 1994, 185 belonged to banks, 16 others also worked on a national basis, and 190 were regionally controlled; cf. Anjali Kumar, Nicholas Lardy, William Albrecht, Terry Chuppe, Susan Selwyn, Paula Perttunen, Tao Zhang: China's non-bank financial institutions, World Bank Discussion Paper 358, Washington, D.C. 1997, p. 8.

<sup>51</sup> Cf. Anjali Kumar et al., op. cit., p. 1.

<sup>52</sup> Cf. Commercial Banking Law of the People's Republic of China (cited from: Almanac of China's Finance and Banking, Beijing 1995), Articles 43 and 11; the latter requires all institutions calling themselves 'banks' to first obtain licences from the PBC.

<sup>53</sup> Cf. Kai M. Kunnasmaa, op. cit., pp. 63f.

<sup>54</sup> Cf. Eric Girardin: Banking sector reform and credit control in China, OECD Development Centre Studies, Paris 1997, p. 34; Anjali Kumar et al., op. cit., p. 21.

<sup>55</sup> Cf. Frank Sieren, op. cit., p. 51.

<sup>56</sup> Cf. Ronald I. McKinnon, op. cit., p. 10.

<sup>57</sup> Cf. Eric Girardin, op. cit., p. 36.

Shanghai, for example, the real-estate market fell back by up to 50% between 1994 and 1997, and 40% of the office space available is currently vacant.<sup>58</sup> So this market, too, has a 'hog cycle' which begins with a situation of excess demand that cannot immediately be satisfied, causing substantial price hikes, but by the time the supply is finally made available, demand has been discouraged by those high prices, thus generating excess supply and sharply falling price levels.

The ups and downs of the property market have not just affected state-owned real-estate companies but also the banks (especially regional banks and TICs) that have injected large sums of money into these projects. The loans were secured by the properties involved, but the assumed values are now far too high following the market's readjustment. If property companies become insolvent, that results in the non-performance of some of the banks' loan portfolio. This setback in asset values can be seen as a parallel to events in other Asian countries.

### Is China Threatened by Financial Crisis?

It is fair to say that weaknesses in the domestic financial system have been the major problem in Asia's crisis countries. This is also the basis for the fear often expressed that China, too, could risk an economic crisis brought on by a financial one. This possibility has been discussed above in terms of the various potential sources of crisis. Summing up, it is safe to conclude that neither volatile macroeconomic indicators nor mismatches between assets and liabilities (as regards term and the denominated currency) give any reason to fear a financial crisis in the People's Republic of China.

Supervision of the commercial banks by the People's Bank of China and the Ministry of Finance is another area that does not pose problems given the continued firm line on lending and interest-rate policies. China is at an advantage relative to other Asian countries in that its domestic financial system is protected by the fact that the liberalization of capital

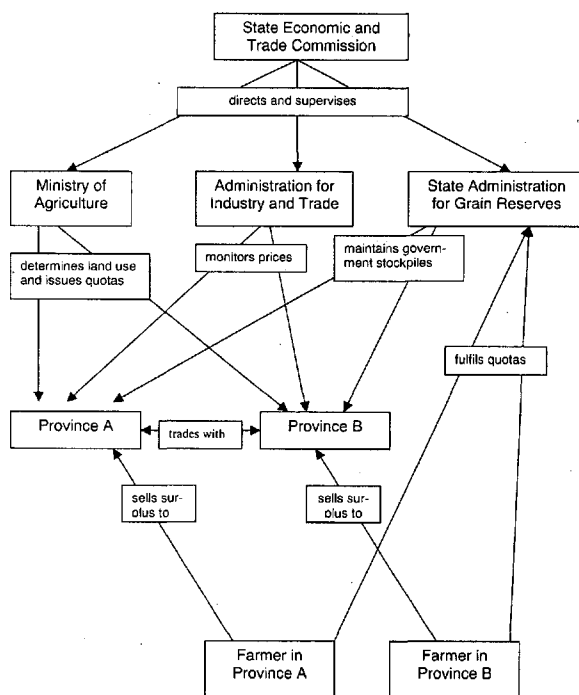
<sup>58</sup> Cf. G. Corsetti et al., op. cit., p. 41.

<sup>59</sup> Cf. also Ronald I. McKinnon, op. cit., p. 10, who holds the view that capital flows based solely on financial transactions should be the last to be liberalized.

<sup>60</sup> Dwight H. Perkins: Reforming China's Economic System, in: Journal of Economic Literature, Vol. 26 (1988), p. 610.

<sup>61</sup> For more precise information on this system, see: 'Reibungslose Reform des Getreidemarketing betont', in: Beijing-Rundschau, Vol. 35 (1998), 33, p. 4; 'Der Getreidemarkt', market report, German Industry and Commerce Beijing.

**Figure 4**  
**The System for Regulating the Agricultural Sector**



flows is still incomplete.<sup>59</sup> However, where the country does have a potential problem is in the continuing strong expansion of state-directed lending, and in the collapse of property prices. In an overall context in which state-owned enterprises face increasing problems, this could spell trouble for the financial system if reforms to deal with bad loans are not put into practice.

### Reforms and Regulatory Mechanisms

Analyses of China's economic transition frequently view the pace of reform and the associated substantial increases in productivity and incomes among the rural population in the early 1980s as having been the key to success. For example, Dwight H. Perkins writes: 'In 1985 the state felt able to cut back sharply on the use of compulsory state quotas for agricultural crops including grain with the goal of their complete elimination within a short but unspecified period.'<sup>60</sup>

Yet this disregards the fact that China's agricultural sector still has not been completely liberalized even today. Cereals (mainly maize, rice and wheat) are still produced as directed by the state, which lays down minimum quotas and controls the prices at which the produce must be sold (see Figure 4).<sup>61</sup> Moreover only state-owned enterprises and agricultural authorities are entitled to purchase cereal products directly from

farmers. They offer certain minimum prices, to protect the farmers against loss of income if market prices fall sharply. Other traders are required to purchase their grain from the government bodies concerned.<sup>62</sup> In the past, prices were kept artificially low when these bodies sold the produce onward. This practice was later discontinued when the 'reform of the cereal marketing system', in addition to retaining the system by which infinite amounts of surplus cereals would always be purchased by the state, also required these authorities to 'earn a small profit'.<sup>63</sup>

If one considers that cereals account for over two thirds of arable farming output (see Table 5), the substantial increases in income since the transition began will be seen to be partly due to subsidization by the government rather than the result of liberalization. Although the Chinese government relaxed its strict controls for the first time in 1993 and allowed private individuals or firms to trade in cereals, this led to a great deal of speculation and huge price hikes (the country's inflation rate in 1994 was the highest since 1983), so the measures were rescinded. Inevitably, the state intervention gives rise to financial losses: between 1992 and 1997 alone, the SOGEs ran up losses totalling \$25.6 billion.<sup>64</sup> So this is quite a contrast to the picture often painted of a fully liberalized

agricultural sector in which peasant farmers are able to sell their produce on free markets with freely determined prices. Although this does apply to certain forms of produce (e.g. fruit), the Chinese government controls both prices and quantities for all products regarded as basic foodstuffs, and especially for cereals.

Nevertheless, the reforms in the agricultural sector have at least provided an additional incentive for farmers to work harder; this was borne out in the 1980s in particular, when total agricultural output rose substantially (see Figure 5).

In contrast to other transition countries, especially Russia, the government in China has held on to its means of controlling the supply of the staple goods that are so important to large sections of the population. That has allowed the authorities to largely avoid major social strife, and to secure broad popular support for the reform process.

### Social Challenges

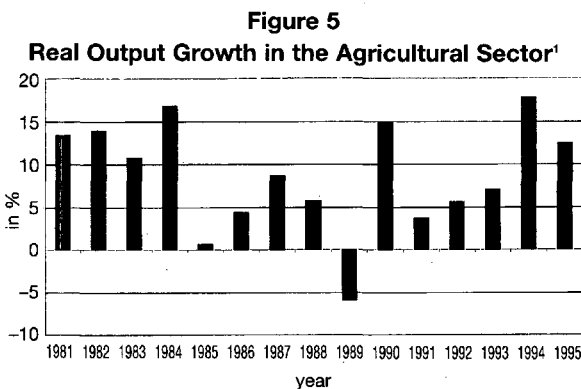
The restructuring of state-owned enterprises and government authorities carried out to date and the reforms in the agricultural sector have not only increased productivity, but have also created growing unemployment. The number of people officially reported as unemployed is 5.5 million, or 3% of the workforce.<sup>65</sup> However, the 'workforce' used for statistical purposes covers only the urban population, and even on that basis the unemployment rate is officially projected to increase to 7.4% in the year 2000. Western experts have estimated the current urban rate of unemployment at approx. 9%, and that in rural areas at 26%.

In China as a whole, between 180 and 260 million people are now thought to be no longer integrated into the world of work, except perhaps in formal terms. The bulk of the unemployed live in rural areas. Thus the stream of migrant workers moving off the land and into the overcrowded cities, already massive, is likely to swell to even larger proportions. The

**Table 5**  
**Output of Agricultural Produce, 1997.**

Product	Output in tonnes	Proportion of total (in %)
Rice	20,073.5	29.70
Wheat	12,328.9	18.24
Maize	10,430.9	15.42
Other cereals	5,067.8	7.5
Other produce	19,693.8	29.14
Total	67,594.9	100

Source: China Statistical Yearbook 1998.



<sup>1</sup> At 1981 prices.

Sources: Datastream; own calculations.

<sup>62</sup> Cf. Dow Jones Newswire: China looks to farmers for next boom, 19th October 1998, Internet (<http://infoseek.go.com>).

<sup>63</sup> Cf. 'Reibungslose Reform des Getreidemarketing betont', op. cit., p. 4.

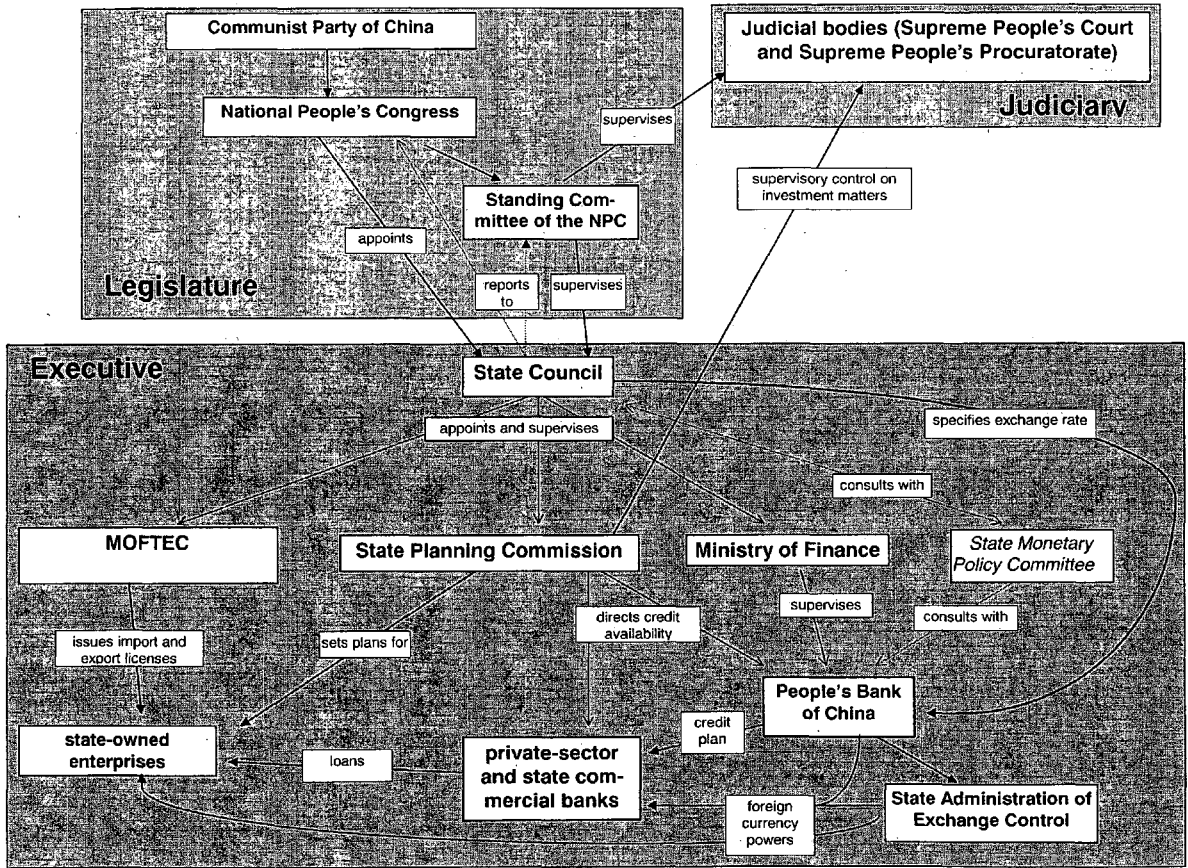
<sup>64</sup> Cf. Dow Jones Newswire, op. cit.

<sup>65</sup> Cf. 'China's baby-boomers: the unlucky generation', in: *The Economist*, 21st November 1998, pp. 63 f.

<sup>66</sup> Cf. *ibid.*, p. 64; 'Gebremste Reformen – Massive staatliche Stimulierung', op. cit.

<sup>67</sup> Cf. China Monthly Statistics: The number and wage of total staff and workers by sectors, Internet (<http://www.cei.gov.cn>).

Figure 6  
Regulation of the Financial Sector



Source: based on Kai M. Kunnasmaa: Banking and Financial Institutions in China, Helsinki 1996.

number of people willing to work and coming on to the labour market each year fluctuates between 8 and 14 million,<sup>66</sup> the largest group of these people are workers made redundant by the state-owned enterprises.

Their numbers are further added to by the government employees shed in the process of administrative reform. In June 1998, over 10 million Chinese people were employed by Party organizations or administrative authorities.<sup>67</sup> If Zhu Rongji implements his plan to sack 40-50% of government employees (as occurred at the Ministry of Foreign Trade and Economic Cooperation in the summer of 1998, for example), this too will send the unemployment rate soaring.

To avoid jeopardizing social stability, it is essential for the Chinese government to expand the system of minimum welfare support provided directly by the state, which is still in its infancy. Yet it is highly unlikely to have sufficient funding available to provide this support. Moreover, as time goes on, the government's

'one child' policy will also give rise to the problem of an ageing society, in which a relatively small working population will be called upon to support an ever growing number of older people. The proportion of over-60s in the total population, currently 10%, is projected to rise to over 25% by 2050. In cities such as Shanghai, a rate of 33% is expected to be reached as early as 2025.<sup>68</sup>

**Conclusions**

Three key conclusions can be drawn from the points discussed above. The first is that the macroeconomic fundamentals do not justify any devaluation of the Chinese currency. Both the underlying trend in the real exchange rate and the

<sup>66</sup> Cf. 'China's baby-boomers: the unlucky generation', op. cit., p. 63. This article points out the problems faced by many of the people in the 40-50 age-group who are now unemployed: in the wake of the Great Leap Forward and the Cultural Revolution, many of them now have substantial gaps in their education, which means they have little chance of being reintegrated into working life.

numerous means at the authorities' disposal to support the exchange rate by imposing controls and intervening in the markets help to bolster the government's stance, namely that it intends to stick by the currency's present international value. Devaluation might destabilize the situation in China and in other Asian countries, triggering off competitive devaluations elsewhere, in a 'beggar-my-neighbour' policy.

The second main conclusion is that reforming state-owned enterprises and the financial sector pose the most important tasks for the foreseeable future. If the government wishes to avoid social unrest, and to attain continued buoyant growth, it will have to 'clear out' the accumulated problems in these areas, to cut back the macroeconomic costs that further delay in implementing reform would mean (especially in the banking system, past delays have already generated very high costs). Above all, the Chinese government must do everything in its power to avoid a loss of confidence among both domestic and international investors, which might trigger a banking or financial crisis.

The third conclusion is that China's government still has a lot of means at its disposal to guide the country's economic progress. In addition to directing the banks' lending and setting the prices charged by industrial enterprises, the main such levers in the

government's hands are the price controls on the staple goods and services which are most important to ordinary people (e.g. food prices and rents). That means that the leadership still holds the key to keeping broad popular support for the continuing transition process. Another advantage relative to other Asian countries lies in the new prime minister's desire to implement reforms: '... but at least China has a leader who, unlike his Japanese counterparts, recognises problems and is quick and flexible in response.'<sup>69</sup>

The discussion of a possible devaluation of the Chinese currency shows the tendency to 'jump the gun' in looking at general macroeconomic developments and resorting to the standard solutions always applied (in this instance, devaluing to regain international competitiveness), without establishing the causes of flagging economic growth. In China's case, the problem is quite clearly one of falling consumer demand due to growing uncertainty on the part of private households, and not one of deteriorating macroeconomic factors. This being so, the factors the Chinese leadership needs to address are micro-economic ones; 'tiddling' with macro indicators, which in any case only helps in the short term, will not solve the economy's problems.

<sup>69</sup> Cf. 'Zhu's struggle', op. cit., p. 15.

Francois J. Gurtner\*

## The Stability of the Renminbi in the Wake of the Asian Financial Crisis

*In the wake of the Asian crisis, a possible devaluation of the Chinese currency has come to the forefront of the academic debate. The currency collapse of the Asian emerging economies has indeed left the Renminbi overvalued relative to its main regional competitors. This article explores the credibility of the 'no devaluation' pledge made by the Chinese policymakers.*

**A**fter the collapse of the currencies of the emerging Asian economies, it is arguable that the Chinese economy remains the only pole of economic stability in the region. Despite rumors and suspicion, the Chinese policymakers have succeeded, so far, in

keeping the value of the Renminbi – the Chinese currency – unchanged. This apparent stability does not signify that no pressure is put on the current value of the Renminbi. While it appears that China's external position remains strong, its banking sector still performs on a non-commercial basis and may endanger, through the huge amount of bad or non-

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