

# **What Happens to the Chinese Economies When Neighbors Are in Crisis?**

Presented to the Seminar

*Crisis in Asia: Analysis and Perspectives*

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The Asian contagion have caused pain to all the Chinese Economies - the Mainland China, Hong Kong, and Taiwan. But the three Chinese economies struggle to reduce the impact. Hong Kong has held its pegging regime successfully. Taiwan new dollar was devalued by 18%, while its total suffering has been minimal. The Mainland China is largely insulated from the crisis. All the Chinese economies readjusted their growth targets for 1998. With a weak banking system and the troubled State sector, China gets a wake-up call and is seriously discussing the lessons from other countries and launching reform on its financial, economic, and government systems.

China has announced that it will keep the yuan-dollar rate unchanged. Vice Premier Zhu Rongji (he will become the new premier in March this year) announced that China won't devalue yuan within. All the neighboring countries as well as IMF feel relieved by the China's decision, and regard it as a great contribution to curb the regional crisis. Though Chinese officials assure this repeatedly, some crisis-watchers seem not to listen. Obviously, they underestimate the China's determination.

## **1. Impact on Hong Kong, Taiwan and China**

All the three Chinese Economies have been affected by the Asian crisis.

Exports growth would be cut by a half, and foreign direct investment into the Mainland China would stop growing. Hong Kong's currency was assaulted but the H.K. Monetary Authority firmly defended H.K. dollar. A major Hong Kong investment company - Peregrine collapsed by over-lending to Southeast Asian countries such as Indonesia. Its stock market fluctuated, and some companies postponed their IPOs. The market is now stabilized. The economic growth rates for Hong Kong is expected to be 3.5% in 1998.

**Table 1. How Hard Is the Hurt to Chinese Economies?**

A slowdown in economic growth estimated by their governments	1997	1998 estimate
	Mainland China	8.8%
Hong Kong	5.2	3.5
Taiwan	6.8	6.2

Taiwan's currency was knocked by about 18% in a short period, and its stock market was affected. The devaluation was not necessary since Taiwan's foreign reserve was huge. The head of Taiwan Auditing Bureau estimated that owing to the devaluation, the Taiwan's GDP per capita would drop \$666 to \$12,567 in 1998 from \$13,233 in 1997, it would be just above 1995 level. This means the purchasing power per capita could fall back by two years. According Taiwan's central bank, the current account balance in January changed to a deficit of \$728mn from a \$1.1bn a year ago. The capital flight reached \$9.67bn, the highest over past 7 years. Taiwan's foreign trade in January and February 1998 dropped by 5.9%. The government estimated growth of trade for 1998 is about 4%.

**Table 2. Purchasing Power Drop - a Cost of Devaluation**

Purchasing power per capita could fall back to	Years
South Korea	8
Thailand	6
Malaysia	4
Taiwan	2

Source: Taiwan Auditing Bureau

Foreign trade statistics shows that a surprisingly small hit China takes. China's exports in January still rose by 8.8% over the same period of last year. Exports with Asian countries dropped by 1.3% while exports with all other continents grew, with a 33.7% growth with Europe and 14.3% with North America.

## **2. Why does Hong Kong keep the pegging regime?**

Hong Kong Government and its Monetary Authority are firm in defending the peg. The total amount of H.K. dollars in circulation is around 25% of its foreign reserves, which is over US\$90bn now. When any of the three banks issues new money, it must put an equivalent of U.S. dollars as reserve. Services account for more than 85% of its economy and most of payments are in U.S. dollars. There is virtually no debt crisis in Hong Kong. It is very difficult for speculators to break the peg. But capital flight can. A capital flight will cause a collapse of confidence. The peg is like chastity, you can only lose it once. The dark days (October 24) revealed the resilience of Hong Kong. There was panic selling of shares, but not capital flight. Armed with its huge foreign reserves and a track record of tough action, HKMA signaled an uncompromising stance towards banks providing funds for speculators.

## **3. Will China devalue yuan in the near future?**

It could be suicidal to devalue it, since it would not only worsen the Asian crisis, but also harm China's stability. When China announced that it will keep the yuan-dollar rate unchanged, all the neighboring countries as well as IMF applause the China's decision, and regard it as a great contribution to curb the regional crisis. The reasons for not devaluating are obvious:

(1). Chinese yuan has been appreciated for the past 31 months, and the demand for yuan is higher than supply. The rate was 8.6 yuan to US dollar in January 1, 1994, and is now 8.3 to the dollar. China experienced high inflation during 1994 to 1995, which reached 21% and 15.6% respectively. The IMF estimated that the yuan appreciated by 25% over this period. The China's Foreign Exchange Administration's estimation of the appreciation was as high as 44%.

The devaluation of yuan in January 1, 1994 from 5.8 yuan to the dollar to 8.6 yuan to the dollar was viewed by some analysts to set the scene of 1997 Asian currency crisis. This was not true. The 1994 devaluation did not have significant impact, since it just unified the dual or two tier foreign exchange system in China. Before the unification, over 80% of exchange went through informal markets or swap market, which had a rate close to 8.6 to the dollar. When the official rate increased to 8.6 to 1, swap markets and black markets disappeared. Both China and most of Asian countries enjoyed high growth in the economies and exports. They were not affected

by the devaluation.

(2). China is strong in trade account, It has \$40bn of trade surplus in 1997. It has built up trade surplus significantly since 1994.

(3). China has \$140bn of foreign reserves now. It has \$35bn net increase in 1997. The central bank bought back foreign currencies of \$34.8bn last year.

(4). China has foreign direct investment stock over \$230bn by the end of 1997. It received FDI inflow over \$30bn since 1994. FDI is long term commitment of foreign investors. The ratio of external debt to FDI stock in China is 1:2, significantly lower than all the crisis-hit countries.

**Table 3. The Ratio of External Debt to FDI Stock**

China	0.5 : 1
Thailand	4 : 1
South Korea	15 : 1

(5) Nearly 90% of external debt of \$120bn is long term debt, the short term debt is around 12%. China has been cautious in using foreign debt. Its debt is manageable by international standards.

**Table 4. China's Foreign Debt**

	World threshold	China
The debt ratio: ratio of the outstanding debts to annual foreign exchange earnings.	100%	75.6%
The indebtedness rate: the ratio of annual repayment of debt principal and interest to foreign exchange income of the same year.	20%	6.7%
The debt servicing ratio: ratio of the outstanding value of its foreign debt to a country's GDP.	60%	14.3%

Source: China Daily

Table 5. Ratio of short-term debt to foreign exchange reserves as of 1/7/98

South Korea	224%
Russia	205%
Indonesia	184%
Czech Republic	53%
Hungary	48%
Poland	22%
China	10%

(6). Though China's exports feels competition from the Southeast Asia's depreciated currencies, China won't make competitive devaluation. Nearly 90% of Chinese exports are industrial products and about two thirds of the exports are export-processing products. The labor cost is around half of that in Thailand with the baht dropped by more than 50%.

(7). There is no roles for any external forces to press a devaluation. The size of China's stock market is small and yuan is not convertible on the capital account.

(8). Politically, China puts the decision as a support to the neighboring Asian countries. If yuan is devalued, there will certainly trigger another run of currency drop in other economies. A devaluation of yuan will definitely affect Hong Kong's pegging. This will bring about damage to Hong Kong's stability.

A devaluation of yuan will shake confidence among the Chinese and foreign investors in China's economy. China struggles in balancing its economic development, economic reform and social stability, it is extremely important to keep its currency stable. If yuan is devalued, a panic of shopping and withdraws from savings could be easily triggered. The need for financial and social stability overweighs any benefits of a competitive devaluation.

#### **4. What are the dangerous problems in China?**

**(1) China's banks are in very bad conditions by the international accounting standard.** Around 20% of their loans are bad loans, since the borrowers are state companies about half of which are in red. It reaches \$145bn while the total assets of banks is only \$54bn. Mr. Dai Xianglong, the governor of the central bank argues that only 5-6% were actually unrecoverable. The central bank will allocate more than \$6bn to cover unpaid loans in 1998, and another \$7bn to \$8.5bn in 1999 and 2000. Some experts caution

China not to open its financial sector too fast.

**(2) Serious problems surge as reform of the State-run enterprises is deepened.** As a result of enhancing efficiency in the sector, millions of workers will be laid off, and there is no social safety net. They need to be relocated. Otherwise social unrest is possible. Most of the State companies have a debt to assets ratio as high as 80% and about two thirds of the State companies are in red. To be worse, they are losing their markets and some of them stop running.

**(3) Central government's control has been weakened.** In recent years the country's revenue has been risen by 100bn yuan (\$12bn) each year. But the proportion of the revenue to GDP has been steadily on the decline. In 1985, the proportion was 22.4%. In 1990, it dropped to 15.8%. In 1996, it further dropped to 10.9%. In addition, the money that central finance can control makes up a declining proportion of the country's revenue: the proportion at present is less than 30%. The decline in the two ratios causes problems: investment has dropped greatly because the State coffers are not strong enough. It accounted for 20.5% of the state total expenditure in 1980, and dropped to 7.7% in 1995.

**(4) China's external debt could be underestimated.** The total outstanding foreign debts were \$118.64bn at the end of June 1997 by the official figures, only up 8.3% from 1996. Among the debt, 88.5% were medium or long term, only 11.5 was short term debt. Since 1985 to 1996, China's foreign debt totaled to \$240.24bn and it repaid \$169.72bn in principal and interest. However, the number could be much bigger if adding offshore borrowings by Chinese companies and foreign deposits with the overseas branches of the Chinese banks which is not included.

**(5) Slowdown of FDI inflow.** The contracted FDI has dropped over the past three years, and the utilized FDI slowed. Since round 80% of FDI comes from Asia, it is possible to have only a single digit growth. Another problem is that certain FDI is actually not foreign investment, it is a round-trip of the Chinese money. Some Chinese companies invest through their foreign or Hong Kong branches to take the advantages of preferential treatments.

## **5. Measures China is taking to strengthen its financial sector**

(1) Reorganization of China's central bank. China decides to transform the central bank - The People's Bank into a new supervising system - one model

of the Federal Reserve in the U.S. The People's Bank of China will eliminate its main branches in each of the 30 provinces and more than 2,000 branches in county level, and replace them with regional headquarters. This prevents the local authorities from forcing local banks to finance favored projects. This will certainly centralize financial decision power under the control of Zhu Rongji. His authorities over economic affairs often puts him at odds with provincial officials.

(2) Accelerating reform on banking system. Effort has been made to turn all the State banks from "specialized banks" to commercial banks and re-capitalize them. One objective is to make them more professional and less political: commercial banks will operate according to law, and not be open to interference by any organization or individual. This will involve a deep shift in business practice and philosophy, as well as government role.

The central bank also decided to scrap lending quotas over commercial banks, which started on January 1, 1998. It was hoped that the commercial banks would strengthen their internal discipline and improve their credit quality. The central bank will use indirect macro-control, such as adjusting deposit reserves, re-lending, re-discounting, opening market operations and altering interest rates. The PBOC no longer imposes annual and quarterly planning of credit increments for commercial banks. Instead, it will monitor the capital positions of commercial banks. As a guideline, it starts to offer an advisory planning service for commercial banks.

All commercial banks are asked to establish the mechanism to rein in credit expansion according to the central bank's requirements for asset-debt ratio and risk control. They will be more prudent in lending to enterprises or projects. Commercial banks need to meet the requirements for asset-debt ratio. The outstanding loans against deposits should be under 75%; the ratio of working capital against working liability should be at least 25%; the ratio of middle and long-term loans against middle and long-term deposits should be no more than 120%. Commercial banks will decide how to use their capital available after deducting required reserves, provisions, and the repayment of loans owed to the central bank. They need to maintain a balance between capital resources and disbursements. Some people worried that this move would lead to a runaway money supply, especially igniting an upsurge in fixed asset investment. But the fact is that commercial banks recently become reluctant in making loans to enterprises and shun risks passively.

(3) Straightening financial markets. China also ordered a cleanup of its

financial markets, apparently to prevent the type of financial crisis that has rocked much of Asia: It plans to shut roughly half of 300 investment and trust companies. The companies have often ignored central government-set reserve requirements and interest rates, charging far above official rates. It will also close a dozen unofficial over-the-counter stock exchanges; (Zibo has a computerized market boasting 51 listed companies and 500,000 investors; Across the country, some 300 companies are believed to have listings on local exchanges.) It calls banks to take over a large number of informal funds.

China raised the business tax rate on financial institutions from 5% to 8% and reduced the income tax rate on domestic financial institutions from 55% to 33% since January 1, 1997. From May 10, 1997, it lifted the stamp duty on stock transactions from 0.3% to 0.5% to fight speculations.

China realizes that its economic and financial systems have many similarities with those in the crisis-hit Asian neighbors. It need to rethink its development strategies, such as foster conglomerates. The supervision over financial system is weak and need transparency. China must speed up economic and institutional reform. The Government is decided to launch an unprecedented operation on the government system to slash bureaucracy. China has a huge government system with numerous departments in each of the four major administrative levels - central, provincial, prefectural and county. There are more than 20 million government employees. This makes most decisions very slow, since different departments often drag each other's leg and wage internal fighting. Some officials form interest groups and try every effort to keep their power over companies, especially the state companies and financial institutions. The bureaucracy becomes a major hurdle to economic and political reform and development. Nearly half of officials - around 4 million - will lose their post, starting from the central government. This will certainly booster confidence in future reform and development.