China: in the East Asia Financial Crisis

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Abstract: This paper reviewed the East Asia financial crisis, how China reacts to its impact, and what lessons should be learned from the crisis.

Key words: East Asia financial crisis, currency devaluation, growth target

The east Asia countries and regions have enjoyed peace and prosperity of a whole generation since the second World War, particularly since the 1960's. This region was once regarded as the most dynamic powerhouse of the world economy. "Asian Miracle" has been the name hailed for the Asian economies. During 1992-95, the developing economies of Asia experienced average real GDP growth above 9%, significantly above their historical average and probably unparalleled at any time by any group of economies of comparable size. Although double-digit growth rates in China formed the largest single component of this regional growth performance, Indonesia, Malaysia, and Thailand all experienced average growth above 7 percent in this period. The Philippines was the only laggard among the group of countries know as the ASEAN-4 (Indonesia, Malaysia and Thailand being the other members of this group), but its growth gradually rose to above 5 percent by 1995-96, with Singapore's growth exceeding 10% in 1993-94 and Korea's approaching 9 percent in 1994-95. The performance of the Asian economies was equally impressive in terms of the growth of trade, which displayed the outward orientation of their growth strategy.

In July last year, however, far beyond the optimistic prediction of many economists and authoritative international financial institutions, countries in southeast Asia were plunged into a financial turmoil one after another. Such a "financial turmoil", regarded by people at the beginning, was later designated as a "financial crisis" as it developed into a more serious situation. And because of the severity of its consequences, some economists have started to use the term "economic crisis". It is an unprecedented crisis in the economic history of Asia with regard to its astonishing effect, extensive coverage of countries and prolonged duration.

The Asian financial crisis attacked Thailand first, then spread to Malaysia, Indonesia, Singapore, and other ASEAN countries. Last November, the Republic of Korea was also under the attack of the crisis. Then came Japan, a big economic power in the world. Still under the shadow of the burst of its bubble economy, Japan was then plunged into its worst economic recession since the Second World War. The devaluation of Japanese yen suddenly became the focus of attention in Asia and in the world as well.

Who could have predicted that the financial crisis swept out the wealth created by the hard-working people of the East Asian countries over the past 15 years almost overnight. It is estimated that the losses in the financial crisis are over $200 billion on the account only and the actual losses would be much more than that. Where goes the money?

These countries were pushed back 15 years or more. Quite a lot of enterprises and banks were bankrupt, closed down and sold out to the multinational companies. The financial crisis has given rise to the economic and political crises, quick turnover of governments and social unrest.

I was particularly touched by the patriotism displayed by the Korean people during the financial crisis. To protest their currency, many Korean people, including old persons, sold their gold ornaments, jewelry, gold rings, bracelets and hair pins to the government. What a great people the Koreans are.

Currency chaos has hit much of Asia wealth

Per capita GDP, US$	1995	1996	1997	Current
Singapore	28,604	30,89	27,361	26,884
Hong Kong	22,208	24,008	25,876	25,910
Taiwan	12,214	12,69	11,476	11,269
Korea	10,138	10,67	5,373	6,055
Malaysia	4,221	4,690	3,216	2,978
Thailand	2,836	3,062	1,671	1,560
Philippines	1,055	1,165	833	808
China	578	674	731	731
Indonesia	1,035	1,147	532	294

Source: Asian Development Bank, CSFB

The Asia financial crisis is, therefore, a big lesson for the countries and region in this part of the world to take.

How China stands in the Crisis

In the crisis, China has become the focus of attention in the world., with the major concerns being:

(1). Will the Chinese currency RMB devalued?

Although the Chinese government has once and again stressed that RMB will not be devalued, the business circles in the world still could not be eased. RMB devaluation has always been a hot topic the world over, because this is the core of all issues. Therefore, I think it might be useful to have a further look at the issue from the academic point of view.

As Asia's economic crisis deepens, the world watches China's currency policy nervously. Many in the markets have suggested that the Renminbi needs to be devalued for the sake of Chinese competitiveness. But I don't think RMB devaluation could be a good response to the Asian financial crisis.

A comparison of Currencies

US$ Exchange Rate

	01/01/97	01/07/9	Av. 1997	01/02/98
China	8.30	8.29	8.3	8.28
Hong Kong	7.74	7.75	7.7	7.74
Indonesia	2,363	2,432	2,904	9,950
Korea	846.0	888.0	951.6	1,504
Malaysia	2.53	2.52	2.8	4.20
Singapore	1.40	1.43	1.5	1.72
Taiwan	27.5	27.8	28.7	33.3
Thailand	25.6	25.9	31.1	51.6

Source: Bloomerg

Yes, devaluation elsewhere has put Chinese exports in an unfavorable position, yet exchange rate is only one of the many variables that affect export growth. For exchange rate to be significant in export, at least two conditions must be in place: first, products of competing nations must be so undifferentiated that they are nearly perfect substitutes for each other in the world market; and second, exports must embody the same proportion of capital, labor and technology as identical exports from competing economies. But this is not the case in Asia, the countries are made up of diverse economies.

For example, the fall in the Korean won may not have much impact on China's exports because Korean products tend to be more capital- and technology-intensive, although it does have some impact on China's domestic market to have made the Korean products more competitive than the Chinese local products. Of course, devaluation in Indonesia, Malaysia, the Philippines and Thailand could have a larger impact on China. But China exports a more diverse range of products than these countries. Also skilled labor costs are below the average for the region. Regional currency devaluation should reduce, but not eliminate, the labor-cost differential relative to China.

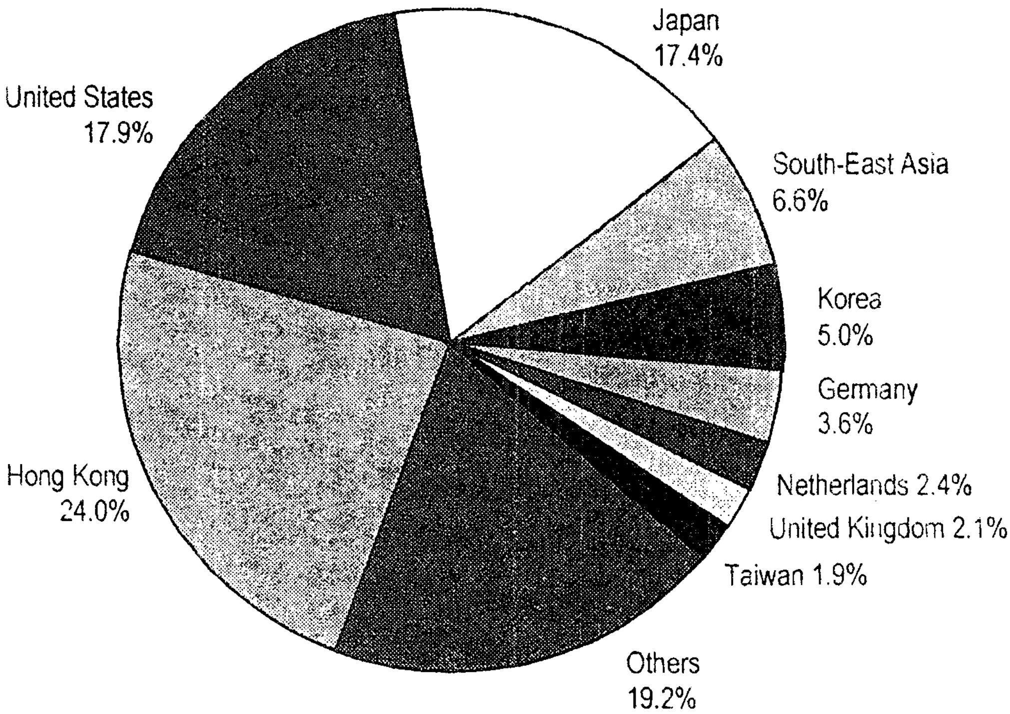
The Change of China's Exports (YOY Percentage)

	1995	1996	1997	1998 (1Q)	1998 (April)	Share of the Total (%)
Total Export	23.0	1.5	21.0	13.2	7.9	
Hong Kong	11.2	-8.6	33.1	15.2	6.2	24.0
US	15.5	8.0	22.5	22.7	16.0	17.9
Japan	32.5	8.5	3.0	-1.8	-6.1	17.4
EU	24.1	3.9	20.2	29.9	29.1	13.1
ASEAN	41.4	-1.9	23.8	-10.4	--	6.0
Korea	52.8	12.6	21.4	-23.4	-26.9	5.0
Taiwan	38.0	-9.4	21.2	23.2	34.7	1.9

Source: Xinbao

China's main export markets

Total Exports 1997: US$182.7 bn



Source: SSB

In industries such as textiles and garments, where competition is intense, Southeast Asia is unlikely to take away significant market share form China as such trade is determined by non-tariff barriers imposed by leading importers such as the United States.

If China were to devalue its currency, the existing foreign direct investmer would first be hurt. As China is not to devaluate its currency, recent data shows that contractual FDIs new commitments by foreigners have been declining, because the foreign companies are waiting for the devaluation, which is certainly a cause of our concern. However, in the long-run, large multinational corporations committing capital to China to serve the local markets rely on a long-term strategy, which assumes, among other things, a relatively stable exchange rate that more or less reflects market conditions. If the Renminbi were to be abruptly devalued, the dollar return on foreign investment in China would be reduced as well. This would also spark fears about future devaluation, and as such is not a prudent policy at a time when investors are already jittery about emerging markets in general.

Devaluation could also re-ignite the risk of inflation. Imports account for around 20% of China's GDP. A devaluation would increase the domestic price of imports ranging from equipment to raw materials and intermediate goods, eventually leading to higher domestic prices for final consumption goods. Sharply declining currencies elsewhere would not help reduce imported inflation for China., as more than 85% of its imports come from industrial economies and Hong Kong, whose currencies have not weakened in tandem with many of Asia's.

Finally, devaluation could create a host of problems for China. An abrupt change in China's exchange rate policy would make the Hong Kong dollar peg more vulnerable, a consequence that we clearly do not want to see for the political and economic reasons.

Furthermore, the Chinese government is clear aware of the fact that a Chinese devaluation would trigger a fresh round of competitive devaluation in Asia and aggravate the current crisis. We sincerely hope the quick recovery of Asia. The region accounts for more than 60% of China's exports and three-quarters of FDI inflows. As Asia's second -largest economy, China's role is critical in containing the financial crisis and stabilizing regional economies. Although China has pledged financial support for Thailand under the IMF bailout package, the most effective assistance it can extend to its neighbors, I do believe, is to maintain its own fast economic growth, led by domestic demand rather than exports.

In addition to the above objective reasons, the most important factor that determined the stability of the Chinese currency is that the Chinese government has taken a responsible attitude towards the Asian financial crisis.

(2) Can the 8% growth target be achieved?

There is growing concern about the robustness of the Chinese economy, given the size of the reform task currently underway and the more rapid deterioration in the economic prospects for many of China's neighbors, including Japan. However, recent studies make me continue to believe the Chinese economy is heading for a soft landing in 1998, with growth likely to accelerate in 1999, particularly in the second half of the year.

To boost economic growth, the central bank of China has employed such measures as lowering interest rates and increasing money supply. Some results have been achieved. China's broad M2 money supply, which includes cash in circulation, personal saving and business deposits, rose to 15.5 percent year-on-year to 9.4 trillion yuan (US$1.13 trillion) at the end of May, this year(1998).

In May, the growth rate was one percent point higher than in April, the first time in the year the declining trend had been reversed.

Loans extended by all financial institutions rose 15.2 percent to 7.7 trillion yuan (US$928 billion) at the end of May, 1998.

China's fixed asset investment growth will exceed 15 percent this year (1998), five percentage points higher than last year.

With efforts, this year's economic growth targets of 8%, or a little bit higher, will be attainable. The supporting factors include: the present status of transportation, energy, raw materials, agriculture, foreign exchange reserve and inflation rate allow the high growth rate of 8%; investment is clearly encouraged instead of being limited; the local governments at all levels are very active.

The world opinion has generally acknowledged China's action in dealing with the crisis as responsible and bold. China has received real recognition both for its active engagement in providing "tangible assistance" to help regional economic recovery, and for its willingness to make the "tough decision" not to devalue its currency.

What lessons should be learned?

What lessons should be learned from the crisis? Many people are studying the causes of the crisis. Why the East Asia countries and regions with their fast growing economies could not resist the attacks by the international money speculators? It is clear now that the fundamental causes for the crisis lie in the irrational economic structure, unhealthy financial systems, extensive way of economic growth, and comparatively backward infrastructure. Actually, the crisis is the "syndrome" of currency crisis, banking system crisis and debt-servicing crisis.

The causes for the financial crisis can be categorized as:

(1) The instability of macro-economy;
(2) The premature liberalization of financial sector;
(3) The inadequate government involvement in the economic activities;
(4) The irrational internal control system;
(5) The unsound market infrastructure.

The Chinese economy has not been directly and severely hit by the East Asia financial crisis because of the following factors:

(1) The central government has taken a series of actions to monitor the financial sector and prevent the financial risks;
(2) The success of China's macro economic adjustment and realization of high growth rate and low inflation, which enhanced the preventive capability of financial risks;
(3) The favorable balance of trade and strong foreign exchange reserve;
(4) The inconvertibility of the Renminbi under the capital account;
(5) The comparatively reasonable structure of China's foreign capital and foreign loans;
(6) China's legal framework construction of financial sector is in good progress

In general, China's financial sector is developing steadily and healthily. However, there still exist some potential financial risks, such as bad debts, financial disorder in some places, non-standard financial operation of non-banking institutions, etc..

China is on the way to the governance by laws. The following actions will be very important for the development of financial sector:

(1) Against the backdrop of globalization of world economy, it is critical to keep the balance between the reform, opening up and the economic, financial safety;
(2) Speeding up the financial reform;
(3) The perfection of financial legislation and implementation of financial laws and regulations;
(4) The perfection of state financial monitoring system and strengthening the internal self-discipline system
(5) To increase the financial transparency;
(6) To standardize the legal relations between the government and the enterprises and banks;
(7) To popularize the basic financial and legal knowledge among the people.

The recent East Asia financial crisis has brought forth a great disaster to the Asian people, but we, Chinese, are used to turning the bad things into good things. We believe in the philosophy that if life gives you a lemon, make it lemonade. The Chinese government is doing everything possible and responsible to stabilize its currency and to maintain its target of 8% of economic growth, even at a very high cost, so as to make due contributions to the stabilization and recovery of East Asia economy. So long as we can draw necessary lessons from the crisis, I have no doubt that the Asian economies, particularly the Korean economy, will regain their glamour before long.

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