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.'[69]

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 microeconomic ones; 'twiddling' with macro indicators, which in any case only helps in the short term, will not solve the economy's problems.

[69] 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.

After 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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performing loans, the stability of the exchange rate over the medium or the long run.

The speculative attack launched against the Thai Baht in mid-1997 has been triggered by macroeconomic imbalances coupled with moral hazard problems, according to certain points of view,[1] or alternatively was the result of a financial panic leading to a bank run.[2] The literature on the subject has been highly prolific over the last year and a half, but the aim of this paper is not to argue in favor of any particular explanation. Rather, it sheds some light on the reasons for the apparent stability of China at a time when the currencies of other Asian countries were under massive and unexpected speculative attack.

Starting from the economic indicators of the country under study, it appears that its external position is very enviable: current account surplus – 3 percent of GDP in 1997 –, low level of debt – about 15 percent of GDP in 1997 –, small fiscal deficit, long-term external liabilities – the short term debt accounts for less than 20 percent of China's external liabilities –, large foreign exchange reserves – $ 140 billion in 1997, the second largest in the world after Japan. From the macroeconomic point of view, China differs widely from the other economies of South-East Asia. Thailand, the first country hit by a speculative attack, ran a large current account deficit several years prior to the crisis, and the short maturity of its debt made it extremely vulnerable to any reversal of capital flows.

China's record is also remarkable in terms of growth and monetary stability. The inflation rate decreased steadily, to recently reach a negative value (–1.4% in 1998). China displayed a double digit annual growth of GDP in the early 90's, and this growth has remained high thereafter (officially 7.8% in 1998). These figures are at the very least impressive, particularly in the wake of the Asian currency crisis. Hence, there are some good reasons to think that China has been apparently unaffected by the regional crisis and has not deeply suffered, so far, from the aftermath of the currency collapses.

Some factors specific to China may have contributed to isolating the country from the negative consequences of the crisis. In this way, the officially closed capital account has no doubt shielded the value of the Renminbi against massive sales. A bank run due to herd behavior has been prevented by the non-liberalization of the operations on the capital account. China has however no 'comparative advantage' when it comes to the state of the banking sector. An average percentage of bad loans counting for at least 20 percent of the total amount of loans is admitted by a majority of observers. This bad shape of the banking sector was one of the main causes of the crisis in the Asian-5 (Indonesia, Korea, Malaysia, Philippines, Thailand). The poor regulation and the lack of credit culture have led the Chinese banking sector to a deep – though hidden – crisis. The amount of bad loans is today as high as it was in the Asian-5 and probably even higher.[3] However, taking advantage of state support and its role of lender of last resort, these financial institutions have not yet gone into bankruptcy.

Clear risks remain ahead. First, the decrease in Chinese exports observed over the last two years may be a good argument for Chinese exporters to lobby actively for a devaluation of the Renminbi. Second, the peg of the Hong-Kong dollar appears to be more and more costly over time – Hong-Kong fell into a recession last year by maintaining a high level of interest rates. So the question of the devaluation of the Hong-Kong dollar is open. Third, the expansionary fiscal policy that is due to be implemented as of 1999 in China might put in question the stability of the Renminbi vis-à-vis the US dollar and push for a readjustment, sooner or later. This argument has become particularly relevant since a big public spending of $ 750 bn – mainly on infrastructure – to boost GDP has been decided for the period 1999-2001, with no indication that a similar scheme will not be pursued in the years after. Therefore, budget problems are very likely to get bigger. Fourth, the Chinese economy differs widely from the US economy, so shocks and cycles are hardly expected to be synchronized. This is an argument in support of a regular adjustment of the exchange rate parity, at least if shocks hit the supply side of the economy.

The rest of the article is organized as follows. Next the state of the Chinese economy after the crisis will be discussed and evidence given that it remains the main pole of stability in the region. This will be followed by a broad macroeconomic comparison with the countries of the Asian-5 which shows that the

[1] See Paul Krugman: What happened to Asia?, MIT, mimeo, January 1998.

[2] See Steven Radelet, Jeffrey Sachs: The East Asian Financial Crisis: Diagnostic, Remedies and Prospects, Brookings Papers on Economic Activity, No. 1, 1998, pp.1-90.

[3] See Nicholas Lardy: China's Unfinished Economic Revolution, Brookings Institution, Washington DC 1998.

costs associated with an unchanged parity of the Renminbi in the short run are not excessively high. The next part highlights some of the more prominent risks that might endanger the current stability of the Renminbi over time, putting particular emphasis on the danger of a weak banking sector. The final part summarizes and concludes.

China's Economy After the Asian Crisis

China's economy has grown on average by over 10 percent in the last seven years. From 14 percent in 1992, the growth of GDP has fallen to 7.8 percent in 1998, reflecting a steady decrease over time. Nevertheless, in the context of a global crisis in the region these figures appear outstanding.

The Chinese currency has proved to be very stable against the US dollar over the last five years;[4] its value has been practically constant between 1995 and 1998. The Indonesian Rupiah – the currency of a country that has somewhat similar specialization to the Chinese economy – lost three quarters of its value against the US dollar over the same period of time. The other Asian countries also experienced a sharp depreciation of their respective currencies between the third quarter of 1997 and the first quarter of 1998. The Japanese Yen started to depreciate in mid-95, and since Japan is a major actor in Asia, the yen's slow decrease – a loss of one third of its value in about three years – threatened the stability of the whole region (even though the Yen simply came back to its 1990 value). Indeed, the Asian-5 currencies were pegged to the US Dollar, and the increasing overvaluation of the Dollar vis-à-vis the Yen was possibly one of the reasons for the triggering of the Asian financial crisis.

Many argued that the Renminbi devaluation already occurred in 1994 when the official rate depreciated by over 30 percent during the first quarter, but this argument seems irrelevant as explained by Radelet and Sachs.[5] They show that the 1994 devaluation of the Renminbi had a very limited impact in the region because it affected only transactions conducted at the official exchange rate, that is less than 20 percent of the total, and its real effects had been largely compensated through the higher inflation in China than in the Asian-5 in the years following the so-called devaluation. Table 2 provides the nominal exchange rate of the Renminbi vis-à-vis the US Dollar for both the official and the swap market. From this, it appears that the nominal exchange rate on the swap market in 1993 – that is prior to the devaluation – already reflected the parity that emerged after the devaluation. Thus, this devaluation only made official a parity that previously existed on the swap market.[6]

Turning to foreign exchange reserves, a dramatic increase has occurred in recent years. From $ 21.99

Table 1
Quarterly Index of Domestic Currency Exchange Rate per US Dollar
(January 1993=100)

	China	Thailand	Indonesia	Malaysia	Philippines	Korea	Japan
93-I	102.5	99.8	100.1	100.4	100.1	100.3	96.7
93-II	109.0	98.8	100.6	98.8	105.6	101.1	88.1
93-III	107.9	98.9	101.7	98.3	110.1	102.1	84.8
93-IV	108.1	99.4	102.0	98.1	112.1	102.2	86.7
94-I	127.2	99.5	103.1	104.6	109.2	102.3	86.2
94-II	129.1	98.7	104.3	101.2	107.4	102.1	82.8
94-III	127.9	97.9	105.2	99.0	103.8	101.5	79.4
94-IV	126.8	98.1	106.1	98.5	97.2	100.6	79.3
95-I	125.6	97.8	107.1	98.1	99.5	99.4	77.2
95-II	124.3	99.8	108.1	95.2	102.2	96.5	67.6
95-III	123.7	97.8	109.6	95.4	101.7	96.9	75.5
95-IV	123.8	98.5	111.0	97.5	103.2	97.4	81.4
96-I	123.9	99.0	112.5	98.1	103.5	99.0	84.7
96-II	124.0	99.2	113.6	96.5	103.4	99.3	86.2
96-III	123.7	99.3	114.0	95.9	103.6	103.3	86.8
96-IV	123.6	99.9	114.3	96.8	103.8	105.1	90.7
97-I	123.5	101.4	116.4	95.5	104.0	109.5	96.7
97-II	123.5	101.6	118.2	96.4	104.2	112.7	96.3
97-III	123.4	126.5	132.2	106.5	117.6	113.6	94.6
97-IV	123.3	156.0	184.9	132.1	138.8	138.9	100.5
98-I	123.3	186.5	462.8	153.4	160.6	203.9	103.3
98-II	123.3	154.3	433.0	144.9	154.1	176.6	107.0

Source: Far Eastern Economic Review, all issues in 1993-98. Quoted by Harry X. Wu: Reform of China's Foreign Exchange Regime and its Implications in the Light of the Asian Financial Crisis, Moct-Most, No. 3, 1998.

Table 2
Nominal Exchange Rate
(Renminbi/US Dollar)

	1988	1989	1990	1991	1992	1993
Official	3.72	3.77	4.78	5.32	5.51	5.76
Swap Market	6.80	6.38	5.80	5.83	6.52	8.59

Source: see Table 1.

[4] The Chinese foreign exchange rate was unified on January 1, 1994 (from a previous dual system) to accomplish current account convertibility. The former dual system consisted of swap and official market exchange rates. Hence, starting from 1994 makes the comparison easier against the value of the US dollar.

[5] See Steven Radelet, Jeffrey Sachs, op. cit.

[6] On April 4, 1994, the first trading day of the China Foreign Exchange Trade System (CFETS) in Shanghai, the Chinese currency was sold at RMB Yuan 8.6967/US $ 1.

Table 3
China's Macroeconomic Fundamentals (1990-1996)

	1990	1991	1992	1993	1994	1995	1996
GDP growth (annual, %)	3.74	9.47	14.61	13.89	12.97	10.73	9.87
Foreign exchange reserves (US $ billion)	11.09	21.71	19.44	21.99	51.62	73.59	105.0
Financing from abroad[1]	0.79	0.68	0.63	0.83	0.15	0.02	n.a.
Short term debt (% of total)	16.84	17.88	19.00	17.80	17.40	18.90	19.72
Exports (% of GDP)	14.80	16.22	16.31	14.39	21.98	20.95	n.a
Imports (% of GDP)	12.04	13.36	15.28	16.36	20.62	19.40	n.a
FDI, net inflows (% of GDP)	0.98	1.15	2.66	6.37	6.24	5.13	4.92
Unemployment rate (%)	2.5	2.3	2.3	2.6	2.8	2.9	3.0
Changes in CPI (annual, %)	3.06	3.54	6.34	14.58	24.24	16.90	8.32

[1] as a percentage of GDP.

Sources: World Bank: World Development Indicators –1998; IMF: International Financial Statistics (unemployment rate); The People's Bank of China (foreign exchange reserves).

billion in 1993, the reserves reached $ 140 billion in 1997, meaning that they have been multiplied by 6.5 in only four years. With $ 140 billion at its disposal, China has the world's second highest level of international reserves, just after Japan. This huge amount of foreign exchange reserves would certainly be a robust shield to face a possible speculative attack, should China allow for a liberalization of its capital account in the medium run. Moreover, the Chinese authorities have lately announced their intention to reduce capital flight, an endemic disease in recent years. Indeed, the State Administration for Foreign Exchange (SAFE) is expected to take a series of measures to plug the holes in China's officially closed capital account.

Because the level of foreign exchange reserves is high – international reserves are nearly three times the commercial bank debt and six times the size of short-term external liabilities – the country's external debt remains a minor issue. China could possibly counter an attack by selling a certain proportion of its reserves, and by doing so, discourage speculators to pursue their action. As far as the maturity of the debt is concerned, most of it consists of long-term debt, leaving the proportion of short-term debt at less than a fifth of the total amount. China is not as reliant on short-term borrowing as were its neighbors.

Some arguments may however darken the picture. First, exports have started to slow down, and the tendency is not expected to be reversed in the coming years. Recent figures show that China's exports have fallen by nearly 8 percent in the first three months of this year, compared to the same period last year. This makes it clear that the massive trade surplus still displayed by China is due to the recent contraction of imports. Second, since the risk premium – measured by the spread between US Treasury Bills and Chinese sovereign debt – has increased, investment in China is considered more risky by international investors.[7] Indeed, potential investors have foreseen an increasing pressure on the value of the Renminbi which could lead to a devaluation, and this uncertainty is likely to keep them out until the issue of the stability of the Chinese currency is settled. Hence, the flow of foreign direct investment should continue to decrease and this constitutes a matter of concern for the future of China's economy, because FDI embodies modern managerial techniques as well as the access to new technologies.

A direct and damaging consequence of the reduced inflow of capital is to make the restructuring of the Chinese economy much more difficult. Indeed, the massive lay-offs that started to occur last year in the public sector will hardly be matched by equivalent job creation in the private sector. Hence, there is an immediate risk of a sharp rise in the rate of unemployment which could seriously endanger the pace of reforms since the Chinese authorities are very keen to maintain social stability in the country, probably at any cost. The short-term gain – the achievement of social stability – may be seen as more valuable than the reforms, related to the restructuring of both the state-

[7] Using a dollar denominated Chinese government bond due in February 2004, the yield spread rose from 75 basis points in September 1997 to 130 basis points in March 1998. See John Fernald, Hali Edison, Prakash Loungani: Was China the first domino ? Assessing Links between China and the Rest of Emerging Asia, Board of Governors of the Federal Reserve System, International Finance Discussion Paper, No. 604, 1998.

Table 4
Debt Service versus Current Account for Selected Countries
(percentages of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997
China								
Current account balance	3.4	3.5	1.5	- 2.7	1.4	0.2	0.9	2.5
External debt service	1.7	1.7	2.3	2.5	2.4	2.2	2	1.9
Indonesia								
Current account balance	–2.8	3.4	–2.2	–1.5	–1.7	–3.3	–3.3	–2.9
External debt service	8.3	8.4	8.7	8.4	8.6	8.5	9	10.5
Malaysia								
Current account balance	–2.1	–8.8	–3.8	–4.8	–7.8	–10	–4.9	–5.8
External debt service	6.9	5.9	5.6	6.1	5.2	6.6	5.4	8.4
Thailand								
Current account balance	–8.3	–7.7	–5.6	–5	–5.6	–8	–7.9	–3.9
External debt service	3.8	4	4.3	4.4	4	5	5.4	7.1
Korea								
Current account balance	–0.9	–3	–1.5	0.1	–1.2	–2	–4.9	–2.9
External debt service	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	15.3	22

Source: IMF: World Economic Outlook, Dec. 1997.

owned enterprises (SOEs) and the banking system, that are needed to put the Chinese economy on the track of a sustained growth in the long run. A tendency to slow down the pace of reforms was observed in 1998, and a major change in the banking sector is very unlikely to occur soon.

Costs of Maintaining the Current Rate

Unlike the other Asian emerging economies, China does not suffer from a current account deficit. Thailand's deficit reached 8 percent of GDP in both 1995 and 1996, the two years preceding the crisis. And the average deficit of 6.9 percent between 1990 and 1996 reflected indisputably a very poor and worrying performance. But Thailand was far from being an isolated case in the region. Indeed, no country of the Asian-5 could do better than a 3 percent deficit in 1996. Placing the respective imbalances on a scale would put Malaysia and Thailand as the worst performers. Indonesia and Korea also suffered from current account imbalances but their records were by far less worrying – 3 percent of deficit in 1996 for both of them. By contrast, China succeeded in achieving in a positive current account balance as of 1990 (see Table 4).

The Asian countries whose currency was under speculative attack as of mid-97 had accumulated a massive amount of external liabilities with a very short maturity. And since they had previously fully liberalized the operations on their capital account, these economies were vulnerable to a currency attack, should foreign investors' perception of Asian emerging markets suddenly be reversed. As the mismatches between short-term borrowing and long-term lending became more and more visible, some foreign investors started selling their position and were rapidly followed by all foreign investors – herd behavior. And because the massive sales of domestic currency by international portfolio investors were not covered by a sufficiently high level of foreign exchange reserves, the advent of devaluations became simply a matter of time. In short, the prerequisites for the triggering of a currency attack were fully met.

As against that, the Chinese currency – though convertible for operations related to current account transactions – has no doubt been protected by its non-convertibility on capital account. Foreign investors had no opportunity to sell short on Renminbi outside China. The cautious approach chosen by the Chinese authorities about the sequencing of capital account liberalization has proven ex-post to be wise. It is arguable that, after the experience of the Asian-5 with respect to an early liberalization of the capital account, China will not open its own capital account in the foreseeable future. But today's officially closed capital account has also revealed substantial leaks. Indeed, a quarter of outflows through the current account may in fact be disguised capital flight: dollars earned from false invoicing, illegal foreign exchange deals and other nefarious activities.[8]

In the eyes of a large majority of analysts, China need not devalue its currency at the moment. Putting aside the fact that China is a big player in the region so that any devaluation of its currency would trigger a further round of other devaluations,[9] they argue that there is no strong justification to push for a modification of the current parity of the Renminbi. This argument is reinforced by the recent appreciation of the Japanese Yen. The weakness of the Yen had provided one of the main excuses for a devaluation of the Chinese currency. But today Japan can hardly be blamed for an excessive weakness of its currency. Therefore, a devaluation of the Renminbi could only be justified by a further – and improbable – decrease in the rate of the Asian-5 currencies. Even in that case, a Renminbi devaluation would show Chinese households the weakness of their currency – relative

[8] The amount of illegal capital flight was estimated by The Economist Intelligence Unit at $ 67 billion last year.

[9] See Rudiger Dornbusch: Asian Crisis Themes, MIT, 1998; Rudiger Dornbusch: Is China Next?, in: The Financial Times, August 4th, 1998; Rudiger Dornbusch: Should China Devalue?, in: World Economic Trends, Vol. VII, Issue 4, 1998, pp. 29-31.

Table 5
Financial Vulnerability Measures in Asian-5
(percentages)

	Indonesia	Korea	Malaysia	Philippines	Thailand
Short-term foreign borrowing/total foreign borrowing					
mid-1990	n.a.	68	26	34	58
mid-1994	61	73	59	43	74
mid-1997	59	68	56	59	66
Short-term foreign borrowing/foreign reserves					
mid-1990	n.a.	115	23	342	54
mid-1994	177	165	26	41	101
mid-1997	174	211	63	86	148
M2/foreign reserves					
end 1990	600	649	291	497	456
end 1993	603	685	209	478	403
mid-1997	616	620	399	487	490

Sources: Short-term foreign borrowing data from Ramon Moreno, Gloria Pasadilla, Eli Ramolina: Asia's Financial Crisis: Lessons and Policy Responses, in: Asia: Responding to Crisis, Asian Development Institute 1998; M2/reserves data from IMF: International Financial Statistics.

to the US Dollar – and this might trigger massive withdrawals from Chinese banks. Hence, the whole banking system, currently based upon general confidence of the public, could be seriously damaged. Therefore, a devaluation of the Renminbi may not be a good idea.

In spite of the above evidence, some analysts, among them Jeffrey Sachs, argue that the Renminbi should immediately be devalued by a few percentage points. His recommendation is that China should gradually devalue its currency which is 'in danger of being on the slippery slope of unchangeability'. Jeffrey Sachs insists on the gradual aspect of the devaluation to avoid criticism related to an eventual panic triggered by a currency devaluation. Mr. Sachs further argues that a weaker Renminbi would actually be good for Hong-Kong since the territory is a service center for China rather than a competitor with China's exports. In fact, the Harvard Professor's underlying argument is that delaying currency devaluations only causes more panic when they eventually occur and that it is best to accede to market exchange rates as early as possible.[10]

At this stage the interference between politics and economics is strong. Indeed, the United States is powerful enough to suggest or even influence the choice of a parity of the Renminbi vis-à-vis the US Dollar. Several times in the recent past, US policy-makers have praised the Chinese leadership for not devaluing the Chinese currency. On that question, the United States essentially worries about the potential effects of a Renminbi devaluation on the bilateral trade between the USA and China. In 1998, according to the Department of Commerce, the US trade deficit with China increased by 15 percent to reach $ 57 billion. This gap has steadily grown over the last ten years, making China the second US trade deficit partner after Japan. In the light of this information, the Americans may be expected to take a series of sanctions against China should the Chinese authorities try to increase this imbalance by a currency devaluation. In short, there is no room for further trade surplus, so the hypothetical gains from a lower Renminbi appear very doubtful.

In the light of the arguments developed above, it seems that the risks associated with a Renminbi devaluation are not well compensated for by the potential gains of the devaluation. The overvaluation of the Renminbi relative to the Asian-5 currencies is not the sole argument to be considered. The external position of China is very strong and the fundamentals of the Chinese economy are sound. The impressive trade balance surplus – $ 17.2 billion in 1996 and $ 40.3 billion in 1997 – is no justification for a weaker currency. The foreign debt remains very low by Asian standards, with only a tiny proportion of short term debt. Finally, foreign reserves jumped from 105 to 140 billion dollars between 1996 and 1997, putting China's reserves above its external liabilities. In the light of this, it is rather unlikely that the value of the Renminbi will be soon put under great pressure. Therefore, the commitment not to devalue made by the Chinese authorities appears sustainable for the time being.

[10] See Philip Segal: High-Profile Call for Lower Yuan, in: International Herald Tribune, March 25th, 1999.

Dangers over the Long Run

China competes on third markets with countries whose currencies have been heavily devalued as a consequence of the financial crisis. The repercussions would not be that prejudicial if the Asian-5 had different economic specializations. Unfortunately, there is a certain similarity in the export structure between China and some of these countries – particularly Indonesia – even if the Asian-5 have to some extend upgraded their exports to more sophisticated manufactures. Moreover, most of the products for which they compete are highly price-elastic by their nature (electronics, garments, etc.) This suggests that devaluations of its competitors' currencies might prove to be harmful to China's competitiveness on export markets and the direct outcome might be a rapid slowdown in Chinese exports. Pressure from the industrial sector – particularly from the shipping industry – might then grow to suggest a currency devaluation in order to restore its competitiveness in the world market.[11]

Yet, China does not really suffer from the collapse of other currencies because of the disorganization and the lack of finance in the affected economies.[12] In the medium run, however, a recovery is predictable and the teachings of the J-curve suggest that the Asian-5 will take advantage of the far lower value of their currencies. This fuels the idea that the current value of the Renminbi will prove to be unsustainable in the long run. One argument may however alleviate this pessimistic forecast. China imports products from the affected neighboring countries and re-exports those products after processing. This means that China benefits from a lower value of the currencies of countries from which these goods are imported. Hence, it is arguable that what the Chinese industrial sector lost in export competitiveness is at least partially offset by lower prices of imports. This argument is robust because processing accounts for about fifty percent of Chinese exports. To sum up, the margin that Chinese exporters lost after the real appreciation of the Renminbi relative to other Asian currencies has been to some extent regained ex-ante by cheaper imports from the countries concerned.

A fixed exchange rate typically appears unsustainable over time when the peg involves countries with non-similar economic specialization patterns. In the present case, linking the Chinese monetary policy to the American monetary policy will certainly appear to be somewhat problematic if a permanent supply-side shock is to occur in one country only. Hence, the Chinese policy makers may be pushed to pursue a more independent monetary policy once the tie with US monetary policy is perceived as excessively costly. This argument is fully relevant even though the behavior of both Chinese banks and consumers is not as heavily affected by interest rates movements as that of their western counterparts would be. And since the Chinese capital account has not been liberalized, any interest rate differential between the Renminbi and foreign currencies does not generate a massive capital flow across the border.

The deflation phenomena that reached China last year may contribute to depreciate the real value of the Renminbi. The Chinese Consumer Price Index (CPI) has been steadily decreasing in recent years and China plunged into deflation in 1998. A negative rate of inflation means a real depreciation of the currency relative to the US dollar. Indeed, when the exchange rate between two currencies is fixed, the country experiencing the lower rate of inflation sees a real depreciation of its currency relative to the other one. In the case of China, it is difficult to predict whether this deflation tendency will occur again over the years to come, but most probably China's inflation rate will remain below both the American and the Asian-5 inflation rates. This means that a too strong appreciation of the Chinese currency could be prevented.

Unlike other Asian countries' banks, Chinese banks do not have a substantial foreign exchange exposure even if other financial institutions of the country are saddled with massive amounts of debt due to foreign agents. The collapse of the Guangdong International Trust and Investment Company (GITIC), China's second largest non-bank institution, in October 1998 – with debts of $ 2.4 billion – has highlighted the difficulties faced by this type of institution in servicing its foreign debt. The closed capital account has prevented Chinese banks from borrowing internationally (at low rates) and lending domestically (at higher rates). Thus, the good news is that the stability of the banking sector is not jeopardized by any

[11] A recent study assesses that the overlapping in export structure is rather modest with only 28 percent of Chinese exports directly competing with the four countries most hit by the crisis: Indonesia, Malaysia, Thailand, and Philippines. See Zhang Xiao-guang: Is Devaluation of the Chinese Yuan Inevitable ? The impact of East Asia's Crisis on China, University of Melbourne, Research Paper No. 621, 1998.

[12] Some economists argue that China has not lost export shares and may even in some instances have gained, particularly in the case of Indonesia. See Ramkishen Rajan: Devaluation of the Chinese Renminbi: Is it Inevitable? Is it Necessary ?, The Institute of Policy Studies (IPS), Singapore, and the Claremont Graduate University (CGU) 1999.

excessive currency risks. The weakness of the Chinese banks' balance sheet remains mainly a domestic problem.

The basic problem in the Chinese banking sector is that lending is politically directed. This excludes profitable projects in the private sector from funding, in favor of loss-making SOEs. About two thirds of the total amount of lending is currently devoted to the public sector[13] even though its inefficiencies – compared to the private sector – are obvious. Indeed, state-owned companies account for only about one-quarter of industrial output, and this share is shrinking continuously. Thus, the high saving rates of Chinese households are basically funding big state companies that will most probably not roll over the borrowed money once the maturity of the loan has expired. This suboptimal utilization of savings clearly constitutes a waste of resources. Over the last years, the share of non-performing loans has been growing but, probably due to the lack of alternatives for savers, the confidence of households has so far been maintained. But what if this tendency suddenly reverses?

The share of non-performing loans in the Chinese banking sector is worrying, and is probably higher than it used to be in Korea, prior to the crisis. The guesses of specialists range from 20 to 40 percent of overall loans. From this it is not clear which percentage is potentially recoverable, but the low quality of the SOEs as borrowers may lead to the most pessimistic estimations. The problem takes its root from the lack of incentives to roll over bank loans, since SOEs have no credit culture and can hardly be declared bankrupt, because of the range of social services they provide to their employees. In addition, when a state-owned bank grants a loan to a company which is owned by a local government, there exists a tacit complicity – between the recipient company and the local government – not to repay the sum due to the state-owned bank, but rather to get as much as possible from its 'generosity'. In short, the nature of the relationships between the central government and local governments tends to deepen the problem of repayment.

Table 6
China Versus Other Asian Economies, Selected Indicators (1996)
(percentages)

	Bank Loans/GDP	Short-term BIS Bank Claims/Reserves
Indonesia	55.4	150.3
Malaysia	93.4	38.3
Thailand	100.5	50.6
Korea	61.5	82.9
Philippines	49.0	24.3
Hong-Kong	162.4	n.a.
China	92.7	25.1

Source: John Fernald, Oliver Babson: Why has China Survived the Asian Crisis so Well? What Risks Remain?, Board of Governors of the Federal Reserve System, International Discussion Papers, No. 5, 1999.

The cost of a possible bank restructuring would probably amount to around 20 percent of GDP, provided that the restructuring were undertaken rapidly. Otherwise the price to be paid is naturally likely to grow. Fortunately, China does not have a massive foreign debt, so bank restructuring would involve only a one-time increase in debt, for the amount to be recovered. The current level of debt makes this possibility desirable. However, to avoid wasting extra money, China should not proceed with the recapitalization of its banking sector before the restructuring of the SOEs has taken place. The overall idea is that bank losses are rooted in the real economy.

A reform of SOEs and a redefinition of their function in the economy are then necessary before undertaking a recapitalization of the banking sector. This means that the state should provide all the range of social services that are currently offered by the SOEs themselves. This shift will lead to an increase in state spending; thus, one of the top priorities should consist in raising tax revenues. Social services should be financed directly from the state budget, not by SOEs. The purging of SOEs' statements of account from spending not directly related to their core activities would certainly increase the probability of success of the bank recapitalization program.

In the present situation, suddenly stopping the politically directed loans would be close to impossible. Due to the range of social services they offer, massive disclosures of loss-making state-owned enterprises would lead to social unrest. In short, the roots of the disease lie in the real economy, and the incentives in the banking sector can be modified only if social services are transferred to the state budget. The risk of doing nothing – a possible option – is a further deterioration of the banks' balance sheet. A typical behavior of unhealthy banks would then consist in trying to raise the intermediation margin, thus hitting

[13] See John Fernald, Oliver Babson: Why has China Survived the Asian Crisis so Well ? What Risks Remain ?, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 633, 1999.

small private firms the hardest.[14] Such a development, which has been observed in other countries, would ultimately not help the banks' recovery.

Removing bad loans from the Chinese banks' balance sheet and pursuing an appropriate recapitalization are necessary steps in order to stop distorting the allocation of credit. The question as to whether the non-performing loans should be separated and placed in a specialized asset management company is open. The alternative solution would consist in simply canceling the debts of SOEs, instead of organizing a transfer. Once a solution is selected, the next step is to give the right incentives to managers through a new corporate governance that allows the board of directors to exercise real control over the management. The global aim must be the introduction of a 'credit culture' in the Chinese banking system.

In fact, China could probably avoid social unrest and currency collapse even if the banking sector is not reformed soon. The recapitalization of the banking sector is not an extreme emergency. It is unlikely that a bank run will occur in China, should the share of non-performing loans remain high – partly because of the lack of alternatives. However, by opting for immobility, the Chinese policymakers would allow a further waste of household savings, which might otherwise be used in a more efficient way. An allocation of credits based on commercial criteria, that is an allocation which gives priority to financing projects offering a high rate of return, would put China's economy on the track of a sustained growth over the long run. Unfortunately, time horizon may not at this moment be a matter of great concern to Chinese leaders. Indeed, some recent statements show a very strong desire for short-term growth, a choice that may endanger the achievement of healthy economic growth in the long run.

Summary and Conclusion

China has not suffered very much from the aftermath of the Asian financial crisis. However, it is still unclear whether a domestic crisis has been avoided or simply deferred. Although few argue that the Renminbi should be devaluated now, the academic debate has not settled the question as to whether it is in China's interest to keep the Renminbi at its current parity with the US Dollar over the medium run.

Some economists insist on the danger of a Renminbi devaluation in terms of stability for the whole region. They also raise the possibility of an overreaction of markets, should China decide to devalue the Renminbi, even modestly. Others highlight the fact that it is usually less harmful to devalue a currency by a few percentage points rather than letting adverse market forces grow and eventually push for a heavy devaluation. The recent market-led devaluation of the Brazilian Real – in January 1999 – certainly provides good arguments to support the latter rather than the former.

Both ways of thinking may actually be correct. Indeed, the first one can hardly be challenged at this moment since no macroeconomic imbalances have so far emerged. But the three-year period program of massive public spending due to be implemented as of this year will certainly drive up imports into China, so that a current account deficit cannot be excluded in the medium run. If this hypothesis is proved to be right, the second approach will become valid.

Some parameters like the evolution of the rates of other currencies are going to influence the decision of the Chinese authorities. If the Japanese Yen and the various currencies of the Asian-5 appreciate against the Renminbi, the core of the arguments of the pro-devaluation stance will be withdrawn and the prospect of a status quo will grow. However, due to China's managed exchange rate, the value of its currency will eventually reflect a deliberate policy decision.

It is worth noting that China's long-standing commitment not to devalue the Renminbi has been softened by a recent statement by the governor of the Central Bank (People's Bank of China). Indeed, Dai Xianglong accepted the idea of a devaluation in case of 'great imbalance in the balance of payments ... and a great increase in the cost of exports'. Chinese officials are also considering the idea of pegging the Renminbi to a basket of currencies of trading partners – including the Japanese Yen and the Korean Won – in order to soften the rigidity of the current peg to the US Dollar.

In the long run, a large country like China will certainly have to move towards a more flexible exchange rate. When macroeconomic imbalances, and most particularly high inflation, have been driven out of the economy, the introduction of a floating exchange rate is desirable. The risks of pegged exchange rates in emerging markets have been abundantly documented and it is advisable for China to let its exchange rate float in the medium run.

[14] See Bengt Holmstrom, Jean Tirole: Financial Intermediation, Loanable Funds, and the Real Sector, in: The Quarterly Journal of Economics, Vol. CXII, Issue 3, 1997.