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Asia's Crisis and China's Response by Ronnie C. Chan

Sooner or later, every emerging economy will face two tests: first, how healthy are its economic and financial structures, and second, how well does its government and private sector manage their financial affairs. The latter can usually be measured by the amount of hard currency debt there is, especially those of short term nature.

When judged by these criteria, East Asia economies fall into three groups. First, only two economies pass both tests, namely Hong Kong and Singapore. Three others, Japan, Taiwan, and Mainland China fail the structural test but nevertheless manage their affairs acceptably. China is also helped by the fact that her financial market is not opened to the outside world. As to South Korea, Indonesia, Thailand, Malaysia and the Philippines, they flunk both, as proven by the recent economic turmoil.

It is inevitable that even Hong Kong and Singapore are affected by the debacle of late. Singapore, as a service center to its neighbors (all of which are in trouble), will recover slower. Hong Kong (which serves primarily the relatively healthy China) should fare better and should be the first to get back on its feet. Hong Kong, however, has an Achilles heel: the Hong Kong dollar – U.S. dollar peg which will keep interest rates high for some time.

Japan and Taiwan have so far been spared. Japan is deep in its own economic problems and so can neither help its neighbors nor take advantage of their plight. Taiwan will stand to benefit from the cheaper production rates in Southeast Asia, although South Korea will be a tougher competitor than before in spite of Taiwan's voluntary currency devaluation.

The big issue on everyone's mind is: what will China do? In the Davos Annual Meeting of the World Economic Forum, Vice Premier Li Lanqing said that China would continue its economic reform and opening, and would not devaluate its currency, the Renminbi. The question is: why?

Since 1978 when China's reform begun, Beijing leaders have gradually come to the conclusion that the country must align its economy with that of the world's. China will never shake off poverty with anything short of that. So for 19 years, government policies have moved toward that direction. A prime example is China's efforts to gain admittance to the World Trade Organization which will mean short term pain but longer term competitiveness.

As a witness to the financial bloodbath of its neighbors, China recognizes that inappropriate economic structure is at the heart of its problem. Since more market opening is inevitable, further reform becomes urgent. The only exception is that China will be careful in opening certain aspects of its financial system to the West. The fear is that unless the economy is strong, China may succumb to attacks on the Renminbi by international financial speculators just as its neighbors did.

For now, the West is also fearful that competitive pressure will force China to devalue its currency. This will set off another round of currency devaluation in the region with catastrophic effect on the global economic system. There are at least four reasons why it is neither to China's advantage nor is it necessary to tamper with the Renminbi.

To start, China's economic condition has remained healthy. Inflation is low, the savings rate is high, and there is a trade surplus. Foreign currency reserves exceed foreign debt which is predominantly long term. This is why only a year or so ago, the U.S. had wanted China to appreciate its currency to alleviate America's trade deficit. If the Renminbi could have strengthened then, why should it weaken now?

Second, competitive devaluation will not work when neighboring currencies have lost 45% to 75% in value. A drop of 10 - 15% for the Renminbi will have little impact. A depreciation of 30 - 35% may help but will also invite inflation which China can ill afford. Worse yet, once a slide of that magnitude begins, there is no guarantee that it will stop at the prescribed level. And no country will volunteer to devaluate its currency to the extent that Thailand or Indonesia has done lately. The damage to the domestic economy is severe and lasting, and it will scare away much needed foreign investment. This is not to mention the possibility that it will spark another round of competitive devaluation which will leave China worse off than before.

Third, China's exports remain strong for now because foreign buyers are not going to Thailand since banks cannot issue letters of credit. They are skipping Indonesia as well for fear of political instability. But these situations will change. Once conditions in Southeast Asia stabilize, China's export will drop. Whereas American trade deficit with Asia shifted from the rest of the region to China when the Renminbi depreciated by some 33% in January 1994, the reverse will inevitably happen. In addition, foreign direct investment into China has already been slowing in the past year, and the trend will continue. After all, one such source of funds previously was the Southeast Asian ethnic Chinese who, as a group, must be the biggest loser in the recent economic debacle. Many of them are now technically bankrupt.

As such, China will need other sources of foreign funds to help in economic developments including the reform of state-owned enterprises. One source is the Hong Kong stock market. In 1997, "red-chip" companies collected about US$9 billion from the Hong Kong bourse. Devaluation of the Renminbi will put pressure, if only psychological, on the Hong Kong dollar-U.S. dollar peg. If the peg breaks, it will drive away investors from the Hong Kong stock market.

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Finally, the present situation presents China with a tremendous opportunity to demonstrate that it too is a responsible, constructive and even caring member of the international community. In the past, the West has felt that China was always demanding something from them - admission to WTO, MFN status from the U.S. etc. Now for once, the West thinks that it needs China; it is afraid that China will devalue its currency. China might as well take advantage of the situation since negotiation with the West will now be easier.

What should China do given the Asian crisis? As Vice Premier Li Lanqing stated in Davos, the country would stimulate domestic demand mostly in the form of infrastructure development. A major source of funds will be the Chinese people's savings. In the banking system alone, there is approximately US$500 billion, on top of the estimated US$80 billion under mattresses. In other words, despite the need for foreign capital, China's financial holdings are not insubstantial. The problem is the mismatch of supply and demand of funds**.** Mechanisms that channel money such as the banking system, capital market and investment vehicles are all inadequate. Herein is another reason why reform must proceed with all haste.

In the longer run, China must do two things. First, open up the Central and Western parts of the country where cheap labor is plentiful. This will not only alleviate the problem of regional inequality but also keep China competitive. So far the bottleneck is the lack of accessibility, and government is expediting infrastructure developments.

Ultimately, China must improve productivity. Management practices of Chinese enterprises must take quantum leaps and the use of technology must increase. Only so will China be weaned from total dependence on cheap labor, and become truly competitive in the globalized marketplace of which it is increasingly a part. If there is a silver lining to the Asian crisis for China, it is the bringing of this need to the forefront. It is now up to the Chinese to meet the challenge.

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