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**The Impact of the  
Asian Crisis on China:  
An Assessment**

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**Economics Department  
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**THE IMPACT OF THE ASIAN CRISIS ON CHINA:  
AN ASSESSMENT**

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## THE IMPACT OF THE ASIAN CRISIS ON CHINA: AN ASSESSMENT

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## EXECUTIVE SUMMARY

### Main Conclusions

- Since the Asian currency crisis erupted in Jul 97, there has been incessant speculation that China would be forced to devalue the renminbi, because China's exports would become less price-competitive compared to exports of the regional countries. However, this "price effect" is only one aspect of the Asian crisis on China. There is also an "income effect" on China if the devaluation leads to a greater slowdown in the regional economies which are important export markets for, and important investors to China.
- While devaluing the renminbi may temporarily improve the price competitiveness of China's exports, the negative income effect on its exports to and investment from East Asia is likely to be worse than what it might gain from greater competitiveness. Therefore, a renminbi devaluation would, on net, still hurt China's external sector. However, anecdotal evidence shows that price competition from the region is already affecting selected industries, e.g. textiles and steel, in China. These industries have intensified their lobbying of the central government for a devaluation.
- With China's strong external position, the government can still hold out against these pressures for a devaluation. Despite a porous capital account, China's foreign exchange reserves of US\$140 bn are large relative to external debt, even after taking into account higher estimates of external debt and unrecorded outflows on the capital account.
- The Asian crisis rules out the possibility of strong external demand offsetting softening domestic demand in China. Given that China needs growth to ease transition problems in its structural reforms, the government is under pressure to stimulate domestic demand through

monetary and fiscal policies. Although there is little scope for stimulus from monetary policy, China can pump-prime the economy through fiscal spending, particularly on infrastructure. The government has to be careful not to give in to the temptation to order the banks to bankroll wasteful fiscal spending, which would compromise long-term banking reform.

### **Did China Devalue Competitively First?**

1 There is little support for claims by analysts that China had devalued competitively first in Jan 94, thus triggering the subsequent East Asian export slowdown in 1996. First, China had devalued its official exchange rate, whereas in its dual exchange rate system then, 80% of foreign exchange transactions were already taking place at a more depreciated, market-driven "swap rate". Weighting by the value of transactions at the two exchange rates, the devaluation was only 7% against the US\$. Second, any competitive gains from the nominal devaluation in Jan 94 was quickly wiped out by China's high inflation in 1994-96. Third, export data showed that China's export growth over 1994-95 was not at the expense of the ASEAN countries, which also had an export boom. Indeed, the subsequent downturn in East Asian exports in 1996 was more severe for China than for ASEAN.

### **The "Price Effect": Would China Devalue?**

2 The "price effect" assumes competition between China's and the region's exports. China's export structure overlaps significantly with that of ASEAN-4 countries, and to a lesser extent, with that of Korea. Looking at US import data, low-end exports of apparel and clothing, footwear, and miscellaneous manufactured articles such as toys comprise 45% of US imports from China. The US imports essentially these same commodities from the ASEAN-4; these commodities comprise about 10-30% of US imports from ASEAN-4. Data from another major market, Japan, shows less of an overlap, because Japan imports more primary commodities such as oil from ASEAN-4.

3 A summary indicator of China's loss of price competitiveness is the real effective exchange rate. Taking into account competitor effects from ASEAN and Korea, calculations show the renminbi appreciating by 12-24% (depending on the weight given to ASEAN) in real effective terms from end-Jun 97 to end-Jun 98. This is a substantial real appreciation, but it is not unprecedented. In 1994-95, the renminbi appreciated by 14% per annum in real effective terms, but this did not substantially affect China's export growth due to strong regional demand. However, with the sharp slowdown in the region, such a large real appreciation in the renminbi now is likely to have a more adverse effect on export growth over the medium term.

4 Media reports show the extent of the official concerns over China's loss in price competitiveness. China has started giving subsidies to certain exporters, e.g. in the textile industry. Domestic producers in heavy industries such as shipbuilding and steel, facing competition from cheaper Korean and Japanese imports, have also publicly spoken out in favour of a devaluation. Moreover, the more export-oriented provinces in China, which would be disproportionately affected by the external sector slowdown, also account for a substantial share of China's GDP (top 5 export-oriented provinces account for one-fifth of China's GDP), and are among China's highest-growth provinces. These industries, and possibly also the provinces, are likely to be strong domestic lobbies for a devaluation.

#### **The "Income Effect": Impact of the Regional Slowdown**

5 The "income effect" of the crisis on China is apparent in China's slowing export growth (7.6% in 98H1 compared to 26% in 97H1). China's exports to Japan, which absorbs almost 20% of China's exports, have contracted by 6% in the first five months of 1998. Overall, China's export growth has been boosted by continued growth in its exports to the US and EU, which together absorb about 30% of China's exports. Moreover, although China's export growth has fallen sharply from that in 1997, it is relatively strong compared to the near-zero or negative export growth in the rest of the region.

6 FDI inflows into China have held up despite the crisis, and totalled US\$20.5 bn in 98H1, roughly the same level as in 97H1. Portfolio inflows, which in magnitude terms are usually less than 10% of FDI inflows, are however expected to slow more sharply in 1998.

7 In all, the income effect of the Asian crisis has not fully affected China yet. China still ran a large trade surplus of nearly US\$27 bn in the period Jan-Jul 98, and strong FDI inflows continued to boost its capital account. In 1998-99, however, China's exports and investment inflows are almost certain to slow further as the downturn in the region sets in. A renminbi devaluation, which could accelerate the regional downturn through the contagion effect, would affect China negatively.

### **China's External Position**

8 China large foreign exchange reserves (US\$140.5 bn equivalent to 12 months of imports as at end-Jun 98) relative to external debt of US\$131 bn, and its closed capital account, are positive factors supporting China's external position. However, there are some weaknesses in China's external position. China's capital account is rather porous despite capital controls. The large errors and omissions figure in China's balance of payments – US\$22.7 bn in 1997, which was equivalent to net recorded inflows on the capital account – suggests large unrecorded capital outflows. Moreover, data from the Bank for International Settlements (BIS) suggests that China's short-term debt could be US\$35 bn larger than the official figure of US\$18 bn.

9 Nevertheless, China's external position is strong enough to withstand devaluation pressures. This conclusion is based on China's large foreign exchange reserves relative to external debt, even after taking into account higher estimates of short-term external debt and unrecorded capital outflows. The recent slowdown in China's forex reserves growth could be partly explained by a net outflow of trade credit, as well as a change in the foreign exchange system that allowed domestic exporters to retain 15% of their forex earnings.



### **Scope for Domestic Stimulus**

10 With the Asian crisis, China's strong external sector performance in 1997 may not be repeated. The effect of the crisis on China will become more severe in 1998. However, China needs to maintain high growth to ease transition problems in its structural reforms, in particular, to stem rising unemployment from state-owned sector restructuring. The government is therefore under increasing pressure to stimulate domestic demand through monetary and fiscal policy.

11 In monetary policy, China has moved away from direct policy tools, such as administrative controls on credit, to more indirect instruments such as managing the reserve money base and interest rates. However, because China's monetary system is still undeveloped, the transmission mechanism for these indirect instruments to GDP growth is still quite weak. For example, the five interest rate cuts since May 96 were ineffective in stimulating either consumption or fixed investment.

12 There has not been a real easing in monetary and credit conditions in China. Despite cuts in nominal rates, real interest rates have continued to rise because of falling inflation, and credit to banks has remained tight. Therefore, Premier Zhu Rongji's statement at end-Jul 98 that China is indeed suffering from deflation is significant, because it could signal the start of a significant loosening of monetary policy. However, monetary easing in the new regulatory environment may be difficult, as banks are increasingly unwilling to lend for fear of running up bad loans. If banks were ordered to lend in a bid to quicken monetary loosening, banks' balance sheet might be weakened further.

13 Fiscal policy offers a more direct and effective route to boost domestic demand. Given that the government has accounted for more than half of China's total fixed investment in the 1990s, increased government spending can be a significant stimulus. The government is targeting its spending in two areas: infrastructure and housing. Infrastructure spending would be focused on building railways, roads and rural infrastructure such as

electricity networks and irrigation systems. With the targeted end to state provision of housing in Jul 98, Chinese households would be encouraged to buy their own homes.

14 Between infrastructure and housing, infrastructure spending, particularly in rural areas, offers more potential for effective fiscal stimulus. In contrast, the boost from housing in the short-term is likely to be limited by the political sensitivity of housing reform. China should be able to finance its increased spending through issuing state bonds. The government's outstanding stock of domestic debt is relatively low at Rmb540 bn or 7.2% of GDP as at end-1997. The increased spending will occur off-budget.

15 To conclude, there is scope for the government to pump-prime the economy through fiscal spending. However, the boost to GDP growth may not be as significant this year; the extensive restructuring in the government apparatus could delay swift implementation of this fiscal spending. As for monetary policy, a balance needs to be struck between a further easing in monetary conditions and the risk of a deterioration in the loan portfolio of the banks.

## 1 INTRODUCTION

1.1 There has been incessant speculation that China would be forced to devalue the renminbi, because China's exports would become less price-competitive compared to exports of the regional countries. However, this "price effect" is only one aspect of the Asian crisis on China. There is also an "income effect" on China if the devaluation leads to a greater slowdown in the regional economies which are important export markets for, and important investors to China.

1.2 These two separate effects have different policy implications for China. Devaluing the renminbi may temporarily improve the price competitiveness of China's exports, but this gain is likely to be overwhelmed by the negative income effect on its exports to and investment from East Asia. Besides looking at these two effects, the paper also examines China's present external position to assess if China has enough foreign exchange reserves to keep its pledge of a stable renminbi.

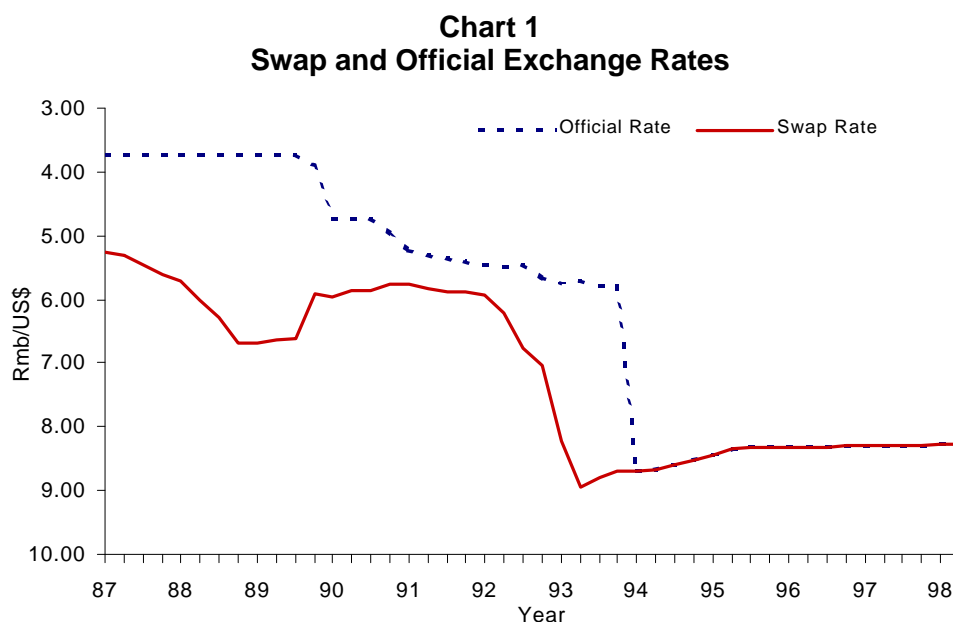
1.3 The Asian crisis also rules out the possibility of strong external demand offsetting softening domestic demand in China. Through slower growth, the crisis could stall China's essential structural reforms.

1.4 The paper is organised as follows: section 2 addresses the argument that China devalued competitively first in Jan 94, causing the subsequent export slowdown in East Asia. Sections 3 and 4 examine the price and income effects respectively of the Asian crisis on China. Section 5 assesses the strength of China's external position. Section 6 examines the scope that China has to stimulate its domestic economy through monetary and fiscal measures.

## 2 DID CHINA DEVALUE COMPETITIVELY FIRST?

2.1 Before assessing the impact of regional devaluation on China, this section looks at the argument often mentioned by analysts, that China was actually the first to devalue competitively in Jan 94.

2.2 Prior to 1994, China had a dual exchange rate system with a fixed official rate, and a more depreciated market-driven rate, the so-called "swap" rate. In Jan 94, the official rate was unified with the swap rate. The official rate was therefore devalued by 33%, from Rmb 5.8 to Rmb 8.7 per US\$, in Jan 94 (see Chart 1). Analysts argued that this was a competitive devaluation that resulted in a surge of Chinese exports, and contributed to the subsequent slump in East Asian exports in 1996.

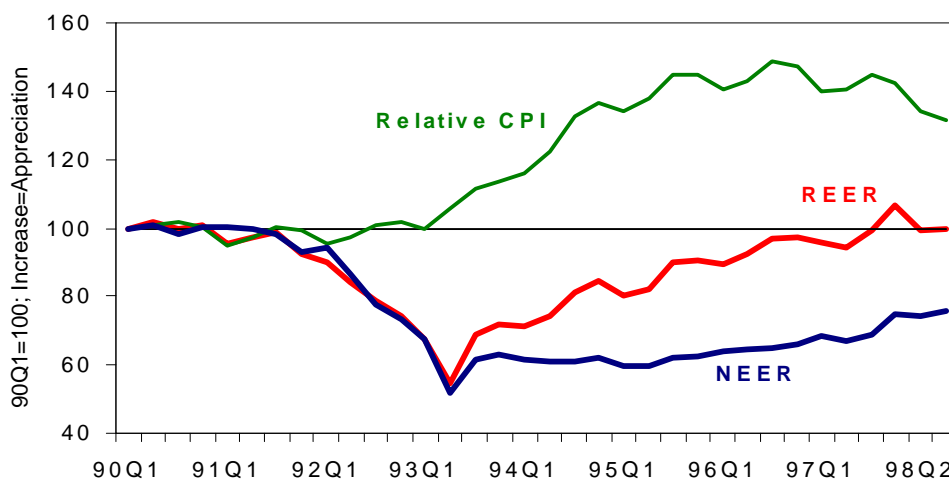


2.3 The impact of the devaluation may have been overstated. First, by 1994, 80% of forex market transactions were already taking place at the market-determined swap rate. The Jan 94 devaluation of the official rate to the swap rate was merely the next logical step in phasing out the

increasingly irrelevant official rate<sup>1</sup>. Weighting it by the value of transactions at the official and swap rates, the renminbi was devalued by only 7% in nominal terms against the US dollar in Jan 94.

2.4 Second, even if China's exports had become more competitive due to its nominal devaluation in Jan 94, these gains were quickly wiped out by its high inflation averaging 18% per annum<sup>2</sup> in 1994-95 (Chart 2). Over 1994-96, China's real effective exchange rate (REER) appreciated back to its level in the early 1990s.<sup>3</sup>

**Chart 2**  
**China's Real Effective Exchange Rate**  
**(Total Trade Weights)<sup>4</sup>, 1990-present**



<sup>1</sup> The overvalued official rate, available mainly to state-owned enterprises, served to subsidise planned imports. Foreign-invested enterprises did not have access to this overvalued rate, only to the market-determined swap rate. See "Whither the Renminbi?", MAS Occasional Paper No.3, Dec 97.

<sup>2</sup> Figure refers to retail price inflation. The retail price index (RPI) is the main inflation indicator in China. Compared to the CPI, the RPI excludes services and utilities.

<sup>3</sup> As Chart 2 shows, the pass-through effect from the renminbi's nominal depreciation in 1992-93 to rising domestic prices is fast, accelerated probably by overheating in the domestic economy.

<sup>4</sup> Partner country weights are based on trade data for 1994-96 and capture bilateral trade only. They do not take into account third-country effects. The swap exchange rate was used for points before 1994.

2.5 Chart 2 shows that over 1992-93, China's nominal effective exchange rate (NEER) – calculated using the market-determined swap rate – had depreciated sharply due to severe overheating in the economy. China's REER had also depreciated in that period. Box Item 1 looks at the differences in China's macroeconomy in 1992-93 and now, and argues why such a depreciation is less likely to happen now.

**Box Item 1**  
**Could China See a Repeat of the 1992-93 Depreciation?**

1 During 1992-93, the renminbi (market-determined swap rate) depreciated by 17.5% p.a. on average in nominal effective terms, and by 13% p.a. in real effective terms (see Chart 2 in text). Could such a large depreciation happen again in 1998?

2 The background to the 1992-93 depreciation was severe overheating in the economy, driven by extremely high growth in fixed investment. (This over-investment followed Deng Xiaoping's "Tour of the South" in early 1992.) GDP growth rates were boosted to 13-14% p.a. in 1992-93, but China's external account also came under pressure. The trade balance registered a US\$12.2 bn deficit in 1993, while the current account deficit was equivalent to almost 2% of GDP (see Table A).

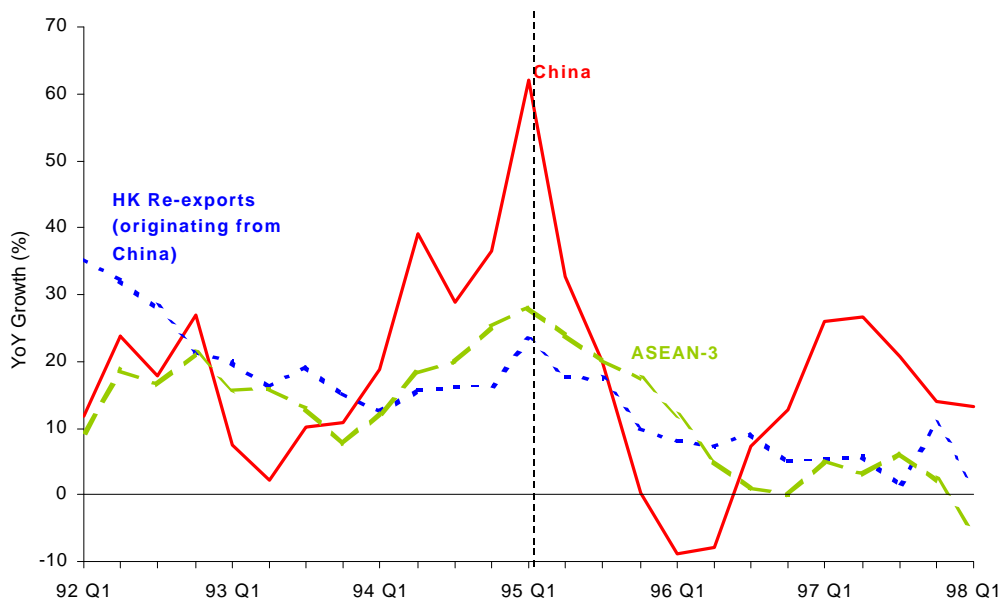
**Table A**  
**China's Macroeconomic Indicators, 1992-97**

	1992	1993	1994	1995	1996	1997
<b>Domestic Economy</b>						
GDP growth, %	14.2	13.5	12.7	10.5	9.6	8.8
RPI inflation, %	5.3	13.0	21.8	14.8	6.1	0.7
Fixed investment growth, %	44.4	61.8	30.4	17.5	14.8	10.1
<b>External Position</b>						
Current account, % of GDP	1.3	-1.9	1.3	0.2	0.9	3.3
Trade balance, US\$bn	4.4	-12.2	5.4	16.7	12.2	40.3
Forex reserves, US\$bn	19.4	21.2	51.6	73.6	105.0	139.9
(In months of imports)	2.9	2.4	5.4	6.7	9.1	11.8

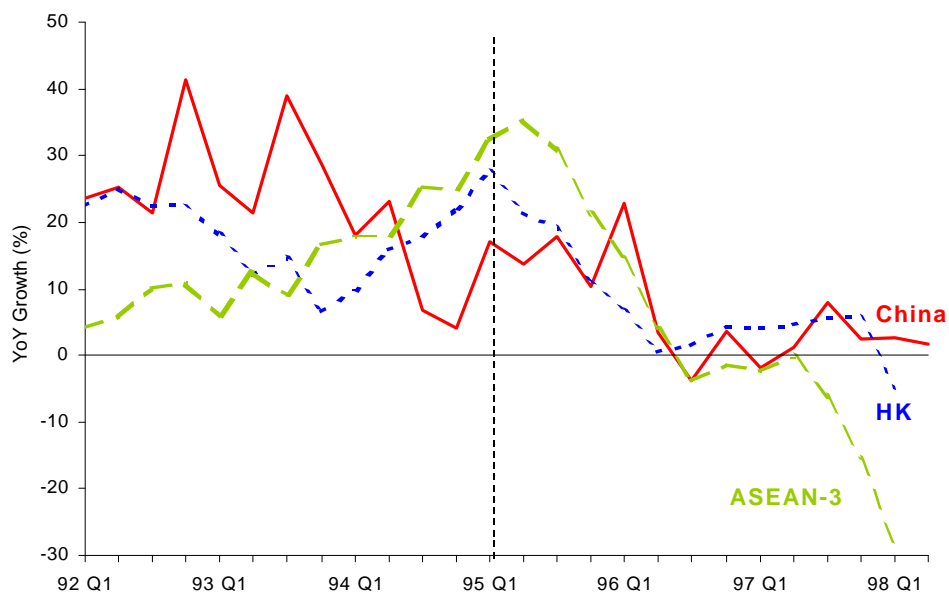
3 The renminbi depreciation in 1992-93 was driven by this deterioration in China's external position. Moreover, China's forex reserves in 1992-93 were low at US\$20 bn or 2-3 months of imports, making a strong defence of the renminbi unfeasible. In contrast to the situation then, China's external position now is not under pressure, and its forex reserves are much higher. More important, perhaps, is that international attention was not focused on the renminbi in 1992-93. China could let the renminbi depreciate without international consequences. This is clearly not the case in 1998.

2.6 Third, China's export growth over 1994-95 did not appear to come at the expense of ASEAN export growth, which also peaked during that period (Chart 3a). Moreover, the high growth in China's exports in 95H1 was due partly to institutional factors, particularly the reduction in tax rebates offered to exporters in Jul 95 and again in Jan 96, which prompted them to frontload exports to 95H1.

**Chart 3a**  
**Growth in Exports (US\$ terms), 1992 - present**



**Chart 3b**  
**Growth in Imports (US\$ terms), 1992 - present**



2.7 Furthermore, the subsequent downturn in 1996 was much more severe for China than for ASEAN countries (Chart 3a). [For completeness, data on Hong Kong's re-exports is included, in case some of the growth in China's exports has been masked by greater exports through Hong Kong; this was not the case, as Hong Kong's re-exports also declined.] This suggests that common factors, such as the cyclical downturn in electronics, were more likely the cause of the 1996 downturn than a competitive devaluation by China.

2.8 ASEAN exports (in US\$ terms)<sup>5</sup> have actually contracted in 98Q1 (Chart 3a). This poor performance ran contrary to the export boost that was first expected when their currencies were devalued. This could be a temporary phenomenon due to "supply-side" problems, e.g. the difficulty in obtaining trade financing, and demand factors, i.e. the sharp slowdown in regional demand including from Japan. However, given the high import content of China's and ASEAN's exports, the collapse of imports in ASEAN countries would undermine their export capability relative to China (Chart 3b). The next two sections go on to examine the price and income effects of the Asian crisis on China.

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<sup>5</sup> The use of export data expressed in US dollar terms is consistent with the focus on real factors underlying developments in export performance. It abstracts from valuation effects, which in the past few months have augmented the recorded domestic currency value of exports, given the sharp weakening in regional exchange rates.



### 3 THE "PRICE EFFECT": WOULD CHINA DEVALUE?

3.1 This section examines to what extent China's exports have become less competitive relative to regional exports, after the regional devaluation. The section first establishes whether China and ASEAN compete with each other in exports, then assesses the impact of the regional depreciation on China's competitive position, in terms of the real effective exchange rate. The section also looks briefly at the industrial sectors and provinces that are most affected by competition from the region.

#### **Extent of Regional Competition with China**

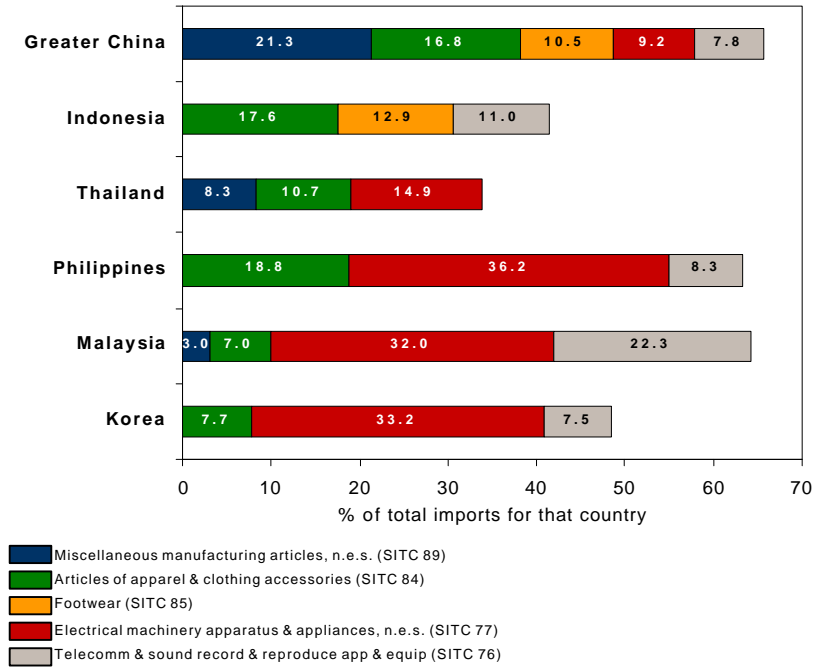
3.2 The paper looks at the main exports of China, ASEAN and Korea at SITC two-digit level to two major export markets, the US and Japan. In 1997, the US absorbed 23% of combined exports of Greater China (China and Hong Kong)<sup>6</sup>, and 19% of the combined exports of the ASEAN-4. Japan absorbed 13% of combined exports of Greater China, and 16% of the combined exports of the ASEAN-4.

3.3 In 1996, about one-quarter of Greater China's exports to the US were apparel and clothing (green bars in Chart 4a), and footwear (orange bars), with miscellaneous manufactured articles such as toys (blue bars), accounting for another one-fifth. These three commodities also make up 30% of Indonesia's exports to the US, about 20% of Thailand's and the Philippines' exports, and 10% of Malaysia's exports in 1996. Thus, there seems to be substantial overlap in these low-end exports of Greater China and ASEAN-4 to the US. The overlap with Korea in these three commodities is quite small, only about 8% of Korean exports. For ASEAN-4 and Korea, the overlap of their exports would be higher if other categories – electrical machinery apparatus and appliances (red bars) and telecommunications and sound recording appliances (gray bars) – are included.

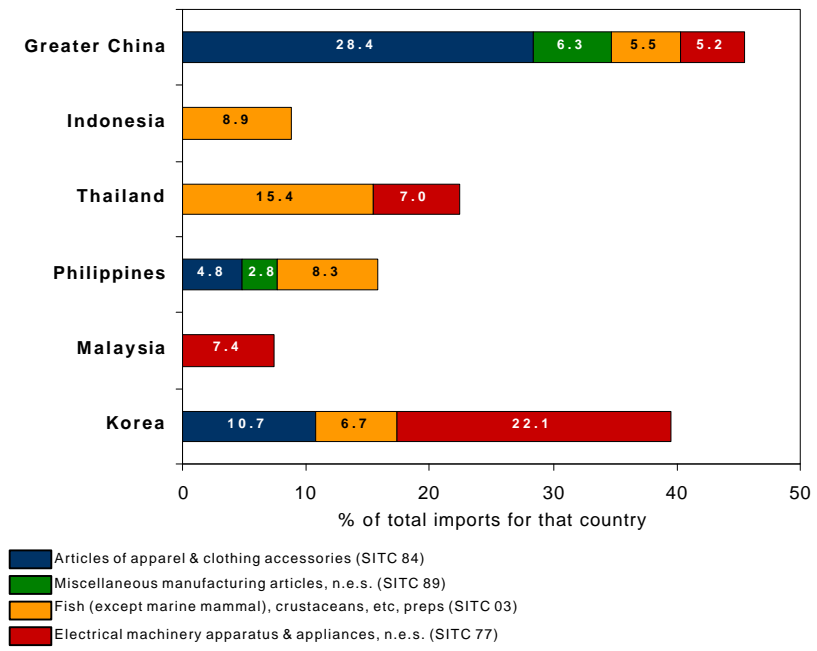
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<sup>6</sup> Excludes trade within Greater China (i.e. Hong Kong-China trade). Charts 4a and 4b shows the combined exports of China and Hong Kong because of Hong Kong's role as a port to export goods assembled/finished in China. (The top 5 exports of Greater China are the same as those for China alone, although the ranking differs slightly.) In 1996, Hong Kong re-exports originating from China made up 49% of its total exports (domestic plus re-exports); in 1995, this figure was 47%.

**Chart 4a**  
**US' Top 5 Imports from Greater China, ASEAN-4 and Korea, 1996**



**Chart 4b**  
**Japan's Top 5 Imports from Greater China, ASEAN-4 and Korea, 1995**



3.4 There is less overlap in the export structures of ASEAN and China to Japan (Chart 4b). In 1995 – the latest year for which data is available – apparel and clothing and miscellaneous manufactured articles made up 35% of Greater China's exports to Japan. These categories are not among Japan's top 5 imports from ASEAN, except for imports from the Philippines, where these categories made up 8%. Instead, Japan imports more resources such as oil and food from ASEAN.

3.5 To conclude, **US data suggest that 10-30% of ASEAN-4's low-end manufactured exports overlap – and hence competes – with those of Greater China, with a less noticeable overlap in Japan**, where primary commodities account for a substantial share in ASEAN's exports to Japan. In both export markets of the US and Japan, the overlap between the exports of Greater China and Korea is quite small.

3.6 It has been argued that even if China devalues, it cannot substantially increase certain exports, e.g. textiles, at the expense of ASEAN because China is subject to **import quotas**. The available data partially supports this argument (see Box Item 2). Thus, this is a constraint on the export boost China could expect from devaluation.

### **Changes in China's Effective Exchange Rates**

3.7 Thus, China's exports do compete with regional exports. This section looks at China's effective exchange rates since the onset of the regional crisis, as a summary indicator of China's loss of price competitiveness so far.

3.8 Using total trade weights, China's real effective exchange rate (REER) had appreciated by 5.7% from end-Jun 97 to end-Jun 98 (Table 1a overleaf). However, using total trade weights does not capture the price competition China's exports would face from ASEAN. This is because ASEAN countries are small trading partners of China, compared with countries like the US and Japan (weights are presented in Table 1b overleaf).

### Box Item 2 Import Quotas on China's Exports

1 Can China increase its exports of certain commodities, e.g. textiles, at the expense of its competitors if it devalues? Table A shows three categories of textile exports at SITC 3-digit level from China and Hong Kong, that were among their top 20 commodity exports to the US, and that were also subject to US import quotas. These three categories of textile exports are also major exports of the ASEAN-4. SITC 845 (articles of apparel of textile fabrics), for example, are China's 8<sup>th</sup> largest export and Hong Kong's largest export to the US, and is also Indonesia's 8<sup>th</sup> largest and the Philippines' 4<sup>th</sup> largest export to the US in 1996. While China and Hong Kong are subject to US import quotas on the three SITC categories of exports, the ASEAN-4 are not.

2 In 1997, China has almost filled its quota in SITC 845 (97.6%), but has some room to go in SITC 842 and 831. Thus, there is partial support for the argument that China's exports are constrained by quotas in the US.

**Table A**  
**US Quotas on Textile Imports from China and Hong Kong**

SITC Category	842*	845*	831*
Percent of Quota filled in 1997, and rank of imports into US in 1996			
China	39.5% (3 <sup>rd</sup> )	97.6% (8 <sup>th</sup> )	77.7% (5 <sup>th</sup> )
Hong Kong	6.3% (2 <sup>nd</sup> )	57.9% (1 <sup>st</sup> )	no quota (not in top 20#)
Rank of imports into US in 1996 (no import quotas)			
Indonesia	3 <sup>rd</sup>	8 <sup>th</sup>	not in top 20
Thailand	11 <sup>th</sup>	6 <sup>th</sup>	17 <sup>th</sup>
Philippines	5 <sup>th</sup>	4 <sup>th</sup>	12 <sup>th</sup>
Malaysia	not in top 20	14 <sup>th</sup>	not in top 20

**Notes:**

\* 842: Women/girls' coats, capes etc, tex fabric, not knit

845: Articles of apparel of textile fabrics nes

831: Trunks, suitcases, vanity cases, briefcases etc

# Not in country's top 20 exports to the US in 1996

Sources: Import quota figures from US Customs Service, 1997 Year-End Textile Status Report at <http://www.customs.ustreas.gov/quotas>. Quotas are in terms of volume (e.g. kg, dozens, metres etc).

Export rankings for year 1996 from US Department of Commerce, International Trade Administration, Office of Trade and Economic Analysis at <http://www.ita.doc.gov/industry/otea/usfth>. Exports are ranked by value.

3.9 To better capture this "price effect", weights of 10%, 20% and 30% are assigned to ASEAN as a whole – as 10-30% of ASEAN's low-end manufactured exports overlap with those of Greater China (para 3.5) – to take into third-country competitor effects. **In nominal terms, China's NEER may have appreciated by 20-30% from end-Jun 97 to end-Jun 98. China's lower inflation meant that its REER has appreciated at a slower pace, by 12-24% over the same period (Table 1b).**

3.10 This is a substantial real appreciation, of the same magnitude or larger compared to the 14% per annum real appreciation registered in 1994-95 (due primarily to rampant inflation then in China). Although China's exports continued to enjoy high growth in 1994-95 despite the large real appreciation, the external environment was much more benign and external demand stronger. **The external environment in 1997-98 has since turned more adverse, i.e. the "income effect" would be much stronger on China's exports over the medium term.**

**Table 1a**  
**Movements in China's REER (End of Period)**  
**Over Jun 97 – Jun 98**

		% appreciation (+)	
		NEER	REER
<b>Total trade weights</b>		12.9	<b>5.7</b>
<b>Plus 3<sup>rd</sup> country effects</b>			
Case 1	ASEAN-3 = 10%	17.7	<b>11.6</b>
Case 2	ASEAN-3 = 20%	25.4	<b>17.9</b>
Case 3	ASEAN-3 = 30%	32.6	<b>23.7</b>

**Table 1b**  
**Trade Weights used to Calculate REERs**

		(percent)		
	Total trade weights*	Total trade weights, adjusted for 3 <sup>rd</sup> country competitor effects		
		ASEAN=10%	ASEAN=20%	ASEAN=30%
Japan	27.0	20.0	20.0	15.0
US	19.4	20.0	15.0	12.5
Hong Kong	20.8	20.0	15.0	12.5
EU	13.0	5.0	5.0	5.0
Korea	8.0	10.0	10.0	10.0
Taiwan	8.7	10.0	10.0	10.0
Singapore	3.1	5.0	5.0	5.0
Indonesia	0.0	4.0	7.0	10.0
Thailand	0.0	3.0	7.0	10.0
Malaysia	0.0	3.0	6.0	10.0
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

\*Note: Total trade weights are based on average total trade shares over 1994-96. As shown, the ASEAN weights are miniscule because they are very small trading partners of China; hence, these weights do not capture the extent of China's competition with the region.

### **The Price Effect on Industries and Provinces**

3.11 Changes in REERs show that China had lost substantial price competitiveness relative to the ASEAN countries. China is giving selective subsidies to ailing exporters. In Jan 98, China raised the VAT rebate on some textile exports from 6% to 11% (VAT is 17%), and from 1 Jul 98, the rebate was raised to the full 17%. Also from 1 Jul 98, exports of ships, iron and steel, cement and coal would enjoy VAT rebates of 14%, 11%, 14% and 9% respectively.

3.12 Besides intensified competition between China's and the region's exports in third markets, **cheaper imports from the region are also undercutting China's domestic producers in key industries like steel.** For example, there are media reports that Japanese exporters have cut their prices of pig iron (the base material for steel products) from US\$160 per tonne in Jul 97 to US\$107 per tonne in Jul 98, and flooding China's markets with these lower-cost imports. China's domestic producers could not produce for less than US\$130 per tonne.<sup>7</sup> The Asian Wall Street Journal reported in Jul 98 that South Korea's Pohang Iron and Steel was selling hot-rolled steel in Shanghai for US\$235 per tonne, undercutting Chinese producers which were selling at prices of at least US\$30 more per tonne. Chinese petrochemical producers were also facing competition from cheaper imports. The affected Chinese producers are large state-owned enterprises (SOEs) in heavy industries, which are undergoing structural reform.

3.13 The competition from the region's exports and imports will hurt some industrial sectors more than others. The affected exporters are already lobbying the government for a devaluation. China's largest shipbuilder, Dalian New Shipyard, has said publicly that it needed a 20%

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<sup>7</sup> "China's sick industries" in Singapore Business Times, 21 Jul 98, p.10.

renminbi devaluation to regain the competitive advantage it has lost to rival shipbuilders in South Korea and Japan.<sup>8</sup>

3.14 Similarly, the Asian crisis will also be an **"asymmetric shock" across different Chinese provinces**, hurting those provinces that are more dependent on trade and exports. The export-to-GDP ratios of China's provinces – the higher the ratio, the more dependent the province is on exports – are plotted against the provinces' share of China's GDP (Chart 5a), and also against the provinces' real GDP growth in 1996.

3.15 In 1996, the five most export-oriented provinces with export-to-GDP ratios above 25% are: Guangdong, Shanghai, Tianjin, Fujian and Beijing.<sup>9</sup> Together, these five provinces account for 60% of China's total exports, with Guangdong alone accounting for 40%. A slowdown in exports is expected to hit these provinces the hardest. These five provinces accounted for 21.5% of China's GDP in 1996 (Chart 5a). Chart 5b shows that these same five provinces are among the fastest-growing provinces in 1996. Thus, a slowdown in these provinces, triggered by slowing exports, would have a substantial, but not overwhelming impact on China's economy. It is less clear whether these provinces are lobbying for a devaluation. This is because given China's high import content of 50-60%, a devaluation would increase the cost of imported components, and ultimately the production cost of exports. Moreover, provinces like Guangdong are dependent on FDI, and would suffer significantly from any backlash on Hong Kong because of a renminbi devaluation.

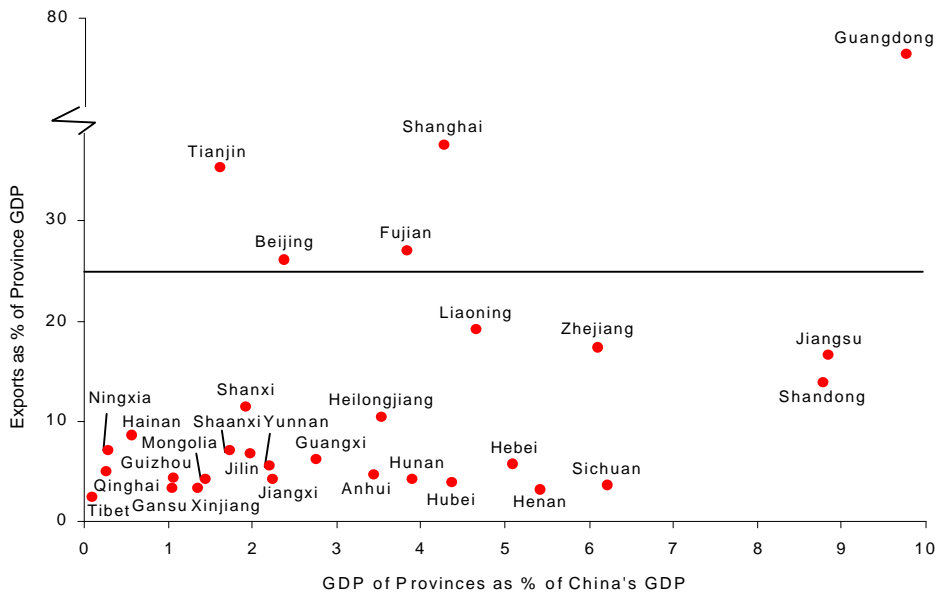
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<sup>8</sup> "China's top shipmaker hopes for devaluation" in Financial Times, 6 Jul 98, p.1. Another shipbuilder, Shanghai Hudong Shipyard, was also quoted in the Asian Wall Street Journal on 7 Jul 98, asking for relief from renminbi strength. China is the world's third largest shipbuilder after South Korea and Japan.

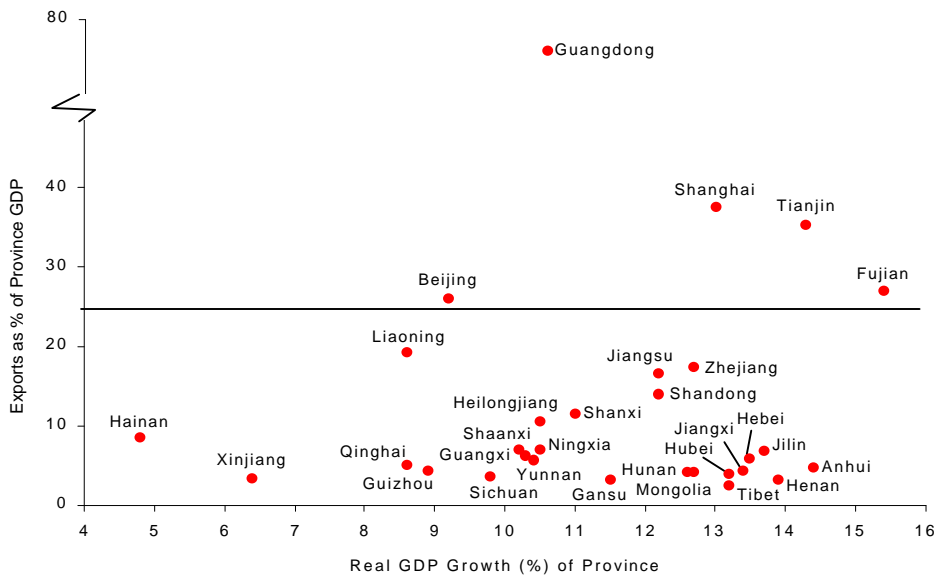
<sup>9</sup> Because of their importance, Beijing, Shanghai, Tianjin and Chongqing are province-level municipalities; i.e. although they are cities, their governments report directly to the central government just like other provincial governments, and Chinese statistics also list them as provinces. China has 31 provinces, including these four municipalities.



**Chart 5a**  
**Provinces' Export-to-GDP Ratios versus Share of China's GDP, 1996**



**Chart 5b**  
**Provinces' Export-to-GDP Ratios versus Real GDP Growth, 1996**



3.16 China's government would have to resist lobbying from its major domestic exporters and probably also from the affected provinces to devalue the renminbi. Calls for devaluation are likely to grow stronger.

3.17 However, a devaluation could affect confidence in Hong Kong's currency and economy, which is a major conduit of trade and FDI into China, and could also trigger off another round of devaluation in the regional currencies which would tend to offset the initial devaluation of the renminbi. This round of contagion would affect not only ASEAN, but Japan, Hong Kong and other countries, which are major absorbers of China's exports, or major investors in China. The next section examines this "income effect".

#### 4 THE "INCOME EFFECT": IMPACT OF THE REGIONAL SLOWDOWN ON CHINA

4.1 The "income impact" of the Asian crisis is becoming apparent in the slowing absorption of China's exports by its East Asian markets, and to a lesser extent in slowing FDI and portfolio investment from East Asia. In May 98, China's exports recorded a year-on-year (yoy) decline of 1.5%, the first time in 22 months, although it rebounded in Jun-Jul 98 to register 7.0% growth for the period Jan-Jul 98. Actual foreign investment in the first half of 1998, while still strong at US\$20.5 bn, has dipped slightly compared to the same period last year.

##### China's Exports to East Asia

4.2 Table 2a shows that China's exports to Japan contracted by nearly 5% in 98H1. Its exports to Korea and ASEAN-4 also contracted by 30% and 20% respectively in the same period. However, **growth in China's exports to the US and EU – which absorbed 31% of China's exports in 1996-97 – remained strong. This has helped to cushion the impact of declining export growth to East Asia.**

4.3 **It is worth noting that the direct "income effect" of the ASEAN slowdown on China is limited.** In 1996-97, the ASEAN-4 absorbed only 3.5% of China's exports (Table 2a).

4.4 Similarly, growth in Hong Kong's re-exports originating from China to Japan and to Korea had declined sharply by 16% and 48% respectively in the first five months of 1998 (Table 2b). Growth had been supported by re-exports to the US and EU, which absorbed over half of Hong Kong's re-exports originating in China in 1996-97.

**Table 2a**  
**China's Exports, 1996 – 1998H1**

China's Exports To:	Export Growth, % yoy			Export Share, %
	1996	1997	1998 H1	Av. 1996-97
US	8.0	22.4	<b>17.9</b>	17.8
EU	3.9	20.0	<b>24.4</b>	13.1
Japan	8.5	3.0	<b>-4.8</b>	18.9
ASEAN-4	-7.7	30.1	<b>-20.3</b>	3.5
Indonesia	-0.7	29.1	<b>-42.2</b>	1.0
Thailand	-28.1	19.3	<b>-21.0</b>	0.8
Malaysia	7.3	39.8	<b>-12.9</b>	1.0
Philippines	-1.5	31.5	<b>-0.6</b>	0.7
NIEs	-6.3	31.4	<b>-1.2</b>	31.9
HK	-10.9	36.5	<b>4.1</b>	22.6
Taiwan	-9.4	21.3	<b>21.5</b>	1.9
Singapore	7.2	15.1	<b>-9.7</b>	2.4
Korea	12.5	21.4	<b>-30.7</b>	5.0
Total	1.5	20.9	<b>7.6</b>	100.0
US\$ Billion	151.1	182.7	87.0	
	Jan-Jul 98: US\$103.1 bn, 7.0% yoy growth			

**Table 2b**  
**Hong Kong's Re-exports (Originating from China), 1996 – 1998 (5 mths)**

HK's Re-exports To:	Export Growth, % yoy			Export Share, %
	1996	1997	98 (5 mths)	Av.1996-97
US	5.9	7.2	<b>4.7</b>	33.3
EU	6.9	4.0	<b>2.9</b>	18.1
Japan	18.3	-2.0	<b>-15.5</b>	9.8
NIEs	10.9	4.9	<b>-10.3</b>	5.7
Taiwan	15.8	8.1	<b>-0.1</b>	2.7
Singapore	0.5	10.2	<b>-0.4</b>	1.8
Korea	17.5	-9.3	<b>-48.1</b>	1.2
Total	7.4	5.8	<b>-0.1</b>	100.0
US\$ Billion	88.4	93.4	34.6	

### China's FDI and Portfolio Inflows from East Asia

4.5 East Asia's FDI into China has slowed down in 1998. Table 3 shows that Japan's FDI into China declined by 36% yoy in 98Q1, while Korea's FDI into China declined by more than 50%. [Japan and Korea contributed 13% of FDI into China in 1996-97.] However, FDI inflows remained large with FDI inflows in 98H1 at about the same level compared to the same period last year. Again, while FDI from Japan and Korea have fallen sharply, FDI flows are continuing from other investor countries.

**Table 3**  
**FDI Flows (Actual) Into China, 1996-98Q1**

FDI into China From:	Growth in FDI, % yoy			Investor's Share of Total, Av. 96-97
	1996	1997	1998Q1	
US	11.7	-5.8	<b>15.7</b>	7.7
Germany	33.3	90.4	<b>-37.0</b>	1.7
UK	42.9	43.1	<b>47.7</b>	3.6
Japan	19.5	17.7	<b>-36.0</b>	9.2
NIEs	6.4	3.3	<b>9.0</b>	64.9
HK	3.1	-0.2	<b>14.8</b>	47.6
Taiwan	10.1	-5.5	<b>2.1</b>	7.8
Singapore	21.1	16.5	<b>54.5</b>	5.6
Korea	30.8	57.4	<b>-51.3</b>	4.0
Total	11.2	8.5	<b>14.1</b>	100.0
US\$ Billion	41.3	45.3	8.6	
			98H1: US\$20.5 bn	

4.6 The fall in FDI was not unexpected. Actual FDI inflows have been increasing steadily in the 1990s, but FDI commitments have fallen since 1995, from US\$91 bn in 1995 to US\$51 bn in 1997 – an indication that actual FDI inflows were likely to fall. Thus, on 1 Jan 98, China restored the duty-free status of capital equipment imports for foreign investors that were

removed in Apr 96.<sup>10</sup> This reversal suggests growing official concern over falling FDI.

4.7 Besides falling FDI inflows, portfolio investment inflows are expected to slow down sharply this year. In China, portfolio investment inflows have usually been dwarfed by FDI inflows (see Table 4). 1997 was a bumper year for portfolio inflows; portfolio inflows grew three-fold from 1996, reflecting a rise in international bond issues by Chinese domestic enterprises, rising interest in China's stock markets in 98H1, and a strong increase in the value of initial public offerings of B-shares (US\$1 bn) in China's stock market and H-shares (US\$4.7 bn) in Hong Kong's stock exchange.<sup>11</sup> The data does not include funds raised by the "red chip" companies in Hong Kong, which enjoyed a bull run in Hong Kong until the stock market crash on 23 Oct 97. Given moribund stock markets in both China and Hong Kong, portfolio inflows may decrease sharply in 1998, augmenting the effect of the FDI slowdown.

**Table 4**  
**China's FDI and Portfolio Investment Inflows, 1993-97**

(US\$ bn)	1993	1994	1995	1996	1997
FDI (a)	27.5	33.8	35.8	40.2	44.2
Portfolio inflows (b)	3.6	3.9	0.7	2.4	7.7
(b) / (a), % share	13.1	11.5	2.0	6.0	17.4

Note: FDI data is based on balance of payments definition, and differs slightly from FDI data presented in the Appendix.

<sup>10</sup> From Apr 96, foreign-funded enterprises had to pay customs duty, VAT and consumption tax on capital equipment imports that could hitherto be imported tax-free. The US-China Business Council and Arthur Andersen estimated then that this would add an average 28% to the cost of a foreign-funded enterprise setting up business in China, and 40% to the cost of importing capital equipment.

<sup>11</sup> China's two stock markets in Shanghai and Shenzhen are segmented into A-shares, which are open to domestic investors, and B-shares, which are open to foreigners. H-share companies are those companies incorporated in China, but listing in Hong Kong. ("Red chip" companies are those incorporated in Hong Kong, but with close business links with China.)

4.8 To conclude, China's exports to and investment from East Asia have already fallen. This income effect will only become more severe as major economies like Japan and Hong Kong register little or negative growth in 1998. China will not want to exacerbate the downturn in these countries through the contagion effect of a renminbi devaluation.

## 5 CHINA'S EXTERNAL POSITION

5.1 As argued in the last two sections, the negative income effect of a devaluation on China's exports to and investment from East Asia is likely to overwhelm what it might gain from greater competitiveness. This section assesses whether China's external position is strong enough to withstand pressures for devaluation.

5.2 Positive factors cited in support of China's external position include its **large foreign exchange reserves relative to external debt, and its closed capital account**. China's foreign exchange reserves<sup>12</sup> reached US\$140.5 bn as at end-Jun 98, equivalent to about 12 months of imports. China has accumulated these reserves by running current account surpluses during most of the 1990s. Although growth in China's exports and inward FDI is slowing, China's trade surpluses and net FDI inflows in 1998 will further boost its foreign reserves (see Appendix for balance of payments data).

5.3 China's foreign exchange reserves are enough to cover China's stock of external debt at US\$131 bn as at end-1997; 86% of China's debt in 1997 is medium or long-term, and much of this is on concessionary terms. Moreover, China's capital account is closed, ostensibly limiting the potential for massive capital outflows that may put downward pressure on the currency.

5.4 However, the errors and omissions figure in China's balance of payments is very large – in 1997, this figure was almost equivalent to net inflows on the capital account – and suggests large unrecorded capital outflows (Table 5).

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<sup>12</sup> Foreign exchange reserves exclude China's holdings of gold and SDRs, and China's reserve position in the IMF.



**Table 5**  
**China's Balance of Payments, 1995-97**

	US\$bn		
	1995	1996	1997
Current account	1.6	7.2	35.5
Capital account	38.7	40.1	23.0
Errors and omissions	-17.8	-15.7	-22.7
Foreign exchange reserves*	73.6	105.0	139.9
External debt	106.6	116.3	130.9
of which short-term debt	11.9	14.1	18.1

\*Excludes holdings of gold and SDRs, and China's reserve position in the IMF

5.5 Moreover, China's external debt may be understated. Data from the Bank for International Settlements (BIS) suggests that China's short-term external debt could be US\$35 bn higher than estimated by the Chinese authorities.<sup>13</sup> Even so, China's foreign exchange reserves are more than sufficient to cover the higher level of short-term external debt.

5.6 As the linchpin of China's external position, any deterioration in China's foreign exchange reserves should be watched closely. China's foreign exchange reserves in May 98 stands at US\$140.5 bn. Foreign exchange reserves have grown by only US\$0.6 bn from end-1997 to end-Jun 98, despite a US\$22 bn trade surplus and US\$20.5 bn in FDI inflows in 98H1.

5.7 What could account for the slow growth in reserves? The first reason is a net outflow of trade credits amounting to US\$6 bn (recorded as "other capital flows" in the capital account). Because of the Asian crisis, Chinese importers have been pressed for earlier repayment of trade credits, while Chinese exporters to the region have had to extend more trade credit.

<sup>13</sup> BIS, Consolidated International Banking Statistics for end-1997, Annex 2, 25 May 98. China's short-term external debt to commercial banks, up to and including one year in maturity, was recorded at US\$53.4 bn as at end-1997. However, the BIS figure on China's short-term external debt is not directly comparable to Chinese figures because of definitional differences.

5.8 The second reason is due to a change in the foreign exchange system. From Oct 97, China's domestic exporters were allowed retain 15% of their foreign exchange earnings, instead of surrendering all forex earnings to the government. Thus, some of the decline in reserves have been transferred from the government's reserves to exporters' private bank accounts.<sup>14</sup> In so far as the foreign exchange earnings are still held by domestic exporters in China, the decline in China's official foreign reserves are less of a concern.

5.9 **To conclude, China's external position is strong enough to withstand devaluation pressures. China's foreign exchange reserves is large relative to its external debt, after taking into account larger estimates of external debt, and errors and omissions on the capital account.** However, China's foreign exchange reserves may grow more slowly in future, given the possible decline in its trade surplus and investment inflows. A significant increase in unrecorded capital outflows would put pressure on foreign exchange reserves, and on the current parity of the renminbi exchange rate.

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<sup>14</sup> This is reflected in the US\$12.5 bn build-up net foreign assets of the banking system in 1997. In China's balance of payments, this is recorded in the item net currency and deposits under "other capital flows" in the capital account. The retention limit for each enterprise is to be revised each year in accordance with actual export earnings in the previous year, i.e. the 15% limit on forex retention in 1998 was based on export earnings in 1997.

## 6 SCOPE FOR DOMESTIC STIMULUS

6.1 With the Asian crisis, the strong external sector performance in 1997 would not be repeated. Despite the regional downturn in 97H2, China's trade surplus still reached a record US\$40 bn and its current account surplus was 3.3% of GDP in 1997. The external sector contributed 2.7 percentage points to China's real GDP growth of 8.8% in 1997, helping to offset softening domestic demand.

6.2 The effects of the Asian crisis on China will become more severe in 1998, with economic indicators already pointing to a sharper downturn. GDP growth in 98H1 was 7.0% against the 8% target for 1998. Also in 98H1, industrial production increased only 5.3% yoy against 11.7% annual growth registered in 1997, while consumer retail sales in 98H1 grew 7.5%, down from 10% annual growth in 1997.

6.3 China needs to maintain high growth to ease the transition problems in its structural reforms. In particular, it needs growth to stem rising unemployment from state-owned sector restructuring.<sup>15</sup> China's government is therefore under increasing pressure to stimulate domestic demand through monetary and fiscal policy. This section examines the scope for domestic stimulus. A hasty loosening monetary and fiscal policy could compromise China's long-term structural reform, particularly in its banking sector.

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<sup>15</sup> The official unemployment rate, which includes only registered unemployed workers in urban areas, has risen from 2.5% in 1990 to 3.1% (5.7 mn) in 1997. However, this official figure excludes the 11 mn 'xiagang' workers (workers who have been laid off but who still maintain labour contracts with their employers), the 50 mn in rural migrants to urban areas, and the 130 mn in rural surplus labour.

## **Monetary Policy**

### ***From Direct to Indirect Policy Instruments***

6.4 The People's Bank of China (PBC), China's central bank, has traditionally relied on direct monetary policy instruments, notably administrative controls on bank lending. As late as 1994, the administrative bans issued on new lending for large-scale investment projects and other such measures proved to be highly effective in stemming the overheating resulting from rampant investment. Administrative controls were effective because credit plans were drawn up for banks, and the credit plans determined how much they could lend, and to which sectors.

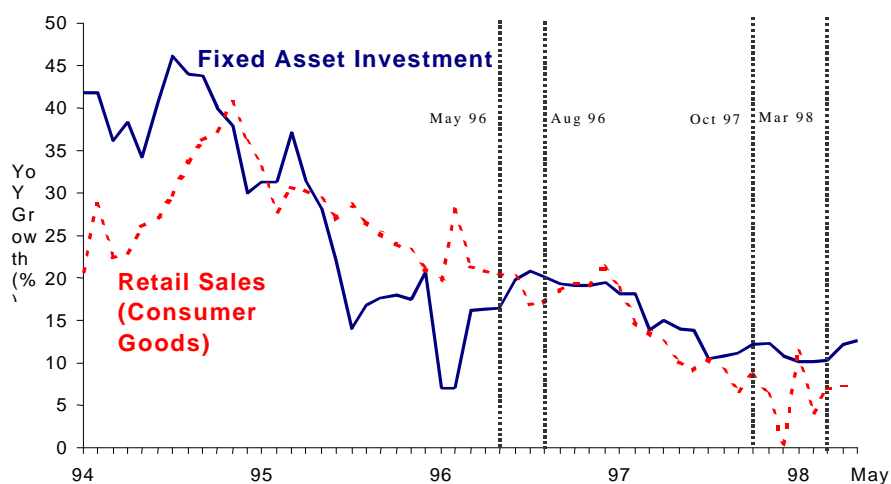
6.5 However, as part of monetary reform, there has been a move away from direct instruments such as the credit plan. Credit quotas were progressively abolished, and in Jan 98, they were abolished for the four major state-owned commercial banks.<sup>16</sup> As a result, indirect monetary instruments such as management of the reserve money base (principally through PBC deposits with commercial banks), and interest rates have become more important.<sup>17</sup> However, because China's monetary system is still undeveloped, **the transmission mechanism for these indirect monetary instruments is quite weak.** For example, consumption demand is relatively insensitive to interest rate cuts, because households do not generally borrow to finance housing or consumer durables like cars.

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<sup>16</sup> These are the Bank of China, the Industrial and Commercial Bank of China, the Agriculture Bank of China and China Construction Bank. In 1996, they accounted for almost 70% of total financial institutions' assets.

<sup>17</sup> In Jan 96, a national renminbi interbank market was established through unifying separate local interbank markets, and in Jun 96, the ceiling on the interbank rate, the China Interbank Offer Rate or CHIBOR, was lifted. However, the PBC continues to set other interest rates, although banks can vary their rates up to 10% from the administered interest rates.

**Chart 6**  
**Impact of Interest Rate Cuts on**  
**Growth in Fixed Asset Investment and Consumption**  
**Jan 96 -- Present**



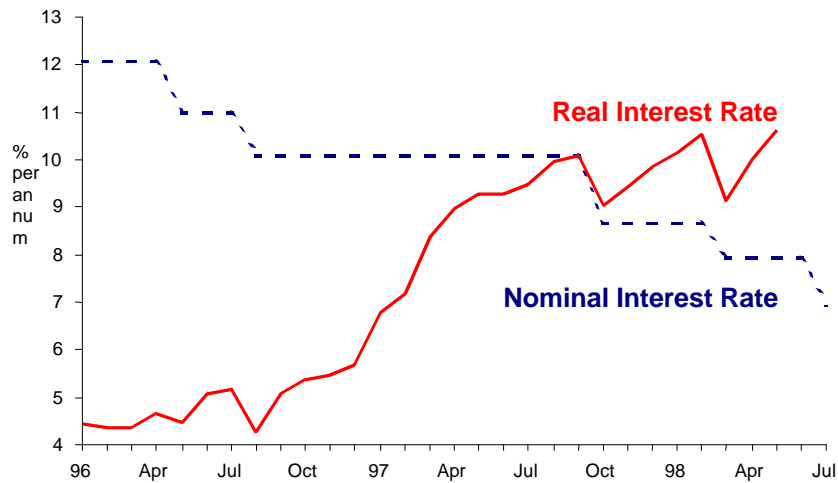
6.6 **Faced with a sharper economic slowdown, exacerbated by the Asian financial crisis, indirect monetary instruments are inadequate in stimulating domestic demand.** There have been five cuts in nominal interest rates since May 96, with cuts in one-year deposit and lending rates totalling 5 to 6.5 percentage points. However, these interest rate cuts have not led to a significant boost in consumption or fixed investment (Chart 6).<sup>18</sup>

#### ***No Easing in Monetary Conditions***

6.7 There has been no easing in monetary conditions in China. Despite the cuts in nominal rates, real interest rates have continued to rise because of falling inflation (Chart 7). Monetary conditions have therefore remained tight. Box Item 3 overleaf examines the possible constraints in cutting interest rates further.

<sup>18</sup> Some economists have argued that if not for the cuts in interest rates, the slowdown in domestic demand would have been even worse.

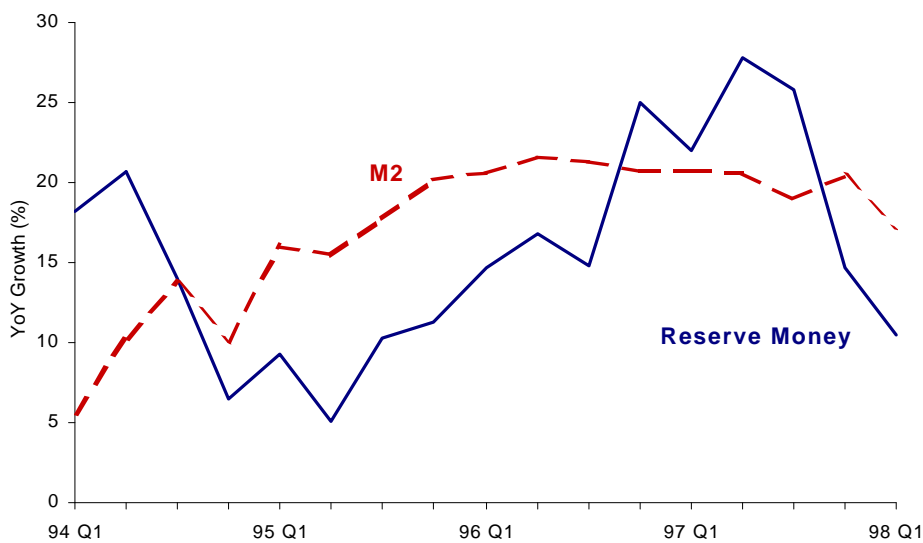
**Chart 7**  
**Interest Rates, Jan 96 – present**



Note: Chart shows the interest rate charged on loans of maturity 6 months to 1 year

6.8 Similarly, money supply is not loosened. In 97H2, credit to banks was actually tightened, resulting in a sharp fall in the reserve money growth (Chart 8). The latest data show that reserve money growth has fallen to 9% in nominal terms, and 10.5% in real terms, in 98Q1. Tight monetary conditions are also evident in the decelerating growth in M2 (in both real and nominal terms) since 97Q3. Growth of M2 in nominal terms has slowed to 14.3% in 98Q1, lower than the 1998 target M2 growth of 16-18%.

**Chart 8**  
**Growth in Reserve Money and M2 (Real Terms), 94Q1 – 98Q1**



**Box Item 3**  
**Can Interest Rates Be Cut Further?**

1 Although nominal interest rates had been cut five times since May 96, real interest rates have continued to rise in line with declining inflation. What prevents further cuts in nominal interest rates?

2 In the last three interest rate cuts, deposit rates were reduced less than lending rates. Part of the reason could be to protect the value of depositors' savings, and to maintain domestic depositors' confidence in the banking system. There is some, albeit limited scope, for depositors to switch between renminbi deposits and foreign currency deposits, usually US dollar deposits. After the latest cut in Jul 98, deposit interest rates on one-year renminbi deposits (4.77%) were slightly lower than those on US dollar deposits (4.875%). Given that renminbi deposit rates are already below US dollar rates, there is limited scope to cut nominal interest rates further without causing a shift into US dollar deposits.

3 However, reducing deposit interest rates less than lending rates means that bank margins are squeezed. This would further hurt the banks' already weak position. [Note: In Aug 98, China undertook a recapitalisation exercise of four state-owned banks. The Ministry of Finance issued Rmb 270 bn in special bonds to the four state-owned banks, who purchased the bonds with the funds released after the PBC cut the required reserve ratio to 8% from 13% in Mar 98. (The PBC also abolished excess reserves, which was 5-7% on top of the required reserves ratio.) Therefore, there was a restructuring of the banks' balance sheet with the banks swapping one form of assets (required reserves) for another (treasury bonds).]

6.9 In the last few years, monetary policy has been "appropriately tight" to curb inflationary pressures, after the period of high inflation averaging almost 20% per annum in 1994-95. However, this conservative stance is becoming untenable, as retail price inflation has fallen to -2.1%, and CPI to -0.3% in 98H1. Therefore, **Premier Zhu Rongji's statement at end-July 98 that China is suffering from deflation is significant, because it could signal the start of a significant loosening in monetary policy.**

6.10 However, monetary easing in the new regulatory environment may be difficult. Banks are increasingly unwilling to lend for fear of running up bad loans.<sup>19</sup> Some commercial bankers are now fearful of being sacked

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<sup>19</sup> Previously, the banks lent to projects that were approved by the State Development Planning Commission. Now, however, they are charged to undertake their own independent feasibility studies, and this has delayed the process of lending.

for bad lending decisions, and would rather not make any lending at all. In other cases, the bankers do not have the expertise to make credit assessments of potential clients. While this is a sign of progress that banks are operating on a more market-oriented basis, the resulting credit crunch will exacerbate the economic slowdown.

6.11 The risk is that when the slowdown persists, banks may be directed to lend at the expense of weakening their balance sheets. In May 98, the PBC issued a circular, "Guiding Principles for Economic Development and Improved Financial Services", asking banks to provide increased credits for key sectors of the economy such as agriculture, irrigation, infrastructure and high-technology projects. The state-owned commercial banks have already pledged specific amounts for infrastructure loans.<sup>20</sup> The next section examines the government's pledges for more spending.

### **Fiscal Stimulus**

#### ***Focus on Infrastructure and Housing***

6.12 **Compared to monetary policy, fiscal policy offers a more direct and effective route to boost domestic demand.** In the 1990s, the government has accounted for more than half of fixed investment, which in turn accounted for about 30% of GDP. Therefore, increased government spending can potentially be a significant stimulus to the economy.

6.13 To achieve the 8% GDP growth target in 1998, the government has targeted fixed investment growth at 15%. Although government spending on fixed investment fell below this target in 98H1, growing by only

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<sup>20</sup> "China Central Bank's Guidelines Issued to Shore Up Bank Lending" in Asian Wall Street Journal, 28 May 98. China Construction Bank will arrange Rmb20-30 bn for road construction, Rmb25 bn for posts and telecommunications, Rmb10 bn for the national and regional electricity grid, and Rmb27 bn for housing construction. The Agricultural Bank of China (ABC) has committed Rmb35 bn in loans to support the agricultural sector in 1998. The Bank of Communications is expected to funnel 20% of its loans into key projects, including the Three Gorges Dam project. See "Top China banks to make more loans" in Singapore Business Times, 29 Jun 98.



13.8% yoy, it is picking up. In Jun 98, state-owned fixed investment spending reached 16.3% yoy.

6.14 The government is targeting its increased spending in two areas: infrastructure and housing. China's leaders including Li Peng and Vice-Premier Li Lanqing have committed US\$370 bn in infrastructure spending<sup>21</sup> – out of a total of US\$750 bn in total government spending – over the next three years. Infrastructure spending would be focused on building railways, roads and rural infrastructure such as electricity networks and irrigation systems.

6.15 On housing, Premier Zhu Rongji has pledged to end state provision of housing from Jul 98, encourage Chinese households to buy their own homes and increase the availability of mortgage financing. The Ministry of Construction estimated that housing reform could boost GDP growth by 0.7–1% if the stimulus to construction-related industries is included.

6.16 **Between infrastructure and housing, infrastructure spending offers more potential for effective fiscal stimulus.** In particular, there is ample scope to build more infrastructure in the rural areas. Building an electricity grid in rural areas could well stimulate rural demand for consumer electronics. In contrast, the boost from housing is likely to be limited by the political sensitivity of housing reform. It is unclear how fast the authorities can push housing reform, given that state-owned enterprise restructuring are already affecting workers' other benefits. Moreover, investment in housing accounts only for a small proportion (9%) of total investment demand, making it an unlikely driver of investment demand in the short term.

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<sup>21</sup> There was some confusion whether the headline US\$750 bn figure referred to total investment spending, or just infrastructure spending. In May 98, the China Economic Times clarified that the US\$750 bn figure committed by Vice-Premier Li Lanqing in Feb 98 included US\$380 bn of project investment items that are usually not classified as infrastructure spending using internationally accepted definitions. Source: Economic Intelligence Unit, Country Report on China, 98Q2.

### **Financing Government Spending**

6.17 China is able to finance its increased spending through issuing state bonds. The government's outstanding stock of domestic debt is relatively low at Rmb540 bn or 7.2% of GDP as at end-1997. The new Finance Minister, Xiang Huaicheng, has said in Jun 98 that the government may issue bonds in excess of the Rmb280 bn earmarked for 1998, in order to raise funds for infrastructure spending. In addition, for spending in specific sectors like railways, the government will also raise fees that are currently very low: e.g. railway freight charges will be raised by 15%, water tariffs by 80-100%.

**Table 6**  
**China's State Budget**

		1996	1997	1998p
Revenue	Rmb bn	741	864	968
	% of GDP	10.7	11.4	11.9*
Expenditure	Rmb bn	794	920	1014
	% of GDP	11.4	12.1	12.5*
Deficit	Rmb bn	(53)	(56)	(46)
	% of GDP	(0.8)	(0.7)	(0.6)*

\*Assuming 7% GDP growth and 0% inflation in 1998.

Note: Data in the table is based on Chinese sources. Unlike international definitions, the Chinese definition of expenditure excludes interest costs on government debt.

6.18 This increased spending will be off-budget. The plans were not reflected in the 1998 budget announced in the National People's Congress in Mar 98. In fact, the budget was slightly contractionary, with the budget deficit projected to fall by 0.1% of GDP, from 0.7% of GDP in 1997 to 0.6% in 1998 (Table 6). [The government has substantial offbudget operations through various social funds and extrabudgetary funds controlled by local governments and financed through fees and levies.]

6.19 To conclude, there is scope for the government to pump-prime the economy through fiscal spending. However, the boost to GDP growth may not be as significant this year; the extensive restructuring in the

government apparatus is likely to delay swift implementation of this fiscal spending. As in monetary policy, there is also a risk to long-term reform through an expansionary fiscal policy, if the already weakened banking system were directed to bear the burden of financing fiscal spending.

## Appendix

## China

### Key Macroeconomic Indicators, 1990-98

	1990	1991	1992	1993	1994	1995	1996	1997	1998 H1
<b>Real sector (YoY % Growth)</b>									
Real GDP	3.8	9.2	14.2	13.5	12.7	10.5	9.6	8.8	7.0
RPI inflation	2.1	3.0	5.3	13.0	21.8	14.8	6.1	0.7	-2.1
Fixed investment	2.4	23.9	44.4	61.8	30.4	17.5	14.8	10.1	13.8 ***
Industrial production	7.7	13.3	21.5	23.7	21.7	3.8	8.8	11.7	5.3
Retail sales	2.5	13.7	17.7	28.4	50.0	26.8	20.1	9.5	7.5
<b>External sector (US\$bn)</b>									
Current account balance	12.0	13.3	6.4	-11.6	6.9	1.6	7.2	29.7	n.a.
(% of GDP)	3.1	3.3	1.3	-1.9	1.3	0.2	0.9	3.3	n.a.
Trade Balance	8.7	8.0	4.4	-12.2	5.4	16.7	12.2	40.3	26.7 (Jul)
Exports (fob)	62.1	71.8	84.9	91.7	121.0	148.8	151.1	182.7	103.1 (Jul)
Imports (cif)	53.3	63.8	80.6	104.0	115.6	132.1	138.8	142.4	76.4 (Jul)
Total external debt	53.1	60.6	69.3	84.4	95.4	106.6	116.3	130.9	n.a.
(% of GDP)	13.7	14.9	14.3	14.0	17.6	15.2	14.2	14.5	n.a.
Long-term debt	46.4	50.3	58.5	70.0	84.6	94.7	102.2	112.8	n.a.
Foreign Exchange Reserves	28.6	42.7	19.4	21.2	51.6	73.6	105.0	139.9	140.5
Months of Imports	6.4	8.0	2.9	2.4	5.4	6.7	9.1	11.8	11.9
Average Exchange Rate (Yuan per US\$)*	4.783	5.323	5.515	5.762	8.619	8.351	8.314	8.290	8.279
FDI (Actual)	3.5	4.4	11.0	27.8	33.9	37.8	41.7	45.3	20.5
<b>Monetary sector</b>									
Broad money (M2) (YoY % Growth)	28.9	26.5	31.3	37.3	34.5	29.5	25.3	20.7	14.3
Domestic credit (YoY % Growth)	23.6	20.0	22.3	42.1	23.8	23.7	24.5	18.5	13.2 (Q1)
Interest rates (% per annum), end of period									
1yr deposit rate	8.6	7.6	7.6	11.0	11.0	11.0	7.5	5.7	4.8 (1 Jul)
1yr lending rate	9.4	8.6	8.6	11.0	11.0	12.1	10.1	8.6	6.9 (1 Jul)
<b>Policy indicators (% of GDP)</b>									
Government overall budget surplus/deficit (-)**	-0.8	-1.1	-1.0	-0.8	-1.2	-1.0	-0.8	-0.7	-0.6 P**

Sources: IMF staff report; Official national sources.

\* As of Jan, 1994 the official and swap market exchange rates were unified. Prior to 1994, data refer to the official exchange rate.

\*\* Using definition of Chinese government. Projected budget deficit for 1998, announced at the National People's Congress in Mar 98.

\*\*\* 1998 latest figure is based on data of fixed investment by state-owned units and urban collectives. Monthly data for total fixed investment is not available.

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