China staves off devaluation

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Introduction

China has come to the forefront of the international finance scene following the East Asian financial crisis for two reasons. First, the post reform Chinese economy closely resembles the other East Asian countries. China experienced significant levels of growth led by exports, with a rapid expansion in labor-intensive exports in its early stage of development. Rapid growth was accompanied by a rapid increase in domestic savings and massive inflows of foreign capital (Perkins, 1986). The banking sector dominated financial intermediation and the ratio of non-performing loans was high. Estimates put non-performing loans at China's four leading banks at 25 per cent — far higher than in South Korea or Thailand before they fell prey to the Asian contagion. Would China be the next victim of the crisis? (Dornbusch, 1997).

The second reason why China came to the forefront of the international finance scene following the East Asian financial crisis is Chinas economic performance became the key to the current economic stability of East Asia. During 1997 – 1998, China was the only country in the region to sustain significant growth. In particular, maintaining the stability of the renminbi, was seen as the last hope of achieving equilibrium in the regional currency system and facilitating recovery (Garnaut, 1998). The Chinese government took up the challenge and made a firm commitment not to devalue the renminbi in the short term. China's decision not to devalue in the face of internal pressures has been credited for stabilizing Asia's economic situation.

Most economists predicted that a currency crisis was unlikely to damage Chinas economy or trade; its macroeconomic fundamentals were healthy and it had the extra insurance of capital account controls. However, surrounded by neighbors in trouble, China could help but be somewhat effected by the larger, regional situation. The rest of the world continued to watch and worry about how much longer China would be able to defend its overvalued currency and still remain internationally competitive on an export basis (Song, 1998).

This paper will begin by examining the economic background of China. We will see how China came to be in the position to devalue its currency as well as address some controls that were used to inhibit the devaluation. The paper will continue by examining the currency and trade noting how Chinas reliance upon export allowed them to move through the crisis with fewer difficulties than its neighbors. Lastly we will examine the current situation China is in and how not devaluing their currency helped neighboring economies. Also, we will project how devaluing may have provided positives and negatives to Chinas own economy.

Background

For more than 2000 years the Chinese economy operated under a type of feudal system. Land was concentrated in the hands of a relatively small group of landowners whose livelihood depended on rents from their peasant tenants. Adding to the peasant farmers burden were agricultural taxes levied by the imperial government and crop yields subject to drought and floods. Under these conditions agriculture remained essentially underdeveloped.

The conclusion of the Opium War (183942) formally began a period of Western entrance into China from the coastal treaty ports. Railroads and highways were constructed, and some industrial development was begun. Such activity had little impact, however, on the overall Chinese economy. In fact, rather than coming together through trade, China was carved up into a number of competing colonial spheres of influence.

By the 20th century China had become a politically and economically weak nation, dominated by foreign powers. The Chinese Communist party emerged in the 1920s in the midst of a mounting economic crisis caused by foreign intervention and increased landlord influence in the countryside. For more than two decades, the Chinese Communist party expanded its control over large rural areas by introducing an agricultural program based on the control of rent and high interest rates, and by giving power to peasant associations. On Oct. 1, 1949, the Communist party successfully established a unified national government and economy on the mainland for the first time since the end of the imperial period in 1912.

In 1978, the Four Modernizations program was launched. It called for the modernization of the agriculture, industry, national defense and science and technology by the end of the century. This was so that the economy can take its place in the front ranks of the world. A 10-year plan from 1976 85 stressed improvement in economic management and a larger role for private and collectively owned (as opposed to state-owned) enterprises.

The policies introduced in October 1984 called for further decentralization of economic planning and for increased reliance on market forces to determine

the prices of consumer goods. The 5-year plan from 198690 anticipated an annual economic growth rate of 7%, but the economy slowed temporarily after a political crackdown in 1989. In the early 1990s the Chinese economy resumed its robust expansion, and government planners forecasted average annual growth rates of 810% through the end of the decade.

Chinas GDP grew at 8. 8% in 1997 and 7. 8 percent in 1998. Strong growth momentum was sustained in 1999, with a slightly reduced GDP growth rate of 7. 1% (State Statistics Bureau, 1999). This is remarkable, considering the negative growth rates experienced by most of Chinas neighbors for the same time period.

The monetary environment, measured by the growth rate of the money supply, was tight in 1998 and early 1999. See table below:

Table 1: China: Macroeconomic Indicators, 1995-9

19951996199719981999

Real GDP (% real change)10. 59. 58. 87. 87. 1

Gross industrial output (%real change)20. 316. 613. 18. 99. 6

Inflation (CPI % change)17. 18. 32. 8-0. 8-1. 4

Growth of M2 Broad Money supply (%)29. 525. 319. 614. 814. 7

Exchange Rate (RMB/US$)8. 328. 308. 288. 288. 28

Fixed Asset Investment (% nominal change13. 310. 69. 014. 18. 9

Retail Sales (% nominal change)26. 820. 110. 26. 86. 7

Exports (% changes in US$)23. 01. 521. 00. 56. 1

Imports (% change in US$)14. 25. 12. 5-1. 518. 2

Merchandise Trade Balance (US$ billion)16. 712. 240. 343. 629. 2

Source: State Statistics Bureau, Chinese Statistical Yearbook 1998 and CEIC Data Company Limited, Hong Kong

In 1997, the Chinese Central Bank introduced frequent interest rate cuts to encourage spending rates by both households and enterprises; however, prices have continued to fall. Deflation began in October 1997 when the retail price index first slipped into the negative and the index has continued to fall. (Chan, 1999).

As expected, the export sector was negatively impacted by Chinas refusal to devalue its currency. The government introduced policies to stimulate exports, including an increase in the rebate rate of value-added taxes for exports (which is regarded by some economists as a hidden form of currency devaluation). In 1998, exports grew by 0. 5 percent and imports fell by 1. 5 percent. In the first five months of 1999, exports decreased by 5. 3 percent and imports jumped by 15. 3 percent. These changes were directly related to exchange rate policy as Chinese exports became less competitive against imports from countries with economies impacted by the crisis and there imports became much cheaper. Growth of exports to East Asian markets declined predictably and quickly during most of 1998, while exports to the

United States and European Union countries increased. This is the income effect described by Huang and Yang (1998).

Since the crisis-affected countries devalued their currencies, their exports to other countries became more competitive and Chinas export market experienced significant loss. The growth rates of Chinas exports to the United States and European Union countries dropped from mid-1998.

The Chinese economy is sound. It did not experience the financial meltdown experienced by other countries in the region; however, it did feel the impact of the other crisis-hit countries.

Currency and Trade

The banking and trade systems in China are largely under government control, although rules were eased in the mid-1990s to allow greater foreign and private participation in the financial sector. The Peoples Bank of China is the central financial institution and the sole source of currency issue, as discussed in class. Chinas international accounts and foreign currency arrangements are primarily the concern of the Bank of China.

Since the 1970s, China has moved away from self-imposed isolation from the international community and has sought to modernize its economic structure. In comparison to the transitional economies found in Eastern Europe, Chinas experience of economic reforms were unique. Instead of a sharp decline, China grew rapidly in the context of the larger reform process that changed the economy from its centrally planned, Communist system, to an increasingly open and market-oriented economy.

Following the completion of deep structural reforms, we see that China has begun to conduct its foreign trade in accordance with its comparative advantage and international conventions rather than through administrative measures, as in the past. Beginning in 1978, China began a change from a situation in which the government had a monopoly on all foreign trade. It did this by decentralizing the power from state corporations and introduced the agency system into various levels of foreign trade institutions. Under the agency system, individual companies were licensed (or given agency) to import and export products, increasing the number of firms that had permission to do so. Because of this, foreign trade under direct administrative control decreased, with the result that trade has been made more flexible by being subject to market forces without government intervention. This step is a necessary process in establishing a competitive position in an open market. The changing market conditions require flexibility that is impossible when bogged down with a mandatory, rigid, time-consuming bureaucratic system (Fong, 2002).

By 1991, exports and imports subject to central planning had fallen to 30 percent of their totals, while exports and imports under the agency plan accounted for only 20 percent. As the roles of central planning and the agency plan have decreased, direct control over exports and have continued through a licensing system that covered 55 percent of exports and 40 percent of imports in 1991. (Bell et al, 1993).

A dynamic relationship exists between the exchange rate and the trade balance of a country, as well as the price and quantity components of the trade balance. When a country devalues its currency, the imports value of

the economy will initially rise in local currency due to the rising of import price. The export value will remain unchanged. In the short run, the trade balance will deteriorate, but over a longer period of time, both export and import volumes will react to the changes in relative prices following the devaluation. Downward adjustment in import volume will occur while export volume will rise as export prices expressed in dollars become more competitive. This results in an improvement in the countrys trade balance (Fong, 2002).

As part of its overall foreign trade system reform, China has repeatedly devalued its currency to promote exports and the balance of trade in the 1980s and early 1990s. In 1991, China changed its foreign exchange policy from the large one-step currency devaluations of the past to more frequent fine-tuning of the renminbis value with respect to the current economic conditions. The unification of Chinas two main currency rates in the beginning of 1994 and the deregulation of foreign invested enterprises abilities to exchange funds freely at selected banks without approval from the State Administration for Exchange Control (SAEC) early in 1996 drove the renminbi a step further toward full convertibility. The IMF has formally classified the exchange rate of renminbi as a more flexible management system.

The reform of the foreign trade system has contributed significantly to the rapid expansion of Chinas foreign trade. In 1978, the total of international trade for all of China was only $20. 6 billion USD; it rose to $165. 6 billion USD in 1992 increasing by a factor of eight. Exports experienced similar

growth, from $9. 75 billion USD in 1978 to $84. 9 billion USD in 1992 (Zhang, 1995).

The pre-reform exchange system of China was characterized by strict control of foreign exchange transactions and rigidity of the renminbis exchange rate. Under such conditions, it was impossible to respond flexibly to changes in price parities between China and the rest of the world. It was also impossible to to make quick adjustments as needed according to the changing money supply and demand of foreign exchange. This was consistent with the highly controlled manner that the state controlled Chinas foreign trade. All import and export contracts with foreign firms could only be signed by a few authorized import and export corporations. By 1978, only ten national import and export corporations under Chinas trade ministry had been solely authorized to sign import and export contracts with foreign firms. Consequently, those working in this economic environment had no incentive to make trade adjustments in response to price changes and exchange rate policy.

In the early stages of reform, various arrangements were tested for managing foreign exchange with the goal of improving incentives for exports. Finally, a retention system was set in place. Exporters would surrender their actual foreign exchange earnings and were issued retention quotas by the SAEC equivalent to a portion of those earnings. The system evolved with a complex set of regulations on allocating foreign exchange according to industry and location before a uniform retention rate for businesses was set throughout the country in 1991.

Other ways used to promote exports included various export subsidies and the facilitation of trading units or foreign trade corporations, the number of which had risen to more than six thousand by 1989 (World Bank, 1990). The introduction of the agency system further increased the abilities and the freedoms of those authorized to conduct importing and exporting.

In 1981, China introduced a dual exchange rate system, one for non-trade transactions and a more favorable rate for international settlement of trade transactions. The dual rate system was abandoned in 1985, but was re-established in 1996 when foreign exchange adjustment centers (FEACs) were set up. FEACs were government- approved enterprises that were permitted to buy and sell retention quotas.

After freer trading was permitted in 1988, the premium on exchange rates in the FEACs was up to about 80 percent the number of participants was steadily increasing and so was the total demand. The FEACs came to dominate Chinas foreign-currency transactions, accounting for 80 to 85 percent of all such activity.

The exchange rate at FEACs was set by a combination of government forces and market conditions, although the government intervention was rare.

In 1986, the official exchange rate was, in effect, pegged to the U. S. dollar. In 1991, the exchange policy was altered to make smaller, more frequent adjustments in response to free market conditions. The policy began with a devaluation of 0. 95 percent on April 9, 1991 to renminbi 5. 2935 per dollar and another on May 20, to 5. 4066 per dollar. Several subsequent small adjustments were made through the year. By April, 1993, the real effective

exchange rate had depreciated 33 percent more than in 1986 and 70 percent more than 1980 (Bell et al. 1993).

However, it must be noted that the Chinese currency was highly over-valued and therefore, an expensive currency making products more expensive abroad and therefore less attractive to importers and, ultimately, the consumers. One of the key reasons for the devaluation was to reduce price distortion and promote exports. Wang (1993) found and wrote that there was a positive relationship between real exchange rate and exports; and Brada, Kutan and Zhou (1993) found that in both the short and long run, devaluation of the renminbi served to improve the balance of trade.

A significant step in foreign exchange reform in the early 1990s was the joining of the two main currency rates (the trade rate and the official rate) and the subsequent allowance of a limited amount of room for the renminbi to freely float from the beginning of 1994. This led to a significant devaluation; since then the exchange rate has remained stable. During this time, Chinas exports grew rapidly, raising a question over the relationship between the real exchange rate and the balance of trade in Chinas transitional and emerging economy. However, the World Bank reports (1990) that the management of the exchange rate in the Chinese economy has played a major role in the level and composition of exports and imports.

It is expected that China will eventually introduce a floating exchange rate regime. This will depend on a number of other conditions. One precondition would be a major improvement in the business practices of the banking sector. The ratio of non-performing loans to total bank assets as about 25

percent before the crisis began, is actually much higher than those in the crisis-affected economies, and some state-owned banks were technically insolvent. The banks could face major problems if bank runs were to be triggered by a loss of depositor confidence the major role of these banks could cause widespread instability in the economy (Lardy, 1998).

The banking sector cannot be reformed separately; it works together with state-owned enterprises and public finance policy. Although the state-owned enterprises are undergoing consistent reform as China works to become internally and internationally competitive in all areas, they are still very inefficient by Western standards. In 1996, these enterprises had a net loss of 38 billion renminbi, a trend that has continued to this day (SSB 1997).

The major proportion of fiscal resources is spent on personnel and administrative activities. The estimated 30 million redundant government workers also cause a strain on the economic system, creating more inefficiency and cost. Issues such as social security, infrastructure development and regional disparity are still hardly addressed.

These factors are mutually induced; for example, the inefficient state-owned enterprises demand budget subsidies and contribute to non-performing loans. This worsens the already poor financial and fiscal conditions. Due to shortages in revenues, the government has often had to shift its financial responsibilities onto the state-owned banks in the form of policy loans that are often set at low interest rates and are rarely paid back. These factors and many, many others create an interlocking web providing a complexity of relationship that inhibits the governments ability to fix the situation on a

sector-by-sector basis. The problems also contribute to other difficulties facing China, such as unemployment pressures and regional disparity. The financial system has become more fragile due to the preponderance of non-performing loans; real estate bubbles and excess production capacity are widespread.

Current Situation

China's renminbi currently trades in a narrow range of about 8. 2760 to 8. 2800 to the dollar, kept in check by the Central People's Bank of China, which uses foreign-exchange reserves to intervene and keep the currency within this range.

According to foreign policy experts at Reuters News Service (5 May, 2002), China's top priority is to keep its currency as stable as it can during what promises to be a turbulent breaking-in period in the World Trade Organization, and ahead of a reshuffling in the top Chinese leadership later in this year.

China has recently been under pressure from the International Monetary Fund to gradually get rid of the RMB virtual peg to the dollar and replace it with a peg to a more flexible basket of currencies. The Chinese authorities have said they are studying the proposal but have no plans to make changes in the near term. Last month, Chinese Premier Zhu Rongji said China had no plans to devalue the renminbi or shift the domestic currency from its virtual peg to the dollar to a peg to a basket of currencies any time soon. " Out of consideration for the interests of the region, and its own needs, China

insisted on not devaluing its own currency. We have continued to adhere to this policy, and this policy will not change," Zhu said (Reuters, 2002)

Weakness in the Japanese yen this year has sparked concern around the region that China might devalue their currency, sparking a round of competitive devaluations by Southeast Asian nations. U. S. manufacturers live in fear of a Chinese devaluation, as it could result in a flood of cheap Asian goods onto world markets undermining exports of U. S. products, which they say are already under pressure from U. S. dollar strength.

Beijing would be reluctant to allow the renminbi to fall back too far as that would put new pressure on Hong Kong's currency, which has already come under attack. A devaluation of Hong Kongs currency so soon after the transfer of power would be a blow to China's prestige. A reduction in the value of the renminbi would also aggravate trade friction with the US. China's trade surplus with the US is expected to reach $50 billion USD this year and Beijing officials have said they were concerned over the imbalance (Reuters, 2002).

While the Chinese leadership has clung to its commitment not to devalue the currency this year, the government has stepped in to stop illegal capital outflows through the cracks in China's foreign exchange controls. The central regulatory authorities have seen that Chinese companies are thinking there is a devaluation coming, so they have acted in an aggressive manner against perceived capital flight. Since mid-September, China's foreign exchange authorities have issued more than 20 different notices and regulations, tightening the supervision of foreign exchange transactions and raising the

requirements for official documentation, conversion and remittance on hard currency transactions. The tougher implementation of foreign exchange controls is a sign of the underlying concern in China about the stability of the currency, the illegal flows of hard currency out of the country and hidden exposure to foreign exchange debt.

The tightening of foreign exchange controls gives significant insight into Chinese perceptions of the stability of their currency and ongoing concerns about infection from the Asian disease. Zhu Rongji, the prime minister, and Dai Xianglong, the central bank governor, are committed to holding to their commitment not to devalue the reminbi, not just for the sake of international economic stability, but more crucially, in the interests of China's own economy.

Devaluation would impact China's ability to raise hard currency. One of its priorities is to strengthen state enterprises, and they hope to use Hong Kong capital markets to raise cash. If Hong Kong dollars were no longer securely pegged to the U. S. dollar, international investors would avoid investing in new Chinese securities, which would lose their value.

A weaker currency could even destroy confidence inside China. Collectively, ordinary Chinese people maintain saving deposits totaling around 8 trillion renminbi (worth about $1 trillion USD) in deposits at local banks; however, many people would be tempted to take their funds out of their bank and buy black market U. S. dollars if their countrys currency fell in value, creating a run on the bank.

China cannot afford a run on its banks. A run would destroy Beijing’s credibility and ability to extend credit to businesses and projects that help keep the economy growing.

A positive to devaluing the renminbi would allow China to hang on to the market and prevent its exports from being undercut by products from the rest of Asia now that drops in other Asian countries have reduced local costs, such as labor. Devaluing the currency would undermine the efforts of other Asian countries to restore their economies setting off another cycle of devaluations. Devaluation also would make it more attractive to foreigners to invest in China, which draws more than half its foreign investment from elsewhere in Asia (Mufson, 1998).

China has some distinct advantages in comparison to other East Asian and Southeast Asian Countries. Its trade surplus is supporting the strength of their currency. In 1997, exports were an impressive $182 billion, $40 billion more than imports. China also has $140 billion in foreign currency reserves, which covers its $119 billion in foreign debt. When the crisis broke, China had a current account surplus of nearly $30 billion USD, which was maintained in 1998. This was in sharp contrast to the persistent current account deficits in Thailand and Indonesia before the crisis began. (See table below).

Table 2: Chinese Economic Indicators for the External Economy, 1995-1998

19951996199719981999

Current Account Balance (US $ Billion)1. 67. 329. 729. 313. 4

Growth of Foreign Direct Investment Inflow (%)5. 912. 37. 00. 0-6. 7

Foreign Exchange Reserves (U. S.$ billion)73. 6105. 0139. 9145. 0154. 7

External Debt (US $ billion)94. 6104. 6118. 6146. 0130. 0

External debt service ratio (% of imports)9. 19. 911. 814. 312. 6

Source: State Statistics Bureau, Chinese Statistical Yearbook, 1998 and CEIC Data Company Limited, Hong Kong.

Additionally, while China was the largest capital importer in East Asia, more than 60 percent of the capital inflow was in the form of foreign direct investment (mostly multinational corporations establishing businesses, commerce and infrastructure to support their presence there and direct international investment into Chinese firms by Western institutions and private individuals). Therefore, it had not borrowed as much as other companies and its debt-service ratio was maintained at low levels. In contrast, the other countries had borrowed short-term money from agencies and institutions. When their currencies were devalued, they were forced to pay back more in their own currency, which they no longer had available.

China still exercised strict controls over the capital account, although they did realize their goal of full convertibility of the renminbi in compliance with the IMFs Article VII stipulations. The controls served as a layer of insulation from the instability of the recent capital markets of the region (Huang and Yang, 1998). These strict controls working in concordance with deep integration into the world commodity markets, increasing flexibility of

structural adjustment and the current account surpluses were important factors in Chinas ability to weather the storm of the Asian crisis.

The controls also prevented attacks on the Chinese currency by international speculators in the overseas capital markets; and significant capital flight has been avoided through the periodic tightening, as recent evidence shows. The controls also have the negative effect of slowing down trade and being counter-facilitative to efficient transactions, since the controls provide tight monitoring of transactions, additional paperwork and closer inspection of how business is done. All this takes time and non-productive (non-income producing effort). However, as has been shown, the Chinese are willing to forego short-term profits in the effort to maintain long-term strength and stability of the entire economy.

Conclusions

In retrospect, Chinas performance in averting a currency crisis in the last few years has been smooth. The positive contribution to regional economic stability by maintaining the value of the renminbi despite probable adverse trade effects has been noticed internationally.

The main difference in Chinas performance versus that of crisis-affected countries was the degree of liberalization immediately prior to the crisis. Capital account controls have efficiency costs, but they helped to protect Chinas vulnerable financial sector from instabilities in the international capital market.

Additionally, capital controls were an important contributor to other advantageous conditions, such as the large foreign exchange reserves and the dominance of foreign direct investment in total capital inflows that helped China avert a currency crisis.

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