

Table 2. Export Earnings (fob, in US\$ million)

	Q1	Q2	Q3	Q4	Year Total
1996	28,249	35,803	39,979	47,166	151,197
1997	35,585	45,360	48,173	53,759	182,877
1998	40,072	46,488	47,190	49,839	183,589
1999	37,290	45,727	54,201	na	na

5. SUSCEPTIBILITY OF CHINA TO A FINANCIAL CRISIS

The Asian financial crisis was typified by (a) a collapse of the exchange rate because of heavy capital outflow, and (b) a collapse of the domestic financial system causing a shortage of working capital that, in turn, caused output to collapse. So how vulnerable is China to a meltdown scenario of this type?

A dramatic speculative attack on the RMB can be ruled out simply because the RMB is not convertible for capital account transactions in financial assets. It is difficult for a person to borrow RMB from a Chinese bank to buy US dollars to speculate against the exchange rate because the purchase of US dollars requires documentation to prove that the transaction is trade-related.

Capital outflow by foreign private agents has not occurred because most of the *foreign private investments* in China are foreign direct investments, and there is very little short-term foreign debt. At the end of 1999, short-term foreign debt was less than 20 percent of the total foreign debt of US\$168 billion. The fact that China also had US\$155 billion in foreign exchange reserves made defense of the exchange rate feasible even if all short-term foreign debts had been recalled.

Furthermore, foreign participation in the Chinese stock markets is limited to transaction in B-shares. Only foreigners can own B-shares, and B-shares are denominated in US dollars and transacted using US dollars. In short, an abrupt withdrawal by foreigners from the Chinese stock markets can affect the value of the yuan-dominated A-shares (that

only Chinese can own) only if their withdrawal would cause Chinese speculators to revise their expectations of future Chinese growth downward.

Of course, capital flight can occur through channels like over-invoicing of imports and under-invoicing of exports. A successful speculative attack on the RMB via large and pervasive mis-invoicing is theoretically possible, but difficult to prove because the paper trail would point to trade imbalance rather than portfolio adjustment being the cause of the exchange rate collapse. An exchange rate collapse from mis-invoicing of trade requires that the government be rigidly committed to current account convertibility, but this is not credible. Any government like China that has in place a comprehensive administrative system that processes every import application to buy foreign exchange (in order to prevent capital movements) can be easily tempted to defend the exchange rate by delaying approvals of import applications. So imports could be compressed to a significant degree whenever a trade deficit threatens to materialise.

We turn now to the issue of whether China's banking system would collapse spectacularly as in the countries experiencing the Asian financial crisis. To a first approximation, when the won, baht, and rupiah went into free fall, many Korean, Thai and Indonesian banks were rendered insolvent through a combination of the following channels: the sudden increase in the value (measured in domestic currency) of their foreign liabilities; the default on bank loans by domestic corporation bankrupted by the soaring of their external debts; and the default on bank loans by exporters who could not get short-term credit from their foreign suppliers of inputs. Many of the Korean, Thai and Indonesian banks were already financially fragile before their collapse because of undercapitalisation, and because of considerable NPLs that had been hidden by accounting gimmicks. And the exchange rate shock pushed these fragile banks over.

Much alarm has been raised in recent months about the amount of NPLs in China's banking system, with estimate for NPLs ranging from 20 to 50 percent of total bank loans. It has even been raised as a serious possibility several times, that a run by depositors is almost inevitable, causing a banking collapse that would trigger a general output decline.

We find the likelihood of either a bank run or a collapse of the banking system to be minimal. Admittedly, there have been bank runs in China since 1978, e.g. in 1988. But these bank runs were motivated by anticipations of high inflation caused by imminent lifting of price controls, and not by anticipations of bank failures. Whenever the government began indexing interest payments to the inflation rate, the bank runs reversed themselves. In the present time of falling prices, inflation-induced bank runs will not occur.

It is true that there is no depositor insurance in China but this in itself is unlikely to cause a bank run induced by fear over the large amount of NPLs. This is because all but one of the banks are state-owned and the government has repeatedly pledged to honour all deposits in the state banks. This pledge is credible because the government is in a position to make good its promise. As pointed out earlier, the government can easily borrow to cover the NPLs; and assuming an NPL ratio of 33 percent, the borrowing would raise the public debt-GDP ratio to just 40 percent. Alternatively, the government could always raise taxes to cover the NPLs.

Even if a bank run does occur, there need not be a collapse in bank credit because the central bank could just issue currency to the state banks to meet the withdrawals. This expansion of high power money cannot be easily translated into a loss of foreign reserves because capital controls are in place. This expansion of high power money will also not have much impact on inflation because this is mainly a shift out of bank deposits into cash, and not a shift into goods.

Simply put, even if the state banks are truly insolvent as has been alleged, and even if the insolvency does induce bank runs, a collapse in bank credit does not have to follow. It is well within the technical ability of the government to accommodate the bank runs, and it is also well within the financial ability of the government to recapitalise the state banks. Furthermore, these two government actions would not cause much damage (if any) to the economy, like lower growth and higher inflation.

While China can prevent the NPLs of the state banks from maiming the payments system and crippling production, we recognise that the

NPLs have imposed real costs on the economy. With NPLs accounting for a third of total bank loans (our estimate), bank loans accounting for about a fifth of fixed investments since 1985, and fixed investments at about 35 percent of GDP, this means that about 2.3 percent of GDP has been wasted annually in the last decade. Moreover, since most of the bank loans are extended to SOEs with little going to the more efficient non-state sector, the performing loans are not in investments with the highest rates of return. In short, the productive capacity of the economy could be higher than what it is.

Of course, we also recognise that the NPL problem might be even worse at the non-bank financial institutions (NBFIs) like the regional trust and investment companies (TICs).²⁰ However, because NBFIs constitute only a small part of the national credit system, their failure is not capable of bringing down the payments system. The biggest dangers from the collapse of NBFIs are social instability (especially when the base of NBFIs is small depositors), and reduction in foreign credit.

In the 1998 closure of the financial arm of the Guangdong International Trust and Investment Company (GITIC), the central government assumed responsibility for all properly-registered foreign debt. Since trade-related credit with maturity of less than three months and foreign debts of GITIC's branch in Hong Kong did not require official registration, it is likely that a very substantial amount of GITIC's foreign debt will not be assumed by the Chinese government. In October 1999, GITIC's liquidation committee reported that, after rejecting illegal contingent guarantees issued by GITIC, the total liabilities had been reduced from US\$4.7 billion to the range of US\$1.7 billion to US\$2.7 billion. The value of recoverable assets was put at US\$0.9 billion.²¹

As discussed earlier, this assumption of all the properly-registered debt of state institutions and SOEs would raise the public debt-GDP

²⁰ According to the *Far Eastern Economic Review* ("TIC Fever: China's shaky trust and investment houses start to fall," October 22, 1998), "most of the country's 243 TICs are on the rocks." Lardy (1998b) reported the claim that 50 percent of the assets of the non-bank financial sector was not performing.

²¹ "Illegal GITIC deals delay payout," *South China Morning Post*, October 23, 1999.

ratio to 55 percent — still a very low level when compared with the public debt-GDP ratios of most Western European countries. As a general principle, the government's decision to let NBFIs fail is important to reducing the moral hazard problem inherent in supervision of the financial sector. Both domestic depositors and foreign creditors have to be encouraged to assess and manage risks better.

As things stand at the beginning of 2000, it looks unlikely that China will soon succumb to a financial crisis marked by bank runs, capital flight, a severe shortage of working capital, and a deep recession.

6. THE IMPORTANCE OF FINANCIAL INTERMEDIATION FOR STABILISATION AND GROWTH

Part A of Table 3 shows that total household consumption has declined steadily as a proportion of GDP. It dropped from an average of 52 percent in 1979–1983 to 46 percent in 1994–98. However, this fall in consumption is not seen in all sectors. While rural consumption fell from 33 percent of GDP in 1979–83 to 23 percent in 1994–98, urban consumption rose from 19 percent to 23 percent. But since the share of population living in urban areas has gone up from 20 percent in 1979–83 to 30 percent in 1994–98, it is not surprising that urban consumption has risen relative to GDP, while rural consumption has fallen. The important analytical issue is whether urban consumption did increase relative to GDP, once the demographic shift has been controlled for.

Part B of Table 3 presents a decomposition of the change in rural and urban consumption behaviour after taking the rural-urban movements into account. The decomposition follows from:

$$\text{Equation (1):} \quad (C_i/\text{GDP}) = [L_i/L] * [(C_i/L_i) / (\text{GDP}/L)]$$

where C_i = consumption in sector i
 L_i = population in sector i
 L = total population

The decomposition in Equation (1) can be described as:
 (consumption in sector i as share of GDP)