

*Young Rok Cheong, Fan Gang, Yung Chul Park, Barbara Stallings,
Yunjong Wang, Wing Thye Woo, Geng Xiao, Xie Ping, Xiaojing Zhang
and others*

China's Role in Asia and the World Economy

Fostering Stability and Growth

Edited by
Jan Joost Teunissen

FONDAD

China's Role in Asia and the World Economy: Fostering Stability and Growth

Forum on Debt and Development (FONDAD)

FONDAD is an independent policy research centre and forum for international discussion established in the Netherlands. Supported by a worldwide network of experts, it provides policy-oriented research on a range of North-South problems, with particular emphasis on international financial issues. Through research, seminars and publications, FONDAD aims to provide factual background information and practical strategies for policymakers and other interested groups in industrial, developing and transition countries.

Director: Jan Joost Teunissen

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The Hague

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Editor: Jan Joost Teunissen

The views expressed in this book do not necessarily represent those of the Forum on Debt and Development or any of the co-sponsors. The summaries of the floor discussions, following the papers, attempt to convey the sense and substance of what was discussed. They have not been reviewed by all of the participants.

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Abbreviations

ACU	Asian currency unit
ADB	Asian Development Bank
ADB I	Asian Development Bank Institute
AFTA	ASEAN Free Trade Area
AMC	Asset Management Company
AMF	Asian Monetary Fund
APEC	Asia Pacific Economic Cooperation
ASA	ASEAN Swap Arrangement
ASEAN	Association of South-East Asian Nations (Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, Vietnam)
ASEAN+3	ASEAN and China, Japan, and Korea
Asia-7	India, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, and Thailand
BIS	Bank for International Settlements
BSAs	Bilateral Swap Arrangements
CAR	capital adequacy ratio
CASS	Chinese Academy of Social Sciences
CBRC	China Banking Regulatory Commission
CEPAL	see ECLAC
CIRC	China Insurance Regulatory Commission
CMI	Chiang Mai Initiative
CPC	Communist Party of China
CPI	consumer price index
CSRC	China Securities Regulatory Commission
EBRD	European Bank for Reconstruction and Development
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN); (in Spanish CEPAL)
ECU	European currency unit
EEFSU	Eastern Europe and the former Soviet Union
EMU	European Economic and Monetary Union
ERM	Exchange Rate Mechanism (European)

ESCAP	Economic and Social Commission for Asia and the Pacific
EU	European Union
FDI	foreign direct investment
FTA	free trade area
G-7	Group of Seven
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
IFI	international financial integration
IMF	International Monetary Fund
KIEP	Korea Institute for International Economic Policy
MFN	most favoured nation (trade status)
MNCs	multinational corporations
MPC	Monetary Policy Committee
NAFTA	North American Free Trade Agreement
NBFI	non-bank financial institution
NPL	non-performing loan
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
PBOC	People's Bank of China
PPP	purchasing power parity
ROA	return on assets
ROE	return on equity
RMB	renmimbi
SAMC	State Asset Management Commission
SETC	State Economic and Trade Commission (of China)
SME	small and medium-size enterprise
SOB	state-owned bank
SOCB	state-owned commercial bank
SOE	state-owned enterprise
TVE	township and village enterprise
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States
WTO	World Trade Organisation

Introduction

“By the end of 2002, only a year after joining the WTO, China overtook the United States in foreign direct investment (FDI) inflows, becoming the most attractive FDI destination in the world,” say two of the contributing authors to this volume.

“In 2002, China’s gross domestic product exceeded RMB10.2 trillion (approximately 1.2 trillion dollars) for the first time, ranking it sixth in the world, and China’s total trade volume reached 620.8 billion dollars, ranking it the fifth of the world,” say two other contributing authors.

“China has one-fifth of the world’s population and its labour force is larger than the sum in all developed economies,” is yet another observation in this book.

That China is now a key country in the world economy is an undeniable fact that has become visible in almost every country around the world. Who has not seen “made in China” on sports shoes, a printer’s cartridge or a children’s toy?

Looking at China’s economy from the viewpoint of people living in the developing world, which is Fondad’s primary focus, the sheer size of China’s own population would be enough reason to examine the country’s prospects of financial stability and growth. If we consider the role China is playing in the Asian region and in the world economy, there are yet more reasons to analyse and discuss the current and future challenges of China’s economic performance.

In this book, a number of renowned Chinese scholars and other experts in international finance and development discuss the challenges faced by Chinese policymakers when dealing with domestic, regional and international economic issues. The book is divided into four parts. The first part deals with China’s economic reform agenda, the second with China’s role in regional financial cooperation efforts as well as in global finance, the third with the functioning of the global financial system, and the fourth with China’s future challenges as seen by a prominent Chinese, Japanese and Korean expert respectively.

In the first chapter, Chinese professors in economics Gang Fan and Xiaojing Zhang address three questions: (i) what has China achieved so far; (ii) what difficulties and risks are present in the Chinese economy; and (iii) how can the reform agenda be designed to resolve these risks and difficulties and realise yet another period of 20 years of high growth? The authors formulate a reform agenda that focuses on reform of the state sector, the establishment and improvement of a basic social security system, the reform of China's financial system, the deepening of rural reform, and changing the role of the government in the economy.

In his comment on Fan and Zhang, professor of economics Keun Lee of Seoul National University observes that a major problem of China is that its leaders want to bring about rapid growth while maintaining political hegemony, social stability and a socialist identity. According to Lee, this policy mix has led to the problems discussed by Fan and Zhang, such as the rising inequality between urban and rural areas, non-performing loans and increasing unemployment.

In the third chapter, Wing Thye Woo, professor of economics at the University of California, discusses the challenges in macroeconomic management China's new leaders are facing since the country became a member of the World Trade Organisation (WTO) in 2002. One of the biggest challenges that Woo sees for China is that its basic economic institutions will have to converge to those of an advanced capitalist country. He observes that such convergence will be particularly difficult given the low employment growth in the industrial sector. He investigates the probability of WTO-induced macroeconomic shocks, the resilience of China's economy to such shocks, the deficiencies in China's financial system, the sustainability of expansionary fiscal policy to keep aggregate demand high, and the problems of the "still too large" state enterprise sector. He concludes that the most serious threat to macroeconomic stability comes from the successive rounds of bank recapitalisation and argues that the key to eradicating the deflation bias in China's economy is to establish an efficient financial intermediation mechanism.

In his comment on Woo, Chang Kyu Lee, a fellow of the Korea Institute for International Economic Policy (KIEP), agrees with Woo's emphasis on the need to transform the Chinese banks into commercially viable entities. He warns, however, that improvements

in the financial system alone will be insufficient for tackling the urban-rural income disparities in China. In his view, the increase of rural income and consumptive spending in rural areas is one of the essential policy priorities.

In the floor discussion that ends the first part of the book, Xiaojing Zhang stresses that some of the issues of China's economic reform agenda cannot be solved in 20 years. He suggests that in the short run, China's policymakers should focus on the financial sector since many of the problems the country is facing are reflected in the banking system and the capital market. "The capital market is at the top of the property rights system," he says, "and unless we are able to establish a good capital market, the economy will not be robust."

In the first chapter of the second part of the book, Korean professors of economics Yung Chul Park and Yunjong Wang discuss the prospects for regional financial and monetary cooperation in East Asia. The crisis that erupted in Asia in 1997 gave Asians a strong impetus to search for a regional arrangement to forestall future crises. It resulted in the so-called Chiang Mai Initiative (CMI), a system of swap arrangements among Asian countries. The authors provide an overview of the current structure of the CMI and discuss a number of its pitfalls. They also explore the issues related to the creation of a monitoring and surveillance mechanism such as the proposed Asian Monetary Fund (AMF). After examining major barriers to financial cooperation and integration in East Asia they sketch three possible scenarios for financial and monetary cooperation in the region.

In his comment on Park and Wang, Charles Adams of the IMF says that the authors are too negative about the prospects for the Chiang Mai Initiative because they are too ambitious in their assessment of what it could and should accomplish. Adams observes that the deepening of financial cooperation takes time, and the development of mechanisms for regional dialogue, the discussion of appropriate financial arrangements for the region and the fact that countries are starting to undertake peer reviews of their policies are already important steps forward.

In the next chapter, Young Rok Cheong and Geng Xiao, professors of economics of Seoul National University and Hong Kong University respectively, discuss some structural and institutional factors that determine China's current and future position in global capital flows. The questions they examine include:

Is China attracting too much FDI? What is the impact of foreign portfolio investment on the stability of the Chinese financial markets and other Asian regional markets? Is China generating global deflation? Should China reevaluate its currency? Is China becoming a growth engine for the world?

In discussing China's increasing role as a "world factory" and the impact this has on the rest of the world, the authors argue that the single most important impact of China's outstanding economic performance is on changes in global relative prices. In their view, there is no doubt that China's new labour supply to the global market will lead to a secular fall in the prices of labour-intensive manufacturing products. Such a fall in prices is already occurring, they say, even though China's huge contribution to the increase of the standards of living in both developed and developing countries is invisible in statistics. "Today's lucky kids around the world can testify to this with their made-in-China toys," they say. Without China's production, most toys would cost five to ten times more. The authors conclude that China is becoming an engine of growth for the world and argue that China's successes and problems should be seriously studied "since they have profound implications for all of us."

In his comment on Cheong and Xiao, Li-Gang Liu, formerly with the Asian Development Bank Institute (ADB), explores the puzzling questions of why wages in the export sector have been stagnant over the last ten years despite an impressive improvement in the sophistication of Chinese exports, and why China – notwithstanding its high growth rates – has grown so little in terms of US dollars. In his view, this indicates that the wealth from FDI-generated income is located overseas rather than within China. The net value added in China's exports has been minimal, mainly in the form of cheap labour income, Liu observes.

The floor discussion that ends this second part of the book includes an observation by Young Rok Cheong who echoes the view expressed earlier by Xiaojing Zhang that reform of the financial sector will be crucial for China's economic success. "The financial sector is a derivative of the real sector and anything that goes wrong will be reflected in the financial sector," says Cheong.

The third part of the book begins with a chapter by Xie Ping, research director of China's central bank, who addresses three questions: (i) given the competition in global financial markets, what

are the costs and benefits of financial integration for Asian economies?; (ii) in response to the shocks of global financial integration, how can Asian countries build a new regional policy cooperation regime after the crisis of 1997-98?; and (iii) given the post-crisis policy option between currency stability and financial deepening, how should Asia's goals be defined?

According to Xie, the Chiang Mai Initiative reveals Asia's intention to follow the European Union mode rather than remain isolated countries linked separately to the world economic system. He expects that the Asian economies will, step by step, unify their foreign exchange systems, bond markets, stock markets, and finally their currencies. Given the dramatic growth of unstable global capital flows, intra-regional crisis prevention and a proper sequencing of financial reform are needed to achieve long-run currency stability in Asia.

In his comment on Xie, Zdeněk Drábek of the WTO assesses the main features of the so-called neo-financial dualism hypothesis and its implications for regional cooperation in East Asia. He concludes that a multilateral approach would be better than a regional approach.

In the next chapter, Barbara Stallings, professor of economics at Brown University, discusses the role of the financial sector in creating growth and stability by drawing some lessons for China from experiences in Latin America and East Asia. Pointing at the way Korea and Chile have eliminated the bad loans in their banking systems and improved their regulatory and supervisory regimes, Stallings stresses the need for China to increase the credibility and functionality of its financial sector. She warns, however, that mismanaged financial liberalisation – improper sequencing, excessive speed, or extreme versions of liberalisation – can lead to financial crisis. She advocates a gradual capital account opening, with long-term flows liberated before short-term, and the ability to take precautionary steps against capital surges, to protect the fragile financial sector against devastating volatility.

In his comment on Stallings, Robert McCauley of the BIS discusses four themes: preventing and responding to financial crisis; unifying the bond market; defining the role of foreign banks; and liberalising the capital account. He observes that Stallings has an unconventional view on the resolution of non-performing loans. "The conventional view holds that the big banks should be

recapitalised and then privatised. Fan Gang argues that since they will not be privatised, they should not be recapitalised. Stallings argues that they should be recapitalised, but not necessarily privatised.”

The floor discussion that ends the third part of the book includes Wing Thye Woo’s suggestion that China should take a more active role in leading the developing countries in efforts at reforming the international financial system. He also suggests that China should participate actively in Asian efforts at regional cooperation. “Regional financial institutions can be useful instruments to complement and critically review global institutions,” Woo observes.

The fourth part of the book includes three short panel presentations. It starts with Xie Ping of China’s central bank, who gives his view on the main financial challenges China is facing: (i) how to deal with the problem of non-performing loans; (ii) how to sequence capital account liberalisation; (iii) how to maintain independent monetary policy and a stable exchange rate; (iv) how to deal with China’s domestic government bond market; and (v) how to liberalise domestic interest rates.

Masaru Yoshitomi, former dean of the Asian Development Bank Institute, summarises ADBI’s risk-based approach to sequencing financial liberalisation and economic reform, applied to the case of China. The seven-point proposal he outlines gives top priority to restoring banking sector solvency through prompt resolution to the problem of non-performing loans. Just like Stallings and others, Yoshitomi warns that China should be cautious with opening the capital account.

Choong Yong Ahn, president of KIEP, ends the book by presenting his view on five major issues concerning China’s role in the region and in the global economy. First, he believes that China’s continuing high growth rate is going to change the economic landscape of not only East Asia but also of the entire world in the next two decades. Second, he thinks that China should work closely together with other Asian countries to ensure regional exchange rate stability. Third, he observes that China’s ability to produce a low-price and high-quality product in shipbuilding, iron, steel and semi-conductors may cause overproduction resulting in a global downward pressure on the price level. Fourth, he stresses that the regional economic leadership struggle between Japan and China

should end because it is harmful for the East Asian integration process. Fifth, he wonders whether China will be able to realise its own version of a socialist market economy without political pluralism. “The future role of China, in the long term, depends on how China is going to combine the market economy and political democracy,” concludes Ahn.

Jan Joost Teunissen
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Part I

Financial and Macroeconomic Reform in China

1

The Chinese Reform Agenda

Gang Fan and Xiaojing Zhang

After two decades of unprecedented growth since the late 1970s, China's economy has entered a new phase of development. What do we mean when we say 'a new phase of development'? The report of the 16th party congress held in November 2002 defines the 'new phase' as a period of an additional 20 years of high growth to realise a 'well-off' society (*xiaokang*)¹ in an all-round way. Given this challenging objective, we address three questions: (i) what has China achieved so far; (ii) what difficulties and risks are present in the Chinese economy; and (iii) how can the reform agenda be set up to resolve these risks and difficulties and realise the new objective?

1 What Has China Achieved So Far?

China's Role in the World Economy

In 2002, China's gross domestic product (GDP) exceeded RMB10.2 trillion (approximately 1.2 trillion dollars) for the first time, ranking it sixth in the world. From the end of 1978 until 2001, China's average annual GDP growth rate reached 9.3 percent.

¹ The term 'well-off' society – in Chinese *xiaokang* was pioneered by Deng Xiaoping in 1979 to describe the realisation of a Chinese-style modernisation. It is hoped that China will achieve a *xiaokang* society by 2020, one of the goals is to ensure that the nation's per capita GDP will reach 3000 dollars, equivalent to today's standard in Beijing.

At the end of 2002, China's total trade volume reached 620.8 billion dollars, ranking it the fifth of the world. The trade volume accounted for more than half of GDP, while in 1978 the trade/GDP ratio was less than ten percent. In the past several years, over 55 percent of China's export consisted of trade in processed goods. Any growth in such exports would require a corresponding increase in imports, that is, every \$100 of exports requires at least \$50-70 worth of imports (Justin Y. Lin, 2002). Thus, China's thriving processing trade translated into an expanding market for many economies.

China became the largest recipient country in terms of the foreign direct investment (FDI) inflow in 2002, which – for the first time – exceeded that of the United States. By 2002, FDI inflow has increased to 448 billion dollars, and foreign joint ventures have contributed to ten percent of the urban employment.

China's foreign exchange (Forex) reserves rose from 167 billion dollars in 1978 to 286.4 billion dollars in 2002 (and 383.9 billion dollars in September 2003), thus becoming the world's second largest nation in terms of foreign reserves after Japan. Although China has often been criticised for maintaining such high foreign exchange reserves given the shortage of capital, the large amount of Forex actually helped China avoid international financial risks and enhanced the capabilities of the Chinese government for macro-economic control.

In many aspects, we can show the greater role of China in the world economy and its beneficial effects on other economies.

Development of Non-SOEs

China's 'gradual' or 'incremental' reform is mostly taken as a successful model in contrast to the radical reform in Russia and some Eastern European countries. The key feature that characterises China's reform so far has been the development of the market-oriented non-state-owned enterprises (non-SOEs), not the reform of state-owned enterprises (SOEs) (Gang Fan, 1994).

With the progress of non-SOEs, SOEs' dominant role in the economy has been totally altered. As Table 1 shows, non-SOEs now account for 66.0 percent of GDP (1999), 55.2 percent of fixed investment (2002), 58.1 percent of fiscal revenue (1999), and 74.0 percent (2002) of the employment in urban areas.

Table 1 Non-SOEs' Contribution to China's Economy
(in percentages)

	Contribution to GDP	Contribution to Fixed Investment	Contribution to Fiscal Revenue	Contribution to Employment in Urban Areas
1978	42.2		13.8	21.7
1980	44.2	18.1	16.1	23.8
1985	53.0	33.9	28.0	29.8
1987	54.1	35.4	30.1	30.0
1990	53.4	33.9	33.3	37.7
1993	55.0	39.4	35.6	37.9
1996	63.8	47.6	44.3	43.3
1999	66.0	46.6	58.1	59.2
2000		49.9		61.9
2001		52.7		68.1
2002		55.2		74.0

Sources: Gang Fan (2002); *China Statistical Yearbook 2002*.

The Dynamic Evolution of "Objective Model" for the Chinese Reform

The market-oriented reform discussed above, however, kept changing in the official "objective formula", which confused people as to where China's reform is heading. It may be useful to view how the official line was drawn from time to time during the past two decades. Box 1 shows how the official "objective formula" kept changing and evolving (in the same direction) over the past 20 years, from "Planned economy supplemented with some market elements" in 1979 to the "Socialist market economy" with the withdrawing of SOEs from most "competitive industries" and "mixed ownership".

Our analysis reveals that nothing was accidental in the ever changing "objective formula" and that the logic of political economy prevailed. For instance, the major policy shift took place in 1993 when the words "socialist market economy", replaced "planned economy" and was adopted by the "Reform Decisions" of the Central Committee of the Communist Party of China (CCCPC). The previous year, for the first time, the share of the non-state sector in industrial output passed 50 percent, and in 1996, the state industrial sector as a whole suffered its first "net loss". In the following year, the CCCPC adopted policies of "diversifying the

Box 1 The Gradual Evolution of Official “Formula” of Reform Objectives Since 1978

Time	Formulation of reform objectives
1978 - 1984.10	Planned economy supplemented by some market elements
1984.10 - 1987.10	Planned commodity economy
1987.10 - 1989.6	”State regulates the market and market regulates enterprises”
1989.6 - 1991	”Organic integration of planned economy and market regulations”
1992	Share-holding system and security market (started) can be used by Socialism
1992.10	Socialist market economy
1994	”Corporatisation of SOEs and reform of property rights”
1997	Developing the state sector together with all other kinds of ownership; “holding on to large SOEs while letting small ones go to the market”.
1998	Constitution Amendment: private ownership should be equally promoted and protected
1999.10	SOEs withdraw from competitive industries; diversification of ownership of corporate and “mixed ownership”; Executive Stock Options for SOEs.
2001.7	”Three Representative Functions of the Party”; allows owners of private and individual enterprises to be Party members; further develop various ownership forms.

Source: Various official documents of Central Committee of the Communist Party of China (CCCCP).

ownership” and “developing the private sector together with the state sector”. In 1998, the Constitution was amended by adding “Private ownership should be equally protected and promoted”. In short, the contents and definition of “socialist market economy” changed over time in line with the changes of the reality. With the further growth of the private sector and private business community – which serves as the main support of the economic prosperity and social stability – the Communist Party recently started inviting private business “millionaires” to join the Party (see Box 1). There is no doubt that the official “objectives” will continue to change in the same direction in the coming future.

2 Difficulties and Risks in China's Economy

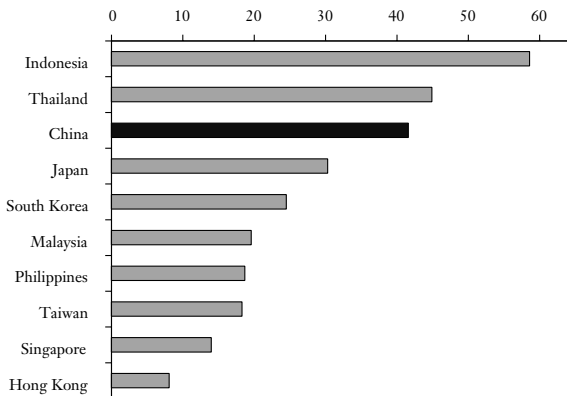
While China has performed quite well during the period of sluggish world economic growth in recent years, fundamental problems still remain in both the financial sector and the real economy.

Financial Risks

Research reports by well-known consulting companies all suggest that great risks are hidden within China's banking industry in terms of the mounting non-performing loans (NPLs). Goldman Sachs estimates that it would take between 44 and 68 percent of China's GDP to clean up the bad loans (see Figure 1).

In recent years, many measures have been taken to tackle the NPLs issue and official figures show a decline in the NPLs ratio. As appraised by the internationally adopted 5-class rating method, the four State banks' bad loans declined by RMB78.2 billion in 2002, and NPLs accounted for 26.1 percent of their total loans, 4.92 percent lower than last year. These optimistic figures, however, need in-depth analysis.

Figure 1 Non-Performing Loans as Percentage of Total Loans*



Note:

* At peak.

Source: Goldman Sachs estimates, In: *The Economist* (2003).

Table 2 Overall National Contingent Liability of China

	2002 percentage of GDP
(1) NPLs of State Banks	18
(2) NPLs in AMCs	13
(3) Government Domestic Debt	18.6
(4) Total Foreign Debt	14.7*
(5) Current Balance of Social Security	0
Overall National Contingent Liability	64.3

Note:

* Figure for 2001.

Sources: *China's Statistical Yearbook 2002*; Gang Fan (2002).

The NPLs of state banks now amount to more than RMB1800 billion,² about 18 percent of GDP. Meanwhile, the NPLs in Asset Management Companies (AMC) account for about 13 percent of GDP.³ If we add NPLs in state banks and AMCs with government debt, the total contingent liability is much greater. As Table 2 shows, the overall national contingent liability reached 64.3 percent of GDP. This might be one of the highest in the world.

The main task for tackling the NPLs is not just cleaning up the existing NPLs, but preventing the increase of new bad loans. As a result, we should pay substantial attention to the potential financial risk in the new phase of development.

Due to the urbanisation process and the shift of consumption structure, China's state banks have recently concentrated more on consumer finance and lending to urban infrastructure constructions.

² In 2001, the NPLs in four major state banks were RMB1800 billion without considering the NPLs in other financial institutions. Therefore, even though the NPLs in four major banks declined by RMB78.2 billion in 2002, the total amount of NPLs must be more than RMB1800 billion.

³ NPLs stripped to AMCs was RMB1400 billion in 1999, and by 2002, the four AMCs have dealt with about RMB300 billion NPLs, reclaimed RMB100 billion of assets and RMB67 billion of cash. Since some of the reclaimed assets can also be the contingent liability while the reclaimed cash is the real reduction of NPLs, the total NPLs in AMCs might be RMB1333 billion, about 13 percent of GDP.

Table 3 The Change of Credit Term Structure

	2000	2001	2002:1	2002:2	2002:3	2002:4
Short-term loans as percentage of total loans	68.5	67.6	67.1	67.2	66.9	66.1
Medium- and long-term loans as percentage of total loans	24.6	25.8	25.9	25.7	26.1	26.4

Source: Gang Fan (2002).

Given this change, the credit structure of banks has altered with a slight increase in medium- and long-term loans and a decline in short-term loans (see Table 3). This could partly explain the decreased NPLs ratio.

Consumer lending by the big four banks has risen from one percent of their loan books in 1998 to about ten percent now.⁴ Consumers seem more reliable than SOEs in terms of paying loans. But some evidences show that with the quick expansion of consumer finance, bad loans have also increased. And the larger amount of loans made to the housing industry, which generated housing bubbles, will inevitably result in potential risks of banks.

Unemployment

To avoid confusion and misjudgement about the unemployment problem, we should note that there are three kinds of unemployment and under-employment in China.

First, the unemployment of urban labour, reflected by the official “urban unemployment rate”, mainly refers to the newcomers to the urban labour force, individuals in transition to new jobs, and individuals who have been laid off in the private sectors. The figures show that in recent years, the registered unemployment rate was about 3.5 percent annually, while in 2002, it jumped to 4 percent, and in 2003, the unemployment rate is just under 4.5 percent.

Second, the laid-off state employees are protected under some special arrangement since they keep a special status called “off-post

⁴ “China’s Financial Market: Bank on Growth”, In: *The Economist*, January 18th-24th, 2003.

workers” (Xia-gang Zhi-gong). With this special status, they are entitled to receive a certain minimum payment (higher than the unemployment insurance payment) and access to re-training programmes and several job offers during a 2-3 year period following their lay off. During 1997-2001, more than 23 million state workers were laid off. Under the best scenario, there will be 20 million in the near future.

Third, there are about 500 million rural labourers in total, and 200 million have engaged in non-farming activities (about 100 million have already settled in cities); 60 percent of the remainder are actually underemployed on the small pieces of household land.

For the time being, China’s fledgling labour market is under immense pressure from a huge army of job seekers, a combination of nearly 14 million laid-off workers from the SOEs, 150 million rural surplus labourers coveting an urban life, and an annual increase of some 10 million urban youngsters who have reached the working age.

It is predicted that in the next three to five years, Chinese cities and towns will have to provide job opportunities for some 22 to 23 million people when it actually creates about 8 million job opportunities annually. Pessimists say that even if the Chinese economy maintains its current high growth of 7 or 8 percent, the country will still face a shortage of 14 to 15 million jobs a year (Ministry of Labour and Social Security, 2003).

Income Disparities and Migration

The increasing income disparity between groups, regions and rural and urban populations has become a major economic and social problem since the beginning of reform. Now it seems particularly serious in rural-urban disparities and regional disparities.

In 2002, the rural-urban income disparity was less than 1:3, and if we consider that urban dwellers enjoy some social welfare benefits that rural dwellers never have, then the real income gap might amount to 1:6. Meanwhile, the regional disparities are also significant.

Immigration plays an important role in bridging income disparities. During 1982-2000, over 109 million labourers shifted from rural areas to urban areas. On average, the yearly migrants reach about 6.09 million. However, the amount of yearly migrants

was about 4 million before 1995, while during 1996-2000, the number of yearly migrants tripled and reached 11.5 million (see Figure 2). Farm workers return their income to rural areas and it becomes one of the main income sources of farmers.

Regarding cross-region migration, about 90 percent of migrating labourers come from central and western China and more than 60 percent of them migrated to coastal regions (see Table 4).

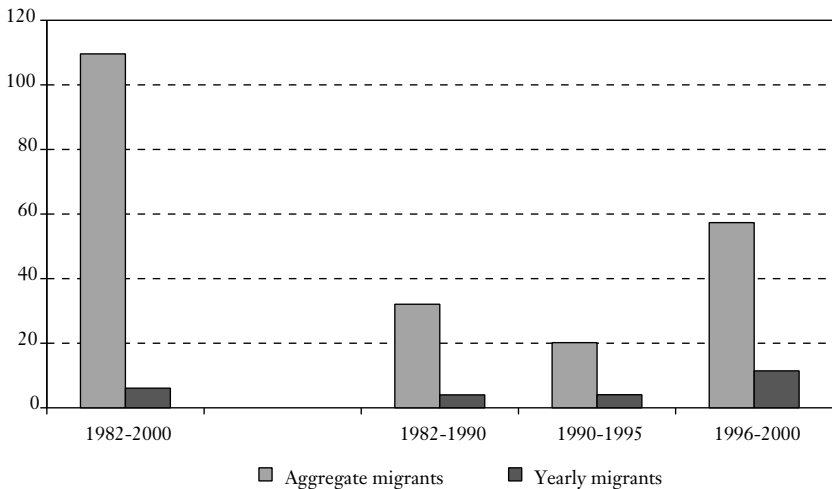
People migrating from rural areas to urban areas foster the process of urbanisation and gradually narrow the rural-urban income disparities and inland-coastal regional disparities.

In the long run, given the resources and the geographical conditions, migration may be the only way for some regions to increase their per capita income. It can be expected that China will experience even bigger mass domestic immigration, and the map of population will be significantly changed along with the economic transformation.

Rural Development and Urbanisation

China has suffered an over-supply of grains in recent years, so the voices questioning “who will feed China” have been fading.

Figure 2 Rural-Urban Migration (1982-2000)
(in millions)



Source: Department of Industries and Regulations, Ministry of Agriculture.

Table 4 Cross-Region Labourers' Migration
(in percentages)

<i>Outflow Regions</i>	
East	10.3
Central	55.7
West	34
Total	100
<i>Inflow Regions</i>	
Guangdong	37.9
Fujian	4.3
Shanghai	8
Zhejiang	7.5
Jiangsu	5.6
Beijing	6.8
Others	29.9
Total	100

Source: Department of Industries and Regulations, Ministry of Agriculture.

However, the low productivity of agriculture and the low income of rural people remain a challenging problem at present and for the near future.

The key issue here is that there are too many people working on the small cultivable land and therefore the ultimate solution to the problem can be nothing other than industrialisation and urbanisation that move people out of the land. Studies show that the marginal product of labour in agriculture is almost negligible and that it will only be possible to use modern technology in China's agriculture if the number of people who rely on the land as their source of income is reduced. Also, only an increase of land per capita can result in a meaningful increase of per capita income in the agricultural sector.

In the past 20 years, the rural industries played a great role in improving the income level of rural people and in supporting overall economic growth. The industrialisation of the Chinese economy progressed significantly up to 56 percent (2001) in terms of non-farming employment⁵ as a percentage of the total labour force.

⁵ This includes the workers in rural industrial enterprises and rural self-employed non-farming individuals.

More than 100 million rural labourers have found new jobs in non-farming sectors. This process has been slowing down in recent years, demonstrating its own limitation, since it has not been accompanied by urbanisation. At the end of 2002, only 37 percent of the total population lives in cities and towns, which can be taken as the urbanisation rate. This disproportion in the industrialisation and urbanisation process is one of the major bottlenecks for further growth.

The government is adopting policies toward speeding up the urbanisation process. There are going to be more large cities or groups of cities emerging in the coastal areas. Currently, China has more than 660 cities and 19,000 towns and the urbanisation rate is about 37 percent. It is predicted that 1.12 billion people or 70 percent of the total population will live in cities by 2050. More than 600 million Chinese people will shift from rural to urban areas in the next 50 years. By then, China will have 50 major cities, each with a population of more than 2 million, 150 large cities, 500 medium-sized cities and 1,500 small ones. It is estimated that small cities and towns will absorb 7 to 8 million rural surplus labourers annually in the future.

3 The Reform Agenda

In order to realise the target of a well-off society in an all-around way, China has to continue its market-oriented reform in the new phase of development. The reform agenda addressed below mainly includes state sector reform, social security reform, financial reform, rural reform, further opening up and government reform, leaving aside some other reforms that are also crucial but deal with less sensitive issues.

State Sector Reform

Many have observed that the most serious economic problem in China has been the troubles of the SOEs. The inefficient SOEs have increasingly become the burden of economic growth. The unemployment of state employees is the major cause for some local incidents of social unrest. The mounting non-performing loans owed by the SOEs to the state banks have been the main source of

China's financial fragility. The stock market, dominated by listed SOEs and state-owned security companies with soft-budget constraints, fails to reflect the real economy.

The SOEs issue remains the key to understanding the Chinese reform agenda since the question of managing the SOEs and making them viable has constituted the main challenge of the reform agenda since the 1980s.

The management mode of SOEs has changed numerous times. Now the prevailing mode for managing state properties is the so-called 'Five Dragons Control the Water' (Wu-long Zhi-shui), which means that development planning departments are in charge of the investments in SOEs while economic and trade commissions decide on their production and operation, Party committees appoint their senior managerial personnel, finance departments control their revenue and assets registration, and an authorised investment institution exercises the investor's right of listed companies.

With this management style, no one really cares about state property and its operational efficiency. A growing consensus calls for replacing the conventional pattern with a new comprehensive institution that can help realise the separation of ownership and control of state property and the separation of government functions from those of enterprises. Thus China is planning to establish a ministry-level State commission to manage and supervise state assets – to be called the State Asset Management Commission (SAMC).

According to the logic of SAMC, the state will give full play to the initiative of both the central and local authorities on the precondition of upholding state ownership. The state will make laws and regulations and establish a state property management system under which the central government and local government perform the responsibilities of investor on behalf of the state respectively, enjoying owner's equity, combining rights with obligations and duties and administering assets, personnel and other affairs. For the first time, there is a clear indication that the local governments have the right to deal with state properties belonging to them while in the past all state properties were controlled by the central government.

As Table 5 shows, among total non-financial state properties, the central government covers about 60 percent and local government accounts for about 40 percent. The central government now performs the functions of investor in more than 180,000 SOEs, while under the future new management mode, the number of

Table 5 Operational State Properties: Aggregate and Structure
(in billions of RMB and percentages)

	Total	Central Government		Local Government	
	RMB	RMB	%	RMB	%
Industrial and commercial companies	5,755.44	3,069.04	53.3	2,686.4	46.7
Financial and insurance companies	830.39	746.76	89.9	83.63	10.1
Overseas companies	119.57	105.19	88.0	14.38	12.0
Varies of construction fund	155.86	155.86	100.0	–	–
Total	6,861.26	4,076.85	59.4	2,784.41	40.6

Source: Zhang Zhuoyuan (2002).

enterprises directly under the control of the State Council will be less than 200, and the management of the rest will be delegated to the local administrations.

One of the problems of the previous pattern of managing state properties was that SOEs have at least two contradicting targets: one was to serve as a stabiliser of society, and the other was to serve as a profit-maker. The key to reform of the state property management system would be to set a single goal for SOEs: give them the priority of keeping and increasing the value of state properties, and remove the goal of acting as a social stabiliser from their primary task. The SOEs' primary task as well as self-incentives is just to make profit. That does not mean, however, that the SOEs have no social functions. The SOEs will achieve some social goals for the sake of their own interests (i.e. profit-making). Government regulations rather than government administrative instructions can also make the SOEs accomplish some social goals.

Other reforms in state sectors should involve the ongoing dissolution of state-monopolised industries (public utilities in particular), as has recently occurred in the power industry, telecom industry and aviation industry, and the continuous retreat of SOEs from competitive industries.

Social Security Reform

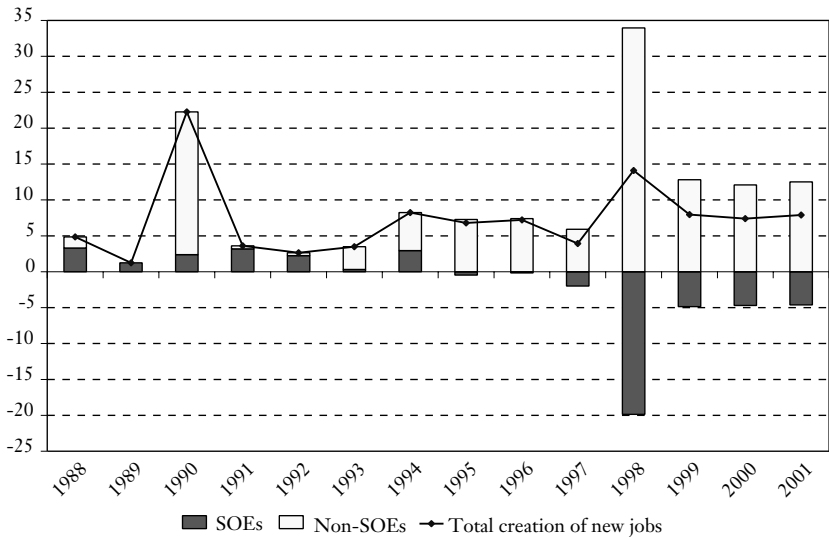
A basic social security system is gradually taking shape in China. By 2003, the number of people covered by the pension system is set to

reach 150 million. And those benefiting from unemployment insurance will amount to 110 million. Meanwhile, the number of individuals with medical insurance will reach 100 million. These three programmes of pension system, unemployment insurance and medical insurance constitute the backbone of China's social security system. Besides, some 20 million urban residents have been helped by the monthly allowance so far, 95.8 percent of whom are individuals – and their families – who were laid off from state-run factories.

However, there are still more needy urban residents who should be covered by the welfare programme, let alone that rural people have not yet been involved. The shortage of funds is another problem in the social security system. Given such problems, more reforms will have to be carried out:

- Consider farmers' social security. The current social security programme has not yet covered rural residents possibly due to the farmers taking land as their 'last resort'. But in the urbanisation drive, some land will be requisitioned which means some farmers will lose their 'last resort'. In this case, the social security fund should cover farmers whose land is requisitioned. Moreover, when conditions permit, the rural population should be involved in welfare programmes similar to those that have been developed in some coastal cities.
- Ensure the minimum living standard of urban dwellers and that the welfare programme covers more people. The government recently decided to spread the social security network in Northeast China's Liaoning Province – the province with the highest jobless rate – to some other regions.
- Develop diversified financing channels to reinforce social insurance funds. One channel should allow State pension funds into domestic stock markets in order to close a gaping pension deficit by investing in shares, bonds and investment funds. Another channel should ask for more fiscal support. The fiscal expenditures on social security are set to rise from 10 to 15-20 percent of GDP. The third channel should collect social security funds through improving the method to reduce untradable state shares and issuing lotteries.
- Create more jobs, particularly through the development of non-SOEs that can provide more job opportunities for laid-off workers and newcomers (see Figure 3).

Figure 3 The Creation of New Jobs: SOEs Versus Non-SOEs
(in millions)



Sources: China Reform Foundation (2001); *China Statistical Yearbook 2002*.

- The government will also experiment with old-age insurance and medical insurance programmes in affluent coastal areas in a step-by-step manner, though doing so nationwide is not yet realistic.
- Create a social security law to ensure the implementation of welfare programmes. Previously, the operation of the social security system just relied on administrative regulations or guides.

Financial Reform

The reform of China's financial system has been one of the most urgent reforms in the economy. Four key points form the backbone of the government's financial reform plan.

First of all, financial regulation has to be strengthened to prevent financial risks. As unveiled by a government report, an individual bank supervisory committee is to be established to supervise the banking industry. Meanwhile, the People's Bank of China, the central bank, may take some steps toward relinquishing its supervisory role.

Reviewing the reform of China's banking system, the split of People's Bank of China (PBOC) forms most of the story. Several functions almost irrelevant to a central bank will be separated from the PBOC step by step: commercial banks will be separated first, followed by the CSRC (China Securities Regulatory Commission) and CIRC (China Insurance Regulatory Commission), and the CBRC (China Banking Regulatory Commission) will likely be set up last.

With this reform, the PBOC will become a central bank in the real sense that it is just responsible for the money control and the price level. The major responsibilities of the newly built CBRC are to formulate supervisory rules and regulations for banking institutions, and authorise the establishment, changes, termination, branching out and business scope of banking institutions.

Second, the state-owned commercial banks must be reformed to reduce bad loan ratios and improve management.

The reform will focus on erasing the characteristics of state banks as state administrations. Their administrative rankings will be nullified and senior bank-management staff will no longer be treated as state officials. By doing this, a new system for senior bank officials' appointments and dismissals will be established.

Property rights reform in the financial sector will be the main concern. Though the SAMC is set up to reform state sectors, it just deals with non-financial assets; the question of who should be responsible for state financial assets still remains. Therefore, a new state financial assets management institution should be created soon. The new institution must not only act as the owner, but also as the manager of the State banks, and be responsible for the management of bank personnel, assets and business operations. Currently, management rights are divided among several institutions.

Third, non-state financial institutions will be favoured to support economic development and the reform of rural credit bureaus will be sped up to better serve agricultural growth.

As state banks gradually liquidate or merge their county-level branches, the vacuum left will be filled by new financial institutions and organisations such as local commercial financial institutions, rural credit cooperatives and jointly funded financial entities which will witness considerable development in the coming years.

The Second Board (the board mainly for SMEs) will be set up for the development of non-SOEs (actually, most of non-SOEs are

small and medium enterprises or SMEs). Moreover, the further opening of the banking industry will be accelerated and foreign institutions will provide more financial service for China's domestic market.

And last but not the least, the financial reform focuses on the need to establish a national credit record and rating system as soon as possible.

Rural Reform

China is a typical rural country with more than 60 percent of the population still living in rural areas. Improving farmers' income and fostering rural development remains a great challenge if China is to realise its target of a well-off society. Therefore, rural reform should be further deepened as follows:

- Carrying out fee-to-tax reforms to alleviate farmers' financial burden. Fee-to-tax reforms implemented on a trial basis in 20 provinces and cities have been successful, with farmers' economic burden reduced by over 30 percent. In 2002, the national average per capita amount of fees or taxes was 78.7 yuan, down 29.3 yuan from 1997, or an annual average drop of 6.1 percent.
- Continuing to encourage the drive toward urbanisation in order to create conditions for urban areas to absorb surplus rural labour force and increase farmers' income. The non-farming income from farm workers is one of the main sources of farmers' income. Statistics indicate that China's farm workers return about 100 billion yuan (\$12.1 billion) in income to their hometowns each year.
- As urbanisation advances and the number of people bundled to land decreases, the scale operation with the transfer of the contractual right of land, carried out according to law and on a voluntary and compensatory basis, will be facilitated.
- Investing more in rural infrastructure construction with favourable fiscal policies to improve farmers' production and living conditions. As official data show, the state fiscal income jumped 121 percent in the 1996-2000 period while China's financial spending in agriculture was only up 75 percent. More favourable fiscal policy should be implemented for rural development.

Further Opening Up

As the Chinese Government lives up to its promises upon accession to the WTO, China will further open up and more foreign investment will flow into China.

Foreign investment is now allowed in many fields which had been forbidden prior to China's WTO accession. In the first year of WTO accession, China mostly opened the sectors with comparative advantages, like manufacturing industries, to foreign competitors. That is why these industries have not experienced a major negative impact. In line with the timetable of WTO requirements, however, more foreign investment will be allowed to penetrate service sectors, like banking, insurance, wholesale and retail business, foreign trade, telecom, transportation and technology service, etc. Therefore, the tougher challenges are yet to come since service sectors – particularly financial sectors – seem rather vulnerable in China.

Recently, China's capital market sped up their opening to foreign investors according to the schedule of WTO accession. China has now granted three foreign banks (i.e. Shanghai branches of Citibank, HSBC and Standard Chartered) approval to act as custodian banks for overseas funds permitted to invest in China's domestic stock markets. They will be allowed to help Qualified Foreign Institutional Investors (QFII) trade yuan-denominated A shares. A new rule on foreign-funded mergers and acquisitions (M&A) in China which aims to promote and regulate foreign investments in China came into effect on April 12, 2003.

China is opening its trade sector wider to foreign firms, and has begun to examine and approve Sino-foreign joint-venture trading firms. Furthermore, other service sectors like the banking industry and the insurance industry have also had joint ventures and will see more foreign investment introduced in the coming years.

Government Reform

China has proposed a new government reform package aimed at shifting the government's role in line with the market system and China's WTO accession.

As China's market economy develops, the government will be required to focus more on management at the macro-level and less on concrete cases and details. The government will lose the grip on

the economy in many ways in order to conform to international standards. The State Council has scrapped the approval formalities on more than 1000 items since China's entry into WTO.

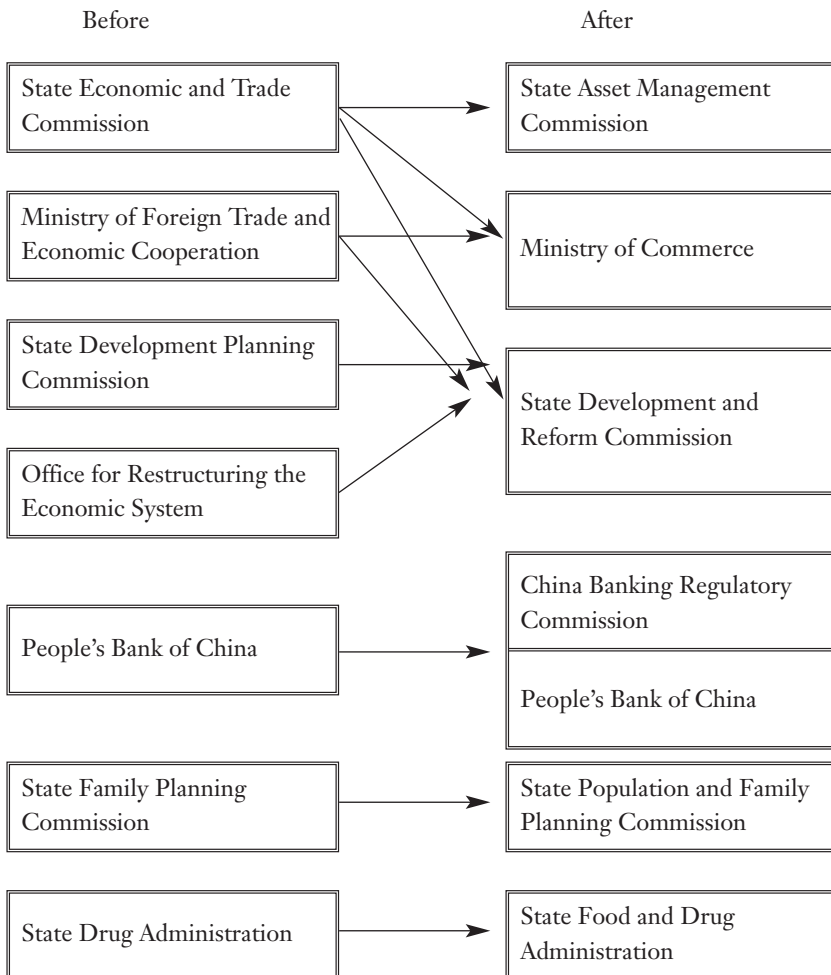
Unlike previous government reforms, which were mainly focused on downsizing, the new restructuring attempts to reduce the overlapping of the government departments' responsibilities, beef up coordination between them, and clarify their duties. It will definitely improve efficiency.

The reform package could be the largest structural reform the government has taken since the late 1970s (see Figure 4):

- The combining of the State Economic and Trade Commission (SETC) and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) into a new agency, the Ministry of Commerce. After China's entry into WTO, some of the functions of MOFTEC have become less important or even futile. The establishment of the new ministry will reduce the power overlap between the departments that used to oversee foreign and domestic trade regulations. This can increase administrative efficiency. For example, SETC originally determined whether foreign imports had harmed domestic firms, and MOFTEC determined whether anti-dumping or safeguarding measures would be implemented. These two functions relevant to China's WTO accession should no doubt be combined into one ministry.
- The establishment of the State Asset Management Commission (SAMC) to manage and supervise State assets, which further deepens the reform of SOEs and attempts to fundamentally resolve the SOEs issue.
- The establishment of a banking regulatory commission (to be called CBRC) to take over supervision of the banking industry from the People's Bank of China (PBOC), the country's central bank.
- The State Development Planning Commission (SDPC) is expected to shed the word 'planning' from its name and gain additional duties from the Office for Restructuring the Economic System and SETC, to become the State Development and Reform Commission to improve its macroeconomic control system. The new commission will merge the functions of development and reform together and make them compatible for economic growth.

- A state food and drug administration will also be established on the basis of the State Drug Administration to supervise the safety of food, health products and cosmetics, while the State Administration of Work Safety will be upgraded to beef up supervision over production and coal mining safety.
- In addition, the State Family Planning Commission will be changed to the State Population and Family Planning Commission.

Figure 4 The Restructuring of Government



4 Conclusion

In the above discussions, we talked about the characteristics of China's reform, the difficulties and risks in the economy and the reform agenda for the new phase of development. China faces more difficulties that need to be resolved and more urgent areas that need to be reformed than those discussed. However, as long as China's economy continues to grow even at a level lower than before, say, 7-8 percent, and the reform maintains, it is sound to project a 'well-off' society (*Xiaokang*) in an all-round way in about 20 years.

Some may wonder whether the progress made at this stage would be sufficient for establishing the foundation for further development or whether it is too small to prevent a crisis in the next stage. Or they may wonder what would be best, gradualism or shock therapy? These questions remain open.

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2

Comment on Gang Fan and Xiaojing Zhang

Keun Lee

The paper by Gang Fan and Xiaojing Zhang has a very straightforward structure. It first lists the achievements to date of the reforms in China and the current problems, and then discusses what is being done to tackle the problems. While this structure makes the paper easy to read, it also renders it less challenging. For example, when one thinks of the achievements of the reform in China (Section 2 of the paper), one would be interested to know how these achievements have been possible. Similarly, when one reads about the current difficulties facing China, one would like to know more about the causes of the problems and their mutual relationships or trade-offs. The solution to the problems would then evolve naturally from the discussion of the origins and interrelationships.

The four problems facing China discussed in the paper (NPLs, unemployment, income disparity and rural poverty) are related. In my view, these problems can be better understood by looking at the reform strategy of the Party leadership and the constraints it is facing. The leadership wants to bring about rapid growth while maintaining political hegemony, social stability and a socialist identity. Therefore, they actively pursue export- and FDI-led growth while preventing the farmers from immigrating to the urban areas in order to maintain social stability. The consequences of this reform strategy have been rapid growth in aggregate terms and rising inequality between urban and rural areas, and between coastal

and hinterlands. The SOE problem is related to this dual track approach and remains “untouched” since SOEs are the source of the political and economic power of the Communist Party of China. As a result, the SOE losses are translated into the NPLs of the state-owned banks and into rising unemployment since the SOEs have had to cut their jobs.

Thus, there is the dilemma between drastic reform of the SOEs to reduce the debts and the NPLs, on the one hand, and continuing a political strategy that aims at maintaining social stability and equality that would require fewer lay-offs, on the other hand. While more rural-urban migration is needed to increase the income levels of the rural population, there are not enough jobs created in the urban areas. In other words, while growth is needed to absorb the laid-off workers from the SOEs, even more jobs are needed to absorb labourers moving into urban areas. The challenge is daunting, because the Chinese government has been accumulating fiscal deficits over the years while the policies for equalising growth call for more government money, especially in the Western Development Project.

The discussion of current and future reform measures should be seen in terms of how successful these measures are in tackling fundamental problems. The nature of the reform measures can be better understood when set against the strategic trade-offs facing the Party leadership. The Chinese Communist Party does not only aim at increased economic growth, but also at continuing political hegemony and social stability. Economic growth is pursued in so far it serves these other two goals. Being aware of this logic, one can better understand the policy choices of the leadership; it is characterised by constrained optimisation.

3

Challenges in Macroeconomic Management for China's New Leaders

Wing Thye Woo¹

China stands at a new economic juncture because it became a member of the World Trade Organisation (WTO) in 2002, a development that will require it to allow its basic economic

¹ This paper has improved tremendously by comments from participants at the following meetings: seminar at the China Research Center of Yeungnam University, April 1, 2003; Conference on China's Role in Fostering Financial Stability and Growth in the Asian Region and the World Economy organised by the Forum on Debt and Development (FONDAD) and the Korea Institute for International Economic Policy (KIEP) at Seoul National University, March 27-28, 2003; seminar at the Institute for International Relations of National Chengchi University, March 24, 2003; seminar at Shih Hsin University, 21 March 2003; seminar at the Centre D'Etudes Prospectives et d'Informations Internationales, February 26, 2003; workshop at the Organisation of Economic Cooperation and Development, February 25, 2003; the Hong Kong Economic Association meeting, 16-17 December 2002; and workshop on the "Economic Challenges to the New Generation of Chinese Leaders" convened by the East Asia Institute at Trinity College, University of Cambridge, 12-13 December 2002. I am grateful to Huang Yiping, and Jeffrey D. Sachs for letting me draw upon results from joint research. I thank Charles Adams, Cheong Young-Rok, Michel Fouquin, Hua Erh-Cheng, Jean-Francoise Huchet, Kim Si Joong, Lee Chang Kyu, Lee Keun, Françoise Lemoine, Charles Piggott, Xavier Richet, Xiao Geng, Wang Jian, Zhang Zhizhao, Zhang Xiaojing, Zhang Wei, Zhu Lijing, and Zhu Shanli for helpful discussions on China's macroeconomic situation. I am deeply indebted to the Citigroup office in Hong Kong for assistance in data compilation.

institutions to converge to those of an advanced developed capitalist country. The management of the convergence process is expected to be particularly difficult because China has been experiencing low or negative employment growth in the industrial sector in the years leading up to WTO accession. Because of the substantial amount of economic restructuring that has to occur in a period when the economy has been showing a lower capacity to create jobs in the industrial sector, it has hence become quite usual to encounter gloom-and-doom predictions about China.

In the following pages we will:

- investigate the probability of WTO-induced macroeconomic shocks,
- assess the resilience of China's economy to such shocks,
- explore policies that the Chinese Government can implement to counter negative developments from WTO membership,
- identify the sources of China's underlying deflationary tendency (the paradox of thrift and liquidity trap) to have common roots in the failure of China's financial system to channel the secular rise in private savings into private investments,
- discuss the sustainability of China's expansionary fiscal policy to keep aggregate demand high,
- identify the benefits of WTO membership for macroeconomic management,
- outline the continued challenge to macroeconomic management from China's still-too-large state enterprise sector,
- conclude that the most serious threat to macroeconomic stability comes from the traditional sources of instability in successive rounds of bank recapitalisation, and
- warn of new non-traditional sources of macroeconomic stability – specifically fiscal shocks originating from areas like public health (e.g. an AIDS pandemic, a SARS epidemic) and environmental construction (e.g. water diversion projects, alternative energy systems) – and that management of these non-traditional problems is difficult because China does not have a wealth of successful domestic experiences to draw upon.

The economic costs of SARS have been greatly magnified not only by an inadequate public health system but also by structural weaknesses in information dissemination within China. Given the many structural weaknesses in China's economic system because of its incomplete transition to a modern private market economy, the

2-percentage points safety margin in fiscal management that we identified in Section 4 should at best be regarded as minimally adequate when we consider the sustainability of China's fiscal policy, and its ability to keep the annual growth rate above 7 percent.

1 China at the Beginning of 2003

China is now truly standing at a new juncture in its history. It stands at a new political juncture because an orderly political succession has occurred for the first time since the founding of the People's Republic. China also stands at a new economic juncture because of its recent membership in the World Trade Organisation (WTO), a development that will require it to allow its basic economic institutions to converge to those of an advanced developed capitalist country. One of the biggest economic challenges facing China's new leaders is the proper management of this internationally supervised process of economic convergence.

The management of the convergence process is expected to be particularly difficult because China has been experiencing low or negative employment growth in the industrial sector in the years leading up to WTO accession. Table 1 shows that the average annual employment growth in the industrial sector was 2.8 percent during the 1992-1997 period, with a minimum of 2.1 percent in 1997. The employment growth rate fell significantly after 1997: 0.3 percent in 1998, -1.1 percent in 1999, -1.2 percent in 2000, and 0.4 percent in 2001. The employment situation in the manufacturing component of the industrial sector had actually turned bad earlier in 1996. Manufacturing employment growth was negative throughout the 1996-2000 period with a particularly large decline of 13.5 percent in 1998. The slow rate of employment creation in the industrial sector from 1998 onward coincides with a significant slowdown in the growth of real GDP. Real GDP grew an annual average of 11.5 percent during 1992-1997 but has not exceeded 8 percent in any year since. As we shall see, because China was already in a situation of lower output and employment growth when it joined WTO, a number of doomsayers have appeared.

Table 2 summarises the main institutional changes that WTO membership would require, e.g. tariffs on automobiles will fall from 90 percent to 25 percent, and state trading will be confined to

Table 1 Employment in China's Industries, 1978-2001

	Employment Level		Employment Share		Growth in Employment		Memo
	Secondary Industry	Manufacturing Sector (in millions)	Secondary Industry (percentage of total)	Manufacturing Sector (percentage of total)	Secondary Industry (percentage per year)	Manufacturing Sector (percentage per year)	
1978	69.5	53.3	17.3	13.3			
1988	121.5	86.5	22.4	15.9	5.8*	5.0*	10.3*
1989	119.8	85.5	21.6	15.4	-1.4	-1.2	4.1
1990	138.6	86.2	21.4	13.3	15.7	0.9	3.8
1991	140.2	88.4	21.4	13.5	1.1	2.5	9.2
1992	143.5	91.1	21.7	13.8	2.4	3.0	14.2
1993	149.6	93.0	22.4	13.9	4.2	2.1	13.5
1994	153.1	96.1	22.7	14.3	2.3	3.4	12.6
1995	156.5	98.0	23.0	14.4	2.2	2.0	10.5
1996	162.0	97.6	23.5	14.2	3.5	-0.4	9.6
1997	165.5	96.1	23.7	13.8	2.1	-1.5	8.8
1998	166.0	83.2	23.5	11.8	0.3	-13.5	7.8
1999	164.2	81.1	23.0	11.4	-1.1	-2.5	7.1
2000	162.2	80.4	22.5	11.2	-1.2	-0.8	8.0
2001	162.8	80.8	22.3	11.1	0.4	0.5	7.3
2002							8.0
2003							7.0**

Notes:

* Annual compound growth rate between 1978 and 1988.

** Expected value in 2003.

Sources: *China Statistical Yearbook*, 1990 to 2001 data from 2002 edition, and earlier data from 2001 edition. Citigroup (2003) for GDP growth rates 2002 and 2003.

cereals, tobacco, fuels and minerals. It is clear that the substantial liberalisation of trade in many services and the lowering of the average industrial tariff from 24.6 percent to 9.4 percent by 2004 and the average agricultural tariff from 31.5 percent to 14.5 percent by 2004 will create considerable adjustment costs for China. For example, China is a natural food-importer and a natural factory-oriented society given its low land-man ratio, but its agricultural sector still employs over 332 million people, which is over two-third of the rural labour force. The bulk of China's state-owned sector relies on WTO-contravening policy instruments like subsidies and import barriers² for survival, and this sector employs over 40 percent of the urban labour force. Together, the agricultural sector and the state sector employ about 60 percent of the total labour force. Conservatively, almost a fifth of China's workers might have to change jobs, and this could be a politically destabilising process if not handled adeptly, and if external shocks were to slow down economic growth.

Because of the large amount of economic restructuring that has to occur in a time when the economy has been showing a lower capacity to create jobs in the industrial sector, it has hence become quite common to encounter gloom-and-doom predictions about China. The WTO process would allegedly generate such large political turmoil that there would be economic stagnation for an extended period. The most-discussed mechanism through which WTO would create a political meltdown is a macroeconomic shock. The macroeconomic shock from WTO membership could take two forms. First, WTO membership might promote a flood of imports that would cause widespread unemployment in the urban and rural areas, and hence provoke the social unrest that would bring about the macroeconomic collapse. Second, the entry of foreign banks could divert deposits from the already bankrupt domestic banks, and the resulting shutdown of the credit system would disrupt production economy-wide.

In the ominous words of Gordon Chang (author of *The Coming Collapse of China*), WTO accession "will shake China to its foundations".³

² This is why China has over 30 car-making firms when Japan, possibly the most efficient car manufacturer in the world, has only 5.

³ Chang (2001), p. xviii.

Table 2 Summary of Key Commitments by the Chinese Government on WTO Membership

Sectors	Key Commitments
Agriculture	Farm subsidy capped at 8.5% of value of domestic production (current level = 2%). Elimination of export subsidies. Average bound tariff down to 15% (1-3% in-quota rate and up to 65% above-quota rate on cereals), further reductions mostly by 2004.
Automobiles	Import tariffs on automobiles to 25% by mid-2006 from current 80-100% Restrictions on category, type and model of vehicles produced to be lifted in two years.
Banking	Foreign bank business conducted in foreign currency permitted immediately, business conducted in local currency with local corporations permitted within two years after accession, business in local currency with local residents permitted within five years. Geographic restrictions on foreign banking business to be lifted over five years.
Insurance	Foreign ownership: 50% of life insurance and 100% of non-life insurance (property/casualty) geographic/business restrictions will be gradually phased out.
Securities	Minority foreign-owned joint ventures in fund management industry. Foreign ownership up to 49% in five years.
Distribution	Foreign companies are allowed to set up joint ventures within two years after accession with majority ownership and without geographic restrictions, with exceptions for a few products.
Telecommunications	Foreign company stakes: 25% in mobile phone, up to 35% in one year and 49% after three years; area restriction will be lifted after 5 years.
State trading and trading rights	State trading will continue in cereals, tobacco, fuels and minerals. All enterprises will be free to import or export after 3 years.

Source: Compiled by the Citigroup (2002) from WTO documents.

“In 1998, there were 60,000 protests ... [and in 1999], there were 100,000. Anecdotal, we know at least that demonstrations last year grew bigger ... But the most significant aspect of the recent demonstrations is not their increasing size. It is that these days, barehanded peasants and workers are desperate enough to do

battle with armed state security forces. That tells us volumes about the state of China today.

“... China’s imminent accession to the World Trade Organisation can only aggravate the problem of instability because membership will limit Beijing’s ability to postpone solutions ... [Imports] will flood the country. And that means uncompetitive state-owned enterprises will fail in even greater numbers than they do today... And in the countryside, expect China’s peasants to be hit even harder than the urban proletariat, as efficient foreign agribusiness penetrates Chinese markets.

“... Accession will knock one or two percentage points off increases in GDP ... [and] China is at the point where the loss of even a percentage point of growth would have a disproportionate impact on urban workers and the peasantry ... [The fact is that] many Chinese today are still hungry, angry and, worst of all, desperate. That desperation will escalate as the country settles into the WTO.”⁴

“The People’s Bank of China, the country’s central bank, says that about 30 percent of the loans of the four biggest banks are nonperforming, but that assessment is based on accounting with Chinese characteristics. Foreign observers put the figure closer to 50 percent, and some even say higher.

“... But in less than five years, foreign banks, in accordance with China’s World Trade Organisation commitments, will be able to accept local-currency deposits from Chinese citizens. If foreign institutions are able to divert just a little liquidity away from the Big Four banks, there will be a banking crisis of historic proportions. Beijing’s leaders will try to avoid tragedy, but they might not succeed. For one thing, they don’t have enough money.”⁵

Given the above possible negative scenarios, it is somewhat puzzling why China has been so keen to join WTO. Since the removal of barriers to the entry of foreign goods and foreign banks could have been implemented unilaterally by China at a pace of its

⁴ Gordon G. Chang, “The Shahs of Beijing”, In: *Far Eastern Economic Review*, September 13, 2001.

⁵ Gordon G. Chang, “Don’t Bank on China”, In: *Far Eastern Economic Review*, July 18, 2002.

own choosing, it is paradoxical why China had pursued arduous trade negotiations with the United States for over a decade in order to undertake a trade deregulation that is set and monitored by other WTO members.

The answer to this paradox has two parts. The first part of the answer is that during the period of China's self-imposed isolation, 1949-1978, the rest of the world (with some notable exceptions, especially Africa) created new wealth on an unprecedented scale. Conventional wisdom attributes this generalised increase in prosperity to the open international trading system that was institutionalised at the end of World War II.⁶ Clearly, China agrees with this conventional wisdom because it has stated numerous times that its full participation in the international trading system is fundamental to keeping its economic growth sustainable. After twenty years of evolution in economic institutions, of rotation in political leadership, and of tectonic change in the political fortune of the communist parties in Eastern Europe and the former Soviet Union, the only organised opposition today to the continued convergence of China's economic institutions to international forms comes from a small group of sentimental Stalinists like Deng Liqun.⁷ The social and political landscape in China has changed so much that the political leadership now incurs only minimal ideological liability when they introduce more capitalist incentives (e.g. differentiated pay, leveraged buy-out, stock options for managers) and capitalist tools (e.g. joint-stock company, bankruptcy law, unemployment insurance). The leadership is confident that its explicit embrace of capitalist institutions under WTO auspices would be seen by the general Chinese public (and the Chinese elite) as a step forward in the reform process rather than as surrender of China's sovereignty in economic experimentation.

The second, and more important, part of the answer to the paradox of why China is so enthusiastic in joining WTO is that WTO membership will greatly enhance China's economic security.

⁶ Sachs and Warner (1995) present convincing evidence in support of this professional consensus.

⁷ "Elder warns on economic change", In: *South China Morning Post*, January 13, 2000, and "Leftists make late bid to slow reforms", In: *South China Morning Post*, February 10, 2000. There is a big debate in the academic literature about whether China's post-1978 growth has been due to institutional innovations or to institutional convergence, see Woo (1999, 2001) for a critical review of this debate.

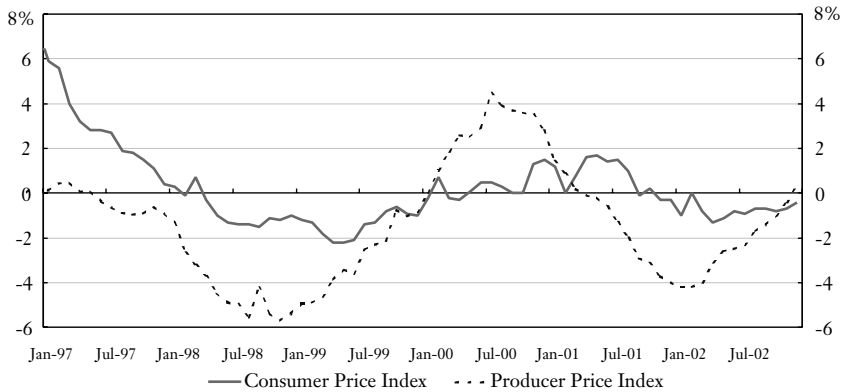
Before China became a WTO member, it required annual approval from the US Congress for most-favoured-nation (MFN) status in order for its exports to compete in the US markets on equal terms against the exports from WTO countries. This annual congressional approval process inevitably rendered China's exports vulnerable to passing passions in the US political arena over accidents like military airplane collisions in the South China Sea, and the Chinese burning of the US consulate in Chengdu following the unintended US bombing of the Chinese embassy in Belgrade. The importance to China of maintaining high export growth and of maintaining the access of its exports to the US market is hard to overstate. Deficit spending and exports are the two growth engines that have kept recent GDP growth rates above 7 percent. Through WTO membership, this second engine of growth could no longer be unilaterally shut off by the United States without the action being a major violation of international commitments of the United States.

The organisation of this paper is as follows. Sections 2 and 3 investigate the probability of WTO-induced macroeconomic shocks, the resilience of China's economy to such shocks, and explores the policies that the Chinese Government can implement to counter negative developments from WTO membership. Section 4 discusses the sustainability of China's expansionary fiscal policy to keep aggregate demand high, and Section 5 identifies the benefits of WTO membership for macroeconomic management. Section 6 outlines the continued challenge to macroeconomic management from China's still-too-large state enterprise sector. Section 7 concludes the paper with some final observations.

2 Import-Induced Unemployment

Gordon Chang's claim that WTO membership would involve considerable costs to China is undeniable. What is deniable is his second claim that WTO membership would definitely lead to the collapse of China's economy. In our view, it would require China's government to mishandle technically the macroeconomic difficulties in order to produce the collapse that Chang has envisaged. The fact is that the recent record of macroeconomic management in China has been satisfactory to good. China has been facing deflation since 1997. Figure 1 shows negative growth of the producer price index

Figure 1 Price Deflation in China
(percentages year-over-year)



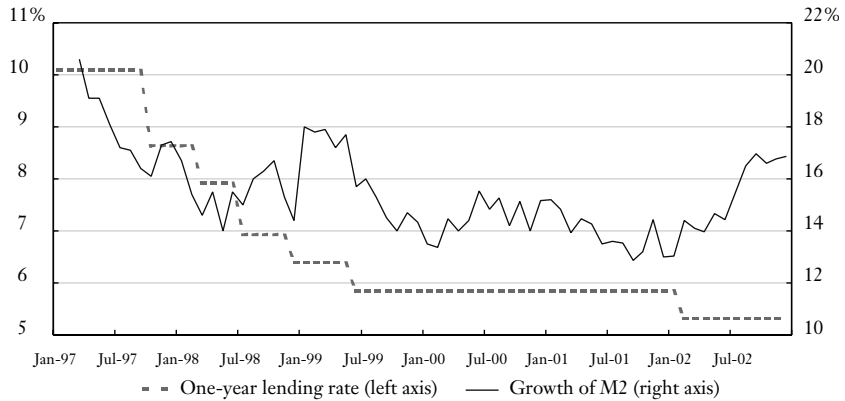
Source: Citigroup (2002) updated in February 2003.

from 1997:2Q to 2000:4Q, and then again since 2001:2Q.⁸ The expansionary fiscal and monetary policies that the authorities have undertaken have succeeded in keeping annual GDP growth at 7 to 8 percent.

The government's vigorous efforts at economic stimulation are summarised in Figures 2 and 3, and Table 3. The interest rate has been cut eight times in less than six years, with the latest rate cut on 21 February 2001 which brought the 1-year deposit rate to 1.98 percent and the 1-year lending rate to 5.31 percent. The annualised (year-on-year) growth rate of fixed asset investment of the state sector was kept above 15 percent from July 1998 to July 1999 period, and then lowered as exports to the other East Asian economies recovered. Fiscal stimulus was renewed in 2001. State spending on capital construction jumped from RMB209.5 billion in 2000 to RMB251.8 billion in 2001, which kept the annualised growth rate of state sector fixed asset investment above 15 percent for 11 of the 12 months in 2001.⁹ When the CPI slipped again into

⁸ A less severe picture of the deflationary pressures is given by the consumer price index (CPI) because it includes the prices of services. The retail price index (CPI minus services) – not shown in Figure 1 – shows negative growth since 1998.

⁹ Apart from investment in capital construction, the government also implemented three pay rises since 1999. In 2001, for example, the public servants, including those employees of the state-run education and research institutions and military personnel, received a 30 percent increase in their base salaries plus the

Figure 2 Growth of Money Supply and Interest Rates

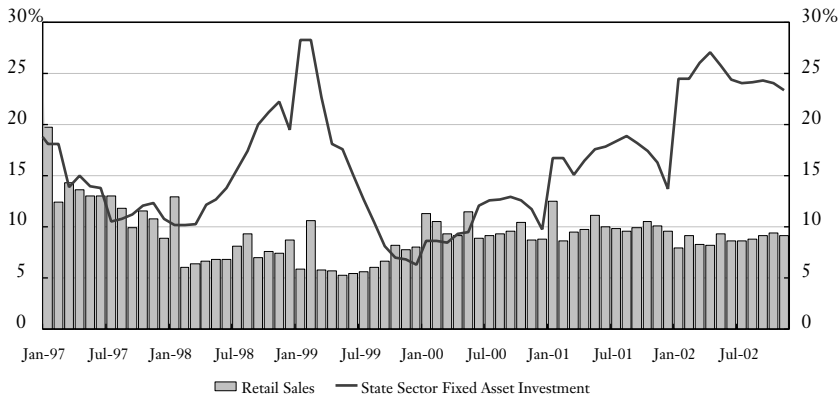
Source: Citigroup (2002) updated in February 2003.

negative growth rates in November 2001 (reaching -1.3 percent in April 2002), the Chinese government increased the intensity of the fiscal stimulus; e.g. the growth rate of state sector fixed asset investment has stayed above 23 percent since February 2002.¹⁰ Most government economists tend to believe that the investment using funds raised through treasury bond issuance contributed about 2 percentage points to GDP growth each year during the past four years (Jia, 2002).

The result of this jump in government spending is that the fiscal deficit has increased substantially from 1.1 percent of GDP in 1998 to 1.9 percent in 1999, 2.5 percent in 2000, 2.7 percent in 2001, and 2.9 percent in 2002 (see Table 3). Citigroup (2003) has projected the budget deficit to be 2.8 percent in 2003. So the important question about import-induced unemployment is whether there are technical

year-end bonus equivalent to one-month's base salary. Between 1998 and 2001, the Ministry of Finance issued a total of RMB510 billion of Treasury bonds for spending on infrastructure projects, especially in the western provinces. The government issued RMB100 billion in 1998, RMB110 billion in 1999, and RMB150 billion each in 2000 and 2001. The planned issuance for 2002 is also RMB150 billion.

¹⁰ The government has also announced a fourth round of pay increase to civil servants that would begin from July 1, 2002 (an increase that some economists have argued as excessive) "Fourth raise for China civil servants attacked", In: *The Straits Times* (Singapore), June 11, 2002.

Figure 3 Growth of Domestic Demand

Source: Citigroup (2002) updated in February 2003.

and political obstacles that can prevent China from implementing macroeconomic policies (especially, fiscal policy) that are even more expansionary, and for a longer period.

Before answering this question, however, we first examine the possibility of WTO-induced bank collapse. This is because, as we will see, the prevention of WTO-induced bank collapse is, in part, ultimately a fiscal issue as well.

Table 3 Growing Fiscal Spending
(billions of RMB and percentages)

	Fiscal revenue	Fiscal expenditure	Fiscal balance	Share of GDP	Spending on capital construction	Share of GDP
1997	865.1	923.4	- 58.2	-0.7	102.0	1.4
1998	987.6	1079.8	- 92.2	-1.1	138.8	1.8
1999	1144.4	1318.8	-174.4	-1.9	211.7	2.6
2000	1339.5	1588.7	-249.1	-2.5	209.5	2.4
2001	1637.1	1884.4	-247.3	-2.7	251.8	2.6
2002			-309.8	-2.9		
2003			-319.8	-2.8		

Sources: Citigroup (2002) for 1997-2001 data, and Citigroup (2003) for 2002-2003 data.

3 WTO Membership and the Problems in the Banking System

China's banks are in undeniably serious financial straits. According to the People's Bank of China (PBOC), the proportion of non-performing loans (NPLs) of the four big state-owned banks (SOBs) is presently about 26 percent, which is 2 percentage points lower than a year ago. However, the recently revealed scandals of the Bank of China suggest that there are probably still undiscovered black holes in the banks' books. Table 4 presents estimates that put NPLs to be 35 percent of outstanding loans at the four big SOBs at the beginning of 2002, and the average capital adequacy ratio (CAR) of these four banks to be 5.0 percent.

The bank reform efforts of the past several years have failed. The proportion of NPLs has come down from its record high of 48 percent in 1998, but this reduction was achieved mainly by the transfer of the NPLs to the state-owned asset management corporations (AMCs). The major portion of the transferred NPLs still needs to be disposed and is thus still the responsibility of the banks or the Ministry of Finance. Worse, most of the problem SOEs remain clients of the parent banks and continue to create new NPLs. What has facilitated the creation of new NPLs is the intermittent pressure on the banks from the government to expand investment credit to combat deflation, and to expand social stability

Table 4 Rising Fragility of China's Banking Sector
(in percentages)

	End-1996	End-1998	Beginning-2002
Proportions of NPLs			
Big four banks	40.0	48.0	35.0
Ten joint-stock banks		13.5	15.5
Average capital adequacy ratio			
Big four banks	4.4	>8.0	5.0

Note:

Proportion of non-performing loans for the four major banks for 1996 and 1998 are re-estimated based on new information made available at the beginning of 2001. The proportion for 2001 excluded the 1.4 trillion of RMB transferred to the Asset Management Companies in the previous year.

Source: Citigroup (2002) estimates.

loans to reduce firm closures.¹¹ This may be an important reason why the quality of banking assets has deteriorated rapidly during the past years, causing the capital adequacy ratio to fall to 5 percent in early 2002 from the 8-plus percent achieved in late 1998 after the recapitalisation of the banks.

The reason that we ended the last paragraph on a tentative note is because it is possible that a large part of the post-1998 NPLs may actually be pre-1999 NPLs that were not recognised as such in the 1998 recapitalisation because the SOBs did not want to reveal that the actual NPL situation then made a big lie out of previous official NPL estimates. In any case, the state banks are now in need of another round of recapitalisation.

In this situation of a fragile banking system, China has committed itself to opening up the banking system completely within five years of joining WTO (which it joined in December 2001). Foreign banks could conduct transactions in foreign currencies from the beginning of WTO membership, conduct transactions with the local corporate sector in renminbi after two years, and conduct transactions with local households in local currencies after five years. Although foreign banks are likely to compete only in the coastal cities, at least in the initial period, the pressure on domestic banks can be high as the big four banks extract about 95 percent of their profits from about half a dozen coastal cities (Shanghai, Beijing, Xiamen, Shenzhen, Guangzhou, and Tianjin). Because there is no depositor insurance in China, the obvious question is whether depositors will believe that these foreign banks will drive the SOBs into open bankruptcy, and hence rush to withdraw their savings from the SOBs, setting in motion the vicious downward spiral of credit contraction, leading to business failures, rendering sound financial institutions insolvent and contracting credit further.

Our reading is that even if pressures on the state banks do occur through depositor withdrawals, there is no need for a full-blown crisis since the central bank will be able to issue currency to the state banks to meet the withdrawals. This expansion of high power

¹¹ Clearly, it is likely that not all of the additional NPLs after 1998 were created after 1998. Some of them were just not recognised in the banks' books in the pre-1999 period, and they came to light after the bulk of the recognised NPLs was transferred to the asset management companies.

money cannot be easily translated into a loss of foreign reserves because capital controls, which we support, remain in place and are likely to do so for the foreseeable future. The resulting 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, or from some banks to others, and not a shift into goods. In fact, in the present deflationary atmosphere, a run from bank deposits to goods is a macroeconomically stabilising development! Simply put, the government has the technical ability to accommodate shifts in bank deposit preferences, even a modest bank run, without risking exchange rate collapse or a runaway inflation.

However, the fact that the government can prevent a bank run from causing a financial meltdown is not good enough. If the banking system is plagued by frequent bank runs, its role as a financial intermediary will be greatly reduced, and economic growth could suffer significantly. The real issue is not whether depositor shifts, or a bank run, could be accommodated, but how to prevent a banking crisis from occurring in the first place. Because depositors have the incentive to withdraw their funds as long as the banks are seen to be insolvent, the prevention of bank runs requires that the government keeps the banks adequately capitalised at all times.

Another reason why the banks deserve recapitalisation is that this will lower the lending rate, and hence spur capital formation. To see how NPLs raise the lending rate, we note that the cash-flow constraint that a bank (regardless of solvency) must meet in the absence of state subsidies, of operating costs, and of a required reserve requirement is given by:

$$r_D D = r_L [D - \text{NPL}]$$

r_D = deposit rate
 r_L = lending rate
 D = amount of deposits

This means that if NPL equals one-third of deposits, then the lending rate has to be at least 50 percent higher than the deposit rate. The important implication, however, is that a new bank (domestic or foreign) can undercut the lending rate of the existing SOBs because it will not have any NPLs on its books. We will use this fact later in our discussion on the policy options available to deal with the present NPL situation.

Since the government had recapitalised the banks in 1998, and needs to do so again now, the important question is whether there

are technical and political obstacles that can prevent China from implementing another round of bank recapitalisation. Or, to put it differently, how many more rounds of bank recapitalisation can China afford without generating a fiscal crisis?

4 Difficulties in Fiscal Management

For China, the prolonged use of loose fiscal policy carries two major risks. The first risk is low economic efficiency of the state investments, especially of many of the infrastructure projects implemented in the last four years. Almost all of these projects were implemented by the SOEs in a rush, with some of the projects approved even before the feasibility reports were completed. In 1998 and 1999 there were frequent reports about the collapse of bridges and roads that were built recently. This risk of a rise in fiscal inefficiency has been confirmed by an internal study of the Ministry of Finance which found that the amount of investment required to create one additional unit of GDP has increased significantly in recent years (Gao, 2002).

The second, and possibly more serious, risk to fiscal management is fiscal sustainability. The proactive fiscal policy contributes to fiscal risks in two ways – it directly increases both fiscal deficits and public debts, and indirectly increases the amount of NPLs by influencing banking lending decisions. A higher debt-GDP ratio means more debt servicing in future periods, and this could require expenditure cuts in order to prevent an upward spiral of the debt-GDP ratio, a development that may convince the financial markets that the state is resorting to a Ponzi scheme to finance its deficits, and cause a shutoff of credit to the state.

The simple fact is that fiscal sustainability lies at the heart of whether a banking crisis would actually occur. As long as the state is perceived to be able and willing to bail out the SOBs, depositors would retain their confidence in the SOBs regardless of the actual state of their balance sheets. The stock of publicly acknowledged government debt comes to only 16 percent of GDP, and so it is commonplace to hear official assurances that the current fiscal deficits of less than 3 percent of GDP do not pose a problem for debt servicing by the state. However, the analytically correct measure of public debt should be the consolidated debt of the state

Table 5 Contingent Liabilities in China, End of 2001
(billions of RMB and percentages)

	RMB billion	percentage of GDP
Accumulated public debts	1,550	16.2
Special T-bonds in 1998 for recapitalisation	270	2.8
Estimated costs for bank restructuring	4,500	46.9
Estimated costs for social security funds	2,500	26.1
Municipal government contingent debt	700	7.3
External debts	1,500	15.6
Total	11,020	114.9

Note:

This is an updated estimation based on new information available on both gaps in social security funds and municipal government contingent debts that the central government is the guarantor for. These were estimated based on communication with government economists.

Source: Citigroup (2002) estimates.

sector, which would include at least some part of the contingent liabilities (e.g. foreign debts of SOEs and SOBs, and unfunded pension schemes in the SOE sector) that the state might have to assume responsibility for when the state-owned units default on their financial obligations. We should note that if an analyst counts NPLs as contingent liabilities, then he or she is really computing what the public debt will be after one more round of bank recapitalisation, i.e. the second bank recapitalisation since 1997. According to Fan (forthcoming), the consolidated public debt at the end of 2001 was 72 percent of GDP; and according to Citibank (2002), it could be as high as 115 percent (see Table 5). So is China's present debt-GDP ratio too low or too high?

To answer this question, we note that the central government debt-GDP ratios in Italy, Sweden and the United States were, respectively, 117.6 percent, 70.8 percent, and 50.5 percent in 1995.¹² So if China undertakes its second bank recapitalisation since 1997, its public debt will still be within the range seen in advanced OECD countries that are not experiencing fiscal crises. However, there are two important points to be made to show that this finding is not an optimistic one.

¹² The US ratio is for 1996. Ratios were constructed from the IMF's *International Financial Statistics*.

First, the forthcoming recapitalisation of China's banks appears to be the last *major* one that the government could implement in the short term without risking the stability of the domestic financial markets and its credit standing in the international financial markets. A third recapitalisation (since 1997) will push the debt-GDP ratio to over 150 percent, well above the OECD norm.

Second, if China recapitalises the SOBs a second time, it will have to compromise the expansionary fiscal policy that has been keeping GDP growth above 7 percent since 1997. This is because China raises much less state revenue, as a share of GDP, than the OECD countries, and hence has a much lower capacity to service its public debt. The revenue-GDP ratio was 16.2 percent for China in 2001, 30 percent for Italy in 1995, 38 percent for Sweden in 1995, and 21 percent for the US in 1996.¹³ The additional debt service from the second bank recapitalisation will be about 1.5 to 2.5 percent of GDP.¹⁴ If China increases tax collection or reduces infrastructure spending to cover this increased debt service, then this second recapitalisation of the SOBs will reduce the fiscal stimulus that has been keeping the GDP growth rate above 7 percent. Between these two options, expenditure reduction cannot be considered the less likely outcome because China's experience in the reform era is that frequent changes to the tax system have not been able to raise revenue significantly for a sustained period. The reason for the low revenue-GDP ratio could be because increasing tax collection is as much a political challenge as it is an administrative challenge.

If the issue of fiscal sustainability is viewed from the broader picture of debt dynamics, one might be tempted to be more optimistic about the present situation, and dismiss the existence of a trade-off between bank recapitalisation and fiscal stimulus as stated in the preceding paragraph. Such an optimistic assessment would be based on the fact that China's annual trend growth in the next decade and a half is likely to be at least 7 percent, and so the high debt-GDP ratio of 115 percent of today would be reduced over time

¹³ The revenue-GDP ratio for China is from Deutsche Bank (2002) which estimated that it will rise to 16.4 percent in 2002 and 16.6 percent in 2003. Debt-to-GDP and revenue-to-GDP ratios for other countries are from the IMF database.

¹⁴ This assumes a bond rate of 4 to 6 percent – an assumption discussed in the next paragraph.

by the high rate of output growth. There is, thus, no need to cut back on the fiscal stimulus in order to service the additional debt from the new round of bank recapitalisation – just borrow more to cover the additional debt service, and wait for the economy to “grow” out of its debt.

To state the above argument more formally, the optimism is based on the evolution of the debt-GDP ratio as given by:

$$d(\ln[\text{debt}/\text{GDP}]) / dt = r + p = b - y, \text{ where}$$

r = real interest rate on government debt

p = primary fiscal deficit rate (i.e. [state expenditure excluding debt service – state revenue] / GDP)

b = NPL creation rate (i.e. [change in NPL in SOBs] / GDP)

y = trend growth rate of real GDP.

For convenience, we assume:

- y to be 8 percent,
- p to be 2 percent (according to Deutsche Bank, 2003, p was 1.8 percent in 2001 and 2.2 percent in 2002, and is likely to be 2.1 percent in 2003),
- r to be 4 percent (which is obtained by combining the facts that the government bond rate on 25 March 2003 is 2.65 percent, and that the inflation rate is about negative 1 percent); and
- b to be 0 percent after this second recapitalisation.

In this contrived example, we see that y exceeds the sum of r and p by 2 percentage points, which means that the debt-GDP ratio will decline over time. This safety margin of 2 percentage point for China’s debt situation allows the optimistic conclusion that China can simply grow out of its debt without having to face the trade-off between bank recapitalisation and fiscal stimulus. It is important to note, however, that this optimistic conclusion is dependent on the two highly unrealistic assumptions: (i) that there will not be another round of bank recapitalisation in the future – an assumption about state banks that has been falsified not only by international experiences but also by China’s own experience since 1998 where the NPL creation rate (b) was about 7 percent; and (ii) that China can promote the development of its financial sector without freeing the presently state-set interest rates.

Because the real interest rate of 4 percent used in the above paragraph is the product of interest rate ceilings, we think that the

shadow interest rate is likely to be substantially higher. As China is a capital-shortage country, the real rate of return on physical capital in China must be higher than the 10-plus percent (in the United States it is over 10 percent). So if there were an efficient government bond market in China today, the lower bound of the real government bond rate in China might be at least 6 percent. This minimum 2 percentage point rise in the real interest rate is made more plausible by the fact that the state would have to issue new bank recapitalisation bonds that amount to 40 percent of GDP. Realistically, the rate of NPL creation will continue to be positive, say 1 percent, which means that under interest rate liberalisation, the primary fiscal deficit (p) would have to be cut from 2 percent to 1 percent, i.e. the fiscal stimulus would have to be reduced, in order for the debt-GDP ratio not to spiral uncontrollably upward.

International experiences show interest rate liberalisation to be indispensable for the deepening and the sophistication of financial markets, so we really see no reason to be assured about the sustainability of China's fiscal situation. The lesson that we learn from this debt dynamics exercise is that we have to be very cautious about the validity of the benign scenario for China's fiscal situation. In a case where the safety margin of 2 percentage points is the result of interest rate ceilings and the unrealistic assumption that SOBs would cease generating NPLs, it might be wiser to err on the side of caution rather than on the side of complacency. If so, the sustainable fiscal options in dealing with the second bank recapitalisation is to either decrease state spending or increase state taxes.

In summary, China's consolidated debt-GDP ratio will be relatively high by international standards after a second bank recapitalisation, while its revenue-GDP ratio will remain relatively low. The greatest threat to the stability of China's financial market is fiscal sustainability, and the biggest threat to fiscal sustainability is successive rounds of bank recapitalisation. This outcome is a systemic feature of the current banking system, and cannot be attributed to WTO membership. In fact, we argue below that WTO membership is likely to rehabilitate China's financial system, and, may, as a by-product, reduce the deflationary tendencies evident since 1997.

5 The Benefits of WTO to Macroeconomic Management

At a superficial level, the systemic deflationary pressures that have plagued China since 1997 have their sources in two Keynesian maladies, the liquidity trap and the paradox of thrift. The liquidity trap refers to the phenomenon of the last few years where monetary policy does not seem to work. China has tried to boost the domestic economy with successive cuts in interest rates, but the rise in credit creation has been disappointing. Credit growth has been much lower than expected, except for brief intervals when the central bank leaned heavily upon the banks. The paradox of thrift refers to the low level of private aggregate demand because the private saving rate has been increasing. The Chinese government has concluded that, because private aggregate demand is falling and monetary policy seems incapable of stimulating it, the key to maintaining macroeconomic stability is government spending.

At a deeper level, however, we suggest that both of these phenomena spring from the same cause, which is the absence of adequate financial intermediation in China. Why, for example, is China suffering from an apparent liquidity trap? The main reason seems to be that state bank managers have been told that if the ratio of non-performing loans were to increase for two consecutive years, they would lose their jobs. The traditional client-base of the state banks is state enterprises, of which, half to two-third, are reporting zero or negative profits. By extending more loans to state enterprises, the non-performing loan ratio would inevitably rise. At the same time, state banks are also unwilling to lend to non-state enterprises and for very good reasons. First, the accounting practices of the non-state enterprises are neither uniform nor transparent. Second, it is politically more risky to do so. A loan to a state-owned enterprise might be a bad economic decision, but a loan to non-state enterprise that goes bad could potentially be a bad political decision as well. The bank manager could be accused of consorting with the private sector to embezzle the state.¹⁵ The liquidity trap then arises

¹⁵ The Chinese government has sought to increase bank lending to private individuals by encouraging banks to establish mortgage loans, which are perceived as less risky because of their seemingly fully collateralised nature. Mortgage lending, however, is a totally new product to be provided to a totally new set of customers, and so the state banks have understandably been slow in setting up this market.

because the banks are unwilling to lend money to either the state-owned enterprises or the private enterprises. The only activity that the banks are happy to allocate their funds to is the purchase of state bonds, i.e. the financing of the government's deficit. The fundamental step to eliminating the liquidity trap is to end the bias against lending to the private sector.

For the paradox of thrift, the right solution to the insufficient domestic demand in the Chinese economy is not mainly for the government to use up the private savings in public investments, but to set up mechanisms to channel private savings into increased private investments. This is where the entry of foreign banks will be exceedingly important. Foreign banks will be concentrating their activities in the large coastal cities, where the state-owned banks are now making the bulk of their profits. This increased competition in the profit centres of the state-owned banks could push the state-owned banks to focus on areas of banking where they have a comparative advantage over the foreign banks.

China's state-owned banks have a comparative advantage in operating in the inner provinces and the rural areas because of their existing extensive branch systems. The state banks have traditionally neglected the inland provinces and the rural areas. The number of rural banks has actually decreased in the 1985-1995 period. One reason is that the regulated interest rate for loans in China made it unprofitable to extend small loans. Large loans and small loans require the same amount of paper work and time to process. It is only natural that rural banks should charge a higher interest rate since the cost of monitoring and processing the loan is higher. But because the government-set margin that rural branches can charge above the (also government-set) lending rate in urban areas is too low to cover the additional costs and higher default risk, banks have retreated from lending in the rural areas (Woo, 2001). The liberalisation of interest rates combined with increased competition in the coastal urban markets will motivate the state banks to expand their activities in the long-neglected inland provinces and rural areas.

What has been happening in the face of strong rural industrial growth is that a lot of informal rural financial institutions have sprouted to meet the financing needs of the rural industries. Given the illegal nature of these rural financial institutions, they live under the constant threat of closure, and so they tend to focus only on the

short run and take more risks. It is not surprising that these risky rural financial institutions often failed. Whenever they failed, the government had to bail them out in order to maintain political stability. The government has therefore been clamping down even harder on these illegal financial intermediaries, because it does not want to choose between the risk of bailing them out and the risk of having social instability. However, increasing strict enforcement of the ban on private financial intermediation is exactly opposite to what ought to be done. The efficient solution is to allow private financial intermediaries in the rural area, and bring them under proper prudential supervision.

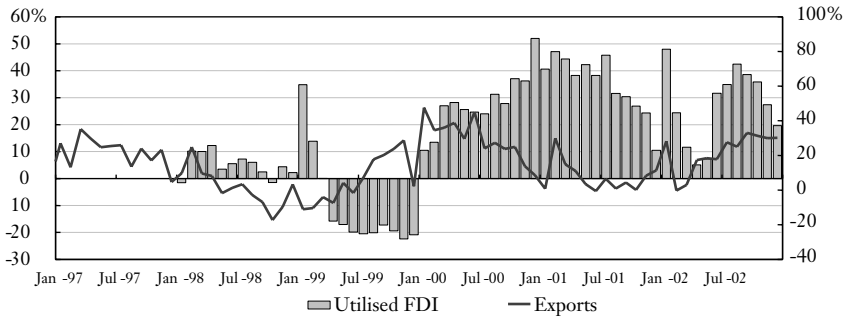
The general principle, and a trend that the Chinese government will find increasingly costly to prevent, is reducing interest rate controls and allowing private banks to come into existence. The improvement in financial intermediation induced by WTO membership can help to eliminate the liquidity trap and reduce the paradox of thrift through improved financial intermediation, and hence ease the task of macroeconomic management.¹⁶

The entry of foreign banks will also improve financial intermediation by enabling the transfer of modern banking technology through a seldom-mentioned channel. In the future, when a successful Chinese enterprise group establishes a bank, it will do by hiring away the local managers employed by the foreign-owned banks. This is exactly the South-East Asian experience – the top managers of the big domestic banks were all ex-employees of foreign banks. This is perhaps what the Chinese leadership sees and why it is willing to allow the entry of foreign banks, giving them national treatment within five years of WTO membership. The Chinese leadership is betting that in the short run, there could be significant displacement of Chinese state banks by foreign banks, but in the long run, Chinese banks (most likely private ones) will rise in importance. Twenty years from now, the international financial world will have more to fear from Chinese banks than vice versa.

We should mention that entry of Western banks into China's financial markets is not the same thing as capital market liberalisation. We do not believe that China would be well served by

¹⁶ For a formal model and empirical investigation of the macroeconomic consequences of inadequate financial intermediation (in other countries, especially in Taiwan), see, Liu and Woo (1994).

**Figure 4 Growth Rates of Exports, and Foreign Direct Investment
(year-over-year)**



Source: Citigroup (2002) updated in February 2003.

a rapid opening of the capital account since that could subject China to rapid swings of short-term capital in the same manner that has whipsawed the economies of South-East Asia and Latin America. Capital market liberalisation should proceed gradually and in stages, because it must be accompanied by sophisticated financial market regulation, something that is clearly not in place at this time. We do not relish the phenomenon of foreign banks suddenly becoming a conduit for large-scale capital flight, or for rapid swings in short-term lending and repayments, or as facilitators of bank runs (in which depositors do not merely switch banks, or switch from domestic banks to domestic currency, but actually switch from domestic deposits to foreign assets).

Finally, we must mention that there has been too little attention given to the fact that WTO membership also creates new employment, especially by ensuring the access of Chinese exporters to markets in the United States, Europe, and other regions. China's entry into the WTO will allow several big Chinese exports greater access to the markets in the United States and Western Europe, e.g. the multi-fibre agreement would be ended. Instead of China losing its shirt because of entry to WTO, Chinese textile industry would expand. Labour-intensive exports will expand more generally to offset some of the increase in imports. For the same reason, WTO membership could increase the flow of foreign direct investments into China in export-oriented sectors, and this will certainly create

new (and, most likely, also higher paying) jobs. Figure 4 shows that the level of utilised foreign direct investment into China has been increasing every month since December 2000, when there was no longer any doubt that China would soon become a WTO member.¹⁷

6 Macroeconomic and Social Instability from the State Enterprise Sector

We have so far concentrated on the WTO-created difficulties for macroeconomic management. This is not to say, however, that the inflationary problem generated by the traditionally biggest macroeconomic destabiliser – the SOE sector – no longer exists. If anything, the SOE sector in 2003 has not only become a source of potentially greater macroeconomic instability, it has also emerged as a source of socio-political instability. To understand the origin of these negative developments, we review the Fan and Woo (1996) argument that the reform strategy for the SOE sector during the 1978-1993 period was inherently inflationary.¹⁸

The crux of the 1978-93 SOE reform strategy was to transfer decisionmaking power from the industrial bureaux to the state enterprises (as advocated by Oskar Lange¹⁹). The increased operational autonomy of the SOEs reduced the ability of the industrial bureaux to monitor the financial situation within the SOEs, and hence created the incentive for SOEs to greatly increase their demand for investment funds. The reduction in bureaucratic oversight of SOEs in a soft-budget environment allowed the SOEs to use creative accounting to privatise profits from good investment projects, and to receive state subsidies to cover losses from bad investment projects. Until about 1996, the SOEs were generally able to satisfy their large appetite for investment because the local governments, in the interest of local development, inevitably lobbied the local branches of the state banks to grant the SOEs' applications for investment loans. The evidence overwhelmingly

¹⁷ The jump in the amount of contracted FDI had occurred earlier when China completed its WTO bilateral negotiation with the United States.

¹⁸ See Huang, Woo, and Duncan (1999) for an account of the failure of SOE reform.

¹⁹ See Lange and Taylor (1938).

shows that the local bank branches, at least until 1995, were unable to resist the demand for easy money.²⁰

The losses at SOEs exploded after 1992 when mother Russia officially went capitalist because many Chinese SOE managers saw the same fate for China in the future, and concluded that this was their last chance to steal. This is why SOE losses skyrocketed even though GDP grew in the range of 10 to 14 percent annually in the 1992-95 period. By 1995, it was common even for government officials to say that “one-third of the country’s state enterprises were in the red, and another one-third were in a latent loss-making state”.²¹ The academic literature, however, failed to catch up with reality by attributing the mounting SOE losses either to increased competition from the non-state enterprises (Naughton, 1995) or to slower improvements in SOE efficiency (Lin *et al.*, 1996). Although the first explanation – the competition explanation – appears to be the favourite one among traditional China-scholars, it lacks empirical validity. Fan and Woo (1996) show that the profit rates of SOEs in the sectors of industry that experienced little entry by non-SOEs displayed the same dramatic drop as the profit rates of SOEs in sectors with heavy penetration by non-SOEs. Profits in SOEs fell regardless of whether they faced competition from non-SOEs.

From the vantage point of 2003, it seems that continued inefficiency, and *de facto* asset-stripping and embezzlement of firm profits by managers and workers are the primary causes for the general decline in SOE profits, with the latter being the more important. The devolution of financial decisionmaking power to the SOEs, and the steady reduction in discrimination against the private sector have made it increasingly easy for the managers to transfer state assets to themselves. In December 1995, the State Bureau for the Administration of State Property reported that asset-stripping in the SOE sector “has been about 50 billion yuan [annually] since the early 1980s”.²² This would mean that the cumulative loss of SOE

²⁰ The institutional reforms of the central bank and the state banks implemented in July 1993 as part of an austerity campaign have not been successful in changing things. Chen Yuan (1996), deputy governor of the central bank, reported that “the enthusiasm for economic growth in some localities is so strong that it is very difficult to stop completely excessive investment financed through *forced* bank credit” (emphasis added).

²¹ Lin *et al.*, (1996, p. 215).

²² “State asset drain must end”, In: *China Daily*, December 13, 1995.

assets in the 1983-1992 period was equivalent to some 34 percent of the net value of fixed assets in the SOE sector as of 1992. It is hence, perhaps, only natural that of the 327 cases of embezzlement, bribery and misuse of public funds that were tried in Beijing in 1999, “76 percent took place in SOEs”.²³ The increasing public outrage over the inequity of the informal privatisation of the SOE sector is well captured in the book by He Qinglian who wrote that the SOE reform has amounted to:

“a process in which power-holders and their hangers-on plundered public wealth. The primary target of their plunder was state property that had been accumulated from forty years of the people’s sweat, and their primary means of plunder was political power.”²⁴

By 1994, the Chinese leadership had recognised the increasingly serious economic and political problems created by the principal-agent problem innate in the decentralisation reforms of Lange-inspired market socialism, and it announced that the clarification of property rights of SOEs would be added into its SOE reform programme. The Communist Party of China (CPC) publicly committed itself in July 1997 to convert most of the SOEs to publicly traded shareholding corporations – a form of industrial organisation that originated in capitalist economies. The 1994-1997 decisions to address the loss-making SOE problem more decisively are the reasons why the employment growth rate in the industrial sector (in Table 1) fell from 2.1 percent in 1997 to 0.3 percent in 1998, and then went negative in the following years. (The restructuring of the state manufacturing industries had occurred even earlier, in 1996.)

The state’s decision in 1997 to accelerate diversification of the ownership structure of the SOEs has to be recognised as a bold move because the experiences with mass privatisation in Eastern Europe and the former Soviet Union (EEFSU) show that the task is an extremely difficult one and that the outcomes have consistently

²³ “Judicial Attention to SOEs Pledged”, In: *China Daily*, February 19, 2000.

²⁴ He Qinglian, *Zhongguo de Xianjing*, (China’s Pitfall), Mingjing Chubanshe, Hong Kong. The translated quote is from Liu Binyan and Perry Link, “China: The Great Backward?”, In: *The New York Review of Books*, October 8, 1998, p. 19.

fallen below initial expectations. For example, in Russia, the “loans-for-shares” privatisation transferred the country’s enormous mineral wealth to a group of oligarchs, and the weak administrative and legal structures allowed many managers to take effective control of the privatised firms and loot them instead of improving their operations. Furthermore, the EEFSU experiences warn that *mass* privatisation is an exceedingly dangerous business politically, no matter how it is done, be it outsider privatisation or insider privatisation. This is because the mass privatisation of SOEs generates so much rent that massive corruption has not been avoided, and the resulting corruption inevitably delegitimises the government, e.g. Vaclav Klaus in the Czech Republic and Boris Yeltsin in Russia.

Despite the mediocre to poor privatisation outcomes in EEFSU, privatisation has been going forward in China, albeit with occasional stops, for two main reasons. The first reason comes from John Nellis (1999) who points out that “governments that botch privatisation are equally likely to botch the management of state-owned firms”. The answer is not to avoid privatisations but to implement more careful privatisations: governments in transition economies should “push ahead, more slowly, with case-by-case and tender privatisations, in cooperation with the international assistance community, in hopes of producing some success stories that will lead by example”.

The second reason lies in that the delay of privatisation can be costly to China’s government politically. Stealing by managers does occur during privatisation and creates a social backlash against the government, but the maintenance of the status quo has become increasingly difficult because SOE managers in China know from the EEFSU experience that they are in an endgame situation. The widespread spontaneous privatisation by SOE managers could create grave social instability.

Our opinion is that the solution to the SOE problem in China is not privatisation *per se*, but a transparent, legal privatisation process that society at large can accept, at the minimum, as tolerably equitable. Because an adequate privatisation programme must compensate the retired and laid-off workers, permit takeover by core investors, and respect the rights of minority shareholders, it is important that legal reforms be carried out simultaneously. Only with a transparent, equitable privatisation process that is overseen by an adequate legal framework, would China be likely to avoid a state-

created Russian-style *kleptoklatura* that would fuel social dissatisfaction.

Recently, there has been some questioning on whether the case for privatisation has been overstated.²⁵ When Zhu Rongji was designated the new premier in 1997, he announced that he would solve the SOE problem in three years. In 2000, he declared victory on the SOE front when the profits of the industrial SOEs leaped from 53 billion yuan in 1998 to 241 billion in 2000. This is indeed favourable news, but should be put in context. This improvement in SOE profitability was actually part of a general phenomenon; the profits of the industrial non-SOEs increased from 93 billion yuan in 1998 to 199 billion in 2000 for a variety of macroeconomic reasons.²⁶ Table 6 summarises a study by Zhou and Wang (2002) who quantified the sources of the financial turnaround. They found that:

- the lower interest rate in 2000 increased profits by 52 billion yuan (28 percent of the increase in SOE profits);
- the higher oil prices boosted overall SOE profits by 79 billion yuan because almost all oil companies are state-owned (42 percent of the increase);²⁷ and
- the conversion of the bank loans of SOEs into equities held by state asset management companies raised profits by 10 billion yuan (5 percent of the increase).

About 75 percent of the increase in the profits of industrial SOEs in the 1998-2000 period was not due to actions taken within these enterprises but to external factors. When Zhou and Wang (2002) calculated the profit rate after deducting the profits from the more favourable external environment, they found that it had increased from 0.7 percent in 1998 to 1.2 percent in 2000 for the SOE sector, and from 2.8 percent to 4.8 percent for the non-SOE sector. Despite the recent good news on SOE profitability, the fact remains that the SOE sector still lags considerably behind the non-SOE sector in efficiency.

²⁵ See Nolan and Wang (1999) for a recent assertion of a turnaround in SOE performance.

²⁶ The non-SOE data exclude small non-SOEs with sales at or below 5 million yuan. Data in this paragraph are from Zhou and Wang (2002).

²⁷ This estimate has taken into account the additional production cost of the non-oil SOEs.

Table 6 Analysing Sources of Profit Growth in SOEs and Non-SOEs (1998-2000)

(in 100 millions of yuan and percentages)

	SOE				Non-SOE			
	1998	2000	Change	Exp*	1998	2000	Change	Exp*
Total profit	525	2,408	1,883	(100)	933	1,985	1,052	(100)
From								
Interest rate reduction			523	(27.8)			300	(28.5)
Higher oil price			791	(42.0)			-341	(-32.4)
Loan-equity swap			101	(5.4)				
Residual = Own Effort			468	(24.8)			1,093	(103.9)
Real return rate**	0.7	1.2	0.5		2.8	4.8	2.0	

Notes:

* Data in parentheses under "Exp" are share of contribution by different factors to total profit changes.

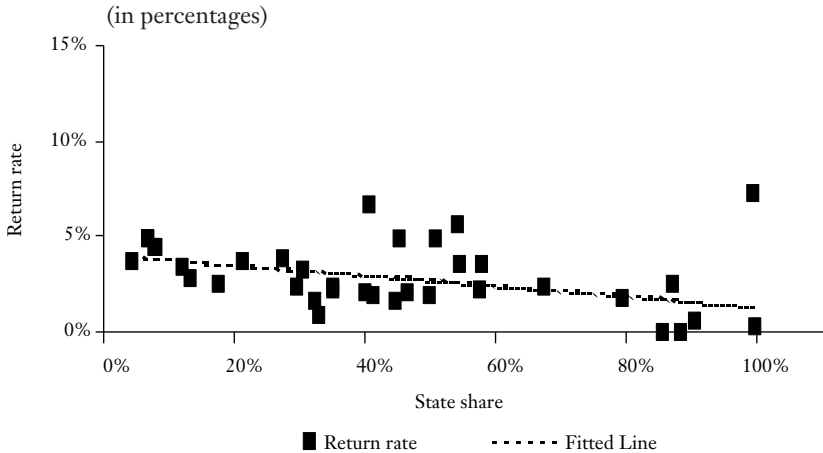
** "Real return rate" for 2000 is calculated as the ratio of total profit, excluding profits that resulted from the three external factors, to total assets. The estimate on the effect of higher oil prices has taken into account the additional production cost of the non-oil SOEs.

Source: Zhou and Wang (2002). Some terms used here differ from the source.

Zhou and Wang's conclusion is supported by the independent evidence in Figure 5, which plots the profit rate in each of the 37 industrial sectors against the proportion of sectoral output produced by SOEs in 2000. It shows that the profit rate of the sector declined as the SOE presence in the sector increased.

To sum up, while the recent rise in profits surely gives some breathing space, the capacity of SOEs to "dissipate rents" through high payments to managers and workers, if not illegal transfer of assets, should remain clearly in the policymakers' minds. Thus, any gains could well be squandered, if not reversed, in a relatively short period of time. It is hence important for China to replace the present uncontrolled (and uncontrollable) process of asset-stripping in the SOE sector with transparent and equitable privatisation in order to improve macroeconomic stability and to defuse socio-political instability.

Figure 5 Relationship Between Profitability and State Dominance in Different Industrial Sectors in 2000



Note:

Data are for 37 industrial branches. The return rate is defined as the ratio of total profit to total assets of each industrial branch.

Source: Zhou and Wang (2002).

7 Final Remarks

We have argued that China's dysfunctional financial system has imparted a deflationary bias to the economy by creating the Keynesian maladies of the paradox of thrift and the liquidity trap. The government has actively fought the deflation through an aggressive fiscal policy. Clearly, the more efficient solution is for private investment rather than public investment to recycle the pool of private savings back into the economy. This means that the key to eradicating the deflation bias in China's economy is to establish an efficient financial intermediation mechanism.

One commonly heard diagnosis is that the large amount of NPLs in the state banks have made them susceptible to periodic bank runs, and hence prevented the banks from becoming efficient financial intermediaries. In 1998, the Chinese government tried to revitalise the role of the state banks as financial intermediaries by recapitalising, but the final outcome was the creation of additional bad loans. We differ from conventional wisdom in holding that the primary determinant of bank runs in China is not the amount of NPLs in the banks but the credibility of the belief that the Chinese

government can afford to bail out the affected banks. Because it appears to us that the government can afford only one more big recapitalisation of the state banks and still be fiscally sustainable, we think that as long as it continues to discriminate heavily against domestic private banks, then there is really little to be gained by recapitalising the SOBs. This suggests that one possibly effective way to slow down the pace of NPL creation in an SOB-dominated financial system and keep the fiscal situation sustainable is to keep the NPLs on the books of the SOBs, and, as suggested by Fan Gang (forthcoming), “the financial status of these loans should be constantly watched and openly discussed” in the public media.

One must note, however, that in order for Fan Gang's suggestion to work, it is necessary that the foreign banks (which will no longer face more restrictions than Chinese banks by 2008), for some reasons, will not expand aggressively out of the big coastal cities to blanket the rest of the country with branches in a short period of time. If the foreign banks do so, then their lower costs from the absence of non-performing loans will allow them to charge lower lending rates than the SOBs. This will eliminate the SOBs because WTO regulations make it illegal for the government to subsidise the SOBs against foreign competition. Our guess is that Fan Gang's method can work for as long as ten years because we think that only HSBC and Citibank are likely to actively expand their banking network in China in the next decade, and even then mostly in the major coastal provinces.

In concluding, we want to stress that beside successive rounds of bank capitalisation, there are other shocks that would undermine the fiscal sustainability of the state. One such shock would be an AIDS pandemic that would send state spending on public health soaring, and another would be massive construction to offset major ecological disasters and significant climatic changes (e.g. water shortage in northern provinces, alternative energy systems to traditional methods of burning coal). We note that the fiscal burden aside, these two examples are new macroeconomic challenges that the proven policies of China's past economic managers cannot solve. The severe acute respiratory syndrome (SARS) epidemic that is emerging at the time that this paper is being written (first draft completed in December 2002) could become a serious macroeconomic shock to China on both the supply and demand side, just like a massive oil price shock. There is no doubt that the

economic costs of SARS have been greatly magnified not only by an inadequate public health system but also by structural weaknesses in information dissemination within China. The SARS epidemic is clearly showing that macroeconomic stability depends on more than just keeping focus on the traditional shocks (e.g. changes in sales taxes) to the aggregate macroeconomic accounts like the state budget deficit.

In short, the existing safety margin of 2-percentage point in China's fiscal management (identified in Section 4) is vulnerable to more than the two factors we had identified – a future round of bank recapitalisation (i.e. the second after 1998) and a rise in interest rates from financial sector deregulation. Given the many structural weaknesses in China's economic system because of its incomplete transition to a modern private market economy, this 2-percentage point safety margin might at best be regarded as minimally adequate when we consider the sustainability of China's fiscal policy, and its ability to keep the annual growth rate above 7 percent.

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4

Comment on Wing Thye Woo

Chang Kyu Lee

Professor Woo's paper is very insightful and informative and it helped me to better understand China's economy. I would like to make two brief comments.

First, Professor Woo evaluates the NPL problem in China's banking sector and analyses the debate about the potential bank-bank loans in China. Professor Woo does not see the possibility of bank loans in the near future in China. I agree with his position completely.

The NPL problem in China should eventually be tackled with NPL funds inserted by the Chinese government. As Professor Woo said, the Chinese government may have enough financial capacity to insert the second re-capitalisation of the Chinese state-owned banks. Basically, I agree with this evaluation, but even after the injection of additional capital into the banking sector, the NPL problem can re-emerge unless the Chinese banks are transformed into commercially viable entities. So in my opinion, re-capitalising alone is insufficient.

The Chinese state-owned banks should function as commercially oriented banks, not as palace banks. The opening of the banking sector after China's accession to the WTO will prompt increasing competition between China's domestic banks and the foreign banks. It will provide great opportunities to convert the Chinese domestic banks into more commercially viable entities.

Second, Professor Woo points out that China's economy has a serious problem of excess of supply. As you know, China's economy was traditionally a shortage of supply economy. That was one of the characteristics of the socialist economy – probably until the mid-

1990s. But since 1996-1997, the Chinese economy has been transformed from a shortage economy into a surplus economy. Aggregate supply now exceeds aggregate demand. Professor Woo suggests that the insufficiency of aggregate demand was mainly caused by a poor financial intermediation system in China, and he argues that improvements in the financial system in China will help to address the supply problem. But it is well known that over 60 percent of China's population still lives in rural areas and until now, the urban-rural income disparities in China have been substantial. So I am not sure that the improvement of the financial system alone can encourage the rural areas to increase consumptive spending sufficiently to tackle the problem of relatively insufficient consumptive spending in China. The increase of rural income and the consequent increasing of consumptive spending in rural areas should be one of the essential policy priorities.

During the past two decades, China's economy has shown excellent performance. China is a solidly growing region in the sluggish world economy. A lot of factors contributed to China's rapid economic development, but generally speaking, China's liberalisation of the commodity market and, since the late 1990s, its liberalisation of the labour market, contributed substantially to the recent economic success. The next step will surely be the liberalisation of the financial markets. The development of the financial system and the financial market is a very important issue in China right now, and the new leadership in China also recognises this problem very well.

In conclusion, after accession to the WTO, some of China's agricultural sectors may feel increasing pressures. However, China should find its own new way to enhance productivity in the agricultural sector and to raise the income of the rural population.

5

Floor Discussion of “Financial and Macroeconomic Reform in China”

The Fan and Zhang Paper

Wing Thye Woo, of the University of California, dwelled on the views of those who believe that a rapid increase in the rate of urbanisation in China would lead to reproducing the horrors of Mexico City, Lagos and Calcutta. He suggested that the Chinese government could prevent this by speeding up urbanisation and, at the same time, trying to improve conditions in the countryside. “Urbanised immigration is certainly one of the best instruments for improving the distribution of income within China,” he said. “What is wrong now is that the poor people are locked in their provinces because of the household registration system. So, first of all, in terms of social stability and increasing income, faster urbanisation is needed to move these people from the poorer to the richer areas. Second, such movement is also desirable for ecological reasons because a lot of places where these folks are living now are running out of water. Northern China is running out of water and instead of moving water to where the people are, you should also encourage the people to move away from these places to the southern and coastal areas. Third, urbanisation is a very effective way of improving the human capital stock because creating a good rural education system is much more expensive in scattered areas than within a concentrated space. Similarly, in order to improve the human capital stock in terms of public health, there will certainly need to be increased legal immigration and urbanisation because the present system of illegal immigration means that only the man

moves, and this creates greater hazard for sexually transmitted diseases.”

Choong Young Ahn, of KIEP, followed up on the urbanisation issue stressing that under the current household registration system, the migrant workers normally do not bring their families and their children to the cities. “Although they work in urban areas, their children are denied access to urban education, so they settle down in the cities without bringing their families and children. This is a very serious problem. If China wants to continue the build up of human capital formation, a substantial amount of fiscal resources should be allocated to the urban centres or the urban local governments to augment the existing education facilities.”

Xiaojing Zhang underlined the importance of carrying out the urbanisation in a well-organised way. “Some people in China say that industrialisation is low-cost and urbanisation is high-cost. Urbanisation can indeed create social problems if we carry out this urbanisation process too quickly. For the time being, the government just pushes forward urbanisation, but I think in about 5 to 10 years we will know better how to speed up this urbanisation process and, at the same time, find ways to increase the farmers’ income.”

Wing Thyee Woo gave an interesting explanation for the high increase in foreign direct investment (FDI) in China. “It has to be recognised that FDI is also a sign of weakness. Part of the explanation for why there has been so much FDI into China is that there was, until recently, strong legal discrimination against the private sector. There were opportunities for enterprises to be set up and export to the rest of the world, but these opportunities were not seized by the domestic capitalists and given instead to the foreign capitalists. Of course this is not unique to China, this is exactly what happened in the case of Malaysia and explains why 90 percent of Malaysian exports are carried out by foreign-owned firms. Because if a local Chinese in Malaysia would expand to become an exporting firm, he has to hand 30 percent of his assets to the government for redistribution. So legal discrimination is a particular reason why FDI has come into Malaysia and China to take advantage of opportunities that domestic capitalists could not exploit.”

Masaru Yoshitomi, former dean of the Asian Development Bank Institute, wanted to know the scope of privatisation and the sort of corporate governance system the new government in China has in mind under the economic reform process. “I wonder to what extent

the ownership structure of state-owned banks and state-owned enterprises will be changed to enhance the incentives for better management. Will the state continue to own the enterprises, and will management continue to be appointed by the Party or the government? So my question is about the ownership and management issue.”

Xiaojing Zhang thought that it was still too early to give a clear picture of the changes in ownership and management that will occur. “With regard to the privatisation of state-owned enterprises, I think the central government should just control the very big SOEs and let the others go. Such a reform will give incentives to the local government to sell its properties. Another channel for the privatisation of China’s state sector is that the foreign companies have the right to do mergers and acquisitions in China’s stock market.

Regarding the changes in management, with the establishment of the new State Asset Management Commission (SAMC) the previous mode of management of SOEs will be changed. There is now only one institution that will control the personnel and the routine operation. In the past several years, there has been some experimenting in Shanghai and other coastal areas to reform the management system of SOEs. They have gained a lot of experiences and I think this will find its way in improving the management of the state-owned enterprises in the non-financial state sector. For the financial state sector, i.e. the banks and other financial institutions, setting up a new institution similar to the SAMC has also been suggested. The current reform of property rights for state-owned banks aims at listing the four big state-owned banks in the stock markets in the next three years. This will also change the corporate governance in the state-owned banks.”

Charles Adams, of the IMF, had a question about the Chinese banking system and about the split between the SOE and the non-SOE sector. “What is the composition of the non-SOE sector because I understand that it is not just the private sector but includes quite a diverse range of ownership structures. My second question is about the banking system. In recent years, the non-state banks have become a more important source of credit provision. On the one hand, that might be seen as a plus in terms of credit allocation. On the other hand, I am wondering whether that makes the financial system more vulnerable.”

Xiaojing Zhang explained that non-SOE is a broader term, which includes the private sector, the foreign companies and also the collectively owned companies such as the township and village enterprises (TVEs). He observed that in the last 20 years the TVEs have played a major role in China's development, but thought that times were changing for the TVEs. "Some of the TVEs have disappeared and some of them have become very large companies in the financial or manufactures sector. They tend to move from the land to the cities, so the character of the TVE is also changing. I think that the future force of growth is not going to be TVEs but rather the non-SOE sector broadly."

Concerning the banking sector, Choong Young Ahn wondered how the large state-owned banks would change their lending decisions. "On what criteria will they reallocate their limited financial resources to state-owned enterprises? Lending criteria should be evolving to commercial lending criteria, but how will these criteria be developed? Chinese scholars and policymakers are saying that the Chinese banking system is now introducing new governance schemes and international standard practices and so on, but are they really adapting to commercial banking criteria when they continue to give loans to state-owned enterprises?"

Xiaojing Zhang responded: "As long as the property rights in the state-owned banks (SOBs) have not been clearly defined, we will not have a sound credit system, nor will we be able to manage the NPLs in a satisfactory manner. The lending decisions were always controlled by the central government and this should end. If a new institution, similar to the SAMC, is going to be set up for the financial sector, and if the main goal of this new institution is making profit, and if, in addition, the property rights in state-owned banks are clearly defined, then I think the lending decisions will be much better than before."

Barbara Stallings, of Brown University, added: "Xiaojing Zhang talks about the new SAMC for changing the management of state-owned enterprises and suggests that a similar commission might be set up for the financial sector, but to me it is not at all clear what thoughts there are in China about privatisation, which is an issue of key importance. Moreover, another aspect of managing the state-owned enterprises is related to the issue of centralisation and decentralisation. My understanding is that in many areas, China has to re-centralise because the decentralisation, for example in

the financial sector, created more problems, more corruption and more bad management. Why is the government advocating decentralisation when it has had such a bad experience in the past?”

Xiaojing Zhang agreed that financial institutions in rural areas had created many problems including non-performing loans (NPLs). “These local financial institutions did not lend carefully and so the NPLs increased rapidly. However, the reform objective of China’s government and the way to deal with these NPLs is not to take the right of decentralised financial institutions back, but to introduce more non-SOEs in the financial sector. Not only foreign financial institutions but also domestic financial institutions. With these kinds of reforms, decentralisation will not be a problem. Our paper does not mention corruption, although it is a very serious problem in China. In the past five years, a number of high officials have been exposed. More and more official corruption has been found and this shows that the problem is quite serious. But it also shows that the government is taking the problem seriously and is trying to do its best to deal with corruption. However, if the political system cannot be changed, the corruption problem and the problem of NPLs will continue to exist in China in the near future.”

Robert McCauley, of the BIS, wondered whether the decline in NPLs could be explained in part by the change in the maturity structure of the loans. Xiaojing Zhang explained that in absolute terms, the NPLs had declined only by a small amount. “But if you look at the ratio of NPLs to total loans,” he said, “you will find that the ratio declined because total loans increased very quickly. The other reason indeed is that the credit-term structure changed, in the sense that short-term loans decreased and medium and long-term loans increased, thus pushing the NPL problem to the farther future.”

Xiaojing Zhang concluded with a remark on the timeframe and focus of China’s economic reform agenda.

“The Chinese reform agenda is a comprehensive reform agenda and some of the issues are part of a long-term agenda which you cannot finish in 20 years, especially those relating to urbanisation and employment. We should try to focus on the most urgent issues. We should probably focus on the banking system and the capital market because all of the problems we talked about – urbanisation, employment or whatever – will be reflected in the banking system and the capital market; especially the capital market, because the

capital market is at the top of the property rights system. Unless we are able to establish a good capital market, the economy will not be robust. Look around the world; the US economy has the best, most robust capital market. So by focusing on the capital market we can sharpen our reform agenda.”

The Woo Paper

Yung Chul Park, of Korea University, wanted to get a clearer understanding of what Wing Thyee Woo meant by a liquidity trap. “If it means that the saving rate is too high, I would say that this must have something to do with the high rate of growth. Usually a high rate of growth stimulates savings and I am sure that the high rate of growth in China accounts for much of the savings increase. But Wing Thyee Woo seems to give a different explanation. He says that because of inefficiency of financial intermediation, much of the domestic savings has not been channelled into domestic investment and has been flowing out of the country. However, my explanation would be that domestic savings have been channelled to finance government investment and, indeed, also to finance foreign investment in the form of current account surpluses. So if you could provide incentives to the private sector to invest more, then you might be able to reduce this investment-savings gap.

In my view, Wing puts too much emphasis on financial intermediation and the importance of the financial sector. If you look at the composition of Chinese savings, the bulk of the increase in savings in the last years has come from the corporate business sector, not the household sector, and these savings have been used to finance business investment. This is the way to look at it rather than saying that people are saving a lot of money which the banks are not able to lend. Instead of looking at the situation from the financial side, I would suggest looking at it from the real sector side and then focus on investment and the increases in savings in relation to development in the real sector.”

Masaru Yoshitomi wondered what assumptions Wing Thyee Woo had made about the real interest rate and about the level of government debt that would be acceptable. “If the real growth rate is 7 to 8 percent and the real interest rate is only 4 percent, this would be too low an interest rate and create a biased economy. A

firm could borrow and invest a lot if it is borrowing at only 4 percent per year. The other fundamental question is what would be the maximum of deficit allowable for China without getting an explosion of debt and too high a deficit. What would be the maximum debt-GDP ratio allowable for China and for what reasons?"

Geng Xiao, of the University of Hong Kong, followed up on the interest rate issue, which he considered one of the most important issues in Asia and China. "The question is whether a low interest rate will stimulate the economy or actually lower the economic activity. When the interest rate is low, it does not differentiate good projects from bad projects, everything just goes on. That is, for instance, the worrying situation in Japan, where you have a zero interest rate and everything just goes on as usual. In the case of China, supposedly the interest rate should be high because there are so many opportunities, which is confirmed by the huge foreign direct investments in China. However, since FDI does not rely on China's domestic financial system but on the global financial market, China's interest rate is irrelevant for FDI. The domestic interest rate in China is low largely because of Wing Thye's version of the liquidity trap. That is, you have a huge amount of deposits – deposits increased from 30 percent of GDP to 160 percent of GDP during the last decade. However, there is no way you can continue a situation in which the deposits are increasing and the proportion of loans within the entire credit assets and liabilities is shrinking. Wing Thye is right that it is very difficult to carry out lending in China's domestic sector other than the FDI sector. In recent years, on average, FDI as a proportion of fixed capital formation has increased – up to 23.7 percent in 2001. This is very high and if you look at the top 9 provinces, that proportion is even higher: 43.3 percent. In the most advanced economies, FDI is almost half of the fixed capital investment. So that shows how convincing Wing Thye's story is that the domestic financial sector is not working. The reason that China continues to grow is largely because of FDI, which gets around this financial bottleneck successfully."

Xiao observed that Woo had not paid any attention to the advantage of China's population structure. "China's population today is almost exactly like Japan's in 1975, with only 7 percent of population above age 65. Today, 20 percent of Japan's population is above 65. So China has a window of opportunity for high growth for the next 20 years partly due to its population structure."

Charles Adams believed that the domestic banks in China were ill prepared for the competition from foreign banks in two or three years time under the WTO agreements. “If foreign banks are going to come in and compete seriously, then the problem will get serious because of cherry-picking and similar behaviour.”

Zdeněk Drábek, of the WTO, believed that despite what had been said about the importance of FDI in China, FDI was still playing a relatively small role in the context of aggregate spending and aggregate savings. “When I look at the growth rate of investment finance by the government and the growth rates of investment finance by the state-owned enterprises, they are completely mind-boggling. This is an incredible growth. The state enterprises are over-investing, probably because credit is too cheap and because they are under no serious budgetary constraints. I would not be surprised if it is the investment boom in the public sector that is driving the growth. In that context I find it a little bit difficult to understand Yung Chul’s plea for generating more investment opportunities.”

Li-Gang Liu, of the ADBI, dwelled on the issue of a credit crunch. “Wing seems to indicate that the credit crunch is quite severe but the money supply growth, M2 growth, is actually quite high, more than 14 or 15 percent during the last several years. On the other hand, some firms, especially small and medium enterprises, are experiencing a credit crunch; they cannot get loans easily. This seems to indicate that there is a dis-intermediation issue in the Chinese banking system. However, Xie Ping told me that the lending rate in the last year has picked up rapidly to around 14 or 15 percent. So the question is: how do you explain this apparent paradox.

The other issue ADBI recently conducted research on is whether non-performing loans is a serious problem for China. We did a simple calculation to show that if you use a crowding-out approach, it will take many years, about 13 to 17 years depending on what level of non-performing loans you put in the banks, before China can grow out of it or not. That’s why we think NPLs need to be taken care of seriously.

We also looked at small and medium commercial banks that are emerging quickly in China. These banks have rapidly growing loans catered to small and medium enterprises. So if we allow this segment of the financial sector to grow in addition to the foreign entry of banks, then perhaps this state-owned bank dis-intermediation issue could be alleviated in the near future.

Another point that Wing hasn't mentioned here, but on which he has worked in the past, is whether China can continue the same development pattern into the next 10 or 20 years without addressing the fundamental issue of property rights."

Finally, Zdeněk Drábek asked what Wing Thye Woo would recommend as "the three most important things" for the Chinese government to do in the next year.

In his reply to the various comments, Wing Thye Woo started with Yung Chul Park's remark on the liquidity trap. "Professor Park suggested that if you look at high growth rates you always see a rising savings rate, and that the corporate sector has a lot of savings. All I am saying is that if the corporate sector could get investment loans easily, it would not need to have so much internal savings, and could have just handed out these savings in dividends. That is normally the choice: you either have the profits as retained earnings to finance future investment, or you distribute them as dividends and get them back in the form of corporate bonds. But because you don't have a functioning bond system in China, the corporate savings have to go up in order to generate the financing for the investment.

What do I mean with the liquidity trap? The credit multiplier is smaller than before. But even that is not necessarily a problem, because if the multiplier is smaller you can just increase your base money even more.

Here I come to the point of the lending rate. Why has the lending rate gone up? Since 1994, when the government leans on the banks, the banks temporarily increase their lending rate. And to whom did they lend the money? I suspect to the social stability loans and to a lot of construction companies for infrastructure in the West.

It would be a misstatement of Professor Park's point to say that China should increase investment even more. I think what Yung Chul and I agree on is that we want to change the composition of investment. It was the government undertaking the investment, but it should be more the private sector. So that would be a big change in the composition of investment. This does not happen because of the non-functioning of the banking system.

As for the problem of non-performing loans, the idea is that you could grow out of it by keeping the rate of the new generation of NPLs lower than the rate of economic growth. How do we get the

NPL problem under control? In the case of China there are basically two schools of thought. One is the ADBI approach that says: recapitalise and privatise, and the private sector will take responsibility for it. The second school is the Fan Gang approach which says: just keep the NPLs on the books of the banks and use that as a disincentive for them to lend more money but, at the same time, promote the growth of alternative financial institutions. This Fan Gang solution works only if the foreign banks do not aggressively expand branches throughout China. Because if they do, they will take away the deposits, take away the lending business. But Fan Gang's assumption is not a bad one, because I don't think foreign banks will come in massively.

Charles Adams said that the Chinese banks are ill prepared for competition with foreign banks. I think he is right, but they have got a breathing space of about 4 to 6 years, possibly even 10 years. The entry of foreign banks should be seen for what it is, a transfer of foreign banking technology to China. In the future, when a Chinese business group wishes to enter in the financial sphere, it will just hire back the local manager to run the Chinese banks.

What are the three big issues I would recommend the Chinese government tackle in the coming year? One of the things I would advocate is what Professor Lee talked about: reforming the agricultural sector. That is something that needs to be done with more imagination and in a more comprehensive manner. It needs to be handled in basically two ways: improving rural income and, at the same time, enabling big migration to the coastal areas. In agriculture, we have to use science in a serious manner and not just build infrastructure. We need to invest in a new Green Revolution, develop new species of seeds that are specific to the ecology of the region. Right now we don't have that, the poorest areas are the areas with very particular crops. We also need to invest in extension services and in irrigation technology, for example.

Second, we need to improve the rural financial sector. The number of legal financial institutions in rural areas has decreased over time, largely because of the interest rate controls. The cost of making a small loan is almost the same as making a big loan and that is why the banks have been retreating from the countryside to the cities. We need more personalised banking; we need more local banks that are under proper supervision of the central bank.

That brings me back to the earlier point about NPLs, where

one school says recapitalise and privatise. But, actually, if you just privatise, all you do is create private monopolies because we have these agricultural banks dominating the agricultural sector. So my third recommendation would be to open up the legalisation of the banking sector. That is also an exceedingly important issue.”

Part II

China's Role in the Region and in the Global Financial System

6

Chiang Mai and Beyond

Yung Chul Park and Yunjong Wang¹

Before the Asian financial crisis broke out in 1997, few would have seriously argued for the creation of a system of regional financial cooperation in Asia. Only market-led natural economic territories were being formed in East Asia, often cutting across political lines (Scalapino, 1991). However, the financial crisis that erupted in 1997 was a major financial breakdown that gave Asians a strong impetus to search for a regional arrangement that could forestall future crises. For instance, Japan proposed the creation of an Asian Monetary Fund (AMF) as a framework for financial cooperation and policy coordination in the region. A regional monetary fund, it was argued, would provide a means of defense, in addition to the IMF lending facilities, against financial crises in Asia. Although the proposal received a positive response from a number of Asian countries, it was shot down by the objection of the US, EU, and the IMF as well as the lukewarm attitude of a few Asian countries in the region.²

The idea of an AMF was revived when the finance ministers of China, Japan, and South Korea, along with the ten members of the Association of South-East Asian Nations (ASEAN) agreed on May 6, 2000 in Chiang Mai, Thailand to establish a system of swap

¹ Comments by Charles Adams and participants to the conference are gratefully acknowledged.

² See, for an insider's account of the AMF's killing, Eisuke Sakakibara's remarks in: Jan Joost Teunissen and Mark Teunissen (eds.), *Financial Stability and Growth in Emerging Economies: The Role of the Financial Sector*, Fondad, The Hague, 2003, p. 240.

arrangements within the group.³ This regional scheme for financial cooperation – known as the Chiang Mai Initiative (CMI) – is now gathering momentum and opening the doors to possibly significant policy-led integration in East Asia.

Since then, the deputy financial ministers of the thirteen ASEAN+3 countries have negotiated the details of the initiative to produce a basic framework of the ASEAN Swap Arrangement (ASA) and Bilateral Swap Arrangements (BSAs) and repurchase agreement. The framework was approved at the meeting of the deputies on November 7, 2000 in Beijing. A progress report on the CMI was then presented at the summit meeting of the thirteen countries two weeks later.

The CMI swap arrangements have been designed and implemented to provide liquidity support to member countries that experience short-run balance of payment deficits. By preventing an extreme crisis or systemic failure in a country and subsequent regional contagion as occurred in the recent Asian financial crisis, this facility is expected to contribute to financial stability in the region. However, emergency support facilities such as the CMI, which are similar in nature to other regional and international “lender of last resort” facilities, are primarily for systemic purposes and as such would likely be used very infrequently. Since the intent of the CMI is to be proactive, there is a need to define a mutually agreed framework for inter-governmental cooperation amongst the ASEAN+3, that can quickly and effectively implement emergency assistance at required levels when the need arises. Moreover, a group approach would ensure that any conditionality associated with the financial assistance is consistently applied across countries.

Although the adoption and implementation of the CMI could be counted as a major step toward strengthening financial cooperation among the thirteen ASEAN+3 countries, these countries will face much tougher challenges and tasks in exploring developments beyond the CMI. East Asian countries need to clarify to the international community what their motivations are, how they will develop an action plan, and how they believe it fits in with the

³ The ASEAN members are Brunei, Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam. The group of China, Japan, and South Korea, along with the ten members of the ASEAN is known as “ASEAN+3”.

existing global financial system. And furthermore, it remains to be seen whether East Asia can emulate the policy-led economic integration that took place in Europe through this kind of financial cooperation framework.

At present, the CMI does not require a new institution like the proposed AMF, and it is also tightly linked to IMF conditionalities. At this stage of development, East Asians may not be well prepared to negotiate an international agreement that includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly.⁴ In this regard, the CMI and its follow-up implementation are acceptable to many detractors of a regional monetary fund. At the most elementary stage of zero institutional integration, the moral hazard problem associated with mutual liquidity provisions can be addressed by the linkage of the CMI with IMF conditionalities (Wang and Woo, 2002). As long as the CMI is simply a source of financial resources supplementary to the IMF, the size of the swap borrowing does not have to be sufficient to meet potential needs, because members can always rely on the deep pocket of financial resources provided by the IMF (Wang, 2001).

Under the CMI framework, East Asian countries have not yet specified common policy objectives toward economic integration. Joint efforts for crisis prevention in the region are rather ambiguous as a policy objective toward promoting economic integration in the region. In this regard, the CMI lies between cooperation and coordination, but is closer to cooperation on the spectrum of economic integration. Two main components are being implemented under the ASEAN+3 framework. One is a regional financial facility under the CMI, while the other is the development of a regional surveillance and policy dialogue mechanism to complement the CMI. However, neither of these components has yet been com-

⁴ For instance, the ASEAN surveillance process is built on the basis of consensus and informality in keeping with the tradition of non-interference (Manzano, 2001). East Asia, in contrast to Europe, lacks the tradition of integrationist thinking and the web of interlocking agreements that encourage monetary and financial cooperation (Eichengreen and Bayoumi, 1999). Eichengreen and Bayoumi (1999) stress that East Asia does not meet the necessary intellectual preconditions for regional integration. For this reason, they conclude that it is unrealistic to speak of pooling national sovereignties. While there is no doubt considerable work to be done in promoting policy coordination in the region, it is wrong to say that it cannot be done in East Asia.

pleted and many members feel they are still in need of significant amendments. The BSA under the CMI will be reviewed in 2004. At that time, the ASEAN+3 may decide to maintain, amend or abolish the current arrangements. The various modalities of a regional surveillance mechanism are now under discussion, but it is highly unlikely that an effective surveillance mechanism will be put in place any time soon.

The purpose of this paper is to provide a view on the current process and future prospects for regional financial and monetary cooperation in East Asia. Looking forward, financial cooperation in East Asia will be evolutionary. For over a half century, European countries worked hard to develop various institutional frameworks which encouraged their cooperation on monetary and financial matters. If the European experience is any guide, it may take many years to develop effective cooperative arrangements and institutions in East Asia. However, some observers note that East Asia may be on the brink of a historical evolution, as Europe was half a century ago (Bergsten, 2000; Dieter, 2000). When the regional group agrees on deepening regional integration through financial and monetary cooperation, it remains to be seen whether East Asia can successfully emulate the European integration process through solid institution building.

The remainder of this paper is organised as follows. Section 1 provides an overview of the current structure of the CMI and discusses a number of its pitfalls. Section 2 explores the issues related to the creation of a monitoring and surveillance mechanism. Section 3 addresses major barriers to financial cooperation and integration. Finally, Section 4 concludes with a discussion of the future prospects for financial and monetary cooperation in the region.

1 Overview of the Chiang Mai Initiative (CMI)

The Chiang Mai Initiative (CMI) has two components: (i) an expanded ASEAN Swap Arrangement (hereafter ASA) encompassing the ten ASEAN countries; and (ii) a network of Bilateral Swap Arrangements (hereafter BSA) and repurchase arrangements basically encompassing the thirteen ASEAN+3 countries.

In 1977, the five original ASEAN countries – Indonesia, Malaysia, Philippines, Singapore, and Thailand – agreed to establish

the ASA in pursuit of their common objective of promoting financial cooperation. Since then, the ASA has been renewed several times, but it has remained a very primitive financial arrangement, mainly due to the loose financial cooperation in ASEAN. The utilisation was very low. Even during the Asian financial crisis, countries did not turn to the ASA.

An expanded ASA became effective in November 2000 to include the five new members of ASEAN, and the total amount of the facility was raised to \$1 billion from the initial amount of \$200 million. The currencies available under the ASA are the US dollar, yen, and euro. The euro, yen and Euro LIBOR interest rates are used as the base rates for swap transactions. Each member is allowed to draw from the facility a maximum of twice its committed amount for a period not exceeding six months, subject to an extension for another period not exceeding six months.

A major drawback of the ASA stems from the “equal partnership” condition, which stipulates that the amount to be granted to a swap-requesting member country shall be provided by the other member countries in equal shares. In addition, a participant may refrain from providing the committed lending by merely informing the other member countries of its decision, and may, at its discretion, provide reasons for the decision. Under such circumstances, other participants, on a voluntary basis, can increase their shares. If the total amount of swap committed collectively by the participants does not sufficiently meet the requested amount, the amount of swap granted is to be reduced accordingly. Considering these conditions, the ASA would not help much to minimise the disruption caused by a financial meltdown in the event that massive scale liquidity provisions are required.

If ASEAN members fail to find a country to contribute a meaningful amount of credit, they will have to link the ASA to global liquidity facilities provided by the IMF or other regional facilities. The ASA could be further expanded to encompass the three North-East Asian countries – China, Japan, and South Korea. However, as long as the two problems of disproportionate contribution obligations and non-compulsory commitments remain unsolved, the effectiveness of the ASA may be seriously undermined. Major revisions should be undertaken to secure the firm commitment of participating countries and enlarged contributions. Alternatively, the second component of the CMI – the network of

BSA – could be a useful source of complementary financial resources.

The BSA is a facility that provides short-term liquidity assistance in the form of swaps of US dollars with the domestic currencies of participating countries.⁵ The maximum amount that can be drawn under each BSA is to be determined through bilateral negotiations. However, disbursements to a member in need of liquidity assistance are expected to be made in a concerted manner through consultation among the swap-providing countries with one of the swap-providing countries serving as the coordinator for the consulting process. The BSA allows a disbursement of up to ten percent of the maximum amount of drawing without an agreement, or even a prospective agreement, with the IMF. Such a disbursement would represent “short-term liquidity support”, and would be renewable only once, and thus repayable within six months of the original transaction. However, countries drawing more than the ten percent are required to accept an IMF programme of macroeconomic and structural adjustments. In this sense, the BSA is complementary to the IMF’s financial assistance.

A number of the participating countries have expressed reservations about the linkage of the BSA with IMF conditionalities and have proposed to increase gradually the ten percent limit on independent disbursements and also abolish the IMF linkage after a period of transition. For instance, Malaysia advocates complete independence of the CMI from the IMF. Severance of the IMF linkage requires the creation of a regional surveillance mechanism for the CMI. At the fifth ASEAN finance ministers’ meeting in April 2001 in Kuala Lumpur, however, there was consensus that the BSA should remain complementary and supplementary to the IMF facilities until a regional surveillance system is established. The ASEAN ministers also agreed that “the terms and modalities of the BSA should take into account the different economic fundamentals, specific circumstances, and financing needs of individual countries”. This agreement implies that the contracting parties of the BSA could deviate from the basic framework on setting terms and conditions of the swap agreements.

Participating countries are able to draw from the BSA for a

⁵ The one exception is the Japan-China BSA, which would swap yen for renminbi.

period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first and first renewal drawings. Thereafter, the premium is increased by an additional 50 basis points for every two renewals, but not exceeding 300 basis points.

A repurchase agreement was also established to provide short-term liquidity to a participating member through the sale and buyback of appropriate securities. Securities of the repurchase agreement are US Treasury notes or bills with a remaining maturity of not more than five years and government securities of the counterparty country. The period of the repurchase agreement is one week, but could be extended on the termination value date by agreement between the contracting parties. The minimum amount for each transaction requested is five percent of the total amount of the repurchase agreement. In each transaction, the buyer is given a margin of 102 percent for US Treasury notes or bills and 105 percent for government securities of the counterparty country. At the inception of the CMI, the participating countries considered expanding these facilities through bilateral negotiations between the contracting parties. However, no new repurchase agreements have been made since the Chiang Mai meeting. Instead, ASEAN+3 governments have focused on negotiating and concluding BSAs.

Since the ASEAN+3 summit meeting in November 2000, Japan, China, and South Korea have been negotiating BSAs with each other and with the ASEAN countries. Japan has been most active: it has concluded six agreements with China, South Korea, Indonesia, Malaysia, the Philippines and Thailand, and is currently negotiating an agreement with Singapore. Korea also concluded four agreements with China, Malaysia, the Philippines and Thailand in addition to the Japan-Korea BSA. Similarly, China also concluded three agreements with Malaysia, the Philippines and Thailand in addition to its agreements with Japan and Korea.

From the beginning, Singapore and Brunei have shown little enthusiasm for the CMI, largely because they believe the BSAs with their neighbouring countries will be one-way arrangements in which they will be asked to provide a large amount of liquidity in case of a crisis affecting the ASEAN region. However, Japan has made progress in bringing Singapore to the negotiating table by proposing a BSA that uses local currencies rather than the US dollar. In fact, Japan has concluded a similar local-currency BSA with China.

Indonesia has not shown any strong interest in negotiating BSA arrangements because of its preoccupation with domestic economic issues and the management of its huge foreign debts, not to mention escalating political instability. Recently, Indonesia has concluded a BSA with Japan, though it does not appear to place a high priority on contracting additional BSAs with other members of the CMI.

At present, the total amount of BSAs covering all thirteen countries is estimated to be around \$32 billion (see Table 1). The maximum amount any individual country can draw varies a great deal. In the case of Thailand, the maximum is about \$6 billion. Given such a relatively small amount of liquidity available through the CMI, doubts have been raised as to whether the BSA system could truly be a credible and effective system of defense against future speculative attacks. Participants of international financial markets are not likely to be impressed with the amount of liquidity available and hence ignore the CMI, unless the ASEAN+3 are prepared to increase the number of BSAs and expand the swap amount of each BSA. However, financial significance does not matter as long as the CMI maintains the linkage with the IMF. If the CMI goes beyond its supplementary role to the IMF by establishing a regional fund and seeking independent conditionalities, then its financial position will have to be significantly enlarged so it can effectively prevent financial crises in the region.

In comparison with the European facilities, the CMI has had a different motivation from the outset. The European facilities were created with the purpose of limiting exchange rate fluctuations under a coordinated exchange rate mechanism. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained relatively fixed exchange rate regimes. Even now, the CMI does not presume any manifest exchange rate coordination.

2 Creation of Monitoring and Surveillance System

From the inception of the CMI, some member countries have opposed the idea of linking the CMI with the IMF programme. Other members, in particular Japan and China, have argued for the importance of forging a cooperative relation with the IMF at an early stage of CMI development to enhance its credibility. They

Table 1 Progress on the Chiang Mai Initiative
(in billions of dollars, as of March 31, 2003)

BSA	Currencies	Conclusion Dates	Size
Japan-Korea	\$/Won	4 July 2001	\$7 billion*
Japan-Thailand	\$/Baht	30 July 2001	\$3 billion
Japan-Philippines	\$/Peso	27 August 2001	\$3 billion
Japan-Malaysia	\$/Ringgit	5 October 2001	\$3.5 billion*
Japan-PRC	Yen/Renmimbi	28 March 2002	\$3 billion
Japan-Indonesia	\$/Rupiah	17 February 2003	\$3 billion
Korea-PRC	Won/Renmimbi	24 June 2002	\$2 billion
Korea-Thailand	\$/local currency	25 June 2002	\$1 billion
Korea-Malaysia	\$/local currency	26 July 2002	\$1 billion
Korea-Philippines	\$/local currency	9 August 2002	\$1 billion
PRC-Thailand	\$/Baht	6 December 2001	\$2 billion
PRC-Malaysia	\$/Ringgit	9 October 2002	\$2 billion
PRC-Philippines	\$/Peso	Negotiation completed	\$2 billion
Japan-Singapore		Under negotiation	

Notes:

BSA = Bilateral Swap Arrangement; PRC = People's Republic of China; and, Korea = Republic of Korea

* The US dollar amounts include the amounts committed under the New Miyazawa Initiative: \$5 billion for Korea and \$2.5 billion for Malaysia.

have succeeded in persuading Malaysia and other opposing members to accept the linkage of the BSAs with the IMF conditionality as a temporary scheme until a formal surveillance mechanism is put in place. Malaysia agreed to the IMF linkage with the condition of establishing a study group to examine the types of monitoring and surveillance systems the CMI would require to function as an independent regional financial arrangement.

Most participating countries agree in principle that the CMI needs to be supported by a surveillance system that (i) monitors economic developments in the region, (ii) serves as an institutional framework for policy dialogue and coordination among the members, and (iii) imposes structural and policy reform on the countries drawing from the BSAs. The ASEAN+3 finance ministers agreed to organise a study group to produce a blueprint for an effective mechanism of policy dialogues and economic reviews for the CMI operations at the ADB annual meeting in Honolulu on May 9, 2001. Japan and Malaysia were chosen to co-chair the group. The study group met in Kuala Lumpur on November 22, 2001 to

discuss the report on possible modalities of surveillance prepared by Bank Negara Malaysia and Japan's Ministry of Finance. However, the member countries could not reach an agreement on the surveillance issues, agreeing only to institutionalising the ASEAN+3 meetings of deputies for informal policy reviews and dialogues. At this stage of development of the CMI, many countries feel uncomfortable about creating an independent regional monitoring and surveillance unit as part of the CMI.

In the long run, however, the participating countries are likely to wean themselves from their reliance on the IMF. If the CMI develops into an independent regional financial arrangement from the IMF, the architect of the CMI will have to decide whether the arrangement could be supported by a surveillance mechanism based on peer reviews and pressure instead of formal policy conditionalities. In our view, economic policy dialogues and peer monitoring may not provide an institutional framework that can minimise the moral hazard problem. In this regard, it is worthwhile to distinguish conceptually two different types of moral hazards in conjunction with regional financial arrangements and related surveillance processes. One is related to liquidity assistance, while the other is related to collective actions required for common policy objectives. Peer pressure may not be effective in rectifying the moral hazard related to liquidity assistance and may have to be supplemented by surveillance and conditionalities attached to the liquidity provision. If the CMI develops into more or less an independent financial arrangement from the IMF, then the regional financial arrangement should be designed to discipline the borrowers to adhere to sound macroeconomic and financial policies by imposing conditionalities.

On the other hand, peer pressure may be an effective means of achieving the objective of economic policy coordination among members. The surveillance and policy coordination may have a double-decker structure in policy formation and implementation. Under the European Monetary Union (EMU), only specific common policies such as monetary and exchange rate policies are binding at the Community level, while economic policies such as budgetary and structural policies largely remain under the national sovereignty of member countries. In the European Union, the framework of broad economic policy guidelines provides a basis for policy coordination. This structured surveillance process has

contributed to assessing the consistency of each member country's economic policies. The ASEAN+3 countries at the current stage do not seem well prepared for establishing a policy coordination mechanism in the surveillance process. In the case of European integration, a more effective and structured surveillance process started only when the European countries sought monetary integration in the 1990s (Wang and Yoon, 2002). The long history of European surveillance shows that an effective surveillance process cannot be achieved overnight but needs many years of constant interaction and mutual trust building. Thus, it will take more time for the ASEAN+3 countries to establish more comprehensive and structured surveillance systems like those under the EMU.

3 Barriers to Financial Cooperation and Integration

East Asian policymakers who conceived the idea of the CMI would easily concede that the BSA system as it is currently structured has a long way to go before it can be accepted as an effective mechanism of defense against financial crises. Although two years have passed since the system was established in May 2000, the leaders of the CMI group have yet to produce an operational structure for BSAs, in particular a monitoring and surveillance mechanism. And it is highly unlikely that they will do so any time soon.

In the absence of a clear vision on the scope and modality of financial cooperation through the CMI, many financial market experts have expressed doubts about whether any country facing an incipient crisis could draw from the BSAs, and if they could, how much liquidity would be available. Technically speaking, swap-providing countries could refuse any support even within the ten percent drawing which is not linked to the IMF conditionality. Because this ten percent of swap can be disbursed only with the consent of swap-providing countries, these countries need to formulate their own assessments about the swap-requesting country. At present, the practices under the ASEAN+3 process cannot effectively identify emerging problems. In this regard, an independent surveillance unit as a standing secretariat to support the CMI operation must be immediately established. However, most participating countries seem to prefer a gradual approach by avoiding institutionalisation of the procedures. Negotiations for

additional BSAs and also the surveillance system may continue, but unless the deadlock over some of the pending issues on surveillance is broken, the future prospects of the CMI do not seem promising.

There are many economic, institutional, and political barriers to financial cooperation and integration in East Asia. A large number of empirical studies have shown that although the ASEAN+3 countries by no means constitute an ideal group for an optimum currency area, they are as qualified for a common currency as the members of the European Union were in the 1970s and 1980s.⁶ These studies invariably point to a large increase in intra-regional trade in East Asia in recent years as a development conducive to the region's financial and monetary integration (see Table 2). Trade and investment liberalisation has been the driving force behind much of the increase in intra-regional trade. This increase, in turn, has had the effect of synchronising business cycles across East Asian countries, thereby producing economic conditions favourable for a currency union in the region.⁷

Against these trade and macroeconomic developments, financial deregulation and market opening have drawn East Asia away from regional financial integration. Financial liberalisation throughout East Asia has caused many countries to establish closer linkages with international financial markets, but not with other country markets in the region. There is no clear evidence that the financial markets of the East Asian countries are more regionally integrated. The financial markets of the European countries that maintained capital controls were much more integrated in the 1970s and 1980s than the markets of East Asian countries are at present.⁸ This difference suggests that financial market liberalisation and opening may not speed up economic integration in East Asia (Park, 2002).

⁶ See Eichengreen and Bayoumi (1999), Baek and Song (2002) and Lee, Park and Shin (2002).

⁷ From the theoretical point of view, trade integration can lead to business cycle synchronisation in either direction – convergence or divergence. However, using the data of East Asian countries, various researches provide evidence that economic fluctuations are more synchronised as trade interdependence deepens in the region. See Choe (2001) and Loayza, Lopez and Ubide (2001). Based on a panel regression, Shin and Wang (2003) find that intra-industry trade is the major channel through which business cycles in East Asia become synchronised, although increased trade itself does not necessarily lead to close business cycle coherence.

Table 2 Trends of Intra-Regional Trade in East Asia and Europe
(in percentages of total trade)

	1980	1990	2000
<i>East Asia</i>			
China	42.4	58.9	48.7
Hong Kong	46.7	60.4	64.1
Indonesia	62.6	56.8	54.4
Japan	23.8	28.0	38.1
Korea	32.7	34.2	42.2
Malaysia	49.2	55.1	56.1
Philippines	37.4	40.0	46.5
Singapore	49.4	50.7	57.5
Taiwan	34.9	43.1	50.9
Thailand	40.1	47.5	54.2
<i>Average</i>	<i>41.9</i>	<i>47.5</i>	<i>51.3</i>
<i>Europe</i>			
Austria	69.8	75.6	71.0
Belgium	74.9	80.4	72.5
Denmark	74.4	75.5	74.8
Finland	57.4	66.6	61.7
France	57.8	67.1	66.7
Germany	63.9	67.4	59.1
Greece	48.2	70.1	56.1
Ireland	77.6	76.1	61.3
Italy	56.1	67.3	59.1
Netherlands	70.5	77.0	67.3
Norway	78.6	75.2	73.7
Portugal	58.7	78.5	78.6
Spain	43.2	68.2	67.8
Sweden	73.8	78.9	68.4
Switzerland	69.0	72.1	66.9
United Kingdom	55.8	62.8	57.0
<i>Average</i>	<i>64.4</i>	<i>72.4</i>	<i>66.4</i>

Note:

This table is Table 4 in Lee, Park and Shin (2002). Intra-regional trade is measured by the share of an economy's trade with the rest of the economies that belong to the same region, in total trade.

Source: International Monetary Fund, Direction of Trade Statistics.

⁸ Free capital mobility was not allowed until the last stage of currency unification in Europe. This is because the conflict between exchange rate stability and the active use of monetary policy was reconciled through internal and external financial repression. As Europe has liberalised its capital account, such a formal coordinated (fixed but adjustable) exchange rate mechanism was greatly endangered by volatile capital movements. When capital controls were lifted, currency union was preferred to maintaining national monetary policies. See Wyplosz (2001) for more details.

Financial claims are all denominated in US dollars and the bulk of foreign lending and borrowing is intermediated through international financial markets in New York and London. As far as finance is concerned, therefore, gains from adopting a common currency in terms of lower transaction costs and foreign exchange risks may not be as large as they could be when regional financial markets are integrated. In particular, Singapore and Hong Kong, as regional financial centres, could lose a substantial portion of their income from the financial services industry.

As for institutional and political constraints on further expansion of the CMI, the most serious one has been that the thirteen countries have failed to articulate the ultimate objectives of the CMI arrangement. The participating countries themselves are still unclear about whether the CMI is going to be fostered as a regional liquidity support programme or as a building block for a full-fledged regional monetary system in East Asia. If bilateral swap arrangements are activated collectively and supported by a surveillance system, then they constitute a *de facto* regional monetary fund. The CMI could then be used as the base on which an elaborate system of financial cooperation and policy coordination is built by following in the footsteps of the European monetary integration.⁹ At this stage of development, many countries in East Asia are not prepared to accept the idea of or may feel uneasy about restructuring the CMI into a forerunner of the AMF.

A second institutional constraint is related to the need to coordinate the activities of the CMI with other regional arrangements such as the Manila Framework supported by the US, Australia, and New Zealand. Most of the CMI countries also participate in the Manila Framework and APEC. At some point in the future, the leaders of the ASEAN+3 countries may have to decide on the mode of cooperation and division of labour in promoting regional growth and stability between these institutions and the CMI. All thirteen countries have been engaged in

⁹ From the theoretical point of the neo-functionalists, initial steps toward integration trigger self-sustaining economic and political dynamics leading to further cooperation. Economic interactions create spillovers or externalities that need to be coordinated by governments involved. Such economic policy coordination at the regional level can be seen as an inevitable response to the increased economic interactions within the region. Once the integration process starts, spillovers deepens and widens integration by working through interest group pressures, public opinion, elite socialisation or other domestic actors and process (George, 1985).

policy reviews and dialogues through the various APEC meetings and the Manila Framework. Unless the CMI is developed into a credible financing mechanism by increasing swap amounts, it will take on a role similar to other regional economic forums. The coherence of the group will then be weakened, as questions are raised as to whether the thirteen countries constitute an appropriate grouping for a regional financing arrangement in East Asia.

A third hindering factor is that the fear of another round of financial crisis has receded with a recovery that has been faster than predicted on the basis of previous episodes of crises. With the speedy recovery, the ASEAN+3 countries have become less interested in enlarging and institutionalising the CMI operations. Instead, their focus has recently shifted to creating free trade areas in East Asia (see Table 3). The ASEAN states have already agreed to establish a free trade area among them. Japan has concluded a free trade agreement with Singapore and proposed negotiations on a similar agreement with Korea. China has announced its interest in negotiating free trade with the ASEAN and other neighbouring countries.

The free trade movement is undoubtedly a desirable development, and the CMI could facilitate further liberalisation of trade by stabilising bilateral exchange rates of regional currencies and minimising the disruptive effects of financial market turbulence. This advantage suggests that the ASEAN+3 countries may have an incentive to broaden the scope of the CMI in parallel with negotiations on establishing free trade areas in the region. In reality, however, it appears that free trade discussions have rather distracted many East Asian countries from their CMI negotiations.

Finally, there is the leadership issue that defies an easy solution. If the thirteen countries have a more ambitious goal of developing a collective exchange rate mechanism similar to the ERM in Europe with the long-term objective of adopting a common currency, they will have to increase the number and amounts of the BSAs. As the European experience shows, such an extension requires leadership that can foster coherence among the thirteen countries by mediating between the divergent interests of the members.

China and Japan are expected to provide leadership in forging regional consensus for expanding and consolidating the BSAs as a regional institution, but they have not been able to agree on a number of operational issues including the surveillance mechanism. Except for Japan, no other potential swap lenders including China

Table 3 Free Trade Agreements in East Asia

	Year	Participants and Status
<i>FTA in Force</i>		
ASEAN Free Trade Area (AFTA)	1992	10 ASEAN members
Australia-New Zealand Closer Economic Relations Trade Agreement (CER)	1983	Australia, New Zealand
Singapore-New Zealand FTA	2001	Effective in January
Japan-Singapore Economic Partnership Agreement (JSEPA)	2002	Effective in November
Singapore-EFTA (European Free Trade Association) FTA	2002	Signed in June and effective in January 2003
Korea-Chile FTA	2003	Signed in February
<i>Agreements Being Negotiated, Studied, or Considered</i>		
East Asia Free Trade Area (EAFTA)	2000	Proposed at the ASEAN+3 summit meeting
China-Japan-Korea FTA	2000	Chinese Premier Zhu Rongji proposed during the ASEAN+3 summit meeting
ASEAN-China Free Trade Area (ACFTA)	2001	Realisation by 2010 (Framework Agreement signed in 2002)
Japan-ASEAN Closer Economic Partnership	2002	Realisation within ten years agreed to at an ASEAN-Japan Summit meeting
ASEAN-India Regional Trade and Investment Agreement	2002	Consideration of an agreement agreed to at the ASEAN-India summit meeting
<i>Bilateral FTA Under Consideration</i>		
China		Hong Kong SAR, Macao SAR
Japan		Mexico, Philippines, Korea, Thailand
Korea		Japan, Mexico, Thailand, ASEAN
Singapore		Australia, Canada, Mexico, United States
Thailand		Australia, India, Japan

Source: Wei (2003) and various other sources.

are prepared to increase the amounts of their bilateral swaps with other contracting parties. Japan could increase its swap amounts with the ASEAN states and Korea (under the presumption that China will not borrow from Japan) to make the CMI a more credible financing scheme. However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are not likely to lead an expansion and institutionalisation of the CMI. As a minimum condition for expansion of the CMI, Japan would demand the creation of an effective surveillance mechanism for the region in which it can exercise influence commensurate with its financial contribution. However, China may feel that it cannot play the second fiddle to Japan in any regional organisation in East Asia. This concern appears to be the most serious roadblock to further development of the CMI.

China and Japan have different interests and hence different strategies for economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN ten members, South Asian and Central Asian countries may be more important both economically and geo-politically than financial cooperation or free trade with either Japan or South Korea. While China is a super military power in the world, it is still a developing economy with a huge gap to narrow in terms of technological and industrial sophistication vis-à-vis Japan. Although China has been growing rapidly, it has a long way to go before catching up with Japan. These differences in the economic and military status of the two countries suggest that, even if they manage to reconcile their troubled memories of the past, China and Japan may find it difficult to work together as equal partners for regional integration in East Asia.¹⁰

¹⁰ France and Germany also had a wartime legacy. Although de Gaulle's nationalism was generally popular within the country, he also appreciated that membership of the common market would benefit France economically. However, de Gaulle remained implacably opposed to any increase in the powers of the European Commission, or to any other increase in supranationalism. He showed just how opposed he was in 1965, when he precipitated the most dramatic crisis in the history of the European Community (George, 1985). It was German Chancellor Helmut Schmidt and French President Giscard d'Estaing that accelerated the stalled integration process at the end of the 1970s. The joint initiative of Chancellor Helmut Kohl and President François Mitterand resulted in a great leap towards EMU in the beginning of the 1990s. The Franco-German alliance formed the core for the integration process in Europe, as it was the political will of these two countries that motivated further integration.

China borders Russia and many of the South Asian and Central Asian countries in addition to several ASEAN members. Therefore, it is natural for China to seek expansion and deepening of its trade and financial relations with those neighbouring countries. In fact, for this reason, China has been courting ASEAN for a free trade agreement and joined in November 2001 the Bangkok agreement on a free trade area that includes Russia and the South Asian countries. China has also taken a leading role in establishing the Shanghai Cooperation Organisation, a cooperative arrangement between Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan and China.¹¹

In contrast, Japan has not been able to articulate its strategic interests in East Asia. While Japan has been at the forefront in supporting greater economic cooperation among the East Asian countries, its perspective on the geographical contiguity of East Asia has not been altogether clear. Japan has been promoting integration among the “ASEAN+5”, but which are the two countries added to ASEAN+3? At times, the five countries are stated as China, Japan, Korea, Australia, and New Zealand, and at other times Taiwan and Hong Kong replace Australia and New Zealand.

There is also the suspicion that Japan is not interested in free trade and financial arrangements *per se* in East Asia for purely economic reasons. Instead, Japan is engaged in the discussion of those regional arrangements with other East Asian countries to maintain its leadership role as the region’s largest economy by checking and balancing China’s expansion. Many analysts believe that Japan’s active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position.¹² On top of this suspicion, Japan is perceived to be a country insensitive to and unwilling to resolve wartime legacies and disputes on historical and territorial claims. Japan has also been

¹¹ In June 2001, the presidents of five countries signed the Declaration of the Shanghai Cooperation Organisation (SCO). The SCO aims at strengthening mutual trust and friendly relations among member states, encouraging their further effective cooperation in politics, economy, science and technology, culture, education, energy, transportation, environmental protection and other fields, jointly ensuring regional peace, security and stability, and creating a new international political and economic order.

¹² See David Wall, “Koizumi Trade Pitch Nests”, In: *Japan Times*, April 21, 2002.

gripped with a decade long recession and inability to restructure its economy.¹³ These developments combined with its lack of a strategy for East Asian development seem to undermine Japan's capacity to pull East Asian countries together for regional cooperation and integration.

4 Future Prospects

What are then the likely courses of development of the CMI? How would regional financial integration proceed in East Asia? One possible scenario is that China and Japan will come to realise that despite the differences in their strategies, the consolidation of the CMI group would serve their interests. This realisation could soften their positions to compromise on an institutional setting and augmentation of the existing BSAs. For instance, China may accept Japan's demand for *de facto* control over monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it is confident about concluding a free trade agreement with the ASEAN members in the near future. China's free trade pact with ASEAN could circumscribe Japan's influence on ASEAN affairs even if Japan is a major provider of financial resources to the region.¹⁴

Another scenario focuses on the possibility of China assuming a more aggressive leadership role in regional integration. In view of the uncertain prospects of the Japanese economy, China could emerge as the region's engine of growth over the longer term if it sustains its growth. Given the envisaged leadership role, China may choose to negotiate both the expansions of the BSAs and a free trade

¹³ Uncertain economic prospects may make Japan unlikely to be the driver in the region's integration movement as it was in the past. China is emerging both as a strong competitor and as a promising market.

¹⁴ The dramatic declines in Japanese equity and commercial prices in the early 1990s put strong downward pressures on the capital positions of Japanese banks. In responding to these domestic shocks, Japanese banks have reduced overseas lending (Peek and Rosengren, 1998; 2000). In particular, Japanese banks repatriated most of their funds during the crisis; Japanese banks withdrew \$38 billion in the six quarters from mid-June 1997 to the end of December 1998 (de Brouwer, 2001).

pact with ASEAN. In this case, the original CMI would become “ASEAN+1” in the sense that Japan could play the second fiddle. Realising that financial integration is an integral part of a successful free trade area, China may indeed seriously consider this option. However, without Japan, ASEAN+1 will not be a viable arrangement for a regional financing scheme simply because China is hardly in a position to commit itself to financing the balance of payments deficits of all ASEAN member states. It is also questionable whether ASEAN will join any regional financial arrangement in which China is the dominant member.

A third scenario is the enlargement of the CMI to include Australia and New Zealand and possibly India from South Asia. This is the route favoured by Japan in the sense that Japan would find it easier to deal with China when there are more countries supporting its strategy. However, many members of ASEAN+3 believe that at this stage forming a critical mass of the CMI should precede any enlargement discussion.¹⁵ Since the enlargement is not likely to increase substantially the availability of short-term financing, most members of ASEAN+3 would not take the third scenario seriously.

Perhaps the most realistic scenario is that the countries participating in the CMI will muddle through, continuously discussing modalities of policy dialogue, the types of the surveillance system the CMI needs, and also augmentation of swap amounts without making any substantial progress. However, a possible breakthrough may come over the next few years as the economic consequences of European monetary unification become better understood. The enlargement of the EU in 2004, when eight Central and East European countries are expected to be admitted, will also have a large impact on the thinking of East Asian policymakers on regionalisation in East Asia. If the members of the European monetary union make a smooth adjustment to the single currency and the EU enlargement proceeds as planned, then these developments will give a strong impetus to East Asian integration.

¹⁵ Kumar (2002) asserts that the five blocs of the Asian regional economy, including Japan, ASEAN, China, India and Korea (JACIK), can form an effective skeleton in terms of management and coherence for the creation of an Asian Economic Community. This approach may be called as “ASEAN+4” in our terminology.

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7

Comment on Yung Chul Park and Yunjong Wang

Charles Adams

Let me begin by thanking the conference organisers – the Forum on Debt and Development (FONDAD), the Korea Institute for International Economic Policy (KIEP) and the School of International and Area Studies (SIAS) – for inviting me to participate in the conference, and comment on this interesting paper by Yung Chul Park and Yunjong Wang (henceforth Park and Wang). The theme chosen for the conference is a very timely and important one and the organisers are to be congratulated for assembling an impressive range of papers and speakers. Park and Wang’s paper fits nicely into the overall theme of the conference and, at the same time, addresses important issues faced by regional policymakers as they seek to deepen and strengthen regional cooperation.

Park and Wang’s main contribution is to take stock of current efforts to deepen financial cooperation in the region – the ASEAN+3 group and the Chiang Mai Initiative are the most visible manifestations of these efforts – and then assess the prospects for further progress. In the process, the authors outline key features of the Chiang Mai Initiative, consider key outstanding issues of both a technical and political nature, and discuss possible roadmaps for the future. Overall, the assessment reached is a fairly negative one: prospects for significant further progress are judged to be low. In fact, the authors characterise the most likely scenario as one in which participants in the Chiang Mai Initiative continue to

“muddle” through, without coming to substantive agreement on important outstanding issues such as the creation of a formal regional monitoring and surveillance mechanism, modifying the swap arrangements etc. While the reasons for this somewhat negative prognosis are not entirely clear, one is left with the impression – reading between the lines – that the main problems are judged to be a lack of leadership on the part of the largest participants and an associated failure to agree on the ultimate objectives of the exercise (Achievement of monetary union? Stable intra-regional exchange rates? Regional free trade?).

As an outsider who has not been involved in the Chiang Mai Initiative, it is obviously difficult to comment on many of the specific issues that have arisen in the efforts to implement and build upon the initiative. The authors’ analysis, however, seems consistent with many other researchers who have written about the initiative and with what one hears “in the corridors” from participants in the process. Having said this, however, one of the main reasons the authors seem unusually negative about the prospects for Chiang Mai is that they are clearly quite ambitious in their assessment of what could and should be accomplished in a short period of time. A contrarian view – maybe this is a case of a glass being half full rather than half empty – would be that deepening financial cooperation will necessarily take time, and that what is important is that efforts are being made, mechanisms for regional dialogue are being developed, the appropriate financial arrangements for the region are being actively discussed, and countries are starting to undertake peer reviews etc. of their policies. If, like me, one subscribes to this more optimistic view then it may not matter too much if reaching agreement on the “big” issues (such as the ultimate objective of the exercise) or on some of the “smaller” issues (such as the precise regional surveillance mechanism) is taking a long time. What matters is that key issues and options are being discussed.

Against this background, let me say something about one of the key arguments of the paper, namely, that further progress on the Chiang Mai Initiative will depend importantly on the two largest participants, Japan and China, reaching an understanding of their respective roles, and there being agreement on the ultimate objectives of the exercise. While I concur with this assessment, the two main scenarios the authors lay out for the possible roles of these countries did not seem to me to be very plausible.

Let me briefly summarise the two main scenarios. According to one scenario, Japan and China (implicitly or explicitly) agree on a division of labour in the area of regional cooperation. In particular, Japan would take the lead in providing regional financing and setting up a regional surveillance mechanism while China would focus on negotiating bilateral and regional free trade agreements in the region, notably with ASEAN and its members. According to the second scenario, China would assume a dominant role in both regional financing arrangements and the promotion of regional trade, with Japan playing a much less important role in both areas.

As I am not a political scientist, I would not want to try to delve very much into the political assessments underlying the two scenarios. I would simply note, however, that neither seems very likely on economic grounds since both go to “corner points” with regard to the role of either Japan or China, and neither is therefore in the cooperative spirit of Chiang Mai. Moreover, both scenarios seem to imply that the key issue is how some – or all – of the “plus 3 group” of countries will interact with ASEAN as a group rather than among themselves. It is too early, in my view, to exclude the possibility of mutually beneficial cooperation within ASEAN+3, with both Japan, Korea and China, together with ASEAN, agreeing on mutually beneficial arrangements. Nevertheless, casting the issues in the stark terms used by the authors is useful in underscoring that Japan and China may have different interests regarding the future of regional cooperation and that finding common ground will be important in determining the evolution of Chiang Mai.

Thinking about the issues in these terms also raises the possibility that the factors driving regional cooperation in the future may be different than in the past. In particular, there is the possibility that the overall emphasis may shift in the next few years towards supporting the promotion of free trade and investment in the region and developing the financing and other arrangements that best support such an objective. Indeed, in looking back at the factors that were initially important in the Chiang Mai Initiative, the “driver” that clearly stands out is the very negative experience in the Asian financial crisis, along with the view that self-help mechanisms are needed at the regional level to help avoid and forestall future crises. Accordingly, the emphasis in ASEAN+3 initially was on setting up a regional financing mechanism and strengthening

regional monitoring and surveillance, with crisis prevention and management as the ultimate objectives. (Relatedly, of course, there has also been interest in promoting local and regional bond markets with a view to helping avoid the currency and maturity mismatches that contributed importantly to the severity of the 1997-98 crisis. Regional solutions have also been supported by important reforms at the country level to help strengthen financial systems and lower external vulnerability).

While crisis prevention will no doubt remain important as the Chiang Mai Initiative evolves, the emergence of China as a major player in the global trading system and the associated growth of intra-regional trade may also tend to shift the emphasis in the initiative. In particular, more attention might in the future be paid to promoting trade and investment in the region and to seeking to minimise disruptions to inter-regional trade that could result from financial problems or instability in one country spilling over to other countries. If I interpret Yung Chul Park's oral remarks correctly, this is what he has in mind when he refers to "new" issues associated with China's emerging role in the region, that might lead either to a change in focus in Chiang Mai or to a strengthening of the case for certain types of financial cooperation.

If issues associated with China's emergence do become more important, it certainly seems plausible that there might be a broadening of the agenda addressed by ASEAN+3 and consideration of complementary – and appropriately sequenced – means to deepen both financial and trade cooperation. If this occurs, I would conjecture that the efforts would continue to be outward rather than inward looking. This would be because the participants in ASEAN+3 have a strong interest in Asia's close integration with the global economy and in helping manage the opportunities and challenges associated with globalisation. In short, regional solutions will likely continue to be seen as a means to strengthen Asia's ability to participate in – and continue to benefit – from globalisation rather than being inward-looking in character. This said, however, it will be important that current efforts to negotiate bilateral and regional free trade agreements – within, among, and beyond ASEAN+3 members – not only be WTO consistent but also do not lead to a patchwork of agreements with different "rules of origin etc.". The reason for this is that a lot of "different" agreements might be difficult to put together into a region-wide free trade

agreement, should there be eventually interest in such an arrangement.

Finally, let me conclude by saying again that I found Park-Wang's paper very stimulating in thinking about the future of the Chiang Mai Initiative. Although I share some of Park-Wang's concerns about the apparent lack of progress in deepening financial cooperation, my sense is that the process will take time and continue to evolve. Far better, in my view, is to spend the necessary time to reach consensus on the "means" and "objectives" of financial cooperation – and the roles of different participants – than to enter into any substantive agreements that may not have widespread support, and might therefore lack credibility or staying power. In addition, it is possible that China's growing importance in the region and the global economy could provide a new impetus for – and lead eventually to broader and stronger – approaches to regional cooperation that more explicitly link the financial and trade dimensions.

8

Global Capital Flows and the Position of China: Structural and Institutional Factors and their Implications

Young Rok Cheong and Geng Xiao

Global capital flows into developing economies have been driven by two fundamental factors: profit opportunities in the emerging economic frontiers and the physical and institutional barriers to international capital mobility. Advancement in transportation and communication technology has greatly reduced the physical costs of cross-border mobility of capital and goods while the spread of global development knowledge has also led to new profit opportunities in less developed economies, such as China.

Since the early 1980s, China has emerged as a major global development frontier, following its open-door policies and economic reforms initiated by Deng Xiaoping. Since that time, the barriers to foreign trade and investment in China have declined steadily, leading to China's accession to the World Trade Organisation in late 2001 – after one-and-a-half decades of tough negotiations. By the end of 2002, only a year after joining the WTO, China overtook the US in FDI inflows, becoming the most attractive FDI destination in the world, receiving \$52.7 billion in FDI.

China's recent dramatic achievement seems to suggest that today's global economy is unprecedented in terms of openness and the amount of foreign capital flows into developing countries.

Unfortunately, this optimistic impression is not confirmed by facts. Foreign capital flows into developing countries today are far below historical record achieved before World War I. The gross value of foreign capital stock in developing countries increased from 8.6% of their GDP in 1870 to a peak of 32.4% in 1914. This ratio dropped to 4.4% in 1950 due to the interruption to the global trade and investment during the war and by 1973, recovered only to 10.9% and 21.7% by 1998 (Maddison 2001, p. 28). Hence, in spite of technological advances during the last century, the world is actually less open for capital flows to less developed countries than one hundred years ago.

Capital flows among developed countries are much freer than between developed and developing countries because of better protection of property rights and less capital control in the developed economies. High capital mobility among developed economies has led to a dramatic change in the holding of net foreign assets among developed countries during the last decade. For example, from 1989 to 1998, Japan's holding of net foreign assets increased from \$294 to \$1.153 billion while the US obligation in net foreign liabilities jumped from \$49 to \$1.537 billion (Maddison 2001, p. 137). Clearly, Japan has exported a substantial amount of capital to the US in search of better risk-adjusted return and in preparation for its aging population, even while the policy environment in Japan, such as the volatility of the exchange rate and the secular appreciation of the yen, is unfavourable to Japanese investment in foreign assets.

In the last decade, foreign direct investment in China increased from about \$3 billion in 1990 to \$52.7 billion in 2002. As impressive as this is, on a per capita basis, China's FDI inflow in 2001 was still below the average of FDI inflows to the rest of developing countries. Per capita FDI inflows in 2001 was only \$37 for China, compared to an average of \$120 for the world and \$42 for all the rest of developing countries.

Foreign invested enterprises in China have contributed to more than half of China's exports. China has been generating current account surpluses for the last nine years. Since current account surplus simply means net savings or net export of capital, China is taking in FDI on the one hand and exporting capital to capital-rich economies like the United States on the other hand. How can we reconcile these seemingly inconsistent patterns of capital flows?

Is China attracting too much FDI? What happened to China's investment in US bonds? What is the impact of foreign portfolio investment on the stability of the Chinese financial markets and other Asian regional markets? Is China generating global deflation? How serious is China's impact on its competitors? Is China saving too much? Should China reevaluate its currency? Is China becoming a growth engine for the world? These are questions we examine in this chapter.

The next section presents the basic facts on the patterns of global capital flows and the position of China. Section 2 explains the uniqueness of China's economic conditions in attracting capital inflows. Section 3 assesses the impact of China's rapid integration into the global economy on the rest of the world. Throughout our analysis, we emphasise structural and institutional factors such as the gaps in development, population structure, and financial and legal institutions and their effects on the patterns of global capital flows and global economic development. Section 4 concludes.

1 Global Capital Flows and the Position of China

In this section, we first summarise the pattern of global trade and foreign direct investment based on the extensive information from the WTO and the World Investment Report of UNCTAD. Then we review global portfolio investment using detailed IMF and US Treasury surveys. Our purpose here is to provide a concise and comparative background to determine China's position in the global capital market.

US Trade Deficits with China and the Asian Region

Global merchandise trade increased from \$124 billion in 1948 to 12.7 trillion in 2000, an increase of more than 100 times over a period of half-century. Western Europe and North America have maintained about 40% and 20% of the global trade respectively throughout this period. Asia's share has risen from about 14% to about 24% at the costs of Latin America, Africa, and other regions.

During the last two decades from 1982 to 2001, the growth rate for global merchandise trade varied from -5.8% in 1982 to 19.5% in 1995, averaging about 6.1% a year. The global trade in commercial

services was relatively stable at a level of about 23% of the merchandise trade (see Table 1.1¹).

In 2000, Asia's share of global exports (at 26.7%) is 3.9% higher than its share of imports (at 22.8%) while North America's share of exports (at 17.1%) is 6.1% lower than its share of imports (at 23.2%) due to exceptional export performance in Japan, Asia's newly industrialising trading economies and China. From 1948 to 2000, Japan increased its share of global export from 0.4% to 7.7% and six Asian traders (see Table 1.2) increased their share from 3% to 10.5%. In the last quarter of the 20th century, China increased its share of global exports from 1.2% in 1983 to 4.3% in 2001, with a strong momentum for further gains of market share in the future (see Table 1.2).

In 2001, the US current account deficit (net capital import) reached \$393.4 billion. On the other side, current account surplus (net capital export) was \$87.8 billion for Japan, \$57.1 billion for the six Asian traders, \$17.4 billion for China, and \$39.6 for transition economies (see Table 4.7). Except for Japan, many countries with a current account surplus (net capital exporters) are not capital-rich economies. In 2000, according to the IMF, the US absorbed 64% of global net capital exports (i.e. the sum of the current account surpluses of the rest of the world).

Who is financing the net capital import to the United States? Table 4.10 shows the exports, imports and balance of goods account for the US in 2002. The US goods deficit, which is the major part of its current account deficit, is as high as \$484 billion. The US goods account deficit is financed by and distributed among the rest of the world: 18% by North America, 18% by Western Europe, 14.5% by Japan, and 21.3% by China. The importance of China in US trade deficits is at the centre of the globalisation debate. Is China taking away jobs from American workers or financing American consumers? Is China generating global deflation? Is China saving too much? Should China reevaluate its currency? We discuss these questions later.

Due to rapid regional integration of production through the so-called supply chain management, China's strong export performance is intimately related to the export activities of its neighbours. This modern management model, pioneered by Hong Kong

¹ All tables and graphs are at the end of this chapter.

entrepreneurs, separates the whole value-added chain into different parts and searches for the best deals in distribution and production among global providers of production and services. This innovation makes our traditional concept of “made-in-China” or “made-in-Japan” much less relevant as many parts of final goods and services are produced or provided by countries other than the one where final goods are exported.

Table 4.9 and Graph 5.2 show the rising US current account deficits with the greater China, including Hong Kong and Taiwan. It is clear that the part of trade deficits attributable to Hong Kong and Taiwan are either declining or stabilising while the part due to China is rising rapidly. This is largely because the production of final goods has been rapidly relocated to China from Hong Kong, Taiwan and other Asian economies over the last decade. But the key components or high value-added parts of the supply chain are still kept in the more developed Asian economies. If this part of the contribution to the production of final goods is excluded, China’s own value added in exports to the US would be very small. This point needs to be remembered as we attempt to assess China’s impact on the world. About two-thirds of China’s FDI is coming from its neighbours such as Hong Kong, Macao, Taiwan, Japan, Singapore and Korea, in part for the purpose of assembling final products to be exported to North America and Europe.

Steady FDI Flows into China

Foreign direct investment is much more volatile than foreign trade, but it is becoming increasingly important in recent decades for both developed and developing countries. The growth rate for global FDI fluctuated widely from 56.7% in 1999 to -50.7% in 2001, averaging about 16.3% in the last two decades. As a result of rapid FDI growth, global FDI flows as a percentage of global merchandise trade increased from about 1.5% in the early 1980s to between 6% and 12% in the last five years. But the scale of global FDI flows is still much smaller than the global service trade, which is about 23% of merchandise trade. At its peak in 2000, global FDI reached \$1.5 trillion, or about 15% of the United States’ GDP (Table 1.1).

Most of global FDI, especially FDI among developed countries, is through mergers and acquisitions (M&A) rather than green-field investment. In 2001, M&A amounted to as much as 80% of global

FDI. Among all the M&A in 2001, 83.5% was conducted in the developed countries, 31.1% in the US alone, and only 5.8% in Asia and the Pacific region.

Developed countries are key hosts of FDI with their share of global FDI at levels ranging from 60% to 80%. At the regional level, North America has been expanding its market share at the costs of European countries although the latter have been picking up in the late 1990.

Graph 5.1 shows the trend since 1979 of FDI inflows to US, China, Asia and the Pacific region, and all developing countries excluding China. The US has been dominating the global FDI inflows with its share ranging from 11.2% or \$19 billion in 1992 to 26% or \$283 billion in 1999. Asia and the Pacific region have increased their market share from 15.2% in 1991 to 24.3% in 1996, but the Asian financial crisis depressed their share to only 9% in 2000.

China's share of global FDI increased from a low base of 1.7% in 1990 to a peak of 13% in 1994. After 1994, China's share of global FDI declined steadily to only 2.7% in 2000 largely due to massive M&A activities in the developed economies during the tech bubble. After the burst of the tech bubble, global FDI dropped 50% in 2001 but China's FDI was growing steadily, contributing to a recovery of China's share in global FDI to 6.4%, which is consistent with its trade expansion to 4.3% of the global export by 2001.

FDI into China has exceeded \$40 billion since 1996 and has been growing steadily every year since 1990. This puts pressure on other developing countries, especially its Asian neighbours. As shown in Table 1.3, the Asia-7, including India, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, and Thailand, with more population than China, only had \$33 billion FDI inflows at their peak year of 1997. After the Asian financial crisis in 1997-1998, the Asia-7's FDI inflows declined dramatically to only \$18 billion by 2001. The Asian financial crisis however did not slow FDI flows into the developing economies as a whole. FDI into developing economies excluding China recorded a steady growth from \$34 billion in 1990 to \$147 billion in 1997, and peaked at \$197 billion in 2000, and then fell to \$158 billion in 2001.

In 2001, per capita FDI inflows are \$120 for the world, \$420 for the developed economies, \$42 for the developing economies excluding China, \$37 for China, and only \$12 for the Asia-7.

Apparently China is winning the competition for FDI inflows and its neighbours are very much concerned about this trend.

Table 1.6 shows inward FDI stocks for selected regions and countries over the period from 1980 to 2001. Global FDI stock increased from \$636 billion in 1980 to \$6258 billion in 2000, an increase of almost ten times. During the same period, the world trade volume only increased about three-folds from \$4 trillion in 1980 to \$12.5 trillion in 2000. This clearly shows the increasing importance of FDI in the world economy and the expanding scope and depth of globalisation.

However, the access to foreign capital is unequal with 5 billion out of a 6.1 billion world population in the developing countries receiving only \$2.1 trillion out of \$6.8 trillion in the FDI stock by 2001. In 2001, per capita FDI stock is \$1,118 for the world, \$3,763 for the developed economies, \$478 for all developing economies excluding China, \$309 for China, and only \$220 for the Asia-7.

The developed economies provided most of the global FDI stock but its share is declining from 95.8% in 1980 to 87.8% in 2001. In the last decade, Hong Kong emerged as a major financial centre for facilitating capital flows into China. Hong Kong's outward FDI stock increased from \$2.3 billion in 1985 to \$375 billion in 2001, exceeding Japan's \$300 billion. In 2001, Hong Kong captured 5.7% of global FDI outward stock, compared with only 4.6% for Japan. A significant part of Hong Kong's outward FDI into China is "round-tripping" Chinese capital, perhaps as much as one-quarter (World Bank, 2002, p. 41).

The pattern of global FDI flows raises a few core questions. Is China attracting too much FDI? Is China hurting its Asian neighbours and competitors? These questions can only be discussed meaningfully after examining many special development conditions in China.

Two-Way Flows in Cross-Border Portfolio Investment

Based on the recent *Global Portfolio Investment Survey* by the IMF (Table 2.1), the derived portfolio investment liabilities for the world in 2001 are \$12.5 trillion, about twice the amount of the global FDI stock and almost equal to the sum of global merchandise exports and imports. The IMF survey is so far the best estimate on the stock of global portfolio investment. Compared to IMF's last survey for

1997, the global portfolio investment stock doubled in only four years. The top three targets for portfolio investment stock are very stable, including the US, UK and Germany, sharing 24.5%, 10%, and 9.2% of the global total respectively. Japan fell from the fourth place in 1997 to the sixth in 2001, now behind France and the Netherlands. Japan's share dropped from 6.5% in 1997 to 4.2% in 2001, reflecting its weakening economy (see Table 2.1).

China made little progress in attracting foreign portfolio investment during 1997 to 2001. The derived amount of foreign portfolio investment in China increased slightly from \$19.3 to \$20.1, reflecting its stagnant "B shares" market, which is a tiny experimental stock market designed for foreign investors with share prices quoted and traded in foreign exchange.

In March 2001, China opened its "B share" market to domestic residents with foreign exchange savings. This opening caused a brief surge in prices and many foreign investors took profits and dumped many shares to domestic residents. At the end of 2002, China announced its plan to allow the Qualified Foreign Institutional Investors (QFII) to invest in its "A share" market designed for domestic investors with RMB savings. The Chinese authorities are also studying actively the mechanism of Qualified Domestic Institutional Investors (QDII), which would allow Chinese residents to invest in overseas securities markets, including Hong Kong markets, where many Chinese companies are listed but their shares cannot be sold to Chinese residents through legal channels. Compared to China's inward FDI stock of \$395 billion, its foreign portfolio investment stock of about \$20 billion is insignificant. However, the potential for foreign investment in China's securities market is bright as its stock market capitalisation is almost the same as that of Hong Kong at \$463 billion at the end of 2002, compared to \$2 trillion in Japan and \$11 trillion in the US. China's financial sector is still underdeveloped and is the major bottleneck for China's sustainable growth and development as will be discussed further in the next section. But with China's commitment to WTO and its recent efforts on modernising its financial regulation and development, it is just a matter of time, perhaps as long as another decade, for China's foreign portfolio investment to catch up with its FDI and foreign trade.

To understand the potential foreign portfolio investment in China, it is useful to take a look at the experiences of China's more developed neighbours. This is possible by examining the bilateral

long-term securities investment data collected and maintained by the US Treasury. Since the US is the largest player as assets and liabilities holder in cross-border portfolio investment, the picture we get from this data set should be illustrative. Some of the findings, such as China's huge investment in US bonds, are not only surprising as new development but also have important implications for building global capital market order.

Graph 6.1 shows the cross-border gross purchases and sales of stocks and bonds between the US and the rest of the world. Clearly the rest of the world traded much more US stocks and bonds than the US traded the rest of the world's stocks and bonds. In the most recent period, the monthly gross purchases of US bonds by the rest of the world are in the range of \$600 to \$800 billion. The monthly gross purchases of US stocks by the rest of the world are in the range of \$200 to \$400 billion. The monthly gross purchases of foreign bonds or stocks by US residents, on the other hand, have never exceeded \$200 billion. A similar pattern can be seen in Graph 6.3 for the cross-border trading of stocks and bonds between the US and Asia. Asia's love with US bonds went back to the 1980s. Asian countries have accumulated large amounts of net holdings of US bonds, led by Japan and followed now by China.

Table 2.2 to 2.5 show the summary trends on cross-border trading of long-term securities between the US and major Asian economies. The transaction data reported monthly are added up to get the annual numbers. The net purchases are derived by subtracting the gross sales from gross purchases. During the ten years from 1988 to 1997, Asia's net purchases of US bonds reached \$415 billion, compared to \$1.447 billion by the rest of the world. In 2001, Asia's net purchases of US bonds were as high as \$147 billion, compared to \$405 billion by the rest of the world. China's net purchases of US bonds in 2001 were as much as Japan's at about \$52 billion. Both Japan and China have increased their net purchases of US bonds after the Asian financial crisis. During the ten years from 1988 to 1997, China's net purchases of US bonds were only 11.5% of the Asia total. But it increased to 23% in 1999, 19% in 2000, and 35.2% in 2001. Given China's \$280 billion official reserves and about \$260 non-official reserves foreign exchange credit in the banking system, China's increased net purchases of US bonds are inevitable. But it is still surprising to know that China's share is as much as 35.2% of the Asia total.

Table 4.8 also shows a summary account of China's balance of payments since 1982. Two items are related to China's capital outflows. One is the current account surplus and the other is the errors and omissions. China's accumulated current account surplus since 1982 reached \$135 billion while the accumulated errors and omissions since 1982 were even higher at \$140 billion, both at about 12% of GDP. Table 4.8 also shows China's external debt at the end of 2001 was only about \$170 billion or 14.7% of GDP. Clearly China is putting a lot of official and private savings in US dollars. Why? A simple explanation is property rights! Like other foreign investors in US assets, the Chinese government and the Chinese people certainly believe that the property rights of their US investment are well protected. On the other hand, China also provides better protection for property rights in FDI in China than on domestic assets. Hence, on the whole, both sides are happy and better protection of property rights enhances value and productivity of capital.

It is interesting to note that the private foreign bank lending to China is not as important as FDI. This can be seen from the changes in cross-border banking capital flows between Hong Kong and Mainland China during the last decade. As shown in Graph 5.3 and Table 4.11, Hong Kong used to be an important centre in Asia for making syndicated loans to China and other Asian economies. From 1994 to 1999, Hong Kong was a net lender of banking capital to Mainland China. After 2000, however, Hong Kong turned into a net borrower of banking capital from Mainland China. Since 1997, there has been a steady decline in Mainland's gross banking liabilities to Hong Kong from more than \$50 billion in 1997 to less than 20 billion after 2001. This was triggered by the bankruptcy of the GITIC (Guangdong International Trust and Investment Corporation), which borrowed from foreign banks in Hong Kong with the implicit understanding that the Chinese government would guarantee the loans. The Chinese government, however, decided not to use its money to save this regional state-owned holding company in order to avoid moral hazard problem in similar cases for other companies and in the future. After the GITIC bankruptcy, foreign banks became very cautious in extending syndicated loans to China.

During the Asian financial crisis in 1997, Hong Kong suffered a huge withdrawal of foreign banking capital. Hong Kong's foreign

banking funds fell from \$630 billion in June 1997 to \$250 billion by April 2002, a drop of 60%. Among the total withdrawal of \$380 billion, \$251 is by Japan (see Table 4.11). In spite of fluctuations in capital flows, Hong Kong's banks have been extremely resilient during and after the crisis with NPLs staying no more than 5%.

During the Asian financial crisis, short-term capital flows were blamed as a driver for financial market instability. Hence, there have been calls for caution on liberalisation of capital accounts and portfolio investment. The role of foreign investors in the stability of local markets becomes an interesting topic. Graphs 6.3 to 6.8 examine this issue using data after the Asian financial crisis and show a strong negative correlation between the size of trading by foreign investors and the level of the local stock market turnover. What it means is that, at least, during the non-crisis period, the participation of foreign investors in the Asian local stock markets enhances the local market stability: the lower the local turnover, the higher the share of trading by the US investors. This pattern appears in Japan, Hong Kong, Singapore, Taiwan, Korea, and even the tiny "B share" market of Mainland China. It appears that the US investment, probably helped by their institutional investors, is more rational than that of the local investors.

2 China's Structural and Institutional Conditions for FDI

In spite of the large volume of literature on China's foreign trade and investment by scholars (Lardy, 2002), investment bank economists (Lehman Brothers, 2002 and Goldman Sachs, 2003), and international organisations (OECD, 2002), in our view, the implications of recent development in China relating to its foreign trade and investment are not appreciated properly in their scale, scope and depth. This is partly due to China's many unique development conditions as well as an inclination to use the standard equilibrium tools of economics to deal with intrinsically a disequilibrium problem of development with unlimited supply of cheap labour in China and other developing economies. This section examines this Lewis type dual-sector development issue in order to answer many of the questions raised in the previous questions. The Lewis model of dual-sector development has many new implications when the cross-border mobility of capital and

capitalist institutions become possible for a country as large as one-fifth of the world in terms of population.

Development Gaps and Unlimited Supply of Labour

China is large with one-fifth of the world's population. China's labour force is larger than the sum in all developed economies. China's total GDP at purchasing power parity prices is about \$5 trillion, or roughly half of the United States' GDP at current prices. However, China's GDP at current prices is much smaller, about one-fourth of Japan's and one-tenth of US's. However, for some manufacturing products, China's market share can be more than 50% of the global total. The size of China allows it to enjoy economies of scale and scope. China can afford to have all major global auto producers set up joint-venture production bases inside China. However, China's size in monetary terms is limited by the extremely low market prices its labour and products have to face now and for the next decade or so, a fact of life due to its effectively unlimited supply of labour.

As shown in Table 3.4, in global context, China's population is mature, not too young and not too old, with 70% in working age of 15 to 65. China currently has only 7% population above age 65 and 23% under age 15.

China's population compares favourably with both the aging population in the developed economies and the less than mature population in developing economies. The share of working age population in China is among the highest at 70%, compared with only 60% in other less developed countries and 67% in developed countries.

The old age population in the developed countries reaches 15%, or eight percent higher than in China. On the other hand, the population under 15 in other less developed countries is as high as 36%, or 13 percent higher than in China.

Compared with both the developed and the other less developed countries, China's population structure in the past two decades and next two decades is particularly favourable for rapid growth in China, independent of other policy and institutional factors. China's advantage in population structure during these decades is further enhanced by globalisation and the sustained prosperity in the developed economies after World War II. Large amounts of

retirement savings from the aging and rich economies accumulated in the last half-century need to be invested in young, growing and productive economies such as China.

China's population structure today is almost the same as Japan's in 1975. Japan's outstanding growth performance during the one-and-half decades since 1975 could suggest that China should have at least one more decade to enjoy the favourable population structure for growth. However, Japan's lost decade since 1990 also reminds China of the challenges ahead. China has a window of opportunities to reform its financial and legal system in the next decade to deal with its future aging problem.

China is poor and has effectively unlimited supply of cheap, mature and educated labour at least for the next one or two decades. China's per capita GDP at purchasing power parity prices of 2000 is \$3,920, slightly higher than the average for other less developed countries at \$3,470, but well below the level of \$22,060 for the developed countries. If using per capita GDP as a rough estimate for average wage, China's average wage at PPP would be about \$1.86 an hour ($\$3,920/[12 \times 22 \times 8h]$). Since China's GDP per capita at current prices is only about \$1,000, China's average wage at current prices would be only \$0.47 an hour, compared to \$10 an hour for the developed economies under the same assumption.

At an average wage of less than half a dollar an hour, China has added 150 million non-farm jobs over the last two decades and reduced the number of people with income less than \$1 a day by 150 million. This number, i.e. 150 million, is as large as the entire population of Western Europe and its Western Offshoots (including US, Canada, and Australia) in 1820 and is more than twice the net migration to the Western Offshoots during the 129 years from 1870 to 1998 (Maddison 2001, p. 28). With this unprecedented achievement in employment creation, China still needs to create at least the same amount (150 million) of non-farm jobs perhaps over the next one to two decades.

China's case clearly fits well into W. Arthur Lewis's dual-sector economic development model of unlimited supply of labour except that the Lewis model has never been applied seriously to an economy as large and as open as the Chinese economy today. Also, China has made great progress not only in providing primary education for most of school age kids but also in higher education. China produces more engineers in one year than Taiwan and Hong

Kong could do in ten to twenty years. Hence, China has not only unlimited supply of cheap labour but also unlimited cheap talents. This is confirmed by the fact that it is now more and more difficult for China's college graduates to find good jobs. China's top executive MBA programmes are as expensive as Hong Kong's. China's overseas students have been putting pressures on their classmates from other foreign countries.

Cross-Border Mobility of Capital and Capitalist Institutions

China's economy is open, in many ways much more open than today's Japanese economy. China attracted much more FDI flows and stocks than Japan. In 2001, Japan, with its half a century long rapid economic growth and development, attracted only \$49 per capita in FDI flows and \$395 per capita in FDI stock, compared to the world average of \$120 in flow and \$1,118 in stock and China's \$37 in flow and \$309 in stock. At official exchange rates, China's foreign trade is more than 40% of GDP while Japan's is about 20%. China allows a large amount of processing trade, which requires a large amount of imported components. Large scale processing trade is only possible for very open economies with close to zero transaction costs, including tariffs and other taxes. China has committed itself to this close to zero transaction costs for processing trade since early 1980s, drawing lessons from its successful neighbours of newly industrialised Asian traders.

China's experiences in opening up its economy have effectively relaxed two crucial assumptions in international trade and development theories: the mobility of capital and the replication of capitalist institutions. Capital is mobile across the Chinese borders on a large scale now as our review in the previous sections show. Traditional trade theories based on factor immobility needs to be modified to take capital mobility into account. For example, capital-intensive industries such as auto and IC manufacturing can be profitable in China because of the capital and technology brought in by FDI and MNCs. The development of these capital-intensive industries is not constrained by the lack of capital. Instead, it is determined by the total costs of internationally linked supply chains and the global demand, including the demand from China itself. Supply chain management theory and global market equilibrium may be more important than the simple application of traditional trade, investment, and macro theories.

China's imitation of capitalist economic institutions is also unprecedented in scale, scope, depth, and speed, ranging from central banks, modern public corporations, labour markets, stock markets, and social security systems. The transfer of capitalist institutions and practices is facilitated greatly by the existence of mature market economies in the overseas Chinese communities in Hong Kong and Taiwan as well as large amount of returning overseas students and overseas Chinese business communities. In this regard, the recent success and failure of Japan, Korea and other Asian economies in development and modernisation also set useful examples for China.

It is now possible for MNCs to combine unlimited supply of Chinese cheap labour and cheap talents with advanced international capital, technology and capitalist institutions by relocating some major parts of their production and research in China. MNCs not only benefit from access to China's domestic markets but also gain international competitiveness when they export some of their products from their China bases. Since China allows MNCs to have complete control on their China operations, they can get around China's underdeveloped financial and legal systems, at least for their day-to-day operation. In other words, their risks of operation in China are much lower than in other places in the region.

China's rapid improvement in infrastructure over the last two decades is also an important factor in attracting FDI. This is especially relevant for a few key economic centres along the eastern coast, including the Pearl River Delta region around Guangdong and Hong Kong and the Yangtze River Delta region around Shanghai. China now has more telephone lines than the US. Its highway length is second only to that in the US and will form a complete national network connecting all major cities across China after the current five-year plan. Satellites are used not only for television but also for clearing and settlements in banking and securities transactions. Hong Kong has the world's busiest seaport and airport, handling 60% of China's container shipments. However, major port development planned in Shanghai and Guangzhou are likely to increase their capacity to Hong Kong's current level in one or two decades. This rapid improvement in infrastructure is coordinated by China's forward-looking planning authorities and led by innovative local leaders. China's population structure and its low level of development also allow fast catching up

of investment in infrastructure. China's obsession with infrastructure investment is also encouraged by a generation of leaders with engineering backgrounds who see investment in infrastructure as much more valuable than investment in loss-making state-owned enterprises. China's government-directed infrastructure projects may not make profits but will certainly facilitate the mobility of labour, goods, and capital across China's vast western, inland, and coastal regions. They have laid a good physical foundation for China's further integration with the global market economy.

However, in the near future, China's financial and legal systems will come under great pressure to price the risks and returns for millions of large and small projects, which would challenge even the best bankers in the world. In spite of great achievements in legislation, the legal system is still weak in the enforcement of property rights and contracts. This weakness directly affects the robustness and efficiency of China's banking sector and capital markets.

China's financial system is efficient in generating savings but is not effective in allocating them to productive investment. China's banking deposits increased from about 30% to 160% over the last two decades. However, about 20% to 30% of these deposits have difficulty finding productive investment outlets. A substantial part of China's surplus deposits ended up in government bonds. The local governments are then forced to invest these funds in infrastructure projects in order to keep the economy growing at 8% a year.

The flood of savings in China's banking system is partly due to a loose monetary policy during the early 1990s and after the Asian financial crisis. China's money supply (M2) increased ten times from 1990 to 2001 while its nominal GDP rose only five times during the same period. Hence, China's money supply is growing twice as fast as its nominal GDP. China's NPLs is in the range of 25% to 55% of GDP by the official and private estimations. However, China's banking system is still stable for a number of reasons. First, the government is still the owner of most banks in China and is determined to reform its state-owned banks. So, the Chinese people do not feel any risks to their bank deposits. Second, the Chinese economy, although growing at 8% a year, still has ample surplus labour and other unemployed resources, which are looking for employment opportunities following two decades of a gradual but steady loosening of migration policies and control of private

enterprises. Third, China's capital account is not open for its domestic RMB deposit holders.

The traditional equilibrium model may not be useful for understanding China's macroeconomic conditions because of China's disequilibrium in the labour markets with unlimited supply of labour. Unlike the situations in Japan and the newly industrialised Asian economies, where the supply of labour quickly hit the limits with wages shooting up, China's market wages for the unskilled labour in major manufacturing centres such as Guangdong have been stagnant at a subsistence level of around \$100 a month for more than a decade.

China's weak and inefficient financial system is creating a puzzle of co-existence of surplus labour and capital. For 16 out of the 21 years since 1982, China ran current account surpluses, including the last 9 years. The accumulated sum since 1982 of China's current account surpluses and the errors and omissions reached 23.8% of GDP in 2001. As China reforms its financial system and opens up its financial sector under the WTO commitment, the efficiency and speed of China's integration into the world economy will be improved steadily. This implies that more and more of China's labour will work directly or indirectly for the global market although their wages will be kept from rising due to ample surplus labour. This trend of development in China is determined by the interaction between China's structural and institutional features and prompts us to further examine the role of China as a world factory and as a regional competitor in the next section.

3 Implications for the Rest of the World

To appreciate the impact of China's development and integration into the global economy, it is useful to review the history of global capitalist development as articulated by Angus Maddison. For thousands of years before 1000, the global economy was stagnant but living standards as measured by GDP per capita were pretty much equal across regions. During the first millennium, per capita GDP of the world declined slightly from \$444 to \$435 (at the 1990 international prices for this and all other numbers cited from Maddison, 2001) while world population increased only from 231 to 268 million.

During the period from 1000 to 1820, global economic growth picked up but slowly. Although the world population increased from 268 million to 1 billion, average per capita GDP for the world increased only from \$435 to \$667. The world started to diverge in development and income during this period. By 1820, the first world, including Western Europe, Western Offshoots, and Japan, increased their per capita GDP to \$21,470 while the rest of the world, or the third world, only had a per capita GDP level of \$573.

From 1820 to 1998, a great divergence in development and inequality in income emerged between the first and the third world. The share of population in the first world declined from 16.8% to 14.2% but its share of GDP increased from 28.5% to 53.4%. By 1998, world population reached 5.9 billion with 5.1 billion in the third world, including 1.2 billion in China.

The above are the global conditions under which W. Arthur Lewis developed his dual-sector theory on economic development under unlimited supply of labour (Lewis, 1954). Lewis pointed out that the non-capitalist traditional sector in the rural area provides a reservoir for unlimited supply of labour at a fixed urban wage slightly higher than the subsistence rural wage. The urban wage is checked not only by the surplus labour in the rural area but also by rising unemployment in the urban area. This is exactly the condition we see in China now. China's leaders have been working hard to raise the income for peasants. But that is a mission impossible with the Lewis type development reality.

Lewis also points out that the capitalist modern sector is able to generate profits and net savings for investment in capital that is critical for sustained growth. He cites the evidences from Britain where net savings increased from 5% before 1780 to 7% in early 1800s, and 12% around 1870. Similar rises of net savings are also observed in the US between 1840s and 1890s, and in Asia after World War II. Consistent with the Lewis dual-sector model, Britain's Manchester, US's New England, New York, and Chicago, Japan's Tokyo and Osaka, and cities in Asia's newly industrialised economies have become the world factories one by one over time. Now, the centre of global manufacturing is once again on the move towards low costs economies. This time it goes to China's Guangdong and Shanghai, where access to unlimited supply of labour is facilitated by low transportation and declining transaction costs.

China as a World Factory: Changes in Global Relative Prices

There is little disagreement on the trend that China will become a world factory. Instead, the debates are on the impact of that trend on the rest of the world. In our view, the single most important impact of China's outstanding development performance is on changes in global relative prices. There is no doubt that new labour supply to the global market will lead to a secular fall in the prices of labour-intensive manufacturing products.

Before China's opening up, the world economy was largely a capitalist open market economy dominated by the developed economies. The majority of the third world population, including those in China, were not very relevant to this global market. Let's use the population of age 15 to 65 in Table 3.4 to estimate the impact of China's opening on the labour supply in the world market. The world's working population at age 15 to 65 is 896 million in China, 2,242 million in other less developed countries, and 802 million in more developed countries. Let's assume for simplicity that about one-quarter of the labour force in China (224 million) and other less developed countries (560 million) are working for the world market now while the rest are effectively isolated from the world market. Then, the total labour force working for the world market today would be 1,586 million (224m+560m+802m). Since China's labour force was entirely outside of the global market twenty years ago, China's opening has added 224 million to the 1,363 million (560m+802m) labour force that have already been integrated into the global market. That is a net addition of about 16.4% over two decades. If China's past success in integrating its labour into the global market can be continued and replicated in other developing countries, the world market would certainly have no shortage of labour.

It is clear that the additional supply of China's labour force to the global market has concentrated in the manufacturing export sector. This means the global prices for manufacturing products have to fall dramatically. For example, the prices of televisions in the US have been dropping by 8% a year since 1988. The deflation in manufacturing products has started from the traditional labour-intensive products such as toys, plastics, clothing but has been spreading to less labour-intensive products such as electronics and machinery as China advances in its production and technology capability.

As the Say's law predicts, supply creates demand, if there is a perfect market. China's opening leads to growth in income and demand for final products. But it is clearly impossible for China to consume all of its manufacturing products such as televisions, DVDs, motorcycles, and bicycles. Because of China's extremely low level of per capita wealth, the Chinese people's savings rate has been as high as 40.3%, compared to 16.5% in the US, 20.3% in the European Union, 26% in developing countries, and 27.3% in Japan. China's high savings depress its domestic current demand. Hence, export is the most convenient way out and China's export significantly depresses global prices on some specific products such as toys, televisions, and bicycles.

China's impact on deflation in the manufacturing products, however, is not going to cause a global deflation because the weight of manufacturing products made in China is too small in the total expenditure basket of the developed economies. China's exports, which usually incorporate a high proportion of imported components, are only about 4.3% of the world total in 2001. There is a long way to go before China has a direct impact on global deflation.

This is partly due to terms-of-trade effect. The more China exports, the lower the product prices, and the lower the share of China's exports in the total expenditure of the developed economies, other things given.

Anderson and Hu (2003) highlighted that China's net export of manufacturing goods is negligible for causing global deflation in manufacturing prices. This is true but the large deflation effects on specific products are hidden within the net manufacturing exports. The export value is likely to be depressed because of falling prices on China's export while the import value is likely to be high, partly due to stronger demand from China for key components which China can not produce.

In monetary terms, China's impact on the rest of the world is small. But in terms of specific product prices and welfare, or the so-called consumer surplus, China's contribution to the increase of the standards of livings in both developed and developing countries is huge but invisible in statistics. Today's lucky kids around the world can testify to this with their made-in-China toys. Without China's production, most toys may cost five to ten times more.

As we have emphasised, China's impact is on changes in global

relative prices. The deflation in manufacturing sector is accompanied by inflation in commodity and skills, which are needed to support the rapid increase in the volume of manufacturing goods and the rising living standards in China and elsewhere. China has turned from a net exporter of oil to a net importer and its imports of oil have increased steadily in the last decade to about 60 million tons a year by 2001. China's net commodity imports since 1990s have tripled. China's tuition for top rank executive MBA programmes is as high as in Hong Kong or even in the US.

Changes in global relative prices are followed by structural changes in the global economy. The most important change is the shift of manufacturing to China. However, China is only becoming a platform for global manufacturing in order to take advantage of China's favourable labour supply and domestic markets. It is clear that this competition is not between China and the foreign manufacturers. Instead, it is a competition among foreign manufacturers themselves with China only participating as a supply of labour and domestic markets. Foreign invested firms produce half of China's exports with only a small part of the value-added going to China's labour and with a high proportion of imported components. FDI in China concentrated mainly in a few clusters of manufacturing bases in the coastal region (see Table 4.5). The unskilled labour for the export industry is, however, largely coming from poor and remote western and inland regions of China.

China's development and integration with the capitalist world economy is not a miracle if we compare it with the industrialisation in the UK, the US, Japan, and the newly industrialised Asian economies. But the size and structure of China's population and the mobility of capital and capitalist institutions – made possible by today's advances in technology and development knowledge – make China's case special, especially for many of its neighbours.

China as a Regional Competitor: Benefits Versus Costs

For many Asians, it is amazing that China weathered through the Asian financial crisis with few changes in its high growth rate of around 8%. Many are wondering whether China's growth is at the costs of others by siphoning off market shares in foreign trade, investment and domestic jobs. There is no doubt that China has become a major competitor in the world market, especially for its

Asian neighbours. The competitive pressure from China can best be seen from Table 1.6 on the share of global inward FDI stock. China increased its share from only 1% in 1980 and 1985 to 5.8% in 2001 while the Asia-7, which has more population than China, did not gain much from 4.2% in 1980 to 4.8% in 2001. China's per capita inward FDI stock reached \$309 by 2001, moving towards Japan's \$395, and well above Asia-7's \$220. However, China's per capita FDI stock is still less than the average for all developing countries, which is at \$478. Table 1.3 shows per capita inward FDI flows and gives similar pattern.

China's competitiveness in labour-intensive manufactures is well recognised and attracted 60% of China's total FDI as shown in Table 4.3. However, FDI is also significant in the non-labour-intensive real-estate sector that has 12% of China's FDI. The services sector also attracted substantial FDI.

What is particularly relevant for our discussion in this section is the concentration of China's FDI in a few clusters of coastal super cities, which have critical mass for global scale production, distribution and financing.

Table 4.5 ranks China's 31 provincial level regions by their FDI inflows in 2001 and provides a number of indicators for the provincial economies. The provinces and cities are then divided into three groups by their ranking in FDI inflows: the top-9, the middle-12, and the bottom-10. The top-9 includes, in descending order of the share of average FDI during 2000-2001, Guangdong (25.7%), Jiangsu (14.9%), Shanghai (9.3%), Fujian (8.5%), Shandong (7.6%), Liaoning (5.4%), Zhejiang (4.8%), Tianjin (4.6%), and Beijing (3.8%). Many foreign visitors are impressed by the physical changes in the cities such as Shanghai and Beijing but the real stars of productive investment and manufacturing capacity in China are Guangdong and Jiangsu, where land prices have not been driven up to international levels as in Hong Kong, Shanghai and Beijing while access to finance, research and other services provided by the big cities is still convenient.

The concentration of economic activities in the top-9 is impressive, if not surprising. This group has about one-third of China's population but produced half of China's GDP, attracted three-quarters of China's FDI, and generated 90% of China's foreign trade.

The middle-12 includes mostly inland provinces while the

bottom-10 consists of all western provinces, the poorest region of China. The middle-12 has half of China's population and one-third of China's GDP but only attracted one-seventh of China's FDI and 8% of China's foreign trade. The bottom-10 has 18% of China's population, 10% of GDP, 3% of foreign trade, and 1.8% of FDI.

Given the diversity of China's regions, it is natural to ask which parts of China we would like to compare with its neighbouring countries. With China's huge population, it is also important to compare FDI per capita.

In 2001, China's top-9 attracted \$97 per capita in FDI, much higher than the Asia-7 of \$12. But the Asia-7 did much better than China's middle-12 at \$10 per capita and bottom-10 at \$4 per capita. Both China's inland and western regions face similar concerns as the Asia-7 countries. They are working hard to improve their investment environment as well as lobby for more support from China's central government. China's central government is also working very hard to help the less developed regions, particularly through the "Go West" strategy. The central government has invested heavily in highways, railroads, airports and other infrastructural works in the western regions but their effects on attracting FDI did not generate the intended results. Instead, the poor people in the western and inland regions continue to rush to the eastern coast for jobs, riding on the new roads built by the government. These unintended results, however, may be better than the plan, as the migrant labourers send remittances, knowledge, and even skills they learnt in the big cities back to their hometowns.

For the Asia-7, labour mobility to China's eastern coast is out of question except for a few highly skilled professionals. But intra-industry trade is expanding as can be seen from the rising trade volume for the six Asian traders (Taiwan, Hong Kong, Korea, Malaysia, Singapore, and Thailand, re-export excluded; see Table 1.2). While China's share of global export increased from 2.5% in 1993 to 4.0% in 2000, the six Asian traders' share increased from 9.7% to 10.5%. During the same period, Asia as a whole increased slightly its share of global exports from 26.3% to 26.7% with a significant decrease in Japan's share from 10% to 7.7% and Australia and New Zealand's share from 1.5% to 1.2%.

There is no doubt that China's export growth is much faster than its neighbours' as shown in Table 4.1. During 1990-2000, China's export growth was 14.9%, compared to 8.4% for the export growth

in Asia. But it is due to two factors. First, China started from a very low share of only 2.5% of global trade in 1993. Even in 2001, China's share of global exports was only 4.3%. Second, as discussed in the previous section, China's exports include many components imported from Asian and Western economies. The value-added from China is small.

Table 4.2 compares the market share in global manufactures exports in 1990 and 2000. This table should ease the concerns by China's competitors in Asia a bit as it shows clearly that they can grow with China at the costs of more developed economies in terms of market shares in manufacture export. From 1990 to 2000, the developed economies lost 11 percentage points of market share in global manufactures exports. Asia's gain is as high as 7.3 percentage points. China gained 2.3 percentage points while the six Asian traders gained 3.1 percentage points, more than the gain by China. The rest of Asia excluding China and the six Asian traders also gained 1.3 percentage points.

Hence, China is not only a regional competitor but also an important partner in terms of the integration of Asia's global-scale manufacturing. China not only has an unlimited supply of labour and talents but also large markets for consumer products and manufacturing equipments and parts, which are all opportunities for its neighbours. Hong Kong and Taiwan are the first in seizing the opportunities, followed by the US, Europe, and Japan.

The competitive pressures from China will not go away until most of China's surplus labour is absorbed by the expanding modern sector. The key is how to best position oneself in the increasingly competitive global economy. The pressure to force China to revalue its currency would not affect China's export competitiveness, simply because the real wage in China is not set by the nominal exchange rate. China's wages are extremely flexible at the low end. The real wage for unskilled labour is determined by the subsistence-level income in China's rural areas. The reliable and sustainable way for China's real wage to increase is to help China to develop its poor regions in the western and inland provinces.

However, a revaluation in RMB is likely to put large deflation pressure in the coastal regions' real estate and services sectors as these modern sectors are already substantially integrated with the world economy. The price structure there, except for the wage of unskilled migrant labour, are much more sensitive to changes in

nominal exchange rates. In particular, large amount of assets and liabilities concentrated in the more advanced regions of China are denominated in foreign exchange. Any attempt to adjust the currently fixed exchange rate of RMB would be equivalent to redistribution of wealth among holders of foreign exchange assets and liabilities, similar to redistribution among creditors and debtors during inflation or deflation. Given China's sustained surplus in current account and rising official and private foreign exchange reserves, it is entirely creditable for China to maintain the current fixed exchange rate regime. Then, China can leave any adjustments in real wages and other prices to domestic price adjustments. Given China's disequilibria in many markets, including the labour markets, China's fixed exchange rate provides an anchor and a reference for gradually rationalising China's price structure. Partly due to the fixed exchange rate, China's price structure today is largely consistent with the requirement of a market economy.

As discussed in the previous section, China's current account surplus implies that China is exporting capital, which does not seem consistent with China's unlimited supply of labour. Would a revaluation of RMB help to turn China's current account surplus into balance or deficit? Not really! China's excessive savings are not due to exchange rates but are a result of its underdeveloped financial system, which is not able to identify good projects and enforce lending contracts. Revaluation of RMB would depress the best parts of the Chinese economy and lead to less lending and more surplus savings, and hence more current account surplus, just like what happened in Japan when the yen appreciated. So, for those who would like to see a reduction in current account surplus in China or Japan, they need to help China and Japan reform their financial system, and not tamper with the exchange rates. After all, we all have learnt from the Keynesian and Monetarist debates about the neutrality of money and monetary policy in the long run. Exchange rate policy is only part of the monetary policy. The role of China in the region and in the global financial system is real, not just a monetary phenomenon. The aging populations in Japan, Europe and the US also need real returns from their savings, not nominal or monetary illusions.

4 Conclusion

This paper reviews global capital flows and the position of China. We have found that the rapid FDI inflows into China, following its economic opening and reform, are essentially driven by two factors: China's unlimited supply of labour and talents and China's declining barriers for cross-border mobility of capital and capitalist institutions.

The combination of China's unlimited supply of labour with foreign capital under capitalist institutions is transforming China into a world factory much like what happened before in Europe, America, and Asia. The consequences of this are also similar to what we have seen in the past: a decline of prices for labour-intensive manufacturing products and a relative rise in the prices for raw materials and skills.

The catching up of China in economic development provides competitive pressures as well as productive opportunities for the world and especially for its neighbours. The aging populations in the developed countries also need to rely on the much younger and mature population in China and Asia to secure good returns on their retirement savings.

However, due to the underdeveloped financial system in China and other developing economies, global savings have refused to flow into these developing economies with growth potential. Even China is having a net export of savings as the Chinese government and people are accumulating foreign assets, especially US bonds and stocks. The global savings and capital flows, although driven by structural factors such as the costs of labour, are hindered by institutional factors, such as the quality of domestic banks and capital markets in the less developed countries. This flight to quality is partly responsible for the tech bubbles in the US and lies at the heart of volatility in global capital flows.

The solution to these global mismatches in capital flows lies not in manipulating exchange rates and other monetary tools, which cannot change the real wages and potential competitiveness of developing economies like China. Instead, developed economies need to focus on real development problems in the developing countries, which have more than 80% of the world's population.

FDI is successful in China largely because foreign investments do not rely on the domestic financial system and foreign investors have complete control over the companies they establish.

China has not yet become an engine of growth for the global economy in cash terms. However, in terms of GDP measured by PPP or the welfare of the global population or the global consumer surplus, China is becoming an engine of growth for the world. This is why we need to study China's success and its problems seriously since they have profound implications for all of us.

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Table 1.1. Global Trade and Investment, 1982-2001
(in billions of dollars and percentages)

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Level										
FDI	59	51	60	58	86	140	164	193	203	160
M&A							116	140	156	81
Service Trade	805	775	800	783	902	1,069	1,218	1,336	1,601	1,673
Merchandise Trade	3,780	3,684	3,889	3,931	4,326	5,050	5,737	6,156	6,982	6,982
Growth										
FDI	-13.2	17.0	-4.3	50.1	61.8	17.1	17.6	17.6	5.3	-21.0
M&A										
Service Trade	-2.4	-3.7	3.2	-2.2	15.3	18.5	13.9	9.7	19.8	4.5
Merchandise Trade	-5.8	-2.5	5.6	1.1	10.1	16.7	13.6	7.3	13.4	0.0
As percentage of Merchandise Trade										
FDI	1.6	1.4	1.5	1.5	2.0	2.8	2.9	3.1	2.9	2.3
M&A							2.0	2.3	2.2	1.2
Service Trade	21.3	21.0	20.6	19.9	20.9	21.2	21.2	21.7	22.9	24.0

Table 1.1. (continued)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Average 1982- 2001
Level											
FDI	171	228	260	331	386	478	694	1,088	1,492	735	351.9
M&A	79	83	127	187	227	305	532	766	1,144	594	206.2
Service Trade	1,863	1,897	2,077	2,387	2,536	2,627	2,662	2,713	2,872	2,870	1,773.4
Merchandise Trade	7,484	7,464	8,485	10,142	10,585	10,950	10,797	11,204	12,538	12,601	7,638.3
Growth											
FDI	6.9	32.9	14.1	27.3	16.8	23.8	45.3	56.7	37.1	-50.7	16.3
M&A	-1.8	4.8	53.0	46.8	21.7	34.3	74.4	44.1	49.3	-48.1	27.8
Service Trade	11.4	1.8	9.5	14.9	6.3	3.6	1.3	1.9	5.9	-0.1	6.7
Merchandise Trade	7.2	-0.3	13.7	19.5	4.4	3.5	-1.4	3.8	11.9	0.5	6.1
As percentage of Merchandise Trade											
FDI	2.3	3.0	3.1	3.3	3.6	4.4	6.4	9.7	11.9	5.8	3.8
M&A	1.2	1.1	1.5	1.8	2.1	2.8	4.9	6.8	9.1	4.7	1.9
Service Trade	24.0	25.4	24.5	23.5	24.0	24.0	24.7	24.2	22.9	22.8	22.8

Source: UNCTAD, *World Investment Report 2002*, website.

Table 1.2 World Merchandise Trade by Region, 1948-2000
(in billions of dollars and percentages)

	1948	1953	1963	1973	1983	1993	2000
World export in value	58.0	84.0	157.0	579.0	1835.0	3641.0	6186.0
<i>Export Share</i>							
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0
North America	27.3	24.2	19.3	16.9	15.4	16.8	17.1
Latin America	12.3	10.5	7.0	4.7	5.8	4.4	5.8
Western Europe	31.5	34.9	41.4	45.4	38.9	43.7	39.5
C./E. Europe/Baltic States/CIS	6.0	8.1	11.0	9.1	9.5	2.9	4.4
Africa	7.3	6.5	5.7	4.8	4.4	2.5	2.3
Middle East	2.0	2.7	3.2	4.1	6.8	3.4	4.2
Asia	13.6	13.1	12.4	14.9	19.1	26.3	26.7
Japan	0.4	1.5	3.5	6.4	8.0	10.0	7.7
China	0.9	1.2	1.3	1.0	1.2	2.5	4.0
India	2.2	1.3	1.0	0.5	0.5	0.6	0.7
Australia and New Zealand	3.7	3.2	2.4	2.1	1.4	1.5	1.2
Six East Asian traders*	3.0	2.7	2.4	3.4	5.8	9.7	10.5
World import in value	66.0	84.0	163.0	589.0	1881.0	3752.0	6490.0
<i>Import Share</i>							
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0
North America	19.8	19.7	15.5	16.7	17.8	19.8	23.2
Latin America	10.6	9.3	6.8	5.1	4.5	5.2	6.0
Western Europe	40.4	39.4	45.4	47.4	40.0	42.9	39.6
C./E. Europe/Baltic States/CIS	5.8	7.6	10.3	8.9	8.4	2.9	3.7
Africa	7.6	7.0	5.5	4.0	4.6	2.6	2.1
Middle East	1.7	2.0	2.3	2.8	6.3	3.2	2.6
Asia	14.2	15.1	14.2	15.1	18.5	23.4	22.8
Japan	1.0	2.9	4.1	6.5	6.7	6.4	5.8
China	1.1	1.7	0.9	0.9	1.1	2.8	3.5
India	3.1	1.4	1.5	0.5	0.7	0.6	0.8
Australia and New Zealand	2.6	2.4	2.3	1.6	1.4	1.5	1.3
Six East Asian traders*	3.0	3.4	3.1	3.7	6.1	9.9	9.5

Note:

* Asia six: Taiwan, Hong Kong, Korea, Malaysia, Singapore, and Thailand; Significant re-exports excluded.

Source: WTO.

Table 1.3 FDI Inflows in Selected Regions, 1990-2001
(in billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Popu- lation (million)	2001 FDI Inflows per capita
Total World	203	160	171	228	260	331	386	478	694	1,088	1,492	735	6,125	120
Developed countries	165	113	107	137	145	203	220	268	484	838	1,227	503	1,197	420
United States	48	23	19	51	45	59	84	103	174	283	301	124	287	433
Japan	2	1	3	0	1	0	0	3	3	13	8	6	127	49
Asia and the Pacific	25	24	33	59	69	76	94	106	96	103	134	102		
China	3	4	11	28	34	36	40	44	44	40	41	47	1,281	37
Hong Kong, China	3	1	4	7	8	6	10	11	15	25	62	23	7	3358
Taiwan Province of China	1	1	1	1	1	2	2	2	0	3	5	4	23	183
Greater China sub-total	8	7	16	35	43	44	53	58	59	68	108	74	1,310	56
India	0	0	0	1	1	2	3	4	3	2	2	3	1,050	3
Indonesia	1	1	2	2	2	4	6	5	0	-3	-5	-3	217	-15
Malaysia	3	4	5	6	5	6	7	6	3	4	4	1	24	23
Philippines	1	1	1	1	2	1	2	1	2	1	1	2	80	22
Republic of Korea	1	1	1	1	1	2	2	3	5	9	9	3	48	66
Singapore	6	5	2	5	9	9	9	11	6	12	5	9	4	2050
Thailand	3	2	2	2	1	2	2	4	5	4	3	4	63	60
Asia-7 sub-total	13	14	13	17	20	26	31	33	24	29	20	18	1,486	12
Developing countries	38	44	59	83	109	113	153	191	188	225	238	205	5,018	41
All developing countries minus China	34	40	48	56	75	77	113	147	144	185	197	158	3,737	42

Source: UNCTAD, *World Investment Report 2002*, website.

Table 1.4 Share of Global FDI Inflows by Selected Regions, 1990-2001
(in percentages)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Developed countries	81.2	70.6	62.7	60.3	55.7	61.5	57.0	56.0	69.7	77.0	82.3	68.4
United States	23.9	14.2	11.2	22.3	17.4	17.8	21.9	21.6	25.1	26.0	20.2	16.9
Japan	0.9	0.9	1.6	0.0	0.3	0.0	0.1	0.7	0.5	1.2	0.6	0.8
Asia and the Pacific	12.2	15.2	19.4	26.0	26.5	23.0	24.3	22.2	13.9	9.5	9.0	13.9
China	1.7	2.7	6.5	12.1	13.0	10.8	10.4	9.3	6.3	3.7	2.7	6.4
Hong Kong, China	1.6	0.6	2.3	3.0	3.0	1.9	2.7	2.4	2.1	2.3	4.2	3.1
Taiwan Province of China	0.7	0.8	0.5	0.4	0.5	0.5	0.5	0.5	0.0	0.3	0.3	0.6
Greater China sub-total	4.0	4.2	9.3	15.5	16.6	13.2	13.6	12.1	8.5	6.2	7.2	10.0
Singapore	2.7	3.1	1.3	2.1	3.3	2.7	2.2	2.2	0.9	1.1	0.4	1.2
Republic of Korea	0.4	0.7	0.4	0.3	0.3	0.5	0.6	0.6	0.8	0.9	0.6	0.4
India	0.1	0.0	0.1	0.2	0.4	0.7	0.7	0.8	0.4	0.2	0.2	0.5
Indonesia	0.5	0.9	1.0	0.9	0.8	1.3	1.6	1.0	-0.1	-0.3	-0.3	-0.4
Malaysia	1.3	2.5	3.0	2.5	1.8	1.8	1.9	1.3	0.4	0.4	0.3	0.1
Philippines	0.3	0.3	0.5	0.5	0.6	0.4	0.4	0.3	0.3	0.1	0.1	0.2
Thailand	1.3	1.3	1.2	0.8	0.5	0.6	0.6	0.8	0.7	0.3	0.2	0.5
Asia-7 sub-total	6.6	8.9	7.6	7.3	7.7	8.0	8.0	6.9	3.4	2.6	1.4	2.5
Developing countries	18.5	27.7	34.6	36.6	41.9	34.0	39.5	40.0	27.0	20.7	15.9	27.9
All developing countries minus China	16.8	25.0	28.1	24.5	28.8	23.2	29.1	30.7	20.7	17.0	13.2	21.5

Source: UNCTAD, *World Investment Report 2002*, website.

Table 1.5 Shares in M&A Sales by Selected Regions and Countries
(in percentages)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Developed countries	91.7	86.2	81.4	87.0	87.9	82.6	76.1	83.4	88.7	92.3	83.5
United States	35.0	20.0	24.1	35.2	28.5	30.0	26.8	39.4	32.9	28.4	31.1
Japan	0.2	0.3	0.1	0.6	0.3	0.8	1.0	0.8	2.1	1.4	2.6
Asia and the Pacific	2.7	4.6	8.8	3.7	3.8	5.9	7.1	3.0	3.8	1.9	5.8
China	0.2	0.3	0.7	0.6	0.2	0.8	0.6	0.2	0.3	0.2	0.4
Hong Kong, China	0.7	2.1	6.4	1.3	0.9	1.4	2.4	0.2	0.5	0.4	1.7
Taiwan Province of China							0.2	0.0	0.2	0.1	0.4
Greater China sub-total							3.2	0.3	1.1	0.7	2.6
Singapore			0.1	0.3	0.1	0.1	0.5	0.1	0.1	0.1	0.2
Republic of Korea	0.2	0.3	0.2	0.2	0.4	0.2	0.1	0.1	0.2	0.1	0.6
India	0.2	0.1	0.6	0.3	0.1	0.3	0.1	0.2	0.2	0.0	0.2
Indonesia	0.1	0.5	0.2	0.7	0.6	0.2	1.4	0.4	0.2	0.0	0.3
Malaysia	0.8	0.0	0.0	0.0	0.1	0.2	0.3	0.7	1.3	0.6	0.6
Philippines	0.3	0.3	0.4	0.3	0.7	0.3	0.1	0.1	0.4	0.1	0.8
Thailand	0.1	0.6	0.1	0.1	0.1	0.1	0.2	0.6	0.3	0.2	0.2
Asia-7 sub-total			1.6	1.8	2.1	1.5	2.7	2.2	2.6	1.2	3.0
Developing countries	7.2	10.3	17.2	11.8	8.8	15.7	22.0	15.5	9.7	6.2	14.4

Source: UNCTAD, *World Investment Report 2002*, website.

Table 1.6 FDI Inward Stock by Selected Regions and Countries, 1980-2001
(in millions of dollars and percentages)

	1980	1985	1990	1995	2000	2001	1980	1985	1990	1995	2000	2001	Popu- lation (million)	Inward FDI Stock per capita
Total World	635,534	913,182	1,871,594	2,911,725	6,258,263	6,845,723	100.0	100.0	100.0	100.0	100.0	100.0	6,125	1,118
Developed countries	389,715	568,670	1,382,978	2,021,303	4,124,261	4,504,122	61.3	62.3	73.9	69.4	65.9	65.8	1,197	3,763
United States	83,046	184,615	394,911	535,553	1,214,254	1,321,063	13.1	20.2	21.1	18.4	19.4	19.3	287	4,597
Japan	3,270	4,740	9,850	33,508	50,323	50,319	0.5	0.5	0.5	1.2	0.8	0.7	127	395
Asia and the Pacific	161,196	228,970	317,663	570,625	1,246,700	1,329,431	25.4	25.1	17.0	19.6	19.9	19.4		
China	6,251	10,499	24,762	137,435	348,346	395,192	1.0	1.1	1.3	4.7	5.6	5.8	1,281	309
Hong Kong, China	124,286	129,750	148,183	174,063	429,036	451,870	19.6	14.2	7.9	6.0	6.9	6.6	7	66,451
Taiwan Province of China	2,405	2,930	9,735	15,736	27,924	32,033	0.4	0.3	0.5	0.5	0.4	0.5	23	1,424
Greater China sub-total	132,942	143,179	182,680	327,234	805,306	879,095	20.9	15.7	9.8	11.2	12.9	12.8	1,310	671
Singapore	1,177	1,075	1,668	5,652	18,916	22,319	0.2	0.1	0.1	0.2	0.3	0.3	1,050	21
Republic of Korea	10,274	24,971	38,883	50,601	60,638	57,361	1.6	2.7	2.1	1.7	1.0	0.8	217	264
India	5,169	7,388	10,318	28,732	52,748	53,302	0.8	0.8	0.6	1.0	0.8	0.8	24	2,185
Indonesia	1,281	2,601	3,268	6,086	12,440	14,232	0.2	0.3	0.2	0.2	0.2	0.2	80	178
Malaysia	1,327	2,160	5,864	9,991	62,786	47,228	0.2	0.2	0.3	0.3	1.0	0.7	48	976
Philippines	6,203	13,016	28,565	59,582	95,714	104,323	1.0	1.4	1.5	2.0	1.5	1.5	4	24,839
Thailand	981	1,999	8,209	17,452	24,468	28,227	0.2	0.2	0.4	0.6	0.4	0.4	63	451
Asia-7 sub-total	26,412	53,210	96,774	178,095	327,709	326,991	4.2	5.8	5.2	6.1	5.2	4.8	1,486	220
Developing countries	245,819	344,463	484,954	849,915	2,002,173	2,181,249	38.7	37.7	25.9	29.2	32.0	31.9	5,018	435
All developing countries minus China	239,568	333,964	460,193	712,480	1,653,827	1,786,057	37.7	36.6	24.6	24.5	26.4	26.1	3,737	478

Source: UNCTAD, *World Investment Report 2002*, website.

Table 1.7 FDI Outward Stock in Selected Regions and Countries, 1980-2001
(in millions of dollars and percentages)

	1980	1985	1990	1995	2000	2001	1980	1985	1990	1995	2000	2001	Popu- lation (million)	Inward FDI Stock per capita
Total World	521,486	691,745	1,721,462	2,854,853	6,086,428	6,552,011	100.0	100.0	100.0	100.0	100.0	100.0	6,125	1,070
Developed countries	499,428	656,276	1,630,443	2,577,550	5,316,292	5,751,947	95.8	94.9	94.7	90.3	87.3	87.8	1,197	4,805
United States	215,375	238,369	430,521	699,015	1,293,431	1,381,674	41.3	34.5	25.0	24.5	21.3	21.1	287	4,807
Japan	19,610	43,970	201,440	238,452	278,445	300,115	3.8	6.4	11.7	8.4	4.6	4.6	127	2,356
Asia and the Pacific	6,206	11,699	47,813	185,931	583,524	603,290	1.2	1.7	2.8	6.5	9.6	9.2		
China	-	131	2,489	15,802	25,804	27,579		0.0	0.1	0.6	0.4	0.4	1,281	22
Hong Kong, China	148	2,344	11,920	78,833	365,803	374,780	0.0	0.3	0.7	2.8	6.0	5.7	7	55,115
Taiwan Province of China	97	204	12,888	25,144	49,187	54,667	0.0	0.0	0.7	0.9	0.8	0.8	23	2,430
Greater China sub-total	2,679	27,297	119,779	440,794	457,026	0.0	0.4	1.6	4.2	7.2	7.0	1,310	349	
Singapore	235	250	281	495	1,311	2,068	0.0	0.0	0.0	0.0	0.0	0.0	1,050	2
Republic of Korea	-	55	77	1,295	2,339	2,464		0.0	0.0	0.0	0.0	0.0	217	11
India	197	1,374	2,671	11,143	18,688	18,955	0.0	0.2	0.2	0.4	0.3	0.3	24	777
Indonesia	171	171	155	1,965	1,220	2,126	0.0	0.0	0.0	0.0	0.0	0.0	80	27
Malaysia	127	461	2,301	7,787	50,552	40,825	0.0	0.1	0.1	0.3	0.8	0.6	48	844
Philippines	3,718	4,387	7,808	35,050	53,009	63,225	0.7	0.6	0.5	1.2	0.9	1.0	4	15,054
Thailand	13	14	404	2,173	2,439	2,610	0.0	0.0	0.0	0.1	0.0	0.0	63	42
Asia-7 sub-total	6,712	13,698	59,163	130,304	132,274	0.9	1.0	0.8	2.1	2.1	2.0	1,486	89	
Developing countries	22,058	35,469	90,404	270,925	751,632	776,065	4.2	5.1	5.3	9.5	12.3	11.8	5,018	155
All developing countries	22,058	35,338	87,915	255,123	725,828	748,486	4.2	5.1	5.1	8.9	11.9	11.4	3,737	200
minus China														

Source: UNCTAD, *World Investment Report 2002*, website.

Table 2.1 Derived Portfolio Investment Liabilities in Selected Countries, Year-End 1997 and 2001
(in millions of dollars and percentages)

	Equity Securities		Long-term Debt Securities		Short-term Debt Securities		TOTAL	Share in TOTAL		
	Investment in:		2001		2001					
	1997	2001	1997	2001	1997	2001				
United States	427,579	997,821	886,325	1,653,419	36,192	417,850	1,350,096	3,069,090	22.18	24.46
United Kingdom	313,962	705,331	232,378	393,148	7,099	153,795	553,439	1,254,346	9.09	10.00
Germany	143,058	271,367	446,255	798,524	2,437	81,488	591,750	1,151,378	9.72	9.18
France	163,195	388,422	105,150	332,358	2,222	55,209	270,567	775,990	4.44	6.19
Netherlands	164,443	285,897	116,817	368,280	1,938	37,417	283,199	691,594	4.65	5.51
Japan	241,804	333,581	144,855	157,246	7,382	36,553	394,041	527,380	6.47	4.20
Hong Kong SAR of China	62,952	79,056	9,884	8,829	1,188	505	74,024	88,390	1.22	0.70
Korea, Republic of	6,085	51,666	31,259	22,650	706	2,018	38,050	76,334	0.62	0.61
Singapore	19,316	35,850	4,918	7,330	129	1,236	24,363	44,417	0.40	0.35
Taiwan Province of China	9,302	38,808	2,545	2,004	21	65	11,868	40,877	0.19	0.33
Russian Federation	10,937	10,753	17,530	14,831	1,687	318	30,154	25,902	0.50	0.21
Malaysia	14,645	11,508	10,541	9,526	417	293	25,603	21,327	0.42	0.17
China, P.R.	4,618	13,210	14,112	5,504	610	1,457	19,340	20,103	0.32	0.16
India	10,396	13,252	4,404	1,793	203	214	15,003	15,260	0.25	0.12
Philippines	4,658	3,452	7,206	8,823	98	332	11,962	12,607	0.20	0.10
Thailand	4,526	7,684	8,108	3,837	276	349	12,909	11,870	0.21	0.09
Indonesia	4,258	3,800	5,226	1,607	870	79	10,354	5,486	0.17	0.04
Total value of investment	2,567,784	5,134,498	3,421,999	6,373,367	98,430	1,038,297	6,088,217	12,546,226	100.00	100.00

Source: IMF, *Global Portfolio Investment Survey, 2003*.

Table 2.2 Net Purchases of Foreign Stocks by US Residents
(in millions of dollars and percentages)

	All-ex-US	Asia	Japan	Hong Kong	Singapore	Taiwan	Korea	China
<i>Amount</i>								
1988-1997	349,729	127,033	80,211	19,773	4,625	202	8,737	1,400
1998	-6,212	8,594	3,694	1,385	929	487	1,907	8
1999	-15,640	46,873	46,134	-2,777	-149	1,767	1,965	222
2000	13,088	-11,198	-16,461	3,254	-3,038	767	2,057	251
2001	50,113	27,523	19,938	4,823	-2,487	2,949	2,006	-40
<i>As percengate of Asia Total</i>								
1988-1997	275.3	100.0	63.1	15.6	3.6	0.2	6.9	1.1
1998	-72.3	100.0	43.0	16.1	10.8	5.7	22.2	0.1
1999	-33.4	100.0	98.4	-5.9	-0.3	3.8	4.2	0.5
2000	116.9	-100.0	-147.0	29.1	-27.1	6.8	18.4	2.2
2001	182.1	100.0	72.4	17.5	-9.0	10.7	7.3	-0.1

Source: US Treasury website.

Table 2.3 Net Purchases of Foreign Bonds by US Residents
(in millions of dollars and percentages)

	All-ex-US	Asia	Japan	Hong Kong	Singapore	Taiwan	Korea	China
<i>Amount</i>								
1988-1997	302,824	15,001	-865	-10,045	-2,532	-7,619	9,627	-825
1998	17,349	-4,602	-1,952	-2,452	-2,445	-815	3,161	-1,716
1999	5,676	-3,912	-2,497	-1,458	-334	-2,173	-719	-336
2000	4,054	-13,290	-4,509	-984	-893	-2,762	-1,365	-1,808
2001	-30,393	-15,654	178	-3,298	-293	-3,792	-1,856	-4,033
<i>As percengate of Asia Total</i>								
1988-1997	2018.7	100.0	-5.8	-67.0	-16.9	-50.8	64.2	-5.5
1998	377.0	-100.0	-42.4	-53.3	-53.1	-17.7	68.7	-37.3
1999	145.1	-100.0	-63.8	-37.3	-8.5	-55.5	-18.4	-8.6
2000	30.5	-100.0	-33.9	-7.4	-6.7	-20.8	-10.3	-13.6
2001	-194.2	-100.0	1.1	-21.1	-1.9	-24.2	-11.9	-25.8

Source: US Treasury website.

Table 2.4 Net Purchases of US Stocks by Foreign Residents
(in millions of dollars and percentages)

	All-ex-US	Asia	Japan	Hong Kong	Singapore	Taiwan	Korea	China
<i>Amount</i>								
1988-1997	115,571	9,615	6,617	1,031	8,828	409	-29	28
1998	50,020	-13,781	-1,171	-2,223	-8,438	-69	-84	1
1999	107,522	3,379	5,723	-156	-852	37	-78	204
2000	174,890	21,683	2,070	215	10,788	-147	-160	-103
2001	116,386	22,516	6,788	675	13,078	261	-76	3
<i>As percengate of Asia Total</i>								
1988-1997	1202.0	100.0	68.8	10.7	91.8	4.3	-0.3	0.3
1998	363.0	-100.0	-8.5	-16.1	-61.2	-0.5	-0.6	0.0
1999	3182.1	100.0	169.4	-4.6	-25.2	1.1	-2.3	6.0
2000	806.6	100.0	9.5	1.0	49.8	-0.7	-0.7	-0.5
2001	516.9	100.0	30.1	3.0	58.1	1.2	-0.3	0.0

Source: US Treasury website.

Table 2.5 Net Purchases of US Bonds by Foreign Residents
(in millions of dollars and percentages)

	All-ex-US	Asia	Japan	Hong Kong	Singapore	Taiwan	Korea	China
<i>Amount</i>								
1988-1997	1,447,448	415,223	202,793	52,694	36,900	22,701	2,900	47,890
1998	227,771	45,092	21,432	9,223	9,935	-2,996	15,812	3,519
1999	242,639	74,155	37,643	6,844	-7,417	-483	11,273	17,053
2000	282,938	82,474	49,936	10,181	-4,574	-5,240	5,839	15,656
2001	405,413	147,141	51,873	29,274	389	9,930	533	51,784
<i>As percengate of Asia Total</i>								
1988-1997	348.6	100.0	48.8	12.7	8.9	5.5	0.7	11.5
1998	505.1	100.0	47.5	20.5	22.0	-6.6	35.1	7.8
1999	327.2	100.0	50.8	9.2	-10.0	-0.7	15.2	23.0
2000	343.1	100.0	60.5	12.3	-5.5	-6.4	7.1	19.0
2001	275.5	100.0	35.3	19.9	0.3	6.7	0.4	35.2

Source: US Treasury website.

Table 3.1 Corporate tax comparison among Asian countries
(in percentages)

	Regular	Preferential rate for foreign investment
Korea	27	
Singapore	22	
Hong Kong	16	
China	33	15
USA	35	
Germany	25	
Japan	30	

Source: Joongang Daily, March 5, 2003, p. 3.

Table 3.2 Foreign Exchange Reserve to GDP Ratio

	1990	1994	1995	1996	1997	1998	1999	2000	Average
Singapore	73.5	79.3	81.8	83.2	84.5	89.2	89.5	86.8	83.5
Hong Kong	33.8	37.7	39.8	41.4	54.3	55.1	60.9	66.2	48.7
Taiwan	44.5	37.2	33.6	31.0	28.5	33.6	36.6	34.0	34.9
Malaysia	21.8	32.6	26.2	26.1	27.6	33.0	37.6	31.8	29.6
Yemen	12.7	17.3	17.8	17.2	16.3	18.6			16.7
Venezuela	17.1	14.5	12.1	18.0	16.3	12.5	12.1	10.7	14.2
Norway	12.4	14.0	14.4	16.0	14.7	11.6	12.9	12.2	13.5
Swiss	12.8	12.3	11.0	13.5	14.5	13.9	14.1	12.5	13.1
China	7.4	9.3	10.5	12.8	15.5	15.0	15.6	15.3	12.7
Indonesia	6.9	6.8	6.8	8.0	11.9	18.8	16.8	21.0	12.1
Korea	5.7	6.1	6.6	6.7	7.4	14.1	17.4	23.4	10.9
Saudi Arabia	8.2	4.9	5.6	9.1	9.2	9.9	10.8	10.4	8.5
Spain	10.0	8.2	5.7	9.9	12.9	9.1	5.5	5.2	8.3
Austria	5.5	7.8	7.6	9.8	9.4	9.4	7.1	7.0	8.0
Denmark	7.8	5.3	5.6	7.5	11.1	7.5	12.7	0.9	7.3
group average	7.8	7.1	6.3	9.1	11.1	8.7	8.4	4.4	7.9
Sweden	7.6	10.5	8.9	7.1	4.2	5.3	5.8	6.3	7.0
Finland	6.8	9.1	7.2	4.9	6.4	6.3	5.6	6.0	6.5
Brazil	1.7	9.0	7.5	7.8	6.5	5.6	6.5	5.8	6.3
Mexico	3.8	2.3	6.3	6.0	7.2	8.1	6.4	6.2	5.8
India	0.4	6.0	5.2	5.2	6.3	6.5	7.1		5.3
Netherlands	5.7	8.9	7.5	6.1	6.0	4.3	1.7	1.9	5.2
Belgium	5.7	5.2	5.3	5.9	6.1	6.0	3.5	3.5	5.2
France	5.3	5.2	4.9	5.0	5.1	4.2	3.9	3.8	4.7
Japan	2.3	2.3	3.6	4.7	5.2	4.6	5.5	7.8	4.5
Australia	5.3	3.0	3.1	3.4	4.4	3.8	4.9	4.6	4.1
Italy	5.5	3.0	2.9	3.5	4.7	2.0	1.7	2.1	3.2
Canada	2.8	1.9	2.1	3.0	2.5	3.4	3.6	4.1	2.9
Great Britain	3.3	3.6	3.5	2.9	2.2	1.9	2.1	2.8	2.8
Germany	2.3	1.1	0.9	1.0	1.4	1.7	1.7	1.7	1.5
USA	0.9	0.6	0.7	0.5	0.4	0.0	0.3	0.3	0.5
Average	11.3	12.2	11.8	12.6	13.4	13.8	14.1	14.1	12.9

Table 3.3 GDP by Country (at current price and official exchange rate)

	1990 Rank	1999 Rank	1990	1999	2000	2001
USA	1	1	5,743.8	9,268.6	9,872.9	10,082.2
Japan	2	2	2,970.1	5,015.0	4,454.6	4,172.5
Germany	3	3	1,503.6	1,991.5	1,891.0	1,845.3
United Kingdom	6	4	983.6	1,448.3	1,397.6	1,423.7
France	4	5	1,195.4	1,355.7	1,308.9	1311
Italy	5	6	1,094.0	1,112.9	1,084.7	
China	10	7	387.8	991.1	1,080.1	1,139.8
Canada	7	8	573.8	675.7	703.9	705.6
Spain	8	9	492.0	565.6	563.9	
Brazil	9	10	442.9	538.8	555.9	
Mexico	15	11	247.0	482.3	567.5	
India	11	12	306.0	450.0	0.0	
Korea	14	13	253.7	424.2	408.9	422.2
Australia	12	14	294.8	397.7	361.1	357.1
Netherlands	13	15	283.5	375.3	373.2	
Taiwan	19	16	162.7	290.5	313.9	282.4
Switzerland	17	17	228.4	242.9	247.1	
Belgium	18	18	193.8	237.1	230.8	
Sweden	16	19	229.8	231.3	218.4	
Austria	20	20	158.4	198.0	191.7	
Denmark	22	21	129.1	166.2	163.6	
Hong Kong	26	22	72.6	158.0	162.5	
Indonesia	24	23	106.1	156.7	134.5	
Norway	23	24	115.5	148.4	158.6	
Poland	27	25	59.0	148.3	165.5	
Saudi Arabia	25	26	104.7	142.9	173.3	
Finland	21	27	134.8	121.0	122.5	
Venezuela	28	28	48.6	96.5	117.8	
Singapore	31	29	37.5	85.3	91.9	85.6
Malaysia	29	30	42.8	78.9	89.9	
Nigeria	33	31	32.4	34.5	36.5	
Kuwait	34	32	18.2	29.8	38.0	
Romania	30	33	38.3	29.6	30.7	
Yemen	32	34	33.6	0.0	0.0	

Table 3.4 Global Population by Region and Age
(in millions of habitants and percentages)

	Habitants				Share in Region Total		
	All	Below 15	15 to 65	Above 65	Below 15	15 to 65	Above 65
China	1,281	295	896	90	23	70	7
Less developed countries excluding China	3,737	1,345	2,242	149	36	60	4
More developed countries	1,197	215	802	180	18	67	15
East Asia	1,512	333	1,058	121	22	70	8
U.S.	287	60	190	37	21	66	13
Western Europe	184	31	123	29	17	67	16
Japan	127	18	87	23	14	68	18

Source: Population Reference Bureau, *World Population Data Sheet, 2002*.

Table 4.1 China in World Trade
(in percentages)

	Merchandise Exports		Merchandise Imports	
	World Total in 2000	Growth 1990-2000	World Total in 2000	Growth 1990-2000
World	100.0	6.0	100.0	6.0
Asia	26.7	8.4	22.8	7.6
Japan	7.7	5.2	5.9	4.9
China	4.0	14.9	3.5	15.5
Hong Kong	3.3	n.a.	3.3	n.a.

	Commercial Service Exports		Commercial Service Imports	
	World Total in 2000	Growth 1990-2000	World Total in 2000	Growth 1990-2000
World	100.0	6.0	100.0	6.0
Asia	21.1	9.0	25.4	7.0
Japan	4.7	5.0	8.1	3.0
China	2.1	18.0	2.5	24.0
Hong Kong	2.9	0.09	1.8	0.09

Source: WTO.

Table 4.2 Share in World Exports of Manufactures, 1990 and 2000
(in percentages)

	1990	2000	Gain/Loss
World	100.0	100.0	
Developed countries	80.4	69.4	-11.0
Developing countries	17.5	27.4	9.9
Asia	12.6	19.9	7.3
China	1.9	4.7	2.8
Asia-Six*	9.1	12.2	3.1
Other Asia	1.6	2.9	1.3

Note:

* Asia Six: Taiwan, Hong Kong, Korea, Malaysia, Singapore and Thailand; Significant re-exports excluded.

Source: WTO.

Table 4.3 Foreign Direct Investment in China by Sector
(in millions of dollars and percentages)

Sector	Value			Share		
	1999	2000	2001	1999	2000	2001
Manufacturing	22,603	25,844	30,907	56.1	63.5	65.9
Electric Power, Gas and Water Production and Supply	3,703	2,242	2,273	9.2	5.5	4.8
Wholesale & Retail Trade and Catering Services	965	858	1,169	2.4	2.1	2.5
Transport, Storage, Post and Telecommunication services	1,551	1,012	909	3.8	2.5	1.9
Farming, Forestry, Animal Husbandry and Fishery	710	676	899	1.8	1.7	1.9
Mining and Quarrying	557	583	811	1.4	1.4	1.7
Construction	917	905	807	2.3	2.2	1.7
Scientific Research and Polytechnical Services	110	57	120	0.3	0.1	0.3
Health Care, Sports and Social Welfare	148	106	119	0.4	0.3	0.3
Education, Culture and Arts, Radio, Film and Television	61	54	36	0.2	0.1	0.1
Banking and Insurance	98	76	35	0.2	0.2	0.1
Geological Prospecting and Water Conservancy	5	5	10	0.0	0.0	0.0
Other Sectors	753	1,453	1,051	1.9	3.6	2.2

Table 4.4 China's FDI Inflows by Source Country, 1995-2001
(in billions of dollars and percentages)

	1995	1996	1997	1998	1999	2000	2001
	<i>Level</i>						
Hong Kong and Macao	20.5	21.3	21.0	18.9	16.7	15.9	17.0
Japan	3.1	3.7	4.3	3.4	3.0	2.9	4.4
Taiwan	3.2	3.5	3.3	2.9	2.6	2.3	3.0
Singapore	1.9	2.2	2.6	3.4	2.6	2.2	2.1
Korea	1.0	1.4	2.1	1.8	1.3	1.5	2.2
Neighboring Countries	29.7	32.0	33.4	30.5	26.2	24.7	28.7
USA	3.1	3.4	3.2	3.9	4.2	4.4	4.4
Virgin Island	0.3	0.5	1.7	4.0	2.7	3.8	5.0
Great Britain	0.9	1.3	1.9	1.2	1.0	1.2	1.1
Germany	0.4	0.5	1.0	0.7	1.4	1.0	1.2
Others	3.2	3.9	4.1	5.2	4.9	5.6	6.5
Total	37.5	41.7	45.3	45.5	40.3	40.7	46.9
	<i>Share of total</i>						
Hong Kong and Macao	54.7	51.0	46.5	41.6	41.4	38.9	36.3
Japan	8.3	8.8	9.6	7.5	7.4	7.2	9.3
Taiwan	8.4	8.3	7.3	6.4	6.5	5.6	6.4
Singapore	4.9	5.4	5.8	7.5	6.5	5.3	4.6
Korea	2.8	3.3	4.7	4.0	3.2	3.7	4.6
Neighboring Countries	79.1	76.7	73.8	67.0	64.9	60.7	61.1
USA	8.2	8.2	7.2	8.6	10.5	10.8	9.4
Virgin Island	0.8	1.3	3.8	8.9	6.6	9.4	10.7
Great Britain	2.4	3.1	4.1	2.6	2.6	2.8	2.2
Germany	1.0	1.2	2.2	1.6	3.4	2.6	2.6
Others	8.5	9.4	9.0	11.4	12.1	13.7	13.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Bureau of Statistics, *Statistical Yearbook of China*, 2002.

Table 4.5 FDI and Trade Patterns by Province and Ranked by Provincial FDI Amount in 2001
(in millions of dollars and percentages)

Province	Population (2001, million)	GDP (2001, current price)	FDI (2001)	Population share (2001)	GDP share (2001)	FDI share (2000-2001 average)	Trade share (2000-2001 average)	Trade contribution by FDI's (2000-2001 average)	FDI as share of Fixed Capital Formation (2001)	FDI per capita (2001)	GDP per capita (2001, current price)
<i>National Total</i>	1,276	1,286	46,367	100.0	100.0	100.0	100.0	50.4	23.7	36	1,008
Guangdong	78	128	11,932	6.1	10.0	25.7	36.1	53.6	75.0	153	1,648
Jiangsu	74	115	6,915	5.8	8.9	14.9	10.5	62.1	49.6	94	1,558
Shanghai	16	60	4,292	1.3	4.6	9.3	11.7	60.8	49.7	266	3,696
Fujian	34	51	3,918	2.7	4.0	8.5	4.8	61.4	80.9	114	1,490
Shandong	90	114	3,521	7.1	8.8	7.6	6.2	49.8	27.5	39	1,258
Liaoning	42	61	2,516	3.3	4.7	5.4	4.2	59.6	32.0	60	1,446
Zhejiang	46	81	2,212	3.6	6.3	4.8	7.0	16.7	31.0	48	1,762
Henan	22	22	2,133	0.8	1.7	4.6	3.6	79.2	51.3	212	2,208
Tianjin	10	34	1,768	1.1	2.7	3.8	3.5	31.7	26.8	128	2,479
Beijing	14	34	1,768	1.1	2.7	3.8	3.5	31.7	26.8	128	2,479
<i>Top 9 by FDI</i>	404	666	39,207	31.7	51.8	84.6	89.4	54.0	43.3	97	1,647
Hubei	60	56	1,189	4.7	4.4	2.6	0.8	29.3	14.3	20	940
Hunan	66	48	810	5.2	3.7	1.7	0.6	17.5	15.9	12	728
Hebei	67	67	670	5.2	5.2	1.4	1.1	29.9	6.6	10	1,003
Sichuan	86	53	582	6.8	4.1	1.3	0.6	21.0	7.1	7	617
Hainan	8	7	467	0.6	0.5	1.0	0.3	45.8	35.1	59	826
Henan	96	68	457	7.5	5.3	1.0	0.7	18.0	5.7	5	711
Jiangxi	42	26	396	3.3	2.0	0.9	0.4	15.5	14.5	9	626
Shaanxi	48	27	384	3.8	2.1	0.8	0.4	23.2	11.6	8	561
Shandong	37	22	352	2.9	1.7	0.8	0.5	14.3	6.1	10	607
Heilongjiang	38	43	341	3.0	3.3	0.7	0.8	11.4	4.3	9	1,126
Jilin	27	24	338	2.1	1.9	0.7	0.7	40.1	8.5	13	910
Anhui	63	40	337	5.0	3.1	0.7	0.7	40.1	7.0	5	626
<i>Middle 12 by FDI</i>	637	482	6,322	49.9	37.4	13.6	7.7	24.4	11.4	10	756
Chongqing	31	21	256	2.4	1.6	0.6	0.4	16.1	8.3	8	681
Shanxi	33	21	234	2.6	1.7	0.5	0.6	11.5	5.9	7	655
Inner Mongolia	24	19	107	1.9	1.4	0.2	0.5	7.9	3.6	5	784
Gansu	26	13	74	2.0	1.0	0.2	0.2	9.0	2.1	3	502
Yunnan	43	25	65	3.4	1.9	0.1	0.4	10.1	1.3	2	583
Qinghai	5	4	36	0.4	0.3	0.1	0.0	6.6	2.6	7	693
Guizhou	38	13	28	3.0	1.0	0.1	0.2	7.0	0.9	1	344
Xinjiang	19	18	20	1.5	1.4	0.0	0.5	4.3	0.4	1	954
Ningxia	6	4	4	0.4	0.3	0.0	0.1	11.6	1.5	3	639
Tibet	3	2	-	0.2	0.1	-	0.0	3.2	0.0	-	636
<i>Bottom 10 by FDI</i>	226	139	838	17.7	10.8	1.8	2.9	8.7	2.7	4	614

Source: National Bureau of Statistics, *Statistical Yearbook of China, 2002*.

Table 4.6 China's External Borrowing in 2000
(in thousands of dollars and percentages)

Borrower / Type of Loan	Foreign Govern- ment	Interna- tional financial institutions	Foreign Banks	Buyer's Credit	Borrowing by exporters, foreign companies and individuals	Issuing Bonds	Delayed Payment (Usance?)	Savings by Foreigners	Lease	Portion of Hard Currency Payment related with Counter- trade	Trade Credit	Total	Share in Total
State Council, Ministries	1,655,869	2,679,027	43,935			603,039						4,981,869	29.3
Chinese Banks	712,225		593,240	1,130,712	5,919	336,999	176,839	49,764	117			3,005,815	17.7
Chinese Non-Banking Financial Institutions			182,602	4,522		249,900		284	591			437,899	2.6
Foreign Invested Enterprises	1,668	77,601	800,517	157,978	2,314,315	76,998	59,498		31,262	154		3,519,989	20.7
Chinese Enterprises	596		89,457	9,432	25,054		13,709		976,296	10,328		1,124,871	6.6
Foreign Financial Institutions			1,581,144				20,036	103,375				1,704,556	10.0
Others			57,947	2,460	8,718		4,821		1,378			75,324	0.4
Trade Credit	2,370,358	2,756,627	3,348,841	1,305,105	2,354,006	1,266,935	274,903	153,424	1,009,643	10,482	2,161,000	17,011,323	100.0
Share in total	13.9	16.2	19.7	7.7	13.8	7.4	1.6	0.9	5.9	0.1	12.7	100.0	

Table 4.7 Population, GDP, Savings and Current Account Surplus by Selected Regions and Countries, 2001
(percentages and billions of dollars)

	Population (% of World)	GDP at PPP (% of World)	GDP (PPP) per capita as % of the World Average	Saving (% of GDP)	Investment (% of GDP)	Net Lending (% of GDP)	Current Account Balance (\$ bn)
China	21.0	12.1	58	40.3	37.9	2.4	17.4
India	16.7	4.7	28	20.3	22.9	-2.6	-0.1
Developing Asia	52.2	22.2	43	32.3	30.3	2.0	39.4
Developing countries	78.0	37.6	48	26.8	26.2	0.6	39.6
Countries in transition	6.6	6.2	94	24.0	21.0	3.0	11.8
Newly industrialized Asian Countries	1.3	3.3	254	29.0	23.9	5.1	57.1
Japan	2.1	7.3	348	27.3	25.2	2.1	87.8
European Union	6.2	19.9	321	20.3	20.2	0.1	3.2
United States	4.6	21.4	465	16.5	19.1	-2.6	-393.4

Sources: IMF, *World Economic Outlook*, September 2002 and World Bank website.

Table 4. 8 China's Balance of Payments, 1982-2001
(in millions of dollars and percentages)

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Current Account Balance	5,674	4,240	2,030	-11,417	-7,035	300	-3,803	-4,317	11,997	13,270
FDI into China	430	636	1,258	1,659	1,875	2,314	3,194	3,393	3,487	4,366
Net Errors & Omissions	279	117	-932	92	-863	-1,371	-1,011	90	-3,134	-6,748
Reserve Assets Change	-6,291	-4,137	-95	2,353	1,954	-4,931	-2,318	503	-12,118	-14,554
GDP in dollars at average exchange rate				304,423	294,247	321,277	400,000	448,913	389,259	406,443
Accumulated CA since 1982				527	-6,508	-6,208	-10,011	-14,328	-2,331	10,939
Accumulated FDI since 1982				3,983	5,858	8,172	11,366	14,759	18,246	22,612
Accumulated capital flight (E&O) since 1982				444	1,307	2,678	3,689	3,599	6,733	13,481
Accumulated official foreign exchange reserves	6,986	8,901	8,220	2,644	2,072	2,923	3,372	5,550	11,093	21,712
External debt				15,830	21,480	30,200	40,000	41,300	52,550	60,560
Accumulated CA since 1982 as % of GDP				0.2	-2.2	-1.9	-2.5	-3.2	-0.6	2.7
Accumulated FDI since 1982 as % of GDP				1.3	2.0	2.5	2.8	3.3	4.7	5.6
Accumulated capital flight (E&O) since 1982 as % of GDP				0.1	0.4	0.8	0.9	0.8	1.7	3.3
Official reserves as % of GDP				0.9	0.7	0.9	0.8	1.2	2.8	5.3
External debt as % of GDP				5.20	7.30	9.40	10.00	9.20	13.50	14.90

Table 4. 8 (continued)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Current Account Balance	6,401	-11,903	7,658	1,618	7,242	29,717	29,324	15,667	20,519	17,405
FDI into China	11,156	27,515	33,787	35,849	40,180	44,236	43,752	38,752	38,399	44,241
Net Errors & Omissions	-8,252	-9,804	-9,775	-17,812	-15,566	-16,952	-16,576	-14,804	-11,893	-4,856
Reserve Assets Change	2,102	-1,767	-30,527	-22,481	-31,643	-35,724	-6,426	-8,505	-10,548	-47,325
GDP in dollars at average exchange rate	481,389	601,223	542,749	701,250	818,873	903,241	960,789	992,353	1,079,481	1,157,211
Accumulated CA since 1982	17,340	5,437	13,095	14,713	21,955	51,672	80,996	96,663	117,182	134,588
Accumulated FDI since 1982	33,768	61,283	95,070	130,919	171,099	215,335	259,087	297,840	336,238	380,479
Accumulated capital flight (E&O) since 1982	21,733	31,537	41,312	59,124	74,690	91,642	108,218	123,023	134,916	139,771
Accumulated official foreign exchange reserves	19,443	21,199	51,620	73,597	105,029	139,890	144,959	154,675	165,574	212,165
External debt	69,320	83,570	92,810	106,590	116,280	130,970	146,040	151,830	145,730	170,110
Accumulated CA since 1982 as % of GDP	3.6	0.9	2.4	2.1	2.7	5.7	8.4	9.7	10.9	11.6
Accumulated FDI since 1982 as % of GDP	7.0	10.2	17.5	18.7	20.9	23.8	27.0	30.0	31.1	32.9
Accumulated capital flight (E&O) since 1982 as % of GDP	4.5	5.2	7.6	8.4	9.1	10.1	11.3	12.4	12.5	12.1
Official reserves as % of GDP	4.0	3.5	9.5	10.5	12.8	15.5	15.1	15.6	15.3	18.3
External debt as % of GDP	14.40	13.90	17.10	15.20	14.20	14.50	15.20	15.30	13.50	14.70

Source: National Bureau of Statistics, *Statistical Yearbook of China, 2002* and People's Bank of China website.

Table 4.9 US Current Account Deficits with Greater China
(in millions of dollars and percentages)

	Amount				Share of Greater China Total			
	China	Taiwan	Hong Kong	Greater China	China	Taiwan	Hong Kong	Greater China
1985	-6	-11,697	-5,610	-17,313	0	68	32	100
1986	-1,665	-14,267	-5,861	-21,792	8	65	27	100
1987	-2,796	-17,209	-5,871	-25,876	11	67	23	100
1988	-3,490	-12,585	-4,550	-20,625	17	61	22	100
1989	-6,235	-12,978	-3,431	-22,644	28	57	15	100
1990	-10,431	-11,175	-2,805	-24,411	43	46	11	100
1991	-12,691	-9,841	-1,141	-23,673	54	42	5	100
1992	-18,309	-9,346	-716	-28,371	65	33	3	100
1993	-22,777	-8,934	319	-31,391	73	28	-1	100
1994	-29,505	-9,597	1,745	-37,357	79	26	-5	100
1995	-33,790	-9,682	3,940	-39,532	85	24	-10	100
1996	-39,520	-11,447	4,102	-46,865	84	24	-9	100
1997	-49,695	-12,263	4,829	-57,129	87	21	-8	100
1998	-56,927	-14,960	2,387	-69,501	82	22	-3	100
1999	-68,677	-16,073	2,124	-82,626	83	19	-3	100
2000	-83,833	-16,097	3,133	-96,797	87	17	-3	100
2001	-83,096	-15,253	4,381	-93,968	88	16	-5	100
2002	-103,115	-13,805	3,283	-113,637	91	12	-3	100

Source: US Census Bureau website.

Table 4.10 US Exports, Imports and Balance of Goods in 2002
(in millions of dollars and percentages)

	Amount			Share of the Total		
	Balance	Exports	Imports	Balance	Exports	Imports
Total Balance of Payments Basis	-484,353	682,586	1,166,939	100.0	100.0	100.0
North America	-86,962	258,360	345,322	18.0	37.9	29.6
Western Europe	-89,218	157,080	246,298	18.4	23.0	21.1
Eastern Europe/FSR	-8,283	6,599	14,883	1.7	1.0	1.3
Pacific Rim Countries	-215,005	178,561	393,567	44.4	26.2	33.7
Australia	6,606	13,084	6,478	-1.4	1.9	0.6
China	-103,115	22,053	125,168	21.3	3.2	10.7
Japan	-70,055	51,440	121,494	14.5	7.5	10.4
Newly Industrialized Countries(NICS)	-22,073	69,823	91,896	4.6	10.2	7.9
Hong Kong	3,283	12,612	9,328	-0.7	1.8	0.8
Korea	-12,979	22,596	35,575	2.7	3.3	3.0
Singapore	1,429	16,221	14,793	-0.3	2.4	1.3
Taiwan	-13,805	18,394	32,199	2.9	2.7	2.8
Other Pacific Rim(3)	-26,369	22,162	48,531	5.4	3.2	4.2
South/Central America	-17,902	51,643	69,544	3.7	7.6	6.0
OPEC	-34,482	18,852	53,334	7.1	2.8	4.6
Other Countries	-36,397	28,956	65,353	7.5	4.2	5.6

Source: US Census Bureau website.

Table 4.11 Cross-Border Banking Capital Flows in Hong Kong, 1997-2002
(in millions of dollars and percentages)

	Period	Outside Banking Claims on HK (HK Gross Borrowing)	Outside Banking Liabilities to HK (HK Gross Lending)	Net Outside Banking Liabilities to HK (Net HK Lending)
All Outside Hong Kong	1997-06	629,554	640,490	10,936
	2002-04	249,541	389,987	140,446
	<i>Change</i>	<i>-380,013</i>	<i>-250,504</i>	<i>129,509</i>
	<i>Change in %</i>	<i>-60.4</i>	<i>-39.1</i>	<i>1184.2</i>
Japan	1997-06	309,067	361,423	52,357
	2002-04	57,942	81,484	23,542
	<i>Change</i>	<i>-251,125</i>	<i>-279,939</i>	<i>-28,814</i>
	<i>Change in %</i>	<i>-81.3</i>	<i>-77.5</i>	<i>-55.0</i>
Singapore	1997-06	48,863	37,597	-11,266
	2002-04	24,214	39,700	15,486
	<i>Change</i>	<i>-24,649</i>	<i>2,103</i>	<i>26,753</i>
	<i>Change in %</i>	<i>-50.4</i>	<i>5.6</i>	<i>-237.5</i>
UK	1997-06	50,679	28,231	-22,448
	2002-04	18,753	60,207	41,454
	<i>Change</i>	<i>-31,926</i>	<i>31,976</i>	<i>63,902</i>
	<i>Change in %</i>	<i>-63.0</i>	<i>113.3</i>	<i>-284.7</i>
US	1997-06	24,974	23,606	-1,368
	2002-04	12,491	31,806	19,315
	<i>Change</i>	<i>-12,482</i>	<i>8,201</i>	<i>20,683</i>
	<i>Change in %</i>	<i>-50.0</i>	<i>34.7</i>	<i>-1511.7</i>
Mainland China	1997-06	40,087	50,105	10,018
	2002-04	39,312	16,651	-22,661
	<i>Change</i>	<i>-776</i>	<i>-33,454</i>	<i>-32,679</i>
	<i>Change in %</i>	<i>-1.9</i>	<i>-66.8</i>	<i>-326.2</i>

Source: Hong Kong Monetary Authority website.

Figure 5.1 FDI Inflows, 1979-2001
(in billions of dollars)

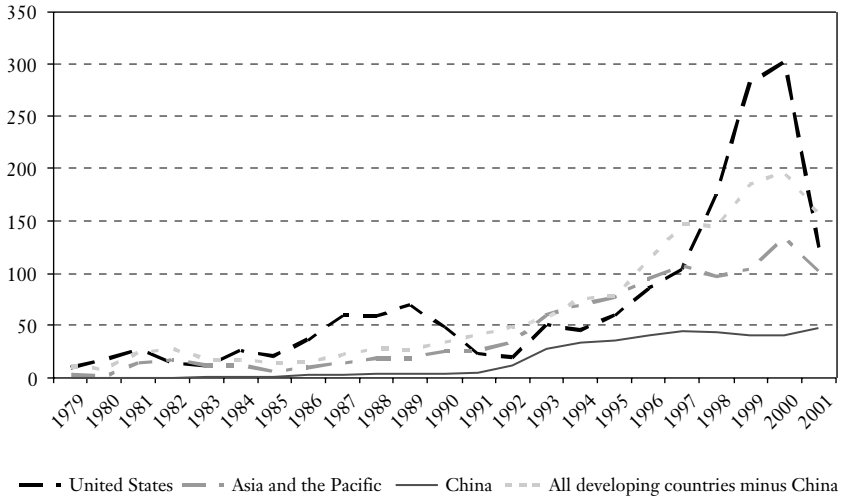


Figure 5.2 US Current Account Deficits with Greater China
(in billions of dollars)

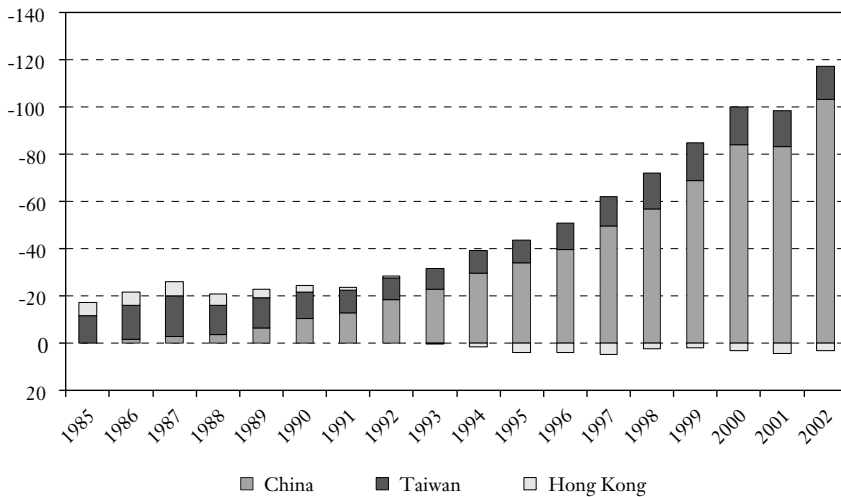


Figure 5.3 Banking Capital Flows between Hong Kong and Mainland China
(in billions of dollars)

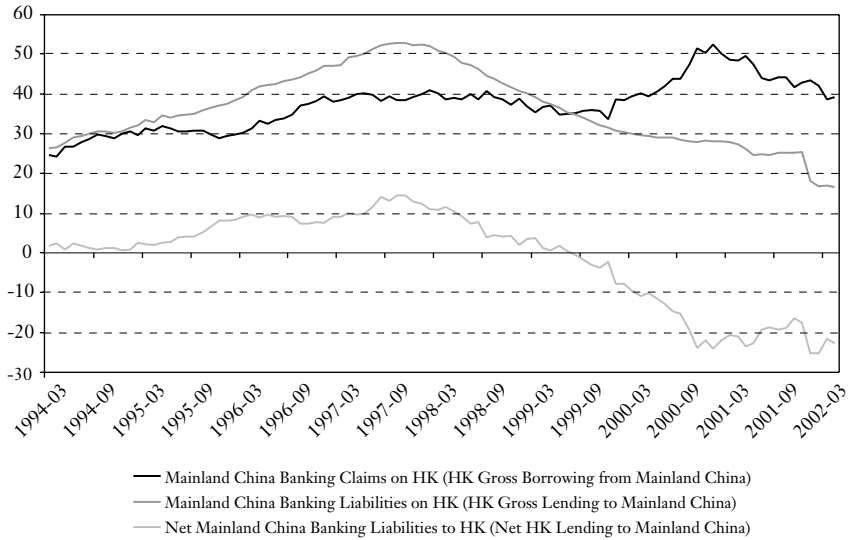


Figure 6.1 Cross-Border Trading between US and the Rest of the World
(in billions of dollars)

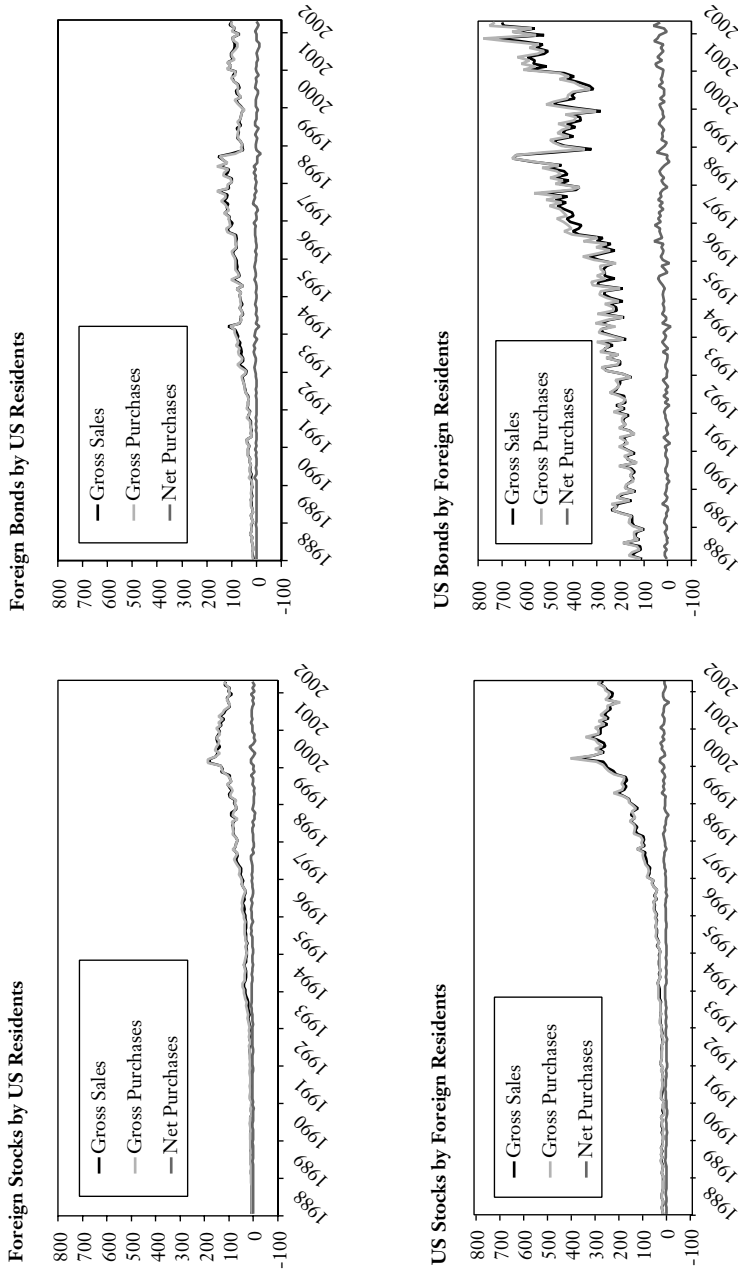


Figure 6.2 Cross-Border Trading between US and Asia
(in billions of dollars)

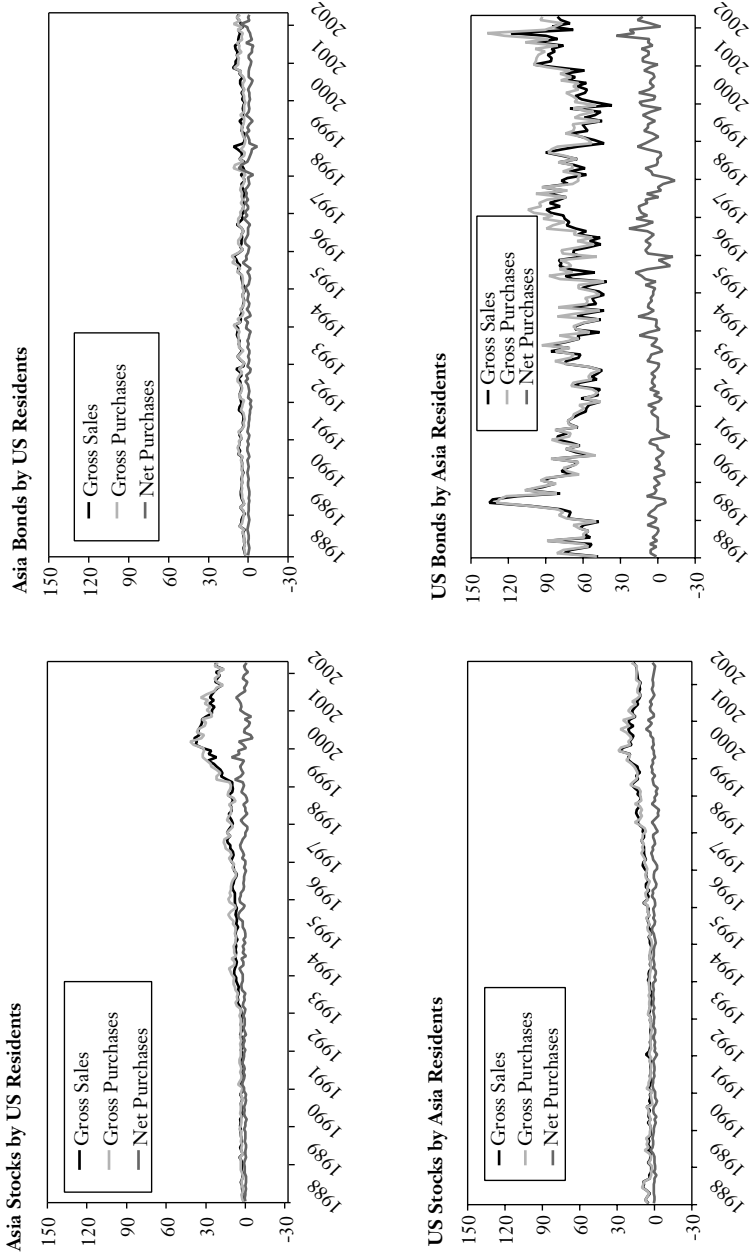


Figure 6.3 The Lower the Local Turnover, the Higher the Share of Trading by US Residents, The Case of Japan
(in percentages and billions of dollars)

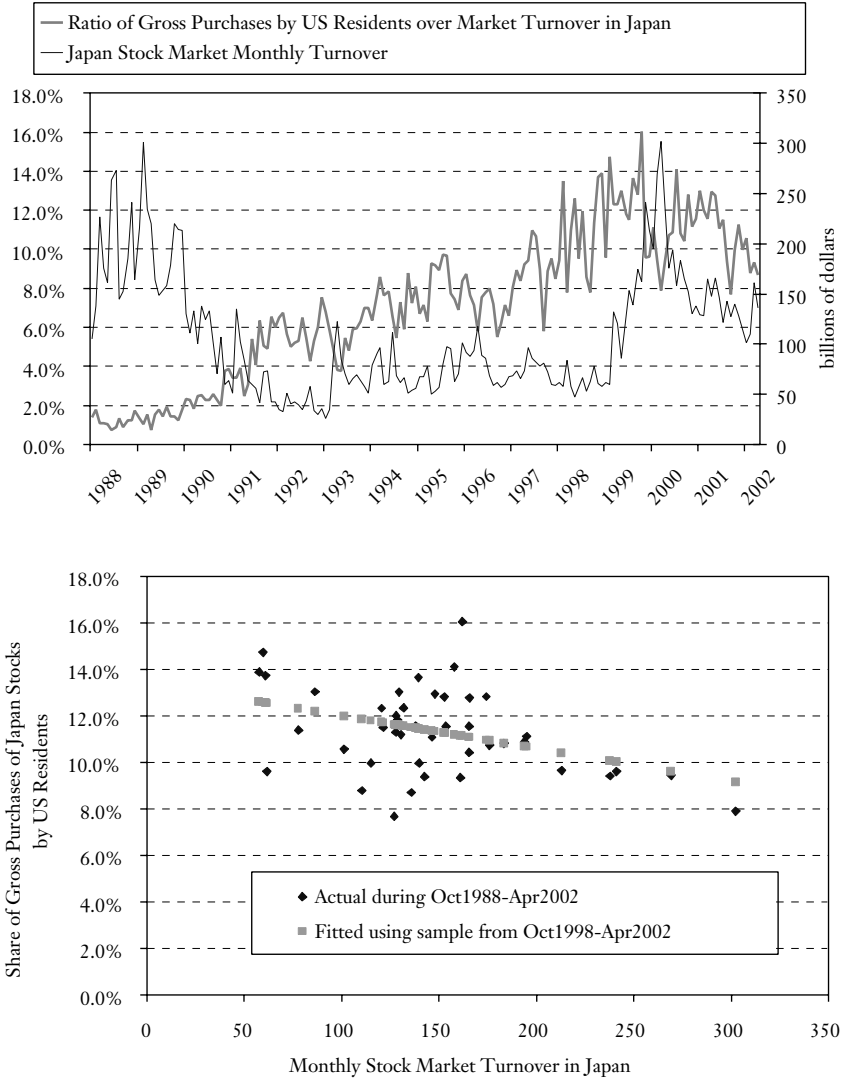


Figure 6.4 The Lower the Local Turnover, the Higher the Share of Trading by US Residents, The Case of Hong Kong
(in percentages and billions of dollars)

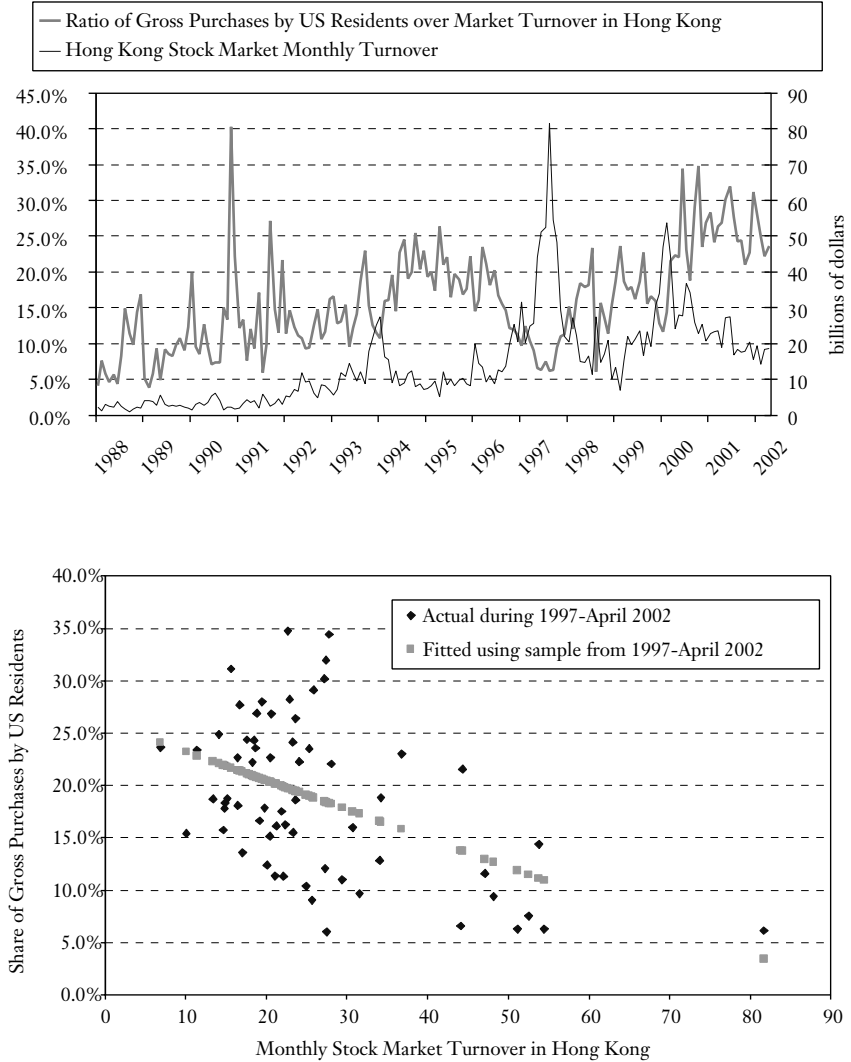


Figure 6.5 The Lower the Local Turnover, the Higher the Share of Trading by US Residents, The Case of Mainland China
(in percentages and billions of dollars)

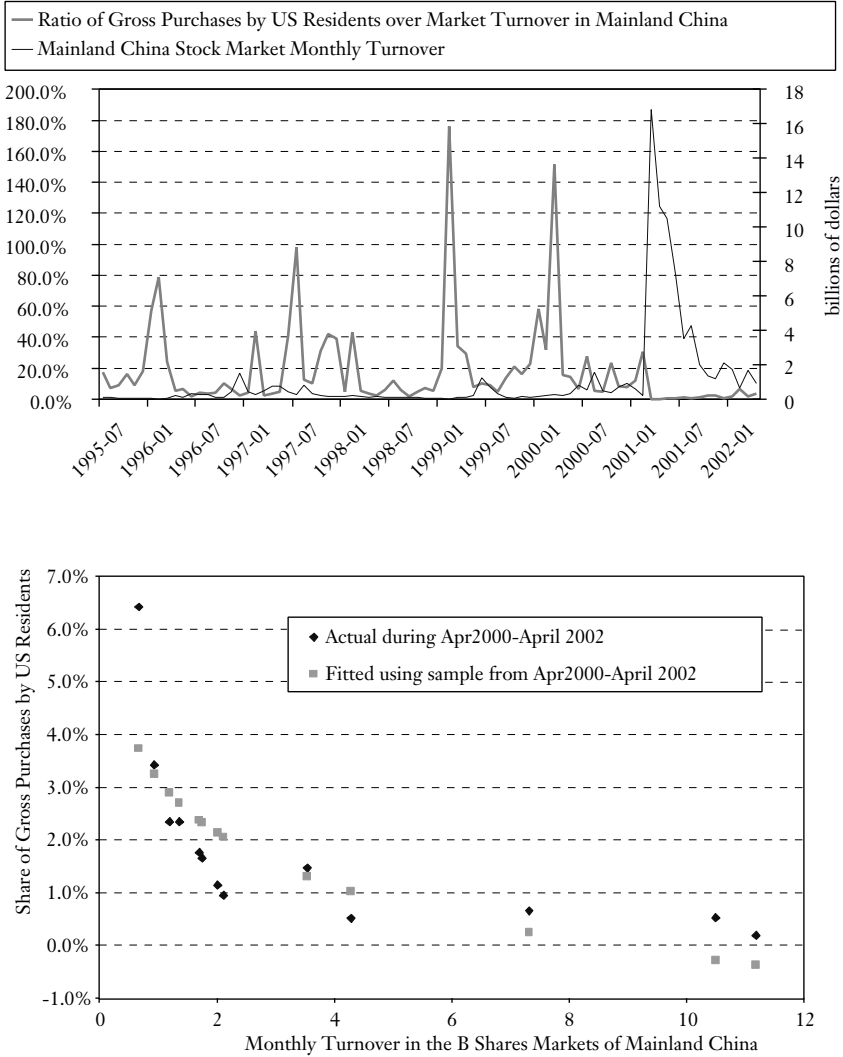


Figure 6.6 The Lower the Local Turnover, the Higher the Share of Trading by US Residents, The Case of Singapore
(in percentages and billions of dollars)

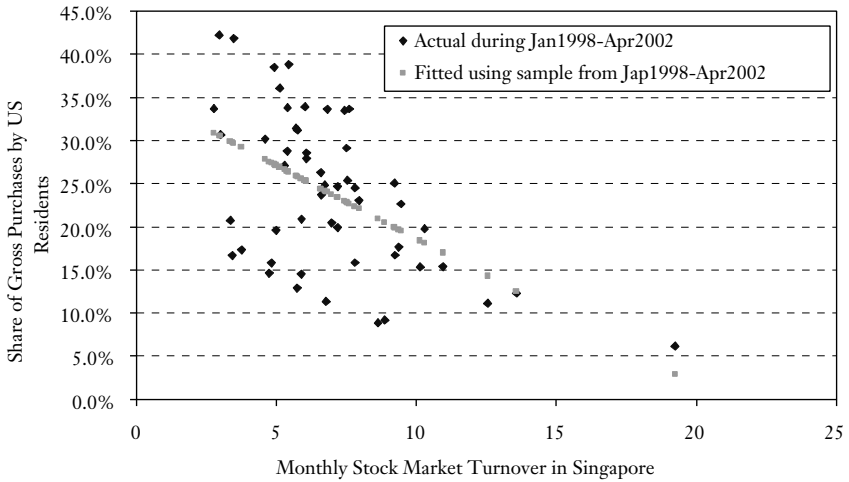
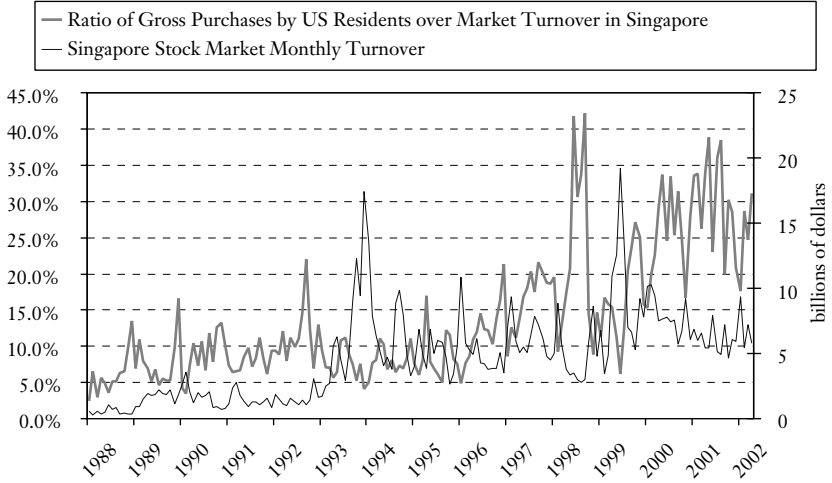


Figure 6.7 The Lower the Local Turnover, the Higher the Share of Trading by US Residents, The Case of Taiwan
(in percentages and billions of dollars)

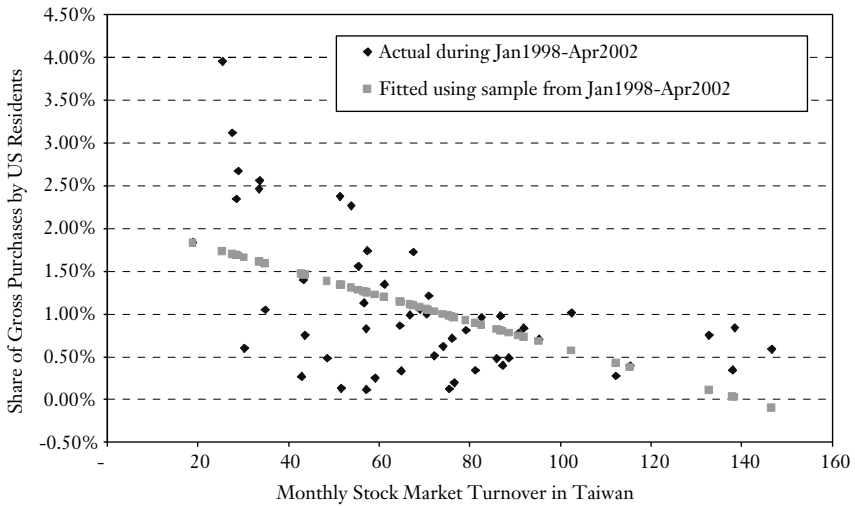
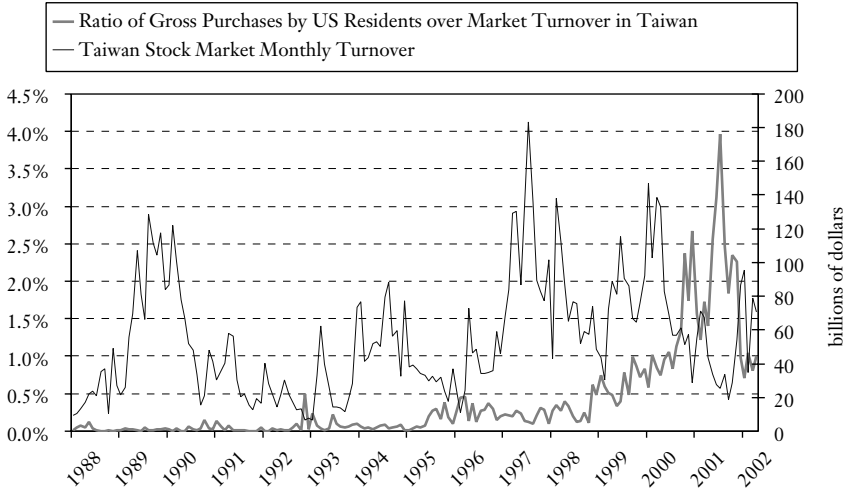
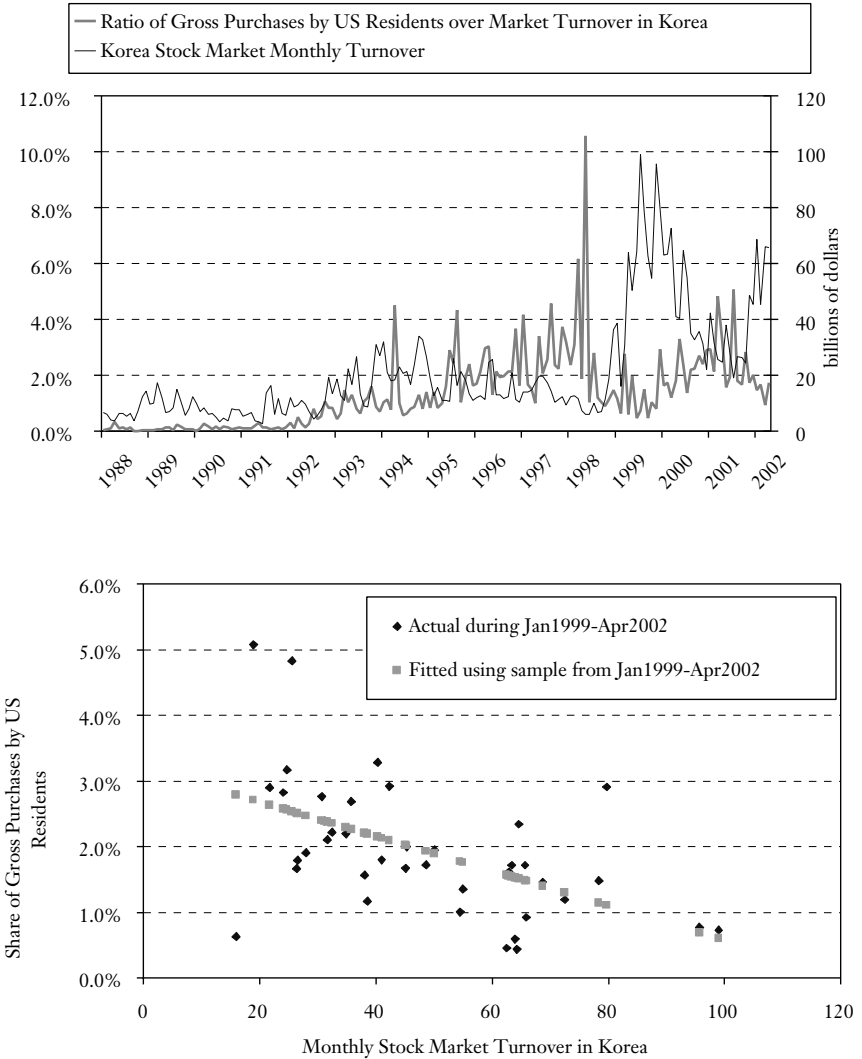


Figure 6.8 The Lower the Local Turnover, the Higher the Share of Trading by US Residents, The Case of Korea
(in percentages and billions of dollars)



9

Comment on Young Rok Cheong and Geng Xiao

*Li-Gang Liu**

This overview paper is very thought-provoking. It has raised many important issues facing the Chinese and world economies. The authors have painstakingly compiled a wealth of data, as indicated in 38 tables and charts, to provide evidence for their argument. The paper raises many interesting issues – each of which would be sufficient for a paper itself; but it is also styled so well that we can understand these complex issues with ease.

Let me give a quick review of key points of the paper. Essentially, the authors raise nine questions.

The first one is how to reconcile the fact that China is exporting capital and, at the same time, importing a large amount of capital. The answer they provide is that China used its trade surplus to finance its main customers, mainly the US customers.

The second question is whether China is attracting too much FDI. The answer appears to be ‘yes’.

The third question is what happens to China’s investment in US bonds. The authors’ figure indicates that China has become the second largest bondholder of the US treasury. Indeed, by 2001, China purchased the same amount of bonds as Japan.

* The discussant was formerly a senior research fellow at the Asian Development Bank Institute in Tokyo. He now is an assistant professor of Public Policy and Finance at the School of Public Policy of the George Mason University in Arlington, Virginia, USA.

The fourth question is: What is the impact of foreign portfolio investment on the stability of the Chinese stock markets? At this moment, the impact is negligible given that China's capital account is closed, but we may expect more impact in the near future as the Qualified Foreign Institutional Investors (QFII) plan to allow foreign institutional investors to set up joint-venture mutual funds in the Chinese stock market.

Fifth, they ask if China is generating global deflation. The answer is 'yes' in the labour-intensive manufacturing products but 'no' in overall manufactured products since China's share in world trade is still rather small, around 4 percent in 2000.

Sixth, they are interested in determining the seriousness of China's impact on its competitors. As Geng Xiao mentioned in his presentation, there are both benefits and costs of China's emergence in the world economy. Perhaps the rational strategy is for other countries to respond proactively and deal with the challenge of the emergence of the Chinese economy.

Seventh, they raise the issue of whether China is saving too much. Their answer is affirmative. Demographics and growth can explain this phenomenon. However, Chinese savings are not well utilised. The existing financial system is the root problem.

Eight, given large capital inflows and domestic savings, they ask a hotly debated question: Should China revalue its currency? Their qualified answer is, 'No, but perhaps some domestic price adjustment should be used.'

The last question they entertain is whether China has become a growth engine for the world. From the paper the answer is not that clear. Although China has become a major trading nation in the world and its GDP size in PPP is the third largest in the world, it is not obvious that China is an engine of global growth at this moment.

Having recapped the key points of the paper, I would like to make the following observations and comments.

The first one concerns the sustainability of the current trade-FDI pattern in China. There is a big difference between 'made in China' and 'made by China'. At present, more than 50 percent of Chinese exports is conducted in the form of processed trade: China imports intermediate components, mainly from Japan, South Korea, and Taiwan, and then assembles them for exports. The assembled products are then disproportionately exported to the US market.

This pattern of triangular trade has allowed China's powerful exporting neighbours, South Korea, Taiwan, and to some extent, Japan, to divert their previously US-bound exports to China, thereby reducing their trade surplus with the US. If this triangular feature of the China-US trade were to be taken into consideration, the adjusted real trade balance between China and the US would be far smaller than the current number since China's value-added in the processed trade has been rather minimal, mostly in the form of low wages of the assembly workers. Indeed, this feature is evidenced by the fact that although China has a large trade surplus with the US, it runs a similarly large trade deficit with South Korea, Taiwan and Japan. Therefore, China's global trade surplus is small, accounting for only 2 percent of its GDP per year. As the US-China trade deficit balloons, it is not surprising that China has become a new target of US trade policies, similar to Japan and other East Asian economies in the 1980s. Thus, it is very doubtful whether the current pattern is sustainable and whether China can continue to export its trade surplus to the US. At this moment, China's trade-to-GDP ratio is close to 50 percent and the US current account deficit is historically high, possibly reaching 7 percent of its GDP by the end of this year. One would have to wonder whether this size of US current account deficits could be maintained. There will have to be some kind of adjustment on both sides.

Second, I am puzzled by the fact that the wage rates in the export sector have been rather stagnant over the last ten years despite an impressive improvement in the sophistication of Chinese exports. The authors mention that FDI-funded firms are the main drivers of China's export growth contributing to 50 percent of China's exports. Indeed, China has become the largest FDI recipient in the world for the first time this year. Then it is puzzling that the wage rates in the exporting sector have not gone up much over the last ten years. Empirical evidence indicates that, normally, a country with a large amount of FDI like China would experience a rapid growth of wages in the export sector. The authors mention that in Guangdong province, over the last ten years, the average wage for manufacturing workers is only 100 dollars per month. I suspect that this rather stagnant wage pattern has a direct connection with the ongoing restructuring in the state-owned enterprise sector and the unlimited supply of labour from China's vast rural area. Because of these two factors, the wages in the export sector have not led to an overall

domestic wage growth, as is usually observed in a country with large inflows of FDI. However, without wage growth, it will be difficult for China to raise domestic demand. This is perhaps why China's growth is so dependent on export growth, as indicated by its trade-to-GDP ratio.

If you look at the nominal GDP among China, the US and Japan over the last 30 years, China's GDP in nominal US dollars as a share of United States' GDP has not changed much; it stayed more or less below 10 percent of United States' nominal GDP. On the other hand, if you look at Japan, its GDP as a share of United States' GDP has converged to the size of the US GDP until the bubble collapsed in the 1990s.

It is quite puzzling that although China has experienced quite high growth, it has not grown much in terms of nominal value of US dollars. This seems to indicate that the wealth from FDI-generated income is located overseas rather than within China. I wonder whether this is because the net value added in China's exports has been minimal, mainly in the form of cheap labour income.

The third issue I would like to comment on is whether there is an FDI diversion from ASEAN to China. This is a controversial issue, especially among Asian countries. However, I want to put this in perspective by asking whether the current trend of high FDI in China is a cyclical issue or a permanent phenomenon. If you look at the overall FDI flows to less-developed countries, excluding China, over the last several years, they have increased. Why have ASEAN countries received less FDI from the rest of the world? I think domestic factors play the major role. ASEAN countries were hit by the financial crisis of 1997-98 and the recovery from the crisis was further exacerbated by the September 11th terrorist attacks in the US. In addition, Islamic countries such as Indonesia and Malaysia may have suffered from a higher investment premium. Western investors may view these countries as quite risky, so they prefer not to move their assets to these countries for the time being.

If we look at the adjusted per capita flows and stock figures of FDI, as the two authors mention, 25 percent of FDI from Hong Kong to China is round-tripped FDI. That is, Chinese money or investment is first taken to Hong Kong or other offshore facilities and is then taken back to China in order to enjoy tax incentives, favourable land use concessions, better property protections, and

other types of subsidies. If these tax incentives are going to be phased out with China's WTO commitment, I feel that such capital flight may not return. After the dust has settled in the ASEAN economies, perhaps such capital from China will go to Malaysia or Indonesia, rather than go back to China.

The fourth issue I would like to discuss is an interesting and rather controversial one, that is, the prediction of the Lewis model the authors used: If the Lewis model is applicable, China is going to contribute to world deflation, or wage deflation at least. According to the authors, currently 224 million of Chinese would be participating in the world market, while two-thirds of the population are still waiting in line. If we think those people are waiting in line to get into the labour-intensive industry only, perhaps that kind of prediction could materialise. However, if we qualify this assumption by assuming that China will continue to grow with industrialisation and urbanisation, the non-tradable service sector will increase to a normal size as we have seen in most of the industrialised countries, and, as a result, the immiserising impact of Chinese export growth on the rest of the world will not take place.

Thus, the participation ratio of Chinese workers in the world economy will be much lower than the authors' prediction, and it is likely that a majority of people in China will engage in the non-tradable service sector rather than compete internationally. Also, as I mentioned, China cannot maintain a 50 percent trade-to-GDP ratio forever. This ratio is obviously unsustainable for a continent-sized country like China.

However, the issue is, as China's nominal GDP ratio to Japan and the US shows, that China's terms of trade have been flat over the years, despite the fact that it has been climbing the value-added product ladder. Perhaps the average wage rigidity, due to a lack of active bargaining power of the workers in the foreign-owned firms, might be the reason why wages cannot go up. And perhaps because of this problem, the income inequality in China in the 1990s has become worse. The problem is that local governments have great incentives to attract FDI, so in a sense, they tend to collude with foreign investors and the interests of workers may have been ignored here.

What is the policy implication then? Wing Thye Woo has mentioned that one should try to increase the income of the rural sector. I think we should go a bit further and also look at the wage

issue of FDI-funded firms. The question is whether the bargaining power of workers can be increased so that their wages can be increased through the bargaining process. In fact, this will be one of the solutions if China wants to sustain its growth by creating sustainable domestic demand in the future. Almost 90 years ago, when Henry Ford offered his workers a wage of 5 dollars a day, a much higher wage than usual, he had an economic insight not apparent to most people at the time. If a majority of his workers could not afford to buy his Model-T automobiles, who would demand them after productivity and efficiency were improved so immensely that the mass production of cars was no longer a fantasy? His insight proved to be right.

Today, the world is facing a similar challenge: integrating large, populous and poor developing countries into the world market. If this succeeds, it will boost their manufacturing capacities because of their large pool of semi-skilled industrial workers and, at the same time, it will directly impact the welfare of industrial workers of the developed world. To address this challenge, the wage rates and income of those developing countries will have to go up so that their own large internal markets can demand some of the goods produced. Besides waiting for the labour market alone to adjust the wage rates in developing countries, this process can also be facilitated if governments in both developed and developing countries collectively pay attention to and enforce their labour laws so as to allow wage bargaining between workers and capitalists to take place. On the other hand, the beneficiaries from the globalisation process, mostly the transnational corporations, will have to share some of their profits with the industrial workers in the developing countries. Similar to the insight of Henry Ford, it may be a difficult policy for some to accept at the moment. But for the sake of global prosperity, such measures will prove to be beneficial for everyone. Presumed as a champion for the welfare of workers and peasants, the Chinese government can play a decisive role in initiating a global movement that will benefit its own millions of industrial workers and peasants at home.

10

Floor Discussion of “China’s Role in the Region and in the Global Financial System”

The Park and Wang Paper

Masaru Yoshitomi, former dean of the Asian Development Bank Institute (ADBI), wondered whether China’s economic boom would eventually end in a financial crisis and what could be done to prevent such a crisis from occurring. “The main reason for the Chiang Mai Initiative is that we want to prevent a crisis similar to the capital account crises that struck Asia in 1997, and to better manage such a crisis when it would occur. First of all, we have to understand the real nature of the capital account crises of 1997. At the ADBI we have just released a report¹ that develops a set of policy recommendations for China on how to sequence its financial liberalisation, given that the sequencing order of financial liberalisation was clearly the missing link when the World Bank published its Asian miracle report in 1993 and only four years later the Asian crisis erupted.

The ADBI found that there was a huge gap between the new risks arising from financial liberalisation and deregulation (changing the incentives of borrowers and lenders), on the one hand, and the pre-existing, old kind of institutions including prudential regulation and supervision, on the other hand. The old regulatory frameworks

¹ ADBI, “Policy Proposals for Sequencing the PRC’s Domestic and External Financial Liberalization”, October 2002.

and institutions were clearly not prepared for managing the new risks under liberalisation because they had no idea about how to do capital account liberalisation. That is quite natural because under the old, regulated financial markets we did not need such concepts at all.

The capital account crisis did, in fact, happen in the 1990s in Asia, and it might happen in the future in China as well. I have come to the conclusion that big financial crises usually occur after a real economic boom with some technological improvements. In this decade, the Chinese economy will continue to boom at least until we have the Olympics in 2008, and probably until 2010 when we have the World Expo, financed by the banks and so on. The WTO accession will liberalise financial services transactions in China by inviting all kinds of financial institutions. So at the end of this decade, there is likely to be a risky combination of a continued economic boom together with a real estate bubble financed by the banks, not by the securities market like in Japan in the 1980s.

The *de facto* capital account liberalisation in China will probably end up in a capital account crisis because such crises tend to take place, not every year but every ten or fifteen years. In order to prevent a crisis from occurring in China, besides implementing the kind of policy recommendation on the sequencing order of financial liberalisation that we at the ADBI have suggested, we may also need the arrangements beyond the Chiang Mai Initiative that Yung Chul Park and Yunjong Wang have suggested in their paper. In my later panel presentation I will talk more about the kind of recommendations we have made in our ADBI report.” (See Chapter 17 of this volume.)

Xie Ping, of the central bank of China, thought that it was not yet clear to the Chinese government how regional financial cooperation beyond the Chiang Mai agreement should be developed. “It is not clear because China receives too many different suggestions. One day the ADB makes a suggestion, one day the World Bank, one day the IMF, and another day the BIS. It has been suggested, for example, that we create an Asian bond market, and that such a market would be very useful for the Asian countries including China. In the context of the Chiang Mai Initiative, last year we agreed on currency swaps with Japan, Thailand, Korea and some other countries, amounting to about 10 or 20 billion dollars. Some people say that this amount is very small and that, if China

would face a financial crisis, it would be absolutely nothing. So maybe this currency swap agreement is just symbolic. It may just mean that China participates actively in efforts at East Asian financial cooperation. Also, we have been discussing this Asian Monetary Fund proposal for a very long time. Some people are upset with it and are saying, 'You cannot do this!', while others are saying, 'This is a good idea'. There are so many people with different opinions about the Asian Monetary Fund.

Last week Professor Mundell from Columbia University, was in Beijing for a week. I met with him and he suggested to me that in the next 10 years, Asia should be united with one currency, and that this currency should be based on the Chinese yuan and the Japanese yen. He also thought that the Chinese yuan should be fully convertible before the 2008 Olympic Games. He gave us, the central bank, a lot of suggestions."

Wing Thye Woo, of the University of California, said that in every regional or global arrangement there is always an issue of economic power involved. "Look at Japan's experience in the IMF. For many years, the Japanese tried to enlarge the capital base of the IMF to increase Japan's voting power, but the Americans and the others resisted it. So any kind of regional financial institution set up now in Asia would mean locking in the present distribution of economic power. The president of such an institution would possibly be a Japanese, the executive vice-president a Chinese, the deputy vice-president a Korean. But let us say that we wait 20 years from now, perhaps the president and the next 5 executive vice-presidents would be all Chinese. So what's the incentive for China to lock-in the present status-quo distribution of power?

Another question is why China should be in favour of a regional bloc when its trade relationship is global in nature. It should be in favour of an Asian bloc only if this would be a building block toward multilateralism. Then the Chinese would be more enthusiastic about it. If you look at China's aspirations for the future, I think it would see its interests better served by a multilateral world rather than a regional bloc; and if it has to be a regional bloc, it should be seen as a bargaining chip to push the multilateral agenda. That's why I think the Chiang Mai Initiative has no life beyond monetary cooperation."

Geng Xiao, of the University of Hong Kong, agreed with Wing Thye Woo on the economic power issue in the Chiang Mai Initiative. "The difficulty of the Chiang Mai Initiative sort of effort

is that, at present, there are no credible leaders. Japan has a problem with its financial system, and nobody knows how to fix it. China is basically free-riding on the US system, pegged with the US dollar and trading with the US. So it is indeed very important to go back to fundamentals, as Yoshitomi and the ADBI people have done, and look at the so-called Asian miracle. If you look at Japan, Korea, Singapore, Hong Kong and all of these countries, they are all special cases of Asia in the sense that they are all small countries with a limited amount of labour supply and when the growth starts, the labour supply hits the limit and then wages go up. But in Asia, which has 50 percent of the world's population, the typical Asian situation is the case of unlimited supply of labour, fitting into the traditional Lewis model, the dual sector model. When China started growing, we had a huge population at subsistence level wages and an unlimited supply of labour, and that had an immediate effect on the ten years of growth. If you look at the Asian countries, we have all these successful economies of Japan, Korea, Taiwan, and now China, and you always see these huge current account surpluses, which mean that these countries are exporting capital, are having huge savings. But at the same time we have a huge surplus of labour in Asia. This means that we have a surplus labour economy exporting capital to the capital-rich US economy instead of investing it in the unlimited supply of labour economies in Asia. If capital and labour combine in Asia, these two things will continue to drive Asian growth. But the problem now is that the capital cannot go to Asia, it can only go to the US, and from the US it goes back to Asia through FDI. So we are actually free-riding on the US system, largely because the US financial system is the most competitive system in the world.

So in this sense, we have to go back to these fundamentals, to assess whether the free-riding on the US system is the best solution for Asia. Hong Kong is the typical case, it is just free-riding, and there is no monetary policy. If Japan would resolve its banking problem, the Japanese interest rate would rise, which would help to better allocate resources because at a 0 percent interest rate, this capital just does not know where to go, it just goes to the US.

We are all without choice just investing in the US, but at the same time we have so many resources in terms of labour, in terms of oil in Indonesia, all kind of resources. We have technology in Japan and in Taiwan, and we have financial markets in Hong Kong, but we

are not using it. Last year, even Hong Kong had capital flight to the US. In Asia there is no leader, we are still relying on the US. But we have to ask ourselves whether that is the best solution.”

Yung Chul Park was not sure that China would face a financial crisis in the next 10 to 15 years. “Whether China is going to be the next epicentre of a financial crisis within the next ten years or so depends upon a couple of assumptions. The first is, to what extent China is going to borrow from abroad, from the global market. The second is, to what extent China is going to borrow from other Asian countries. In the next 10 to 15 years, I don’t think China is going to borrow so much from outside. Since the savings rate is still very high, China will continue to run a current account surplus for some time. But the foreign debt of China will not go up to the level of Korea or Thailand or Indonesia, so the foreign debt-to-GDP ratio will remain very low.

I am more concerned about domestic financial turbulence in China because of this non-performing loan problem and the bankruptcy of the state-owned banks. And this domestic instability may spill over to other East Asian countries and that might be something to worry about even though I think the spillover would be relatively small. So I am not as much worried about the possibility of China getting into a serious financial crisis as Yoshitomi.”

Li-Gang Liu, of the ADBI, was puzzled about the leadership issue in Asian financial cooperation that Park and Wang raised at the end of their paper. “I am not sure that the analogy of Germany and France, as leaders in European integration, necessary applies to China and Japan as leaders of Asian integration. In terms of economic size, China is just one-fifth of the Japanese economy. Also, if the rest of the Asian countries are further advanced in terms of financial services liberalisation, capital account liberalisation and domestic financial liberalisation, why can’t they start some kind of a financial cooperation framework? China can always join at a later stage. The IMF system started without Russia, and the WTO did not have China as a member for many years, so why should the other countries, if they are willing to go ahead, wait for China?”

Zdeněk Drábek, of the WTO, thought however that Chinese cooperation was of key importance. “Since the stability of the exchange rate in the region is important, the Chinese role in that context is important. It would be very useful for Korea, for Thailand, for Indonesia to know whether the Chinese are going to devalue their

currency or not. So in that sense monetary cooperation with the Chinese is not premature but highly important.”

In his reply to the comments, Yunjong Wang stressed that the basic aim of the Chiang Mai Initiative (CMI) and the Asian Monetary Fund (AMF) is to prevent financial crisis and manage the crisis better. “In terms of crisis prevention, we need two things: one is the swap facility and the other is the monitoring and surveillance system. Regarding the facility, the current CMI just links to the IMF, so if we are really satisfied with the current Chiang Mai swap scheme, we should probably be happy with the way in which the IMF deals with crisis prevention and management as well. Then we don’t need to go any further. But if we are dissatisfied with the role of the IMF and the current scheme of the CMI, then we should think about what kind of elements could be introduced to better prevent the crisis. Regarding the monitoring and surveillance system, the main task is to identify the emerging problems in East Asia. The policy dialogue has already started, but that’s not enough, we need a secretariat to detect and initiate a discussion about the emerging issues.

Probably ASEAN+3 will just have to forget about exchange rate coordination, because it is too early. Currency union and currency unification is a delicate political issue. In terms of exchange stability, European countries have a different past, they started with the fixed exchange system, and they didn’t need to care too much about exchange rate stability. The Bretton Woods system guaranteed exchange rate stability through various ways, and for two decades the European countries had quite stable exchange rates and also capital controls.

In East Asia there are now different degrees of capital market opening. Geng Xiao talked about China’s free riding, but I think that China’s monetary policy is independent because China has a restrictive capital market opening. Hong Kong has a currency board system and its capital market is open, so it is very sensitive to US monetary policy. But China can maintain an independent monetary policy.

Talking about currency unification, there is indeed this fact of status quo in economic power. It is a very important factor. If we pursue monetary unification, political will is important. Political scientists are trying to explain why the East Asian countries have no particular political will. European leaders have a kind of new

functionalistic vision underpinning the European system. In Europe there is a lot of interaction between the countries and the spillover effects are large, so there is a natural need for policy coordination. But in East Asia we still have a relatively low degree of intra-regional trade. It is increasing but it is still low. We also have minimal financial integration among the countries, but that is a less important factor. The most important factor is that countries have different policy objectives. For China, economic development is a more important issue than regional integration, and Japan may have yet another policy objective. Different political instruments are required for these different policy objectives. My conclusion is that it is probably still too early to say much about a high level of economic integration in East Asia.”

The Cheong and Xiao Paper

Robert McCauley, of the BIS, wondered whether the Lewis model, in the modern monetary world, would be the right way of looking at wages and employment in China. “The current world is quite different from the employment model when potential growth was reasonably well defined. For example, if the renminbi were to revalue, would that mean that the nominal wage would simply go down more or less in proportion to the devaluation?”

Geng Xiao explained that in the Lewis model, the real wage is determined by subsistence labour and the unemployment rate. “There is a lot of unskilled labour in China, and labourers are competing with each other to find a job. On the one hand, the wage level has to be higher than their incomes in the countryside and, on the other hand, they have to face the unemployment in the cities. So these two conditions more or less determine the wage rate. Chinese people have lived so many years of endurance and frustration in real income that they can deal with low wages. An exchange rate revaluation would probably have an effect on real wages, but not too much. On the longer time horizon of 5, 10, 20 years, wages are hard to change, largely because you have so many people coming out of the countryside who are looking for a job. Wages will go up largely when things become cheaper and the living standard increases. Food has become cheaper for everybody in China, including the people in the countryside, and that has increased their living standards.”

Masaru Yoshitomi wondered how one could reconcile the fact that income in China has increased and, at the same time, a large part of the population still lives at a subsistence level. “How does the Lewis model apply to China? On the one hand, we are hearing that the income of people in China has increased over the past 20 years and that it will continue to increase in the next 20 years. But, on the other hand, Geng Xiao insists that the Lewis model applies because the wage level will continue to be based on wages at the subsistence level. How do you reconcile these two sort of conflicting facts?”

Young Rok Cheong thought the explanation was quite simple. “These facts go together because there is a large inequality in income in different areas. Look at the per capita GDP in the cities, and at the difference between the top rich 9 cities and the rest. The gap is widening.”

Yoshitomi insisted: “But the question is: Have the wages of the labourers who migrated to the coastal areas remained constant over the past 20 or 30 years? And are the wages in the coastal areas still determined by the subsistence level in the very remote areas in China? That is what I’m asking.”

Cheong explained: “You will be surprised to know that wages for the workers in Guangdong in assembling lines in foreign investment enterprises are actually lower than probably in the whole nation because the competition in the labour market is so perfect that labourers are coming from all over China. If you want to find a job you go to the coastal cities. The wages there are not higher than in the interior cities.”

Yoshitomi continued: “What kind of immigrants are they? Are they coming into the cities from relatively near or from remote areas?”

Cheong: “Both, they are coming from the Western part of China, and they are coming from within the province. Many of the migrating workers are not seeking the job by themselves but are being sent by provincial governments. They organise the provision of cheap labour, as cheapest as possible, and export the labourers to the coastal areas. I visited many companies and they have their own dormitories and maintain a very low level of wages.”

Geng Xiao added that for skilled labour, wages are increasing rapidly in China. “The wage income of the professors and the technicians is going up very fast, every year. The gap between skilled and unskilled labour is increasing rapidly. Wages for unskilled

labour, on the other hand, remain low because you have plenty of supply. For example, when you advertise for a waitress, there are hundreds of people applying. How can you then increase the wage? Even in Hong Kong the wage for unskilled labour has not changed much, it is still the same as 10 years ago.”

Charles Adams thought that at the time Lewis developed his model, he did not make a distinction between product wages and consumption wages and that the subsistence argument is about the consumption wages. Second, he found it very odd to be talking about China's exporting deflation. “At best it is an issue of relative prices. But in the case of the US, manufacture prices have been rising less rapidly than service prices for a long time, and well before China was potentially on the scene. So I suspect it has something to do with differential productivity. And just to make a provocative point: while it seems that one can make the case that the RMB does not need to appreciate vis-à-vis the US dollar, one can also make the case that the RMB should appreciate against the rest of Asia. What would happen if the US dollar weakened against the other Asian currencies and the RMB did not change?”

Geng Xiao said that his quick answer would be that most Asian economies are pegged to the US dollar, “so when the US dollar changes everyone just follows”.

Adams observed that there might be a *de facto* pegging, but on paper, most countries were floating. “So if we see adjustments in other Asian currencies, then there will be an issue about the cross-rate between those currencies and the RMB. So all I'm asking you is, if you think on that margin, what would be your answer?”

Xiao: “According to economic theory it is very simple: you just don't mess with the exchange rate. The issue of prices and price changes is confusing in China because the country is not an equilibrium economy. The exchange rate is about inflation; it is about the price. In China, there are many sectors and many regions, all fragmented, and they are all trying to find equivalent prices. So the exchange rate is used as an anchor.”

Adams: “I may be old-fashioned, but nominal exchange rate changes have quite a profound effect on real exchange rates, for a sustained period, in many countries.”

Xiao: “That is true, but exchange rate fluctuations in China would also have a huge wealth impact in the sense that China's holding of foreign assets are huge. I did some rough calculations:

once you change the exchange rate by, say, 10 to 20 percent, there is going to be a redistribution of wealth in China of the range of 7 to 8 percent of GDP. That is why I doubt whether China should have floating exchange rates. The monetary system in China relies so heavily on the US dollar, 45 percent of China's central bank assets are in US dollars, and 24 percent of China's GDP is in US dollars. So if you mess with the exchange rate, you will stimulate huge speculations of people who will be trying to make money out of the exchange rate changes. That's why the exchange rate in China should remain fixed. By remaining fixed, the renminbi remains credible – at least, as long as China continues to have a surplus. And a fixed rate substantially reduces the risks for traders, producers, foreign investors and Chinese people. So, in my view, the current monetary system is the best for China. I don't believe in the traditional IMF recipe because that is only right for an economy based on an equilibrium model. It is better to give China an exchange rate anchor, so that it can fully employ its labour force. Once that is realised, we can talk about floating and all the other traditional arguments coming into effect. But first China has to address the basic question of development.”

Xiao stressed that China's trade-to-GDP ratio of 45 percent was rather meaningless because of the minimal value-added in China's exports, and that China would remain a very attractive country for foreign investors. “As a percentage of GDP, the value-added is very small and China's GDP, in PPP terms, is highly undervalued. It is the opposite in Japan. Japan's exports are only 10 percent of GDP because its GDP, in PPP terms, is overvalued. I don't think that the potential of FDI into China is going to decline, largely because once every major multinational corporation has production facilities in China, you generate an economy of scale and scope that is going to have its own momentum. Look at what happened earlier in history in Manchester, New York, Chicago, Tokyo, Osaka – they have all become major manufacture centres of the world. The same is now happening in Shanghai and in Guangdong.”

Yunjong Wang shared Xiao's view that China would continue to attract foreign investors, because of its own large population and that of neighbouring India. “I cannot see a turning point in foreign investment in the near future. India, with its large English speaking population, is trying to establish special economic zones along its coast. Just like China, India also has an unlimited supply of unskilled

labour. The two countries together may have 1 billion unskilled labourers. That is going to attract a lot of capital. But we should be careful. There are still many foreign investors who do not want to invest in the western part of China. To attract foreign capital, you need a good infrastructure and a good working discipline. Foreign factories are mostly concentrated on the coastal line and this might create growing inequality, undermining social cohesion and stability. However, both India and China have an enormous potential for foreign investments.”

Geng Xiao emphasised that the competitive pressure of China in the world is just there, not only because of the Lewis model and the unlimited supply of labour, but also because of the mobility of institutions and of capital. “The successes of Shanghai and Hong Kong are tremendously important. You cannot believe how many people are focused on China, and how much advice is given to China. Look at the whole world, look at the major US and European corporations, or at the major international, US and European institutions, they all have China experts who study China, advise China, and think about China. All the high techs are in Hong Kong. So this is real. If China continues its success, the implications for the whole world are tremendous. It is so simple, I mean, 1000 or 500 years ago we spent most of our time on getting food and shelter, but today one hour is for food and the other time is for entertainment. In a way, this relative price adjustment is good news, it means that now, in principle, it should be easy for everyone in the world to have a decent basic life. We have the technology, the knowledge and the institutions to realise that.”

Zdeněk Drábek wondered about the importance of FDI for China's growth. “How important is the foreign sector? What is really driving the growth? I would think that most of the aggregate demand is domestic and that most of the investment must be domestic investment. So I don't think that foreign investment is the engine of economic growth in China. What is much more important is what the government is doing. I think that the fiscal policy and the investments by state enterprises are driving this big investment drive in China.”

Young Rok Cheong agreed. “The magic is not just FDI or the unlimited supply of labour. The magic is to put everything together. The Chinese government is a very stable government and very open-minded to foreigners. And indeed, the infrastructure investments are huge and unprecedented in China.”

Cheong ended the discussion with three policy suggestions. “The first is that the Chinese government can and should allow the market to work. The market is working at the global level and it should also work at the national level. Second, once China fully employs all its surplus labour, it can apply the traditional recipes of economic equilibrium theory. China’s labour force provides competitive pressure to other countries, but it also harbours domestic risks, social risks. Third, the development of the domestic financial system in China is of key importance for sustained growth. Economic growth is facilitated by the protection of property rights, and the protection of property rights in China is coming through in the wrong way, through the foreign investment enterprises. Only when the foreigners came in, the government started to secure property rights and apply other standards of international practice in, for instance, the hiring of workers. Property rights protection is going to be the key for China to have success in the next stage. The financial sector is a derivative of the real sector and anything that goes wrong will be reflected in the financial sector. So by tracing the road for the financial sector in China, we can trace the road for maintaining growth and development.”

Part III

Asian and Other Views on the Functioning of the Global Financial System

11

An Asian View on the Global Financial System

Xie Ping

It is difficult to present a unified Asian view on the global financial system. But, as an emerging market, Asia has its independent interest which provides some clues.

I would like to concentrate on three issues which have attracted most of our economists' and policymakers' attention during the past two to three years. These are: (i) given the competition in global financial markets, what are the costs and benefits of financial integration for Asian economies?; (ii) in response to the shock on benefits of global financial integration, how can we build a new Asian policy cooperation regime after the crisis of 1997-98?; and (iii) given the post-crisis policy option between currency stability and financial deepening, how should Asia's goals be clearly defined?

As many Asian economies express their views in various ways, an Asian view on the global financial system can be concluded as follows. First, the recent initiatives on intra-regional financial cooperation reveal the intention of Asian countries to combine their economies as a subset within the global financial system, following the European Union mode, rather than remain isolated countries linked separately to the world economic system. The Asian economies are expected to unify their foreign exchange systems, bond markets, stock markets, and finally their currencies. Second, at the operational phase, Asian financial development is on the crossroad between collective action and individual growth. In order to minimise a conflict of interests, collective action within the

ASEAN+3 framework is a better choice; intra-regional crisis prevention and control will be more efficient given the dramatic growth of global capital flows. Third, the instability of global capital flows results in foreign exchange rate volatility; however, a vulnerable financial system is more likely to be attacked by speculative forces than a robust one.

1 Cost-Benefit Analysis: What Is Asia's Role Within International Financial Integration?

An Institutional Explanation of Financial Globalisation

Financial globalisation is a trade-off between institutional innovation, which reduces the individual country's transaction cost, and the increase of uncertainty. On the one hand, as Obstfeld (1994) and Acemoglu and Zilibotti (1997) show, international financial integration (IFI) facilitates risk-sharing and thereby enhances production specialisation, capital allocation and economic growth. Further, in a standard neoclassical growth model, IFI eases the flow of capital to capital-scarce countries with positive output effects (Edison *et al.*, 2002). Also, at the institutional level, IFI enhances the functioning of domestic financial systems through the intensification of competition and the importation of financial services, with positive growth effects (Klein and Olivei, 2000; Levine, 2001). On the other hand, as Boyd and Smith (1992) show, IFI only promotes growth in countries with sound institutions and policies since capital may actually flow from capital-scarce countries to capital-abundant countries with better institutions. In order to measure IFI, Edison *et al.* (2002) compare five-category indicators: IMF-Restriction, Quinn measure, Stock of Capital Flows, Flow of Capital, Stock of Capital Inflows, and Inflows of Capital. They find four statistical stylised facts. First, rich countries tend to be more open. Second, countries with well-developed financial intermediaries, stock markets, legal systems, and low levels of government corruption tend to have greater capital account openness. Third, IMF-Restriction negatively correlates with capital account openness. And fourth, IMF-Restriction, Stock of Capital Flows and Flows of Capital are not significantly correlated with economic growth; however, Stock of Capital Inflows and Inflows of Capital are.

Based on the above literature, Asian economies may draw the following lessons. First, IFI is an innovation for breaking down domestic financial restrictions, through which transaction costs in cross-border capital flows can be reduced. Second, IFI and capital flows are double-edged swords. Poverty reduction or growth is never the task of IFI. Therefore, since Asia as a whole is a developing region, an overestimation of the positive effects of a too early openness and an underestimation of the positive effects of capital restrictions are both unwise. The optimal solution is a sequencing arrangement, i.e. reforming the domestic financial sector in advance, then cooperating within the region and building up of fair play circumstances within the global financial system, and finally, thoroughly opening up to the rest of the world.

Asia's Costs, Risks and Benefits in the Current Global Financial System

Although, as mentioned above, IFI brings benefits to open economies with sound institutions, the crisis in 1997 still suggests a deep thinking on costs and risks that the whole region takes. Financial globalisation usually refers to the growing financial interdependence of countries worldwide brought about by the increasing volume and variety of cross-border financial transactions and international capital flows (Wagner, 2001). IFI imposes both persisting and transitory effects on Asian economies. As Citrin and Fischer (2000, p. 27) show, FDI and capital inflows are driving forces for growth, while IFI forces Asian governments to ensure sound institutional and political frameworks, and limits 'the scope for countries to pursue policies that are incompatible with medium-term financial stability'. Therefore, the persisting effect is that competition among economies with a similar infrastructure is going to be more intensive.

On the other hand, the transitory effect is contagion in a region. Theoretical research shows that contagion could happen through three channels: global shocks, weak fundamentals, or "pure contagion". In the global-shock model, crisis is triggered by common external shocks, such as war. Contagion as a result of weak fundamentals (Kaminsky and Reinhart, 1999) is also called "spillover" (Masson, 1998). Eichengreen, Rose and Wyplosz (1996) show how a currency crisis in one country can have a real effect on

the economy of its trade partners. In the third mechanism, contagion can be caused by herding behaviour of investors (Calvo and Mendoza, 2000), by a shift in investor's expectation (Masson, 1998, Rorik and Velasco, 1999), or through a "liquidity squeeze effect" (Valdés, 1998). Asia's crisis in 1997 shows a mixed contagion of weakness of fundamentals and herding behaviour, imposing significant costs on Asian economies.

The Role of Finance in Asian Economies

The role of finance in economic stabilisation and growth has produced one of the most passionate debates in economic literature. As Joseph E. Stiglitz writes in "The Role of the State in Financial Markets", "financial markets essentially involve the allocation of resources. They can be thought of as the 'brain' of the entire economic system, the central locus of decisionmaking: if they fail, not only will the sector's profits be lower than would otherwise have been, but the performance of the entire economic system may be impaired" (Stiglitz, 1994). However, financial liberalisation remains a special topic because successful financial markets have identical characteristics, while successful economies have not. For example, transparency, full information disclosure and mature accounting standards are necessary conditions for all major financial markets, hence there is no institutional difference between the New York market and the Hong Kong market. But successful economies, such as the US, the EU, Japan and Hong Kong, have their own rules and norms.

At the theoretical level, the theorists can be classified into two categories: the financial structuralist and financial repressionist schools (Gupta, 1987). The former contends that the quantity of financial variables and its composition affect the growth and stability of the economy, and financial deepening (e.g. aggregate financial assets in relation to GDP) is the path to a modern economy (Gurley and Shaw, 1960; Goldsmith, 1966, 1969; Patrick, 1966). On the other hand, the financial repressionist school, which lays the emphasis on price variables such as real interest rate and real exchange rate, believes financial repression, especially in the form of below-equilibrium real interest rate and domestic currency overvaluation, retards growth. Accordingly, its policy recommendation is financial liberalisation (e.g. introducing a flexible market price regime) (McKinnon, 1973; Shaw, 1973; Fry, 1987).

However, the financial crises in Latin America and East Asia show that neither financial deepening nor financial liberalisation is a sufficient condition for financial development and steady economic growth. Therefore, a new but simple framework is needed to analyse the structure of the Asian countries' financial markets and find a practical dynamic path to financial development.

Neo-Financial Dualism Hypothesis: Financial Intermediation and Risk-Sharing Mechanism

The traditional financial dualism theory defines a developing country's financial system as two parts: a formal financial sector and an informal one (Emmerij, 1991; Germidis *et al.*, 1991), in other words, a regulated and an unregulated market (Wijnbergen, 1982). However, this classification is not helpful for discovering the nature of developing countries' financial structures as well as the deep cause of crisis. First, government intervention distorts a financial sector's intermediation activities, and this leads to corruption and weak contract enforcement in financial transactions (Krugman, 1998a, b; Demirgüç-Kunt and Detragiache, 1998). Second, while the informal sector is believed to be a more "liberalised" institution, the narrow information base and the limited capacity for risk-pooling may also make the transaction less efficient (Cho, 1990; Fischer, 1989).

Therefore, both sectors may create distortions in resource allocation. If we follow the remedy offered by the traditional financial dualism hypothesis, i.e. "to achieve a single, homogeneous financial system by expanding and transforming the formal financial sector so that it fully absorbs informal financial activities" (Germidis *et al.*, 1991, p. 214), we just substitute one inefficiency for another.

A neo-financial dualism hypothesis of explicit versus implicit financial transactions is helpful for understanding the financial performance in most Asian developing economies. The dualism only occurs in a financial intermediation system, not in a capital market (i.e. direct investment) system.

Why Financial Intermediation Is Dominant in Asian Financial Markets

One of the financial characteristics of the East Asian developing countries is the dominant role of bank and non-bank financial intermediation (Wade, 1988). For those countries, financial inter-

mediation brings more comparative advantages to private investors, firms and governments than securities markets. First, given the problems of productivity risks, information asymmetry and costly monitoring of finance in developing economies, debt contracts with fixed payments are better than risky share holding (Gale and Hellwig, 1985). Second, with their large and diversified investment portfolios, financial intermediaries can guarantee a yield for their deposits and can commit themselves credibly to monitoring the return of the projects (Diamond, 1984). Third, debt financing does not change the ownership structure and keeps the families or “insiders” (internal shareholders and managers) in control of the firms. Finally, a credit-based financial system provides the government with the necessary political clout to implement its industrial and development strategy (Wade, 1998, p. 134).

Explicit and Implicit Financial Activities

To avoid the problems of adverse selection (e.g. purchasing bad securities due to *ex ante* information asymmetry) or moral hazard (e.g. managers’ agency cost because of *ex post* information asymmetry) in capital markets, investors consider financial intermediation a better choice. Unfortunately, they are trapped in another dilemma, the problem of financial dualism. The nature of this problem is the lack of market discipline, even though all financial transactions are in the form of market activities. The neo-financial dualism hypothesis divides a financial contract into two parts, the explicit contract and the implicit one. The former is the “form” of a transaction, such as credit evaluation, auditing, credit terms negotiation, etc. The latter transaction, in the nature of financial behaviour, is not based on profit-risk analysis, but on government instruction or the relations between the creditor and the debtor. This phenomenon can be called an implicit government guarantee problem (Krugman, 1998a, Garnaut, 1998), or a “crony capitalism” problem. In China’s financial sector, it is defined as a “relative loans” or *guanxi daikuan* problem (Krugman, 1998b).

Two arguments are extended from this hypothesis. First, without structural reform, i.e. eliminating the implicit financial transaction, neither financial liberalisation nor financial deepening is effective for steady financial development and economic growth, because each emphasises the expansion of the explicit financial transaction

(quantity or price) and ignores the implicit one. Second, the integration of a dual financial structure should not aim at merging the formal and informal financial sectors, but at strengthening market rules. With implicit financial transactions, both regulated financial sectors and more liberalised ones fall into the high-risk category, which may lead to systemic crisis.

Risk-Sharing Mechanism: Hard Versus Soft-Budget Constraints

The dual structure of financial transactions creates an asymmetric risk-sharing mechanism. As we know, financial intermediation divides the fund allocation into two stages: the transaction between private investors and financial intermediaries, and the transaction between financial intermediaries and firms. In the first stage, the debt contract is set with hard-budget constraints, i.e. the financial institution has to pay the deposits in fixed amounts at fixed times. In the second stage, the credit contract may be set with soft-budget constraints (Kornai, 1986) due to the implicit financial behaviour. There are two different cases of these soft-budget constraints. First, the state-dominated financial transactions endow financial intermediaries with systematic risks because the government's strategy is based on a socio-economic plan and not on profit maximisation. If the government's plan is proved to be wrong or an unexpected demand-side shock occurs, the government guarantee is not credible, and financial institutions have to take the total loss (Garnaut, 1998). Second, the credit contracts are based on a crony relationship emanating from the belief that "privilege leads to excess profit", and not on risk. If this privilege is challenged by political instability, expected profit will turn into excess loss. Hence, under the condition of financial dualism, financial intermediaries have to face an asymmetric risk-sharing mechanism. On the one hand, depositors endow them with hard-budget constraints. On the other hand, they offer soft-budget constraints to debtors. Undoubtedly, this kind of financial system is vulnerable.

Structural Crisis: An Inevitable Result of Risk Accumulation

Recent Crisis Models and Critiques

What is the nature of the East Asian crisis? Recent studies generate quite different answers. One viewpoint believes that the crisis was a

currency crisis since “inconsistent policies before the attack push(ed) the economy into a crisis” (Flood and Marion, 1998, p. 13) and is an extension of the first-generation crisis model (Salant and Henderson, 1978; Krugman, 1979; Flood and Garber, 1984; Agenor *et al.*, 1992). A second proposition views the crisis as a being one of market confidence (Goldfajn and Valdés, 1997), which is an application of the second-generation model (Obstfeld, 1994, 1995). “The logic of crisis arises from the fact that defending a parity is more expensive if the market believes that defense will ultimately fail” (Krugman, 1998a, p. 5). The third hypothesis believes that the nature of the crisis was a demand shock plus contagion effect (Baig and Goldfajn, 1998; Masson, 1998). The crisis broke in Thailand because its fundamentals were shocked by several demand-side factors, and then spread into other countries because of the cross-country correlations within East Asia. In a word, the crisis was an economic crisis.

However, none of these hypotheses can cover the whole story of the crisis. First, the economic fundamentals did not show sufficient signs that Asian economies were on a turning point. For instance, from 1991 to 1995, Thailand, Korea, Indonesia and Malaysia had maintained moderately high growth; the annual average growth rates were 8.6%, 7.5%, 7.8% and 8.7%, respectively. Even in 1996, on the eve of crisis, their growth rates were 5.5%, 7.1%, 8.0% and 8.6%. Their inflation rates were quite low, 5.9%, 4.9%, 7.9% and 3.5% in 1996. The growth of real exports remained strong in Korea (13.0%), Indonesia (5.5%) and Malaysia (7.2%), except Thailand (-1.8%) in 1996 (Kochhar *et al.*, 1998). Therefore, the “policy push” or weakness of fundamentals hypothesis is not applicable to the Asian crisis. Second, the “demand-side shock and market contagion” theory also fails to offer a reasonable explanation for the following two observations. One is that those shocks (e.g. movements in the yen-dollar rate and terms-of-trade deterioration; Kochhar *et al.*, 1998; Garnaut, 1998) should have affected all economies with the same export structure in the region, but no severe crisis occurred in Taiwan and Singapore. The other observation is that Hong Kong and Singapore, the two regional financial centres, which should have the closest relations with other economies, have proved to be immune to infection (Chan-Lau and Chen, 1998). Finally, the confidence or expectation model fails to explain the reason for the confidence crisis and why it occurred in certain areas. Why did

investors in Thailand, Korea and Indonesia lose their confidence? Why has confidence of Hong Kong, Singapore and Taiwan remained strong? There must be some difference between the latter economies and the countries in crisis.

Risk Accumulation: The Structural Root of the Asian Crisis

Krugman's (1998a) "third-generation" crisis model and Chan-Lau and Chen's (1998) "inefficient financial intermediation" model grasp the nature of the Asian crisis most completely. The former model emphasises the level of financial institutions' behaviour, and concludes that the implicit government guarantees and deregulation led to a moral hazard over-investment problem (Krugman, 1998a). The latter takes the "costly loan monitoring", resulting from a lack of transparency in the corporate sector, as the cause of crisis (Chan-Lau and Chen, 1998, p. 5). Their approaches are based on two levels of information asymmetry: the regulator and financial institutions, and the financial institutions and firms. On the one hand, they are right because implicit government guarantees and inefficient finance have been the causes of the Asian crisis. On the other hand, they are not entirely right because there is no evidence that the asymmetric information structure really exists. In fact, central banks know what happens in financial institutions, and financial institutions also know the actual operation of firms. Private investors cannot know each credit or investment project well, but they know the whole investment channel. In Korea, the close credit relationship between banks and *chaebols* was not a secret. In Indonesia, investors knew the financial privilege of the Suharto family and its related enterprises. In Thailand, depositors were clear that their funds are put into the real estate market.

Therefore, the root of the Asian crisis is not the information structure but the financial structure and the risk-sharing mechanism. First, depositors believe their deposits are safe enough based on their hard-budget constraints on financial institutions. Second, financial institutions have no incentive to assess investment risk due to "credible" government guarantee and "profitable" crony relationship. To sum up, the true story of the Asian crisis is the following: financial dualism concentrates risk into financial intermediaries who are over-convinced of government guarantees and the profitability of privilege; the distorted financial activities

lead to structural crisis when risk is accumulated beyond a critical point.

The structural crisis hypothesis can explain the following facts. The first has to do with the “confidence puzzle”. Investors did not lose their confidence in fundamentals but in financial structures, i.e. Korea’s Bank-*Chaebol* structure and Indonesia’s crony capitalist structure. The second is the “contagion puzzle”. The crisis only infected those countries that had a dual financial structure. Therefore, Singapore, Taiwan and Hong Kong escaped from the crisis due to their better-developed capital market, i.e. investors took symmetric risks and returns by direct investment (Chan-Lau and Chen, 1998). Third is the “crisis duration puzzle”. Since the cause of crisis is not a boom cycle or currency overvaluation, Asian afflicted economies will experience a painful mid-term structural adjustment, and any short-run recovery expectation is over idealistic.

2 Collective Action Versus Isolating Development: What Should Asia Do in the Global Financial System?

The previous section analysed the costs and benefits of Asian economies in the global financial system, and suggested that the root of the crisis is institutional or structural weakness rather than *unfair* competition. To achieve long-run regional development, Asia’s attitude should be on the side of collective rationality, i.e. consistent action would be beneficial for both advanced countries such as Japan and less developed economies in Asia.

A Negative Case: Yen’s Depreciation

As mentioned above, IFI encourages intra-regional competition. However, over-intensive competition without coordination results in losses. The table below shows that an isolated depreciation of the Japanese yen attacks the regional benefit including Japan itself.

The Research Department of the People’s Bank of China (2002) empirically studied the effects of yen fluctuation during 1990-2001 on the trade of six Asian neighbouring economies. Conclusions are significant (see Table 1). First, the depreciation of the yen imposes a significant negative shock on its neighbours’ exports: when the yen depreciates 1 percent, the region’s exports to Japan and the rest of

Table 1 The Effects of a 1 Percent Depreciation of Yen

	Bilateral Trade		Multilateral Trade (excluding Japan)	
	Export	Import	Export	Import
Six Asian Neighbour Countries	-0.43	Current period : -0.44 1 period lag : -0.53 2 periods lag : 0.03	-0.15	-0.13
China	-0.13	0.19	-0.03	-0.04
Hong Kong	-0.2	Current period : -0.29 1 period lag : -0.07 2 periods lag : 0.04	-0.14	-0.12
Korea	Current period : -0.04 1 period lag : -0.25	0.18	1 period lag : -0.01 2 periods lag : -0.03	2 periods lag : -0.12
Malaysia	-0.07	Current period : -0.02 1 period lag : -0.02 2 periods lag : 0.3	-0.03	-0.12
Thailand	1 period lag : -0.1	0.11	-0.007	1 period lag : -0.09
Indonesia	1 period lag : -0.07	0.29	-0.005	2 periods lag : -0.02

the world drop 0.43 percent and 0.15 percent, respectively. However, Japan is also hurt by the currency depreciation: the neighbours' imports from Japan decline by 0.44 percent, while the stimulation effect on Japan's export to the rest world is insignificant! The possible explanation is competing depreciation among Asian economies, though there is no persuasive empirical evidence.

This case suggests that individual action by one country may mean losses for all countries, so collective action to build up a sounder global financial system through increasing Asia's status is a feasible solution.

Collective Action to Reform the International Financial Architecture

In the post-Mexican and post-Asian crisis era, reform of the "international financial architecture" to prevent crisis has become a popular topic. Soros (1998) calls for the formation of an international deposit insurance corporation. Fischer (1999) suggests the introduction of a multilateral lender of last resort, while Sachs (1995) advocates the formation of international bankruptcy court. Krugman (1998a, b) believes in the effectiveness of capital outflow control, whereas Eichengreen (1999) prefers Chilean-style capital inflow control. Kaufman (1998) recommends constructing a single global super-regulator of financial market and institutions. Unfortunately, as Rogoff (1999, p. 39) observes, the above remedies can be classified "into three categories: those that are politically infeasible given the absence of a supranational legal authority; those that would raise costs to lenders or add protections for borrowers, and thus would lead to a sharp contradiction of capital flows to developing countries; and those that would shift risks or costs away from creditors" which introduces more moral hazard problems.

Winners and Losers in the Global Financial System

It is obvious that the US and the EU are winners in the global financial system given their market efficiency, innovation and competition. But the situation is very different in the developing world, especially during the capital flight period in crises. Thus, the benefits of international capital market integration seem overrated. However, though some economists and politicians believe that

countries such as China and India with capital control are risk free, liberalisation is an inevitable trend, because continued tight control brings a long-run efficiency loss to those economies. Hence, in Asia, the feasible way is a two-step reform scheme. First, cooperation must be sought in the foreign exchange system, and second, there must be a formation of a regional risk manager.

Foreign Exchange System Cooperation

Currently, economists have doubts about the usefulness of an intermediate exchange rate system, and instead favour one of the corner solutions: a completely fixed or a freely floating system. As Fischer (2001) noted, an intermediate foreign exchange system lost much of its appeal in the 1990s. In 1991, 62 percent of the countries reporting to the IMF had an intermediate system, but in 2000, this figure dropped to 34 percent. There are three causes for this trend. First, political pressures force central banks to abandon their independence, especially under external shocks. Second, there are only a few freely floating currencies, such as the US dollar, euro and yen, thus limiting the floating space for other currencies (Meltzer, 2002). Third, considering the *impossible trinity*, few central banks prefer a floating system to domestic monetary targets, e.g. the Taylor or McCallum rule. Within the Asian region, a fixed foreign exchange system is an optimal choice. First, the geographic factors make for similar industrial structures in Asian economies, or at least, even though they are in different stages of development, they are on the same path; for example, Japan, Korea, ASEAN countries and China have similar growth strategies. Second, a floating system means risk and requires sufficient risk-management measures, and most Asian countries lack such measures. Third, a fixed rate is the first step toward closer cooperation, just as the former European currency unit (ECU) was a step towards the euro. Only if Asian financial integration would *not* be a target, a fixed system might be ignored. Finally, a fixed system can be a remedy for competing depreciation.

Practically, a fixed system requires a key currency. Most Asian economies chose the US dollar. However, ASEAN+3 currencies, or yen and RMB in particular (as the currencies of the two largest economies) should be a better choice since there is no significant correlation between the Asian real business cycle and that of the US.

Regional Financial Crisis Manager

The debate on the need for an international financial crisis manager is whether the IMF can fulfil this role satisfactorily. At the 1998 G-7 meetings, the “Clinton Proposal” suggested that the IMF would offer a new emergency credit line (Contingency Credit Line) for which countries would have to pre-qualify by meeting certain macroeconomic or regulatory standards. Actually, the financial resource is insufficient for regional risk management, and to reform the IMF based on Asia’s needs is an impossible mission. Thus initiatives have emerged in Asia such as the establishment of an Asian Monetary Fund. The major problems facing this initiative are shares-allocation and control right, which are political economy issues. However, it is expected that economic and financial cooperation at the micro level will remove these obstacles, as the EU gives a sound example. First, Asian economies should encourage cross-border financial institutions’ entry. Second, common debt issues and stock markets may be co-constructed by major economies in the region. After these two steps, the formation of a regional financial crisis manager is not a possibility, but a demand of all countries.

3 Currency Stability Versus Financial Deepening: Which Goal is to Advance in the First 10 years of the 21st Century?

In the first section of this chapter, we have shown that the banking-based financial system dominance in Asia and structural weaknesses led to the crisis. As a logical inference, under such internal conditions, currency instability is inevitable. There are two sources of bias under the current global financial system towards banking-based economies (Rogoff, 1999). The first is explicit (Korea) or implicit (China) deposit insurance schemes, which expand the banking system through taxpayers’ subsidy. If we consider the international fund flow, such schemes may result in taxpayers in debtor countries subsidising the creditor countries! Equity finance, however, is free from such guarantees. Second, the international legal system does far more to protect the debt holders than the providers of equity finance. These evidences partially explain China’s narrow escape from the Asian crisis since FDI is the

major part of its foreign capital inflow, while Korea takes more debt.

It is true that currency stability and financial deepening are two sides of the same coin. However, financial deepening is the only way to achieve long-run currency stability, even though the region has constructed risk-management regimes. From this analysis, a sequencing agenda is put forward as follows. Under the structural hypothesis, the optimal policy arrangement is clear: First, structural adjustment is necessary in order to integrate dual financial transactions accompanied by moderate price (interest rate and exchange rate) controls. When structural adjustment is accomplished, domestic financial liberalisation should be implemented. Inter-regional free capital flow is the final step.

Step 1. Structural Adjustment Under Financial Repression

The Asian crisis shows that under structural weaknesses, the market mechanism cannot allocate resources optimally. The crisis also demonstrates that financial reform is not a *laissez-faire approach* (Long and Vistas, 1991; Hossain and Chowdhury, 1996). Financial regulation is not equal to government, while financial liberalisation is not synonymous with so-called deregulation.

Undoubtedly, structural reform should not be delayed; i.e. implicit financial transaction must be eliminated. Since risk is concentrated in financial intermediaries, moderate financial repression is a reasonable method for redefining the risk-sharing structure. Relatively low deposit rates may reduce the financing cost of financial intermediaries and make it less costly to solve the problem of accumulative non-performing loans. The Asian crisis shows that the main element of the establishment of a strong financial system is not whether the price is determined by markets. The deeper factor is whether the financial institutions and firms adhere to market rules, i.e. whether the allocation of funds is by market competition. Hence, the most urgent structural adjustments should concentrate on two tasks. One is establishing a competitive financial mechanism. The other is strictly distinguishing regulation and intervention. The basic role of government is not intervention, but risk-based regulation.

Step 2. Domestic Financial Liberalisation Under Moderate Capital Control

The elimination of implicit financial transactions establishes the base for a competitive financial market; domestic financial liberalisation is necessary for creating an undistorted price system. However, capital control is still necessary at this stage. First, structural adjustment can only solve the problem of new financial transactions, not the financial “stock”. To absorb cumulative bad loans, long-run operations are needed. Therefore, the quality of the domestic financial sector will remain lower than that of foreign financial institutions for many years. Premature capital account convertibility will lead to capital flight, inadequate domestic saving mobilisation and economic instability. Second, due to the “natural” imperfect competition of financial markets (Sussman, 1993; Berthélemy and Varoudakis, 1996), an early opening of financial markets will result in the monopoly of transnational financial institutions that damage efficiency and stability. As McKinnon (1973, 1982) and Dornbusch (1983, 1984) suggest, any early opening of the capital account may result in large destabilising capital flows under the condition of imperfect domestic financial markets.

Step 3. Free Capital Flow

If the economy has sufficient market condition and regulating techniques, capital account convertibility enables the economy to mobilise international capital, and offers to domestic funds profitable foreign investment opportunities.

4 Conclusion

We draw the following conclusions. First, given the competition nature of the global financial market, improvement of the institutional structure is the only way to choose winners and losers. Thus the major lesson drawn from the Asian crisis is to reform the internal structure. Second, Asia achieves benefits and costs simultaneously from the current global financial system, and the trend of openness is inevitable. Third, collective actions in the

regional foreign exchange system and the risk-management regime are feasible. Finally, the sequencing of reform is necessary for long-run currency stability in Asia.

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12

‘Neo-Financial Dualism’ Hypothesis and Regional Cooperation in East Asia: Comment on Xie Ping

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It is very encouraging to see that China currently contributes to the global economy not only as a major emerging economic power but also in terms of economic ideas. One of such contributions is the recent paper by Xie Ping, Director General of the Research Bureau in the Peoples Bank of China. Mr. Xie has adopted a highly innovative approach to the assessment of the financial sector of China which he calls ‘neo-financial dualism’. The approach allows him to analyse the operations and performance of state-owned banks in China and explain the emergence and persistence of non-performing loans, strong demand of state industrial enterprises for bank credit, the trend towards ‘over-investment’ as well as the liquidity positions of banks. Mr. Xie takes the liberty of even suggesting that the main building blocks of the hypothesis are not necessarily China-specific and that they can be

¹ The author benefited from interesting discussions at the conference as well as of other contributions, all very relevant for this paper. I would especially like to thank Jan Joost Teunissen, Yung Chul Park, Masaru Yoshitomi, Barbara Stallings and other participants for their insights. Despite having sometimes different perspectives, they helped me a great deal with this paper. All shortcomings that may remain are, of course, my own responsibility. The views expressed in this paper are personal and should not be attributed to the WTO members or the Secretariat.

also applied to other countries in the region. Even though he diplomatically avoids naming any countries, one can deduce that he could think of countries such as, for example, Japan or Indonesia.

The idea of neo-financial dualism is brought in his paper in the context of the debate about China's role in fostering financial stability in the Asian region and in the global economy. He suggests that governments have a choice between financial stability and financial deepening, which has become a frequently used argument of opponents of capital account liberalisation.² He recognises the standard explanations of financial fragility and instability – first, the so-called 'structuralist' view which claims that the instability is due to the absence of deep financial markets to provide a wide range of financial instruments and to dilute the spread of 'shock waves' generated by financial failures, external shocks, moral hazard etc. Second, the so-called 'financial repression' view which argues that the problem of financial instability is due to government policies leading to disequilibrium interest rates and exchange rates. Mr. Xie believes that these 'theories' do not adequately explain the financial instability and fragility of the Chinese financial sector, especially those of state banks. In his view, the instability is due to neo-financial dualism.

The purpose of this paper is to evaluate the main features of the *neo-financial dualism hypothesis* and to assess its implications for regional cooperation in East Asia. In order to clarify the link between the neo-financial dualism and regional cooperation I shall try to answer the following questions. What are the main features of the neo-financial dualism hypothesis? What are the implications for international cooperation? What are the main issues for discussion and, potentially, for negotiations for the Chinese authorities with foreign partners? What form of international cooperation should the Chinese authorities pursue under the circumstances – regional or global?

It is clear that the idea of neo-financial dualism leads to a novel approach to the analysis of problems of the Chinese financial sector. The idea will undoubtedly raise interest among scholars and observers of the Chinese reform. Since the approach is rather unconventional, I shall provide my own interpretation of the hypothesis with the view of perhaps putting it into a more familiar

² See, for example, the contribution of Yoshitomi in this volume.

terminology. This, together with a brief assessment of the hypothesis will be the subject of the next section. Section 2 will provide a discussion of the implications of neo-dualism for international cooperation. Discussion of issues for international cooperation will be in Section 3. Finally, the choice between regional and global cooperation from the point of view of Chinese policymakers will be discussed in Section 4.

1 Neo-Financial Dualism – What Is It and Is It Plausible?

The hypothesis of neo-financial dualism starts from the idea that financial intermediation plays the most critical role in the present context of Chinese development. Chinese banks act as the conduit for domestic household savings which are then transformed by banks into loans. Alternative investment opportunities for Chinese households are still extremely limited.³ *Pari passu*, alternative sources of financing other than bank credit are also very limited for Chinese firms. Thus, the operations of the financial sector are limited to fairly simple financial intermediation rather than or in addition to more sophisticated operations of capital and money markets. This is only a short step away from arguing that financial stability is a function of the performance of bank intermediation.

In theory, the neo-financial dualism hypothesis is based on the critical distinction between two types of contracts in the banking sector. The first type is represented by *formal contracts* which are strictly enforceable. They cannot be manipulated, by-passed, or avoided, and they represent as formal arrangements as legal contracts do in well functioning legal systems. These must be contrasted with the second type of contracts which, too, may be based on legal documents but they can also be in the form of *informal arrangements*.

In the Chinese banking sector the deposit arrangements between households and banks are subject to formal contracts. The deposits made with banks are believed to be (fully?) guaranteed by the state. This means that the liability part of the banks' balance sheets is given; it cannot be manipulated and is subject to strict rules of

³ According to Goldman Sachs, only about 4% of Chinese savings are held in stocks. See "China's Big Year?", In *Global Finance*, March 2002, p. 27.

surveillance, use and control. In contrast, the banks' lending operations are heavily influenced by informal arrangements. Perhaps the most important among these arrangements are those arising from the influence and interference of political authorities into the lending operations of banks. Since banks' lending is heavily oriented towards lending to state-owned enterprises (SOEs) – currently about 70-80 percent of bank credit is allocated to SOEs – the political authorities (i.e. read the Party) are clearly concerned about any shifts in the structure of bank lending away from SOEs.⁴ The lending transactions of banks can also be subject to formal contracts. But what makes them different from the formal contracts with the depositors is the lack of enforceability and discipline. The state may and often does direct the credit to SOEs irrespective of the high risk of non-repayment. In other words, the state takes over, in a way, a great deal of the commercial risk that is normally carried on the banks' books.

Thus, according to the hypothesis, the operations of Chinese banks can be divided into two groups – those that are subject to deposit contracts and those that are subject to lending transactions. Correspondingly, the banks' balance sheets have two separate circuits – those subject to formal contracts between depositors and the banks and those subject to informal arrangements between the banks, SOEs and the political authorities. The banks face a strict and enforceable obligation to return depositors' deposits. They do not face the same pressure of returning profit to their investors as would be the case in a properly functioning market economy. The reader with background in central planning will undoubtedly already recognise that the hypothesis is built on the well known idea of “hard” and “soft” budget constraints invented and developed by Janos Kornai.

The consequences of informal lending arrangements is the emergence of asymmetric risk sharing – banks (with the state) take a full risk for managing household deposits but the state takes over, partially or fully, the lending risk. Since banks do not take a full responsibility for lending risks, this may lead to moral hazard. Moreover, lax enforcement of credit contracts can only encourage SOEs to further borrow and thus provide additional incentives to

⁴ According to Oxford Analytica, the numbers may be even higher – 80-90%. See *China—Banks at Risk as WTO Opens Door to Foreign Rivals*, Oxford, June 2002.

'over-invest'. Most importantly, the loose lending practices lead to the emergence of an excessive share of non-performing loans (NPLs). According to Wing Thye Woo, NPLs of the four large state banks represented 35 percent of GDP in the beginning of 2002, and the corresponding number was 15.5 percent in other ten joint-stock banks.⁵

Intuitively, too, the hypothesis seems quite plausible. As already noted above, deposits of Chinese depositors are guaranteed by the state. This should make deposit contracts enforceable. The banks' responsibility to mobilise domestic savings is further increased by the fact that there is hardly any competition for household savings since the bulk of savings is concentrated in only four banks. Moreover, since financial markets are 'thin' and the choice of alternative instruments is very limited, households are highly dependent on banks as their main and, sometimes the only savings outlet. Nevertheless, it is not entirely clear how 'hard' the deposit contracts really are. In particular, are deposit rates based on market conditions? That is, are they related to costs of capital, costs of banks' borrowing, costs of provisions?

The 'soft-budget' constraint of credit transactions is also quite plausible. The symptoms of this are non-performing loans, excessive debt, non-transparent accounts. While there has so far been no direct and comprehensive evidence of 'neo-financial dualism', the evidence of poor credit control, most likely originating in informal arrangements between banks and their clients is widespread and powerful. In discussing the origins of East Asian financial crisis, for example, the proclivity towards 'over-investment' in South Korea and other East Asian countries under conditions of lax credit controls has been well documented by Krugman (1998) and further discussed, for example, by Wade (1998). The World Bank has reached similar conclusions for Indonesia in, for example, its Country Economic Memorandum. The problem of non-performing loans has been widely discussed in the context of banking crises in countries as geographically wide apart as Argentina, Japan, the

⁵ See Wing Thye Woo (2003), Table 4. There is a dispute among economists about the size of NPL. However, there is an agreement that the problem of NPL is large and persistent. The Chinese already transferred about \$170 billion of NPLs (about 18% of total loans) to asset management companies. See Guonan Ma and Ben S.C. Fung (2002).

United States (the S&L crisis), Sweden, Mexico and other. ‘Over-investment’ was one of the standard features of firms under central planning which China has been trying to reform for the past 20 years or so. And similar deficiencies in credit control (and bank supervision) have been found in other transition countries.⁶

2 Implications for International Cooperation

The implications of neo-financial dualism for policy making are quite important and serious. The ‘soft-budget’ constraint can be characterised as being equivalent to a subsidy. If banks can lend without (much) regard to the credit risk and to the chances of having their loans repaid they can either do so by assuming that the credit will be financially covered by the investors or, as in the case of Chinese banks, by the state. In other words, the financial operations of Chinese banks would have to be seen as supported and subsidised by the state.

The presence of ‘subsidy’ will, in turn, have three effects, two of which are international consequences. First, and arguably most importantly, the origin of neo-financial dualism is domestic. This means that the first-order policy measure which has to be taken to address the problem of poor credit discipline will involve changes in domestic policy to make the credit contracts ‘hard’. The policy measures may include such steps as changes in property rights, measures to improve the enforcement of contracts, ownership changes in the banking sector, measures to improve credit appraisal, increasing competition and, first and foremost, liberalising the interest rate policy.

Second, the serious implication of the ‘subsidy’ element of financial credit is its effect on international competition. It is evident that subsidised credit distorts international competition in the ‘traded goods’ sector. This will be particularly the case of commodities produced by the state enterprise sector. The size of subsidy and its specific use may not be consistent with the country’s commitment to the subsidy agreement in the WTO. This means that the trading practices of China could be contested by the WTO members as being illegal or they can be countervailed.

⁶ See, for example, Griffith-Jones and Drábek (1995).

Third, even if the bank subsidy is found in conformity with the WTO agreement, it may still create tensions in the country's relations with its trading partners. Under such a scenario, an international solution to the problem will be desirable. China could, for example, pursue a subsidy policy that would optimise its trade benefits by changing its terms of trade. It could obviously do that because China is a big country and many of its trading partners are small. This is what is known as the 'optimal tariff argument' and the solution to which is – for small countries – to seek a cooperative solution.⁷ Thus, it would make a great deal of sense for the small East Asian and other countries to negotiate an appropriate arrangement that would address the subsidy question.

3 Issues for International Cooperation

The next question that needs to be asked is what kind of issues should be addressed through international cooperation? These issues could be grouped under the three following headings: credibility of government policies, exchange rate management and crisis prevention. Let me turn to each in turn.

One of the greatest contributions of international agreements is, in my view, the stamp of approval they give to governments' commitments. In other words, international agreements normally greatly enhance the *credibility of countries' policies*. Consider, for example, that China agrees to a reduction of subsidies to the state enterprise sector. Appropriate legislation is adopted and policy measures introduced. Foreign partners may accept these changes but may not have much recourse to counter-measures if the subsidy policy turns out to be different than what is acceptable to foreign countries. Now, compare that scenario with the alternative whereby China agrees and signs an agreement with foreign countries. An international agreement should in principle carry a much greater weight, because the Chinese commitments will be made as a part of *pro quid quo* and their power will be that much stronger if these agreements are enforced with penalties such as sanctions.

⁷ The literature was reviewed and the argument of 'optimal tariff' elaborated in Staiger (1995).

The second major issue concerns *exchange rate management*. “Dualism” refers, by definition, to two segments in the economy – one functioning subject to formal rules of contracts, the other operating under the influence of informal contracts. To repeat, the two segments operate subject to different rules of business, one that is subject to “hard-budget constraint”, the other to rules under “soft-budget constraint”. It is very likely that under those conditions, the economy will also operate in two separate circuits which will perform differently. The savings mobilisation and discipline in China appears to be induced by strong and enforceable rules on deposits. On the other hand, credit operations, which are subject to “softer” rules will not be subject to strict commercial discipline. Moreover, state-owned enterprises clearly operate under different – softer – rules than firms in the private sector. One could, therefore, argue that under these circumstances China continues to operate a “dual exchange rate mechanism”. An exchange rate that is appropriate for the “formal” sector and another exchange rate that is appropriate for the less formal sector.

The implication of dual exchange rates for regional cooperation would be quite serious. The ‘softer’ exchange rate could be seen by China’s trade partners as a disguised subsidy to the Chinese sector producing tradables, which would be hardly acceptable. Depending on the design of foreign currency restrictions and on the way the banks are linked to the budget, however, the outcome may be even the opposite. In that case, a dual exchange rate would act as an instrument of transferring resources from exporters to importers.⁸ The solution to the problem of dual exchange rates is, of course, unification of exchange rates, which would require measures to “harden” the budget constraints of banks by, presumably, privatising banks, allowing foreign entry, increasing competition, strengthening supervision etc., as I have already noted above. While these are measures of domestic nature, some of them could become subject of negotiations with China’s foreign partners, such as measures affecting market entry.

The third important area of issues for international cooperation concerns *crisis prevention*. Would a dual exchange rate system be

⁸ For a review of multiple exchange rate systems, see IMF (1995). For a recent case study of the effects of multiple exchange rate systems, see, for example, Rosenberg and de Zeeuw (2000).

intrinsically more unstable than one in which exchange rates are unified? There are two kinds of answers possible, I believe. First, the dual exchange rate system is operating in the Chinese context under rather specific conditions. The government maintains restrictions on capital movements which basically eliminate the external financial instability originating in capital surges and capital flights. Second, other sources of financial instability still exist and some of these may be due to the specifics of the dual exchange rate system. The system creates various forms of allocative distortions which lead to inefficiencies and distributional changes, which, in turn, may undermine economic growth and also lead to external imbalances as documented by the experience of countries which have practiced the policy of multiple exchange rate systems. Thus, financial crises can arise even under conditions of closed capital accounts.

4 Regional or Multilateral Cooperation?

To conclude, which path should be pursued by China and its regional partners? Should they seek a closer regional cooperation to address the issues that I have raised above or should they continue to work within the multilateral trading and financial framework? As we know all too well, there are strong feelings in the region that there is too little of East Asian cooperation.⁹ This is despite the growing body of evidence which suggest that the East Asian markets are becoming increasingly more integrated.¹⁰ These are critical questions for the region today as evidenced from various contributions to this subject.

The answers to these questions are quite straightforward on three grounds. The first issue that the countries in the region should address in any type of arrangements – regional or global/multilateral

⁹ See, for example, Sakakibara (2003) and Yung Chul Park (2003). However, see also Yin-Wong Cheung *et al.* (2003) who argue that China, Taiwan and Hong Kong are already closely integrated. They show that real interest parity, uncovered interest parity, and relative purchasing power parity all hold over longer periods. The study confirms the earlier findings of Gros and Thygesen (1998) for European currencies.

¹⁰ McCauley and his colleagues, for example, have found that bond markets and syndicated loan markets are already fairly highly integrated. See McCauley *et al.* (2002).

ones – is the extent to which these arrangements will provide credibility to policy reforms. This, in turn, greatly depends on the degree of enforceability of mutually agreed conditions and concessions. For example, if market access to the Chinese banking sector is the big issue for foreign investors, it is more likely that a Chinese commitment can be more effectively enforced through a multilateral agreement in which more countries' interests are at stake and which have an enforcement mechanism already in place.

The second factor which also would tend to favour a global/multilateral solution is the relative size of countries in the region. Given the enormous size of China relative to the countries in the region, perhaps with the exception of Japan, it must be in the interest of the small countries to seek a global solution to their problems. Surely, the interests of countries such as Thailand, Malaysia and even Korea and Taiwan will be better protected in global for than in a regional one.

These are quite standard arguments that one usually makes in favour of the multilateral system. But there may be another, more fundamental reason which is closely related to the existing norms of the international financial architecture and of the WTO agreements. The best answer to the question which of the “cooperative solutions” is preferable depends on answers to the following additional questions:

(i) *Liberalisation of capital account.* Suppose that, for some reason, a regional approach to financial integration was pursued giving regional banks priority market access in the Chinese banking sector – rather an unlikely scenario considering the violation of the MFN principle in this scenario. Would, say, Japanese banks be less destabilising investors than banks from other countries? Moreover, are not the financial markets already integrated to a very large extent?¹¹

(ii) *Surveillance.* It is clear to me that whatever lender of last resort would eventually be put on the table, the lender will have to address the question of surveillance and conditionality. These were arguably the most sensitive issues created by the intervention of the IMF in the region during the financial crisis in 1997 and thereafter. The question is then: would a regional surveillance mechanism be

¹¹ See the study of Yin Wong Cheun *et al.* (2003) and footnote 9 above. The existing degree of financial integration makes capital controls less effective.

more acceptable – politically or on substantive grounds – than the one operating under the IMF? Moreover, given the IMF Articles and their treatment of multiple exchange rates, would this not make alternative regional arrangement about Chinese dual exchange rates redundant?

(iii) *Liquidity*. One of the major justifications for the idea of a regional lender of last resort was the existence of large international reserves in the region. In theory, these reserves could be made available during liquidity crises in the region. The question is then: Would a regional arrangement make sufficient resources available for this purpose?

(iv) *Exchange rate regimes*. The countries in the region have become increasingly integrated, as noted above. The trade linkages have already become quite deep. Moreover, the countries pursue different policies towards fully opening their foreign currency markets. This makes the stability of intra-regional trade flows particularly important and, for that reason, so will be the stability of exchange rates. Even though there has been some increase in the use of local regional currencies to promote mutual trade, this shift has been relatively minor indicating the continued strong links of local currencies to the US dollar.¹² The question is then: Would the stability of intra-regional exchange rates be more likely achieved by tying the local currencies to, say, the yen or renminbi (RMB).

This takes us back to the main subject of this paper – the question of neo-financial dualism. The dualism and the existence of multiple exchange rates could enormously complicate China's integration into world markets – global or regional. There are good reasons to believe that these problems could become particularly evident in the regional context in which the commercial interests are relatively more concentrated and less dispersed than in global arrangements. A classical example from recent history was COMECON – the trade arrangement of centrally planned economies which was abolished in 1990. The arrangement was extremely inefficient and eventually collapsed primarily because of the existence of multiple exchange rates which each member country maintained. The effect of that system was the emergence of markets

¹² Kerney and Mukley found that 1 percent appreciation of the US dollar has been linked with a mean of 1.27 percent appreciation of Asian currencies against the yen. See Kerney and Mukley (2003).

that did not clear with persistent excess demand in some markets and with a persistent excess supply in others. The solutions to “market clearing” were a strict bilateralism in payments settlements.

These were extreme solutions to extreme distortions. However, since multiple exchange rates lead to distortions of incentives and, hence to trade distortions, they will be also perceived by China’s trading partners as providing an unfair advantage to Chinese exporters in some sectors while providing an additional protection to other Chinese producers. This would call for measures that unify the multiple exchange rate system as the origin of the distortion before any further measures could be taken. The WTO rules have very little to say about multiple exchange rates. But China will have the obligation to do so under the IMF agreement – which is China’s multilateral obligation. Thus, the whole new idea introduced by Mr. Xie Ping is not only interesting but also has very serious economic policy implications – for domestic policy making as well as for regional and multilateral cooperation.

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13

The Role of the Financial Sector in Creating Growth and Stability: Lessons for China from Emerging Market Economies?

Barbara Stallings

There is overwhelming consensus that the financial sector is an essential component of the modern capitalist economy, in developing countries as well as the industrial world.¹

Without a robust financial sector, households and firms cannot spend beyond their own means, and resources are inefficiently allocated, so that growth is substantially constrained.² At the same time, there is also widespread agreement that the financial sector is a fragile institution, which must be protected and nourished if it is to perform its functions in an adequate way. This includes prudential regulation and supervision, but also the creation and maintenance of a stable macroeconomic environment. A financial crisis can damage economic prospects and harm the most vulnerable groups in ways that take a very long time to repair. Here the consensus ends. What are the main causes of financial crises, how best to deal with them,

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² Despite agreement about the correlation between finance and growth, disagreement persists on the nature and direction of causality between the two.

and how to structure a financial sector that can promote growth for all – these are issues that are heatedly debated.

This paper aims to contribute to some of these debates in the context of reflecting on the challenges facing China's financial system and possible lessons that can be learned from the experiences of other emerging market economies. The paper begins with a brief look at the characteristics of the Chinese financial sector at the beginning of the twenty-first century. It then reviews selected country experiences from two emerging regions: Latin America and East Asia (excluding China). Major topics of interest are financial liberalisation, crisis and response; the evolving structure and performance of the financial markets; their contribution to investment and growth; and the problems of access to finance for vulnerable groups. Finally, it concludes with some lessons that China might draw from its Asian neighbours and Latin America. This is a broad and complex agenda, and only a few highlights can be presented here. The paper focuses on issues that are most relevant for the new authorities who have recently taken office in China. Of course, the size of China's economy makes it difficult to extract useful lessons from the experience of others, but many of the issues are common to all emerging markets.

1 Characteristics of the Chinese Financial Sector

While China has been undergoing economic reforms for over two decades now, a new turning point was reached when the country joined the World Trade Organisation (WTO) in December 2001. Among other obligations, accession to the WTO required much more extensive liberalisation of China's financial markets, especially its banking sector.³ By 2005, geographical and numerical restrictions on foreign banks will be lifted, and the scope of foreign banking activities will be gradually expanded. Five years after accession, foreign banks will enjoy full national treatment. Their aim, of course, is to gain access to the domestic currency market, both for deposits and loans. Just as foreign merchants have hungered for centuries for access to the 'China market' (McCormick, 1967), so

³ Other financial services are also to be liberalised to a lesser extent, e.g., insurance, securities, and fund management.

banks and other financial service providers dream of participating in the intermediation of China's one trillion dollars pool of household savings. For its part, China's government believes that the resulting rise in competition will increase the efficiency and productivity of the financial sector itself and that it will have positive spillover effects on the production system, in both the state and private spheres of the economy. Thus, the considerable sacrifices that will be required are considered an acceptable price to pay for the expected long-term reward of maintaining a growth rate sufficient to deal with employment and other social needs. (On China and the WTO, see Lardy, 2002; Panitchpakdi and Clifford, 2002.)

China's financial sector has changed dramatically over the last 25 years. For the first three decades after the 1949 revolution, China had only a single bank, the People's Bank of China (PBOC), which allocated credit according to central planning criteria. Starting in 1978, however, with the general initiation of economic reforms, financial diversification also began. Four state commercial banks were set up to assume the commercial banking functions of the PBOC: the Bank of China, the Agricultural Bank, the Construction Bank, and the Industrial and Commercial Bank. The PBOC, in turn, assumed the normal functions of a central bank. Later, publicly-listed commercial banks were established, and many non-bank financial institutions appeared, notably the thousands of rural and urban cooperatives. In the mid-1990s, three new 'policy banks' – the State Development Bank, the Export-Import Bank of China, and the Agricultural Development Bank – took over the role of providing subsidised credit to the government's priority projects. As a consequence, the four state-owned commercial banks evolved further in the direction of their western counterparts and are the dominant institutions of the financial sector today. Beyond banking, China has two stock markets, in Shanghai and Shenzhen, where the number of listed companies rose from zero in 1990 to around 1200 in 2002; market capitalisation at some \$500 billion exceeds that of all Asian exchanges except Japan.⁴ A much smaller bond market, predominantly featuring issues of government paper, completes the

⁴ This figure exaggerates market capitalisation in the sense that some 60 percent of shares are not traded; these are held by the central or local governments or "legal persons". Thus, a complementary statistic is the so-called negotiable capitalisation (Shirai, 2002a, p. 17). Both statistics are given in Table 1.

current design of the financial sector, as shown in Table 1. (For a more detailed look at China's financial sector, see Lardy, 1998, chapters 3 and 4; Chen, Dietrich, and Fang, 2000; Shirai, 2002a and 2002b.)

The financial sector just described is embedded in a larger macroeconomic and structural context, which must be taken into account in order to understand the characteristics of the financial sector itself. Just as central planning requirements led to a single bank that served as a funnel for government funds in the early revolutionary period, so the partially liberalised, but still state-controlled, economy shapes financial sector operations today. In macroeconomic terms, the most important characteristics are the closed capital account and the non-convertibility of the renminbi (RMB), together with the power of the authorities to set interest rates. These characteristics limit the volatility to which the financial sector is subject, but they also limit its ability to allocate resources

Table 1 China: Domestic Credit, Bonds, and Stock Market Capitalisation, 1992-2000
(percentage of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Domestic credit	94.7	103.6	92.3	91.1	97.2	106.2	119.5	130.4	132.7
Bonds	8.4	7.2	6.6	9.6	11.0	13.0	17.2	21.7	24.5
Government	4.8	4.6	4.9	5.6	6.4	7.4	9.9	12.9	15.3
Corporate*	3.6	2.6	1.7	4.0	4.6	5.6	7.3	8.8	9.2
Total stock market capitalisation	3.9	10.2	7.9	5.9	14.5	23.4	24.5	32.3	53.8
A Shares		9.6	7.5	5.7	13.9	22.9	24.3	31.9	53.1
B Shares		0.6	0.4	0.3	0.6	0.5	0.3	0.4	0.7
Negotiable market capitalisation	n.a.	2.5	2.1	1.6	4.2	7.0	7.2	10.0	18.0
A Shares		2.0	1.7	1.4	3.7	6.5	7.0	9.7	17.4
B Shares		0.5	0.3	0.3	0.5	0.5	0.3	0.3	0.6
Total (1)**	107.0	121.0	106.8	106.6	122.7	142.6	161.2	184.4	211.0
Total (2)***	n.a.	113.3	101.0	102.3	112.4	126.2	143.9	162.1	175.2

Notes:

* Includes bonds issued by financial institutions.

** Total based on total market capitalisation.

*** Total based on negotiable market capitalisation.

Source: Calculated from Shirai (2002a), p. 13.

efficiently. In structural terms, the centrality of state-owned enterprises, which are generally in a very weak financial position, and which continue to be the main borrowers from the banks, has a strong negative impact on the latter's balance sheets.

China's performance during the recent Asian financial crisis both provided satisfaction to authorities and served as a wake-up call about what could happen in the future. While GDP growth slowed by about three percentage points between 1995-96 and 1998-99, output nonetheless expanded by nearly eight percent in 1998, a year in which most economies in the region contracted. (For a comparison, see Fernald and Babson, 2000.) Moreover, the external accounts continued strong, and the RMB maintained its nominal value and even appreciated in real terms against the dollar. No banks collapsed or had to be taken over by the government, as happened elsewhere in the region. On the surface, then, it appeared that the Chinese economy was operating from a position of strength.

At the same time, no one – including Chinese officials – doubts that China's financial sector also suffers from serious underlying problems. We have already seen the extent to which banks dominate the financial sector. More important is the dominance within the banking industry of the four state-owned commercial banks. Table 2 shows the extreme level of concentration among deposit-taking institutions; the four hold 78 percent of total assets and 88 percent of foreign assets. Foreign banks play an extremely marginal role. While more than 150 foreign banks have branches in China, they are limited to foreign currency transactions and represent a mere 1.3 percent of total loans outstanding. Indeed, loans outstanding from foreign banks have actually fallen in absolute amounts since 1997 as the regional economic environment deteriorated (Lardy, 2001, p. 272). Taking a more aggressive stance, a few foreign institutions have recently purchased small stakes in some of the publicly-listed (but still state-controlled) banks: Citibank bought five percent of Shanghai Pudong Development Bank; HSBC acquired eight percent of Bank of Shanghai; and Newbridge Capital is seeking a 20 percent share in Shenzhen Development Bank (*The Economist*, March 8, 2003).

An examination of the traditional indicators of financial performance reveals significant problems, especially among the four state-owned banks. Return on assets (ROA) is low in international terms, between 0.1 and 0.2 in recent years. This was substantially

Table 2 China: Concentration among Deposit-Taking Financial Institutions, mid-1990s
(RMB billions and percentages)

Type of institution	Total assets	Foreign assets	Reserve assets
State-owned commercial banks	4,310.51 (78.2%)	327.79 (87.7%)	643.64 (74.1%)
Publicly-listed commercial banks	361.35 (6.6%)	46.10 (12.3%)	75.48 (8.7%)
Rural credit cooperatives	571.25 (10.4%)	0 (0.0%)	99.24 (11.4%)
Urban credit cooperatives	229.16 (4.2%)	0 (0.0%)	47.24 (5.4%)
Finance companies	41.04 (0.7%)	0.01 (0.0%)	3.15 (0.4%)
Total	5,513.31 (100.0%)	373.90 (100.0%)	868.75 (100.0%)

Source: Calculated from Chen, Dietrich, and Fang (2000), p. 11.

lower than returns on the publicly-listed banks in China, which had ROA ratios of nearly two in the mid-1990s, but have themselves fallen to around 0.5 (Shirai, 2002a, p. 14). Capital adequacy ratios are also generally below the BIS-mandated eight percent, according to a recent statement by the Governor of the PBOC.

Most attention by experts, however, has been directed to the non-performing loans (NPLs) in the banking system. A recent BIS study (Ma and Fung, 2002) reported that NPLs amount to 42 percent of loans outstanding of the four state-owned banks, including both those turned over to the asset management companies established to deal with the bad loans and those still held by the banks themselves. The total amounts to 35 percent of GDP in 2001. The BIS economists also raised concerns about the funding amounts and sources for the asset management firms. Other experts believe the NPL problem is even greater than the BIS estimate. Nicholas Lardy (2001) cites three reasons, based on information from the Governor of the PBOC. First, the NPLs are still continuing to emerge, so the problem is one of flows rather than stocks. Second, China has only recently begun using a more stringent loan classification system, which greatly increases the NPL statistics. The figure reported by the Governor (45 percent of loans outstanding) could thus be nearer to 65 percent by the new criteria;

this would be 60 percent of GDP. Third, the figures cited refer only to the four state-owned banks, but the publicly-listed banks are also under state control, and they have NPLs as well.

The main reason for the large stock of NPLs is the weak condition of the state-owned enterprises, which are the main clients of the banks; reportedly 80 percent of the four banks' loans go to state-owned firms (*The Economist*, February 8, 2003). Until these firms at least begin to break even, there is no way the banks can really improve their performance without changing their client base. A recent study by the Asian Development Bank Institute, which examines the banks and their clients after the reform process (Shirai, 2002a), tries to determine whether such a change is taking place. The conclusion is that, during the 1994-2000 period, banks had a lending bias toward large and less profitable firms and firms with greater state ownership. A parallel study (Shirai, 2002b) looks at China's equity markets and finds that less profitable, large, and old firms prefer bank lending despite rising stock prices that lower the cost of equity finance. This suggests that they must be getting favourable financing conditions. The other side of the picture is that newer firms, including exporters and the private sector in general, cannot get credit and have to rely on retained earnings, foreign direct investment, or informal (and thus more expensive) credit.

Despite these criticisms, experts nonetheless agree that substantial progress has been made toward improving the banking system and the equity markets. Better prudential regulations have been established, banks are learning about risk management, and the asset management firms have at last begun to tackle the NPLs. Government officials clearly believe that a greater foreign bank presence will help push the reforms further, as will recent changes in the political hierarchy. Among them, the new prime minister was in charge of financial reforms in his previous post.

2 Financial Crisis and Government Response in Emerging Markets

Since the Mexican crisis of the mid-1990s, there has been an outpouring of literature on financial crises.⁵ A central point has been

⁵ It is impossible to do justice to this literature in terms of citations. Suffice it

the argument that there is a new model behind the breakdowns in comparison with earlier financial crises in developing countries. In addition, much time (perhaps too much) has been devoted to debating two other points: whether external or internal factors were primarily responsible for the crises, and whether the international financial institutions (especially the International Monetary Fund) played a helpful role or further exacerbated the crises. This literature has made valuable contributions to both theory and practice, but it has focused too narrowly on one particular type of crisis. Here we suggest three models, or patterns, of crisis and associate them with government responses: (i) full-blown crisis and (possible) government clean-up, (ii) low-grade crisis and government paralysis, and (iii) government destruction of the financial sector. As will be indicated below, there is some overlap among the three.

Full-Blown Crisis with Government Clean-Up

The sudden large-scale disruptions that hit the Asian countries in 1997-98 are the prototype for this first model, but they are quite similar to several earlier crises in Latin America, especially Mexico in 1994-95 and Chile in 1981-83. All began with a mismanaged financial liberalisation process, both internal and external. On the internal front, the freeing of interest rates, the end of directed credit, and the privatisation of state-owned banks were accompanied by a disregard for prudential regulation and supervision and sometimes by outright illegal activities. The combination resulted in inordinately rapid increases in credit, large loans to 'related' clients, and inadequate provisioning for potential losses. Eventually, these elements set the stage for a crisis.

The above situation was made much worse by a simultaneous external financial liberalisation, usually referred to as opening the capital account. The external liberalisation process was also

here to indicate that Fondad itself has made important contributions (see especially Teunissen, 1998, 2000a, 2000b, and 2001). International and regional institutions that have been major participants in research and debates include the Asian Development Bank Institute, the Bank for International Settlements, the Economic Commission for Latin America and the Caribbean, the International Monetary Fund, and the World Bank.

frequently mismanaged. Typical aspects included a fixed exchange rate, which led to massive capital inflows and exchange rate misalignment, and improper sequencing, which favoured short-term over long-term inflows. A very rapid liberalisation exacerbated both problems. In addition, domestic firms (financial and non-financial) were allowed to enter the international markets to seek finance, creating currency mismatches, over-leveraging themselves, and endangering their future if/when the exchange rate had to be devalued. Not infrequently, the result was a systemic crisis, affecting both real and financial sectors. While, as mentioned above, much of the recent literature has concentrated on whether external or internal forces were to blame for these crises, the real danger lies in the combination of weakened domestic institutions and a sudden opening to external markets.

Following such a crisis, even the most *laissez-faire* oriented governments had to step in to stop the haemorrhaging. A typical package of measures for crisis management can be identified. A first set includes the take-over of non-performing loans, the recapitalisation of the banks, and liquidations or mergers, usually involving foreign institutions. Later, in an attempt to prevent future crises, regulation and supervision are stepped up, greater information and transparency are required, and better corporate governance is introduced. The main question becomes whether governments have both the will and capacity to intervene quickly and extensively enough to really clean up the financial sector and set it on the path of better performance for the future. This is largely a political economy question, and the answer varies from case to case. (For a political economy analysis of the Asian cases, see Pempel, 1999; Haggard, 2000.)

In the Asian context of the late 1990s, Korea provides the best example of a decisive approach that has largely, if not completely, dealt with the problems of both banks and corporations.⁶ Korea appeared to be an unlikely candidate for a financial crisis, as it had been one of the world's most successful economies in the postwar period. Until the 1990s, however, the bank-dominated financial sector had had little autonomy, since the banks were heavily influenced by the country's economic authorities in the pursuit of

⁶ Malaysia used a more "heterodox" approach, which has also been quite successful, although the crisis itself was not as deep in that country.

their policy goals. An important shift occurred in 1993, when financial liberalisation was stepped up. Although the government had intended to move slowly, the process accelerated, partially in response to Korea's application to join the OECD. In that context, both external and internal debt grew very rapidly, and insufficient attention was paid to the sequencing of reforms, leading to a shift toward short-term debt.

After the Thai crisis of July 1997, foreign creditors reconsidered their loans to Korean entities and began to withdraw. At the same time, many of the corporate conglomerates (*chaebol*) failed, resulting in a systemic crisis, as mentioned earlier. The government initially tried to handle the situation on its own, announcing deposit guarantees and providing liquidity to financial institutions. The size and speed of the crisis, however, drove it to an agreement with the IMF, which influenced but did not totally determine later steps. In a first phase of restructuring, in early 1998, public monies were used to close or reorganise troubled banks, with the government taking control of several, and to dispose of non-performing loans through the asset management company, KAMCO. This process had to be repeated in late 2000 as a result of the worsening of corporate problems. Once the immediate crisis was under control, the government began to reprivatise the banks it had taken over, and foreign investment laws were changed to allow foreign participation. The number of banks and other financial institutions was reduced, and foreign ownership increased substantially.

Another set of reforms involved strengthening prudential regulations, including accounting, auditing, and disclosure requirements. The definition of NPLs was tightened, coming closer to international standards, and the capital adequacy ratios were brought up to BIS levels. Corporate governance was also improved, with outside directors as well as checks and balances between management and board members.

The outcome of the restructuring process has been positive from the point of view of economic growth and of traditional financial performance indicators (see Table 3). Profitability has returned, capital adequacy ratios have increased, and NPLs have been reduced. In addition, there has been a significant shift in bank portfolios toward more consumer lending and fewer corporate loans. Interestingly, among corporate loans, a larger share is going to small and medium-sized firms, which bring in higher interest

Table 3 Korea: Financial Indicators of Commercial Banks, 1994-2001
(in percentages)

Indicator	1994	1995	1996	1997	1998	1999	2000	2001.9
BIS ratio	10.6	9.3	9.1	7.0	8.2	10.8	10.8	10.7
NPL ratio	5.8	5.2	4.1	6.0	7.4	13.6	8.8	5.1
ROA	0.4	0.3	0.3	-0.9	-3.3	-1.3	-0.6	0.7
ROE	6.1	4.2	3.8	-14.2	-52.5	-23.1	-11.9	14.1

Source: Cho (2002), p. 73.

rates and also has important social benefits. (On the Korean financial crisis, see Kim *et al.*, 2000; Ahn, 2001; Cho, 2002; Kang, 2002; Park and Lee, 2002).⁷

In the Latin American context in an earlier period, Chile provides another positive example of response to crisis. Of course, the Chilean economy in the early 1980s was far less sophisticated than its Korean counterpart in the late 1990s. Moreover, Chile's record of economic growth was quite poor, especially in comparison with Korea. Nonetheless, the problems they suffered and the outcomes produced were surprisingly similar.

In 1981, a severe financial crisis erupted in Chile. As in Korea, it was the result of a mismanaged financial liberalisation, but of a more extreme kind – in Chile, the military government set out to eliminate virtually all regulations. The following year, the situation was complicated by a balance-of-payments crisis, as the fixed exchange rate was devalued. The financial crisis was marked by the insolvency of the majority of the private national banks and finance houses, which were taken over or liquidated by the Banking Superintendent. By mid-1982, the crisis had become a systemic one, extending to many of the largest corporations, which also ended up in government hands.

Resolution of the crisis involved various measures to assist banks and debtors as well as the reprivatisation of the institutions that the

⁷ Recently, Korean banks have gotten into additional difficulties through their consumer loans, especially their credit card operations. The problems of one of the major conglomerates have also put pressure on the banks, as has the exacerbation of the North Korean nuclear stand-off. Nonetheless, virtually no one expects a repeat of the 1997-98 crisis.

government had intervened. The overall operation is estimated to have cost more than 35 percent of GDP. In the aftermath of the crisis a new attitude emerged with respect to regulation and supervision of the banking sector. The Banking Law of 1986, which became an example for the region, reinforced the powers of the Superintendent. Expanding on initiatives that began earlier in the decade, it required that portfolios be ranked by risk categories and that provisioning be made for higher risk credits. It also increased the transparency of the process and tightened policies with respect to credits to 'related' parties. Capital adequacy requirements were left at the previous levels, but definitions were tightened. Deposit insurance was eliminated for term deposits, so as to make depositors more vigilant, but all sight deposits were covered, as were accounts of small depositors.

In 1997, the Banking Law was modified to bring it up to date with international and domestic trends that emerged over the preceding decade. At this time, Chile adhered to the BIS capital adequacy ratio of eight percent; BIS risk categories were also adopted. Banks were permitted to increase their international activities: setting up subsidiaries abroad as well as engaging in new activities such as administering mutual funds, leasing, factoring, and financial advising. They were also allowed to provide guarantees to clients in the international market. Finally, conditions were created for more banks to enter the Chilean market, both national and foreign, after a decade of closure.

As a consequence of the processes just discussed – the thorough clean-up of the banking industry and the improved system of regulation and supervision – the Chilean financial system functioned very well in the 1990s (see Table 4). It is essential to point out, however, that this good performance also depended on the context in which it took place. On the one hand, macroeconomic policy contributed to a stable and growing economy, which had a strong positive interaction with the financial sector. On the other hand, the capital account of the balance of payments was managed so as to limit volatility from the international economy. All of these were necessary elements for the positive outcome. (On the Chilean crisis, see De la Cuadra and Valdes, 1992; Sanhueza, 1999; Ffrench-Davis and Tapia, 2001; Held and Jimenez, 2001).

Of course, these two positive examples are not the only possible outcomes of full-blown crises. Two alternatives are more common

Table 4 Chile: Financial Indicators of Commercial Banks, 1996-2001
(in percentages)

Indicator	1996	1997	1998	1999	2000	2001
BIS ratio	n.a.	n.a.	12.48	13.53	13.34	12.73
NPL ratio	0.95	0.96	1.45	1.67	1.73	1.62
ROA	1.14	1.01	0.90	0.73	1.00	1.32
ROE	15.50	13.67	11.54	9.36	12.70	17.70

Source: IMF.

occurrences. One is when a government cannot or will not make headway with respect to the crisis, and it continues to fester. In Asia, Thailand and especially Indonesia have suffered this unhappy trajectory up till now. Another possibility is that the crises appear to be under control, but not enough progress is made, or new problems appear, and the countries fall into one of the other types of crisis discussed below. Mexico and Argentina can be seen in this light, as will be explained later.

Low-Grade Crisis and Government Paralysis

While attention has focused on the full-blown crises for obvious reasons, another type has received insufficient notice. These are crises where the financial sector is loaded with non-performing loans, and is highly inefficient, but it is kept afloat by government aid of various sorts. Typical government support includes public money to recapitalise banks, permission to roll over delinquent loans or capitalise interest payments, and lenient supervision. All of this is to avoid an open crisis that would bankrupt large corporations if their loans were called and create major political and social problems. It is hoped that, in the long run, the problems will be dealt with 'automatically' by higher growth. The downside, however, is a credit crunch, where viable – or potentially viable – firms cannot get access to credit and thus the hoped-for growth remedy cannot take place. Japan and Taiwan are examples of this type of crisis in the Asian region. Although Mexico was a clear example of the first type of crisis in the mid to late 1990s, it may now have lapsed into this second type.

Japan's economic crisis is 'homemade'. Unlike the crises

discussed in the previous section, foreign capital flows were not a factor. Indeed, Japan has imported very little foreign capital and has the world's largest foreign currency reserves. Financial liberalisation, which took place in Japan in the 1980s, did create problems for the banks since it took away many of their traditional clients among the largest corporations. After the liberalisation, they could find cheaper financing alternatives through the stock market, the bond market, and commercial paper. The main source of Japan's financial crisis, however, was the asset bubble of the 1980s, especially the stock market and real estate prices. The Nikkei index went from less than 7,000 points in 1980 to almost 39,000 in 1989; now it is back to near 1980 levels. Real estate prices have followed a similar, if less dramatic, trajectory.

The bursting of the asset bubble has been important to Japanese banks in at least two ways. First, they themselves own stocks and real estate. While these are not valued at market prices, the 'unrealised gains' between book and market value can be counted as capital for determining capital adequacy ratios. Second, they have loans outstanding to other owners of both assets, especially in the construction and real estate sectors, who are then unable to keep up with their debt payments.

Two sets of indicators provide evidence of Japan's financial problems (see Table 5). One is the falling, and now negative, value of return on assets (ROA) and return on equity (ROE). The other is the rising volume of NPLs, compounded by the fact that Japan uses more lenient standards than other countries to determine whether loans are non-performing. In absolute terms, according to a recent study of NPLs in Asia by the accounting firm, Ernst and Young,

Table 5 Japan: Financial Indicators of Commercial Banks, 1998-2000
(in percentages)

Indicator	1998	1999	2000	2001	2002
BIS ratio ^a	9.6	12.1	12.3	11.7	11.0
NPL ratio	5.4	5.8	6.1	6.6	8.9
ROA	-0.6	-0.9	0.3	0.1	-0.7
ROE	-20.0	-25.1	6.8	1.2	-19.5

Note:

^a Seven internationally active banks only.

Source: IMF (2003c), Supplementary Information, pp. 8-10.

Japan has about 1.2 trillion dollars of such loans or 60 percent of the nine-country total. While Japan has disposed of \$300 billion since 1997, a similar amount has come onto the books, so that the total has not changed (*Asian Wall Street Journal*, July 11, 2002).

Like many of its Asian neighbours, Japan has established an agency – the Resolution and Collection Corporation (RCC) – to deal with bad loans. Set up in 1999 and modeled after the US Resolution Trust Corporation, the RCC has made little headway, both because it lacks resources and any firm date to complete its tasks and because of political foot-dragging by important politicians from the ruling Liberal Democratic Party. The latter do not want any radical steps to clean up bad loans because of the negative impact for major contributors and for fear of making Japan's long-lasting recession and deflation even worse. (On Japan's financial crisis, see Hoshi and Kashyap, 2000; Hosni and Patrick, 2000; Kanaya and Woo, 2000; Montgomery, 2002; Callen and Ostry, 2003.)

Taiwan shares many characteristics with Japan, but they are not yet as serious. The most important similarity is that an asset bubble, also involving the stock market and real estate, was the dominant factor leading to financial problems. Indeed, Taiwan was notable for having avoided the Asian financial crisis of 1997-98.⁸ Growth dropped slightly, but nothing like in its neighbours. There are several reasons for the differences. Taiwan has virtually no foreign debt and the third highest level of foreign reserves after Japan and China; in per capita terms, Taiwan's reserves are obviously much higher than the other two. Although it underwent financial liberalisation in the late 1980s and early 1990s, including semi-privatisation of state-owned banks, Taiwan nonetheless maintains important economic controls. Perhaps most important, the currency is not fully convertible.

The indicators of financial difficulties are also similar between Japan and Taiwan. As Table 6 shows, profits have fallen, while NPLs have risen. (Like Japan, Taiwan's definition of NPLs is less stringent than international standards.) While no banks have failed, there

⁸ Agosin (2001) has compared Korea and Taiwan in their economic performance during the Asian crisis. He favours the latter, but he was looking at an earlier period and concentrating on international factors, while Taiwan's problems were domestic.

Table 6 Taiwan: Financial Indicators of Commercial Banks, 1994-2000
(in percentages)

Indicator	1994	1995	1996	1997	1998	1999	2000
NPL ratio ^a	2.58	3.75	4.94	4.82	4.80	5.15	5.17
NPL ratio ^b	2.27	2.74	3.36	3.74	3.98	5.15	6.68
Return on assets (ROA) ^a	0.69	0.49	0.57	0.69	0.67	0.44	0.38
Return on assets (ROA) ^b	0.91	0.67	0.73	0.91	0.27	0.27	-0.12

Notes:

^a Old banks

^b New banks

Source: Montgomery (2002), p. 19.

were serious problems in 2002 among rural cooperatives. The government initially planned to close some of them down, but then backed off in response to farmers' protests. The finance minister resigned as a consequence, leading observers to conclude that the government will do nothing dramatic about the problem (*Far Eastern Economic Review*, December 5, 2002).

What the government has done is to intervene actively in the real estate and stock markets to help keep prices up. It also established a six-month rollover for company loans and mortgages when economic problems arose in 2000. Later, taxes were lowered on banks in order to give them resources to write off NPLs, and mergers or acquisitions have been encouraged. Most of all, the strategy is to hope that the economy will grow fast enough to eliminate the NPLs without causing extensive bankruptcies and unemployment. But without a sound financial system, this is unlikely to happen. (On the Taiwanese crisis, see Shea and Shih, 1999; Yang and Shea, 1999; Chow and Gill, 2000; Montgomery, 2002.)

Government Destruction of the Financial Sector

Although Argentina is the only recent case of this third crisis pattern, it is important to mention it because it is always a possible response to very severe economic problems. Banks tend to be unpopular institutions, so the temptation exists to make them scapegoats in a political sense and to look to them for resources to

full gaping holes in fiscal and/or international accounts. The consequence, however, is a long-term drag on the economy since credibility as well as assets must be recovered before the financial sector can again play a positive role in economic growth.

Ironically, Argentina in the mid-1990s seemed to be a clear example of a crisis that was overcome by prompt and effective government action. Caught in the tidal wave of the Mexican collapse, and exacerbated because its currency board system prevented the central bank from functioning as a lender of last resort, the country suffered a run on its banks, which lost 18 percent of total deposits in four months. The run was stopped by a large loan from the IMF and World Bank, together with a local ‘patriotic bond’ purchased by the banks and large corporations. As a consequence of this experience, the authorities implemented several new policies to prevent future crises: (i) a fund to promote restructuring of the banking sector, which led to a smaller number of stronger institutions, including the entry of many foreign banks; (ii) a deposit insurance scheme, financed by the private sector; (iii) a new system of reserve requirements that covered more types of deposits; and (iv) contingent credit lines with foreign banks, which constituted a proxy lender of last resort. As a result, after a five percent decline in GDP in 1995, growth resumed and the banks more than regained the deposits they had lost. In terms of capital adequacy ratios, Argentine banks were among the most solid in the world, although other indicators were less positive (see Table 7).

By the end of the 1990s, the picture turned bleak again, due to a combination of international shocks and internal political and

Table 7 Argentina: Financial Indicators of Commercial Banks, 1996-2002
(in percentages)

Indicator	1996	1997	1998	1999	2000	2002
BIS ratio	23.8	20.8	20.3	21.0	20.1	n.a.
NPL ratio	13.6	11.6	10.3	11.5	12.7	34.4 ^a
ROA	0.8	1.2	0.7	0.5	0.4	“Hefty losses”
ROE	5.1	7.8	4.9	4.0	3.2	“Hefty losses”

Note:

^a Average of three largest private banks only.

Sources: IMF (2003a), p. 45 (for 1996-2002); Fitch Ratings (2003), pp. 3-4 (for 2002).

economic factors. Notwithstanding a brief respite due to the election of a new president and another IMF package, conditions deteriorated sharply in 2001. A 'voluntary' debt restructuring was carried out to help relieve fiscal pressures, but by the end of the year the government froze all bank deposits to avoid devaluing the currency. In part because of opposition to this move, months of political chaos resulted, including five presidents in a brief period. By early 2002, there was a large devaluation and the end of the currency board, together with a default on the country's foreign debt obligations.

The main problem for the banks was that their assets and liabilities were converted to local currency at different rates. To protect debtors and depositors, bank loans were converted at 1:1, while their deposits were converted at 1:1.4. Thus, the banks were to pay much of the cost of the crisis, although the government promised some (unspecified) kind compensation. The banks were closed for some time, and several foreign banks exited the market, unwilling to recapitalize their branches. To make matters worse for the banks, the public tended to blame them for the fact that they could not get access to their deposits and, when the latter were unfrozen, they could only get their money back in devalued pesos rather than dollars. The foreign banks were singled out for particular attack since they were seen as having betrayed the expectation that they would bring in as much additional capital as necessary to keep their operations solvent.

This situation has continued for nearly two years, with no agreement on compensation for the banks and virtually no loans being made, although deposits have been returning to the system. Few statistics are available on the sector, and it is unclear when any resolution will be achieved. Bankers expect it will take years to regain their credibility, even after 'normality' returns. (On Argentina, see Kiguel, 2001; de la Torre, Levy, and Schmukler, 2003; Fanelli, 2003; Todesca and Acosta Ormaechea, 2003).

3 Beyond Crises: Finance for Development in Emerging Markets

Preventing crises and overseeing recovery efforts are fundamental tasks for governments of emerging market economies, but there is

also a more positive agenda to be addressed. In particular, governments need to construct a financial sector that will be able to promote development, including both higher growth and greater equity. With respect to growth, much attention has been devoted to the issue of bank-based systems versus capital markets (see, for example, Allen and Gale, 2000; Demirgüç-Kunt *et al.*, 2001). This is a chimera for two reasons. First, banks and capital markets are complements, not substitutes. Second, banks will continue to dominate the financial sector in emerging market economies for some time, so it is necessary to find ways to make them work better, while, at the same time, promoting bond and stock markets. With respect to equity, the discussion is primarily on whether public or private, national or foreign, institutions are more likely to expand access to finance (see, for example, Holden and Prokopenko, 2001; Westley, 2001; World Bank, 2001). Again, there is some evidence that these various types of institutions are complementary.

This section of the paper will contribute to this agenda by reflecting on the relative merits of two types of banking systems: Chile, which has a private-sector dominated system with an important foreign presence, and Korea, which maintains a strong public-sector presence, despite the reprivatisation trend that we have already mentioned. Both also have large securities markets. In each case, we will look at questions of finance and growth as well as finance for smaller enterprises.⁹

A Privatised Banking Sector

The Chilean commercial banking sector has been nearly completely privatised since the 1980s. The single public-sector institution (*Banco del Estado*) holds only about 13 percent of the banking system assets. During the 1990s, the foreign presence rose substantially to 53 percent of assets in 2000. Both the banking sector and the securities markets performed impressively in the 1990s, and they were very supportive of the growth process witnessed during the decade. The banking sector was marked by rapid growth, increased efficiency, and stability. In dollar terms, total lending of the system increased steadily from \$15 billion in 1991 to around \$40 billion in 2000. This

⁹ For a more detailed comparison of the financial sector in these two countries, see Stallings (2003).

trend was also reflected in the rise of lending as a percentage of GDP (see Table 8). Almost all of this credit went to the private sector, as budget surpluses meant that the government no longer required finance. This fact was important since the private sector had access to bank credit without competition. Not surprisingly, then, growth of credit and investment were closely linked.

Another way to study the relationship between credit and growth of output is to move to the sectoral level. The supply of credit to the productive sectors, consumers, and homeowners all rose in the 1990s, but this growth was particularly impressive for the latter two where average growth rates were above 16 percent. Even though the pace of growth varied significantly across productive sectors, credit as share of production value rose in almost all sectors. This is a good indicator that bank credit has been playing an increasing role in the financing of productive activities or, alternatively, that self-finance is becoming a less important mechanism (Stallings and Studart, forthcoming).

Table 8 Chile: Growth, Finance, and Access, 1990-2000
(in percentages)

	GDP ^a	Bank credit ^b	Bonds ^b	Credit to large firms ^c	Credit to SMEs ^c
1990	3.3	47.2	n.a.	n.a.	n.a.
1991	7.3	44.8	n.a.	n.a.	n.a.
1992	10.3	48.0	n.a.	n.a.	n.a.
1993	6.9	52.8	37.2	n.a.	n.a.
1994	5.0	52.1	43.9	68	32
1995	9.0	54.4	39.7	70	30
1996	6.8	59.8	42.6	66	34
1997	6.8	63.0	44.2	69	31
1998	3.3	64.3	42.6	69	31
1999	-0.7	67.3	45.2	70	30
2000	4.4	68.0	46.6	71	29

Notes:

^a Annual growth rate.

^b Amount outstanding to private sector as share of GDP.

^c Share of total credit to corporate sector.

Sources: ECLAC, *Statistical Yearbook of Latin America and the Caribbean*, various years (growth rates); IMF, *International Financial Statistics*, various years (bank credit); IMF (2002), p. 51 (bonds); Roman (2003), p. 36 (credit to large firms and SMEs).

Trends in the securities markets were similar to those just described for the banking sector. There was significant growth in value of issues: in US dollars, they almost doubled between 1991 (\$3.9 billion) and 2000 (\$7.5 billion). This growth was not monotonous: the value of issues grew from 1991 to 1997 (\$11.8 billion) and then fell in 1998 (\$4.8). The decline had to do with the uncertainties brought by the Asian crisis, which directly affected the issues of corporate bonds and equities, and with the sharp decline of issues of Central Bank notes. Overall, however, the access of the corporate sector and households to securities markets expanded substantially.

While the private sector had more competition with the public sector in the securities than in the credit market, there was no problem of crowding out of the former in the Chilean case. Government bonds – mainly attributable to the Central Bank policy of sterilising capital flows – remained at about the same absolute level throughout the 1990s, but declined significantly in relative terms (from over 70 percent in 1991 to less than 30 percent in 2000). In both markets, then, the government's austere macro-economic stance left plenty of space for the private sector to finance itself and thus contributed to the successful economic growth process (Stallings and Studart, forthcoming).

If Chile's financial system made an important contribution to growth rates in the 1990s, what about access to finance? The number of borrowers of bank credit more than doubled during the decade, rising from 1.6 million in 1990 to 4.5 million in 1997, before falling to 3.7 million in 2000, which is a positive sign. Nonetheless, the distribution of credit was heavily skewed. The most complete study of credit allocation provides data on debt outstanding by size of firm over the period 1994-2000 (Roman, 2003). It shows that at the beginning of the period small and medium-sized firms accounted for 32 percent of debt outstanding and large firms for 68 percent. Between 1994 and 1996, the former increased their share somewhat, but by the year 2000, as a result of the economic shocks that hit the Chilean economy at the end of the decade, the distribution was more unequal than it had been six years earlier: SMEs' share had fallen to 29 percent, while that of large firms had risen to 71 percent (see Table 8).¹⁰

¹⁰ The study referred to above also includes data on credit for microfirms, but

After the return to democratic government in 1990, the Chilean government maintained the predominantly private character of the banking system, but began to provide programs to help micro, small, and medium enterprises. Rather than subsidise interest rates or direct credit to smaller firms as in earlier times, the programs act through ‘second-tier’ public-sector financial institutions that subsidise transaction costs for commercial banks willing to lend to small firms. Nonetheless, these programs have not made any significant change in the distribution of credit, which continues to mirror the vast discrepancies in wealth that characterise the country (Foxley, 1998).

A Continuing Role for the Public Sector

The banking sector in Korea played a key role in the government’s development strategy in the 1960s and 1970s. In particular, the nationalised banks served as the channel for allocating resources to the *chaebol* and their export-oriented subsidiaries. While contributing to Korea’s successful industrialisation, the banking sector itself became highly distorted and inefficient. Already by the 1980s, the government began to make changes, reprivatising the banks in 1981-83 and giving them greater autonomy. Nonetheless, it continued to operate behind the scenes to influence the banks and propagated regulations to guide their behaviour. One of the most important was the ceiling on the share of loans that could go to the *chaebol* and the promotion of lending to SMEs. It also continued to own a number of ‘specialised’ or development banks that carried out particular government policies (Hahm, 1999, 2003).

In response to the restrictions, the *chaebol* turned to new sources of finance. One was the non-bank financial institutions (NBFIs), such as investment trusts, which were much less regulated than the commercial banks. Another source was the capital markets – stocks, bonds, and commercial paper – which the government was advocating as an alternative for the *chaebol*. As a share of GDP and as

these are excluded in order to make the Chilean data comparable with those available for Korea. It is interesting to note that microfirms maintained their share of credit over the period analysed, in contrast to small and medium-sized firms. The author of the study attributes this to a government program that subsidises transaction costs for loans from commercial banks to microfirms, but not to SMEs.

Table 9 Korea: Growth, Finance, and Access, 1990-2000
(in percentages)

	GDP ^a	Bank credit ^b	Bonds ^b	Credit to large firms ^c	Credit to SMEs ^c
1990	9.5	87.8	n.a.	n.a.	n.a.
1991	9.1	87.6	n.a.	n.a.	n.a.
1992	5.1	93.2	n.a.	42.	58
1993	5.8	101.3	45.2	38	62
1994	8.6	106.5	46.0	34	66
1995	8.9	109.6	46.4	27	73
1996	7.1	117.9	45.9	27	73
1997	5.0	131.2	27.3	32	68
1998	-6.7	153.5	75.7	35	65
1999	10.9	147.6	65.4	30	70
2000	9.3	134.2	69.4	29	71

Notes:

^a Annual growth rate.

^b Amount outstanding to private sector as share of GDP.

^c Share of total credit to corporate sector.

Sources: ADB, *Asian Development Outlook*, various years (growth rates); IMF, *International Financial Statistics*, various years (bank credit); IMF (2002), p. 51 (bonds); Cho (2002), p. 73 (credit to large firms and SMEs).

a share of total financial liabilities of the corporate sector, both increased dramatically. Bank credit also increased as a share of GDP, although declining as a share of corporate finance. Based on this new division of labour, the financial sector continued to support a high growth rate in Korea during the 1980s and most of the 1990s (see Table 9).

Under the surface, however, problems were building. As was explained earlier, they were exacerbated by the way in which financial liberalisation was undertaken in the 1990s. Both domestic and international financial liberalisation were unbalanced. In the former case, the NBFIs were given much more freedom than were the commercial banks. They were free to set their own interest rates, leading to a large gap in deposit rates between the two sets of institutions. Also there were no ownership restrictions on NBFIs, so the *chaebol* began to take control of them. In the latter case, short-term borrowing was liberalised before long-term borrowing, and merchant banks and commercial-bank subsidiaries undertook a surge of international activity. Ultimately, these problems set the

stage for the eruption of the 1997 crisis, when a negative shock spread from neighbouring economies. As we have already seen, however, the government moved quickly to rescue and then clean up the financial sector, which – after a slump in 1999-2000 – has resumed its dynamism within a more liberalised framework. While the government took over several commercial banks at the height of the crisis, it is now reprivatizing them, and foreign ownership has increased as a consequence. Nonetheless, it shows no sign of privatising the five state-owned development banks, which together account for about 15 percent of total bank assets (IMF, 2003d, p.8).

While there are similarities in the sense that both Chilean and Korean financial sectors have supported growth in their respective countries, the picture in terms of access to finance is dramatically different. The last two columns in Tables 8 and 9 present some relevant data, which show that the two economies are mirror opposites with respect to access. In the year 2000, large firms in Korea received approximately 29 percent of all bank credit to the corporate sector, while SMEs received the remaining 71 percent. As we have seen in Chile, large firms accounted for 71 percent and SMEs 29 percent. Even if these figures substantially exaggerate the gap,¹¹ it is clear that SMEs have a great deal more access to credit in Korea. A number of factors help explain these differences, but variation in government policies is certainly one of them. While the Chilean government has basically left the allocation of credit to market forces (with some small compensatory programs), its Korean counterpart – although retreating from its domination of the financial sector in the earlier postwar period – has continued to intervene in favour of SMEs.

The policies favouring SMEs date from the 1980s; the new constitution of that era stipulated that protection and promotion of SMEs should be part of the government's responsibilities. Loans from the government-owned specialised banks are one instrument; special credit funds are another as are tax breaks of various sorts (Nugent and Yhee, 2001). More important, commercial banks are required to allocate 45 percent of their new loans to SMEs; for

¹¹ There are many problems with this kind of comparison. Among the two most important are: (i) the data for individual countries are hard to collect and the relationships difficult to measure; (ii) the different definitions across countries make comparisons only rough approximations.

regional banks, the figure is 60 percent. In addition, the Bank of Korea provides special refinancing facilities for a portion of loans extended by banks to SMEs (Fitch Ratings, 2002). It is possible to argue about the efficiency of these policies, e.g., SMEs clearly seem to be less productive than larger firms. Nonetheless, it is noteworthy that SMEs in Korea engage in substantial amounts of research and development activity, and they account for around 40 percent of total exports. At the same time, there is some evidence that the pro-SME policy has contributed to greater equality in income distribution (Nugent and Yhee, 2001).

4 Lessons for China from Emerging Market Economies

At the beginning of the twenty-first century, despite its impressive economic trajectory, China faces a number of challenges with respect to its financial sector. These are magnified by the deadlines for liberalisation accepted in the WTO accession process. The main challenges can be summarised as follows:

- The NPLs should be rapidly reduced, and a more transparent process should be established for funding them. For the future, a means should be developed to avoid incurring additional bad loans.
- Stronger prudential regulation and supervision must be put into place, together with greater transparency and better corporate governance.
- Liberalisation should be phased in an orderly manner, with respect to both the capital account and interest rates.
- Ownership should be diversified. Privatisation, including foreign ownership, can increase efficiency as well as provide new technology and resources. Nonetheless, it should be asked if public-sector banks have a useful role to play in terms of expanding access to finance.
- Over time, the stock and bond markets should be strengthened to provide alternative sources of finance for firms.

In meeting these challenges, the experience of the emerging market economies documented in the paper can provide some guidance, despite the difference in size and background. As China moves toward a western-style financial system, similarities will become more important than differences.

The typology of crisis presented in the paper is useful from the Chinese perspective. In many ways, China's situation is most similar to that of Japan and Taiwan. Low return on assets continues and NPLs continue to increase on the banks' books, constituting a drag on the economy. The government seems unable or unwilling to move the clean-up process forward. Moreover, despite the rapid growth, there is no indication of being able to grow out of the NPL problem. In this context, Chinese authorities should look to the two examples (Korea and Chile) of rapid elimination of bad loans and a stronger regulatory and supervisory regime to prevent crises from recurring. This combination returned Korea to rapid growth (unlike other Asian crisis countries) and was instrumental in putting Chile onto a growth path from the mid-1980s. Finally, the Argentine situation provides a useful lesson of what to avoid, even when conditions become very difficult. China must protect and increase the credibility and functionality of its financial sector; otherwise, its growth potential will be held back. Moreover, care must be taken with any implications extracted from Argentina's experience with foreign banks. Some observers are claiming that the withdrawal of several foreign banks and the failure of others to recapitalise their branches mean that foreign banks are not trustworthy partners. In reality, the actions of the Argentine government were so misguided as to justify bank actions.

Beyond the present, China can also learn from the historical experiences of the various countries discussed. In this vein, the most relevant examples are the countries where trouble with financial liberalisation, internal and/or external, led to full-blown crises. Mismanaged liberalisation – whether through improper sequencing, excessive speed, or extreme versions of liberalisation – can lead to crises, even in countries with stronger financial fundamentals than China currently enjoys. Since China still has a closed capital account, it can take advantage of others' experience. In particular, a gradual capital account opening, with long-term flows liberated before short-term, and some ability to take precautionary steps against capital surges, can protect the fragile financial sector against devastating volatility. Likewise, putting in place an adequate regulatory and supervisory framework before liberalisation will prevent the lending booms and failure to take adequate precautions that have preceded so many crises in the past.

In addition to dealing with problems and protecting itself from

future dangers, it is equally important for China to consider how best to structure its financial system to promote growth and to broaden access to finance for the large majority of the population. The two models presented offer differing combinations of actors and policies. The Chilean financial sector is almost completely privately owned, and foreign capital is increasingly dominant. In the context of strong regulatory rules and supervisory capacity together with a stable macroeconomy, the financial sector has proved a boon to growth, as financial deepening has progressed and diversification toward capital markets has advanced further than in any other country in the region. As expected, foreign financial institutions have brought new technology and management skills and have helped smooth Chilean firms' entry into international markets. Nonetheless, the system has not done enough to spread opportunities to sectors of the population – small and medium enterprises, microfirms, poorer households and individuals – that were left out of the growth opportunities during the 1990s. Perhaps there are ways to stimulate more equal opportunities, and some success has been attained through joint public-private venture such as second-tier banks, but the jury is still out on this crucial point.

South Korea, by contrast, is an important example of a country where the government and public-sector institutions continue to play a major role. Abandoning its *dirigiste* role of the 1960s and 1970s, the government has looked to private-sector banks, non-bank financial institutions, and the capital markets to provide the main support for economic growth in the last two decades. Nonetheless, it has remained active in promoting the interests of small and medium-sized enterprises. Key instruments have included credit from the five government-owned development banks, and the requirement that commercial banks devote a substantial share of their loans to SMEs. The interesting question, for China as well as for other emerging market countries, is whether state-owned development banks should continue to play an important role or whether a way should be sought to transfer their current functions – both social and developmental – to the more efficient private sector. A few years ago, the answer seemed to be settled in favour of privatisation, but now renewed interest is emerging for some level of public-sector involvement.

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14

Korean and Chinese Finances: Comment on Barbara Stallings

Robert N. McCauley¹

In this paper, Barbara Stallings has drawn lessons from Latin America and East Asia for China as it develops its financial system and opens its capital account. This is a very worthwhile enterprise; the Latin American leg of the comparison is often neglected in East Asia. Had East Asian paid more attention to the crises of 1994-95 in Latin America, 1997-98 might have gone differently. Moreover, one can only agree on the value of drawing lessons from Korea for China (Cho and McCauley, 2003), recognising that this orange still has juice to be squeezed.

These comments are organised around four themes in Professor Stallings' paper: preventing and responding to financial crisis; unifying the bond market; defining the role of foreign banks; liberalising the capital account.

Preventing and Responding to Financial Crisis

Preventing financial crisis seems to require more and more in the way of good policies (Crockett, 2001). It has become evident that low inflation is no guarantee against financial crisis. Indeed, there are aspects of the disinflationary process that seem to contribute to

¹ Views expressed are those of the author and not necessarily those of the BIS.

financial excesses.² Policymakers need to look out for rapid credit growth and high asset prices (Borio and Lowe, 2002). A corollary is that, contrary to many studies that have examined cross-sectional data, more credit is not necessarily good for growth – as the time series evidence from more than one country suggests.

Korea provides an interesting case study in crisis prevention. In 2002, the Korean authorities recognised the danger of too rapid growth of household credit and surging property prices. Their focus was on credit – its underwriting standards; the capital backing it; and the speed of recognising profits from it (McCauley *et al.*, 1999). In response they adopted four measures, three addressed to the credit and another to the underlying market for the asset subject to price pressure (land):³

- Lowered maximum mortgage loan-to-value ratios;
- Increased Basel weight on mortgages;
- Increased *ex ante* provisioning versus household loans; and
- Increased supply of land.

Note that these measures were taken in a year in which the policy interest rate was raised by only 25 basis points. We shall never know whether the strong household credit growth would have led to a full-blown crisis if left untreated (International Monetary Fund, 2003). In the event, political uncertainties, Peninsular tensions and financial strains combined to tip the Korean economy into recession in the first half of 2003. The financial strains included an accounting scandal at SK Group, which, along with rising credit card delinquencies, led to a run by Korean households on investment trust companies that held the bonds of credit card companies. The credit card companies in turn required concerted lending from the banking system and recapitalisation. Under these circumstances, it is also very difficult to know the role played by the measures above in the subsequent sharp deceleration of household credit growth at the beginning of 2003.

Crises and widespread financial distress will not always be prevented. Stallings usefully contrasts various modes of dealing with such challenges. The evidence strongly suggests that a speedy and

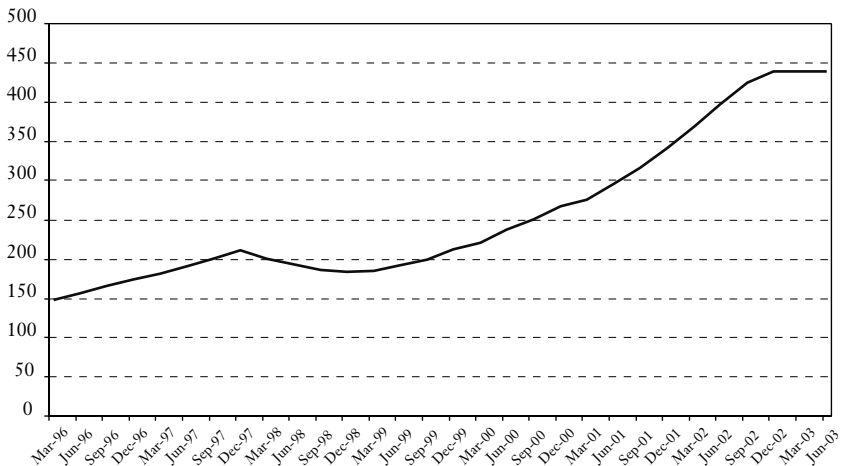
² For an examination of the role of lower nominal interest rates in giving a spurious impetus to US corporate profit growth in the late 1990s, see McCauley *et al.* (1999).

³ See Financial Supervisory Service (2002a).

thoroughgoing response is best for growth and cheapest in long run. In particular, rough justice is better than the dead weight that drawn-out distributional trench warfare usually entails. This is by no means an emerging market lesson, as Stallings' references to Japan make clear. If the Nordic countries and Korea point to the possibility of speedy resolution, Japan and Taiwan suggest a different possibility. China, with its mix of non-performing loans to state-owned enterprises, a legacy of the early transition days, and very modern troubled real estate or equity-related loans, presents a very complicated and difficult case. But by official reckoning, the measures taken to date are half measures (Ma and Fung, 2002).

Regarding the question of what to do with the Chinese banks, Stallings stakes out a position different from the conventional one and that of Fan Gang. The conventional view holds that the big banks should be recapitalised and then privatised. Fan Gang argues that since they will not be privatised, they should not be recapitalised. Stallings argues that they should be recapitalised, but not necessarily privatised, for reasons discussed below.

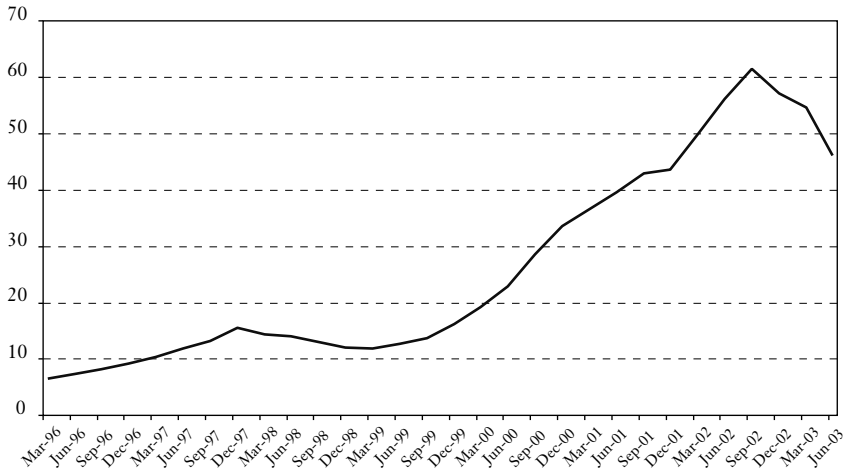
Figure 1 Credit to Korean Households
(in trillions of Korean won)



Source: CEIC Database, Nanyang Technological University, Singapore.

Figure 2 Household Credit Extended by Korean Non-Bank Financial Firms

(in trillions of Korean won)



Source: CEIC Database, Nanyang Technological University, Singapore.

Unifying the Bond Market

Recognising the fiscal cost of cleaning up the financial system leads to a larger government debt. The United States gave bad example in issuing FICO bonds, rather than using Treasury borrowing, to recapitalise the insurer of the deposits of savings and loans in the late 1980s. Using these bonds instead of full faith and credit bonds of the US Treasury added to the expense, because they did not enjoy an explicit government guarantee, and split the government bond market. The damage in this case was minor, however, because the cost of the savings and loan clean-up was small in relation to outstanding Treasury debt.

Unfortunately, window-dressing the fiscal costs of bank restructuring is not unusual. It is, however, costly. It often increases interest costs by introducing some ambiguity into the government's commitment to service bonds issued to restructure troubled banks. Even where outright guarantees are extended to such bonds, the government bond market ends up split. Such a fracturing of the government bond market imposes a second cost in the form of a less

liquid bond market. At the micro level, the bonds of different issuers will not trade interchangeably, even if economically they are very close substitutes. Even in the German bond market, the debt of the Federal Republic (“bunds”) and the government-guaranteed financial institution KfW are quite distinct and the latter yield 15-30 basis points more than the former. Liquidity split is liquidity lost.

In this matter, Korea is in the process of setting a better example. Korea split its government bond market in the process of restructuring its banking system after the crisis. In particular, Treasury bonds, Korea Asset Management Corporation bonds and Korea Deposit Insurance Corporation bonds all trade separately in the market, even though the KAMCO and KDIC bonds are government-guaranteed. In addition are the Monetary Stabilisation bonds of the Bank of Korea. Now, however, the Korean government is in the process of refinancing most of the KAMCO and KDIC bonds in the form of outright government debt, which will save on interest expense and make for a more liquid government bond market. China, for its part, has government bonds and asset management corporation bonds. In addition are the central bank bills sold by the People’s Bank of China. The liquidity of China’s government bond market would benefit if “full faith and credit” obligations of the government were used to refinance the asset management corporation and central bank paper.⁴

Defining the Role of Foreign Banks

All around the world, foreign banks are increasingly involved in domestic intermediation (“global banking”) instead of cross-border intermediation (“international banking”). This can be seen in the table, which focuses on the banking markets in countries that on which Stallings focuses.

Pure international banking would have sizeable amounts in the first two columns and zeros in the third column. Pure global banking would have zeros in the first columns and substantial amounts in the third column. In general, the ratio of local to cross-border claims of banks in the BIS reporting area has been rising (McCauley, Ruud and Wooldridge, 2002).

⁴ See McCauley (2003).

China's low ratio of local to cross-border claims reflects not only restrictions on foreign banks operating in China, but also restrictions on foreign-invested enterprises there. Foreign-invested firms, or in other words, multinational firms, operating in China have been limited in the extent to which they can borrow renminbi to finance their operations in China. As a result, multinationals in China rely relatively heavily on equity that enters China as direct investment. At the global level, however, these firms do depend on debt to finance a substantial share of their assets. As a result of the constraints in China, however, most of the debt that in effect finances the Chinese assets is offshore.⁵ As constraints on foreign banks and companies are eased, multinationals in China will borrow more locally, and to the extent that foreign banks capture this business, local loans will rise.

Stallings has some apprehension regarding the large share of the banking market held by foreign banks in Latin America, and considers that it may be worthwhile for the government to hang on to some banks, especially to serve small and medium-sized enterprises. An important difference between Latin America and East Asia is the market share of foreign banks. Outside of Hong Kong, the share of foreign banks in Korea's total bank credit, about a tenth, is more typical of East Asia than the half to two-thirds share that foreign banks have gained in Latin America (see last column of the table).

In the Chinese context, foreign banks could widen access to credit, at least to some extent. Three groups of potential borrowers have traditionally not been well served by the state-owned commercial banks. These are firms outside of the state sector, households and foreign-invested enterprises. Judging from foreign bank strategies elsewhere and their moves so far in China elsewhere, they will target the household sector (which the big four banks have also been targeting for 3-4 years) and foreign-invested firms.

⁵ In balance of payments terms, the constraints tend to raise foreign direct investment relative to other countries that allow multinationals to borrow onshore. The higher foreign direct investment has a counterpart in turn in the higher foreign currency holdings of the banking system, including the SAFE, in China.

Table 1 International and Local Banking in Selected Countries
(in billions of dollars and percentages)

	Total Cross- border Claim	Cross- border Claim on Non-Banks	Local Claims in Local Currencies	Share of Local Claims to Cross- border Claims	Share of Local Claims to Domestic Bank Credit	Share of Foreign Bank Credit in Total Bank Credit
China	54	27	5	0.09	0	2
Korea	54	23	20	0.36	5	10
Argentina	61	53	21	0.34	26	67
Brazil	72	53	66	0.91	30	45
Chile	20	19	22	1.08	48	66

Note:

Foreign bank credit is the sum of cross-border claims on non-banks and local claims (second and third columns), while total bank credit sums domestic bank credit and cross-border claims on non-banks.

Sources: IMF and BIS.

Liberalising China's Capital Account

Stallings urges a gradual opening of China's capital account. She wants "long-term flows liberated before short-term, and some ability to take precautionary steps against capital surges". This advice reflects the Chilean, and in a negative way, the Korean experience. How this applies to China may be affected by China's initial conditions.

In Chile and Korea, inflation was above the level obtaining in major countries, interest rates were accordingly higher than abroad and equity prices were relatively low. Thus, surges of capital flowing into the country was a likely consequence of liberalisation. China enjoys low inflation, relatively low interest rates and high equity prices. Although China is currently dealing with large inflows of capital attracted both by higher yields at the shortest maturities than on US dollar instruments and by the prospect of an appreciation of the renminbi, over time incipient outflows of capital may prove a challenge (Icard, 2003).

China may have some advantages in coping with such challenges. In particular, the Chinese authorities already have experience in dealing with outflows associated with significant dollarisation of domestic banking system (Ma and McCauley, 2003).

Recent experience in Korea highlights how quickly perceived exchange rate policy can feed back into capital flows. The Korean won has tracked the yen more closely than the dollar only since late 2000. Yet by the mid-2002 a considerable sum of yen borrowing had been taken on by the Korean corporate sector to “profit” from the low interest rates on yen. Reportedly, the borrowers were mostly small and medium-sized enterprises that had not been taught a lesson, as the chaebol had, about the dangers of dollar liabilities when the won depreciated sharply in 1997-98. As the Financial Supervisory Service (2002b) put it:

“At the end of November, the total amount of yen-denominated lending [to Korean firms] stood at \$7.68 billion, up \$7.1 billion ... from \$0.57 billion at the end of last year. The government’s decision in October 2001 to allow companies to secure foreign currency-denominated loans for operational funds has brought an increased demand for yen-denominated loans. In the past, foreign currency-denominated loans could only be secured for import payments, foreign direct investments or to pay back maturing foreign currency-denominated loans. *The relatively stable won/yen exchange rate and low interest rate have contributed to the growth in yen-denominated loans as well*” [emphasis added].

Conclusions

- Policymakers need to be on guard against rapid credit growth and buoyant asset prices. The recent credit measures in Korea point to alternatives to interest rate policy.
- The contrast between Korea and Japan suggest speed and thoroughness in responding to widespread financial distress best serve an economy.
- Government bond markets gain liquidity from lumping rather than splitting public bond issues. The recapitalisation of a banking system should have a silver lining in the greater size, depth, and liquidity of government bond market.
- Foreign banks might help widen access to credit, especially in Chinese context.
- China may face unusual challenge of incipient outflows in capital account liberalisation. Perceived exchange rate policy can feed back into capital flows very rapidly.

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15

Floor Discussion of “Asian and Other Views on the Functioning of the Global Financial System”

The Xie Ping Paper

Yung Chul Park, of Korea University, thought that the neo-financial dualism problem might disappear if China strengthened its regulatory system, changed the ownership restrictions within the banking sector, and deregulated interest rates. “This neo-financial dualism may not cause any serious problems to reforming China’s financial sector in the future if the government allows, as many other countries have done before in their process of financial liberalisation, the commercial banks to engage in different types of financial activities – insurance business, capital market activities, derivatives dealings and all those activities that would transform them into universal banks of the European style. In such a process of reform and liberalisation, this dualism problem may disappear, because the banks will have to compete in the market. When China also deregulates interest rates, the banks are likely to charge market interest rates to the borrowers so that this advantage of having implicit credit rationing may disappear to some extent, not entirely. So I think the answer to this dualism problem is financial liberalisation and a strengthening of the regulatory system.”

Turning to the issue of regional cooperation, Park said he had spoken last year with Asian central bankers who were working on negotiations for free trade between the ASEAN member states. “Their main preoccupation is to maintain financial stability within

the Asian region. Instability in Asia would affect China's bilateral relations with the Asian countries, which is obviously not in China's interest. The argument of Xie Ping's colleagues is that China's priority, as far as regional cooperation is concerned, is to engage in another round of parallel negotiations for monetary unification. Now that Asian countries are working on monetary unification among themselves, China may find it easier to join in the Asian discussion on monetary unification within the next 10 or 20 years, and China may absolutely not be interested in any kind of regional exchange rate arrangement with South Korea or Japan. However, one learns from the European experience that financial cooperation and monetary integration is a 90 percent political process. If China's new prime minister and Japan could agree to unify the currencies of the two countries, I'm sure that many other countries in the region would follow. Without the agreement between Germany and France, where would Europe have been now in terms of monetary integration? Nothing would ever have happened over the last 10 years or so."

Masaru Yoshitomi, former dean of the Asian Development Bank Institute (ADBI), wanted to reinforce Park's argument from a different angle. "This neo-financial dualism system is nothing neo, it is very traditional. Sorry to say that because we have two different kinds of non-market mechanisms. One is the no market or less-market oriented mechanism where we have state-owned enterprises and where we are talking all the time about reforming the socialist system into a market system. The other is a more complicated non-market mechanism that is family business. We should be very careful when talking about relational banking because even in the advanced economies, including the US, there is relational banking. The interaction between family businesses and their related banks and the government is the kind of triangle system that prevailed particularly before the crisis in the East Asian economies. So this neo is nothing neo, it's very traditional and we at ADBI are studying how to reform that. But don't forget that, under the miracle economies, such triangle worked quite well. That's why I asked how one could explain the fact that the miracle economies of East Asia got into financial crisis only a few years after the World Bank published its study 'The East Asian Miracle'."

Yoshitomi believed, just like Park, that China's financial system would gradually evolve into a more market-oriented system as a

result of financial liberalisation. “After WTO accession, China is engaged in more free international capital movements. Foreign financial institutions will be welcomed and financial services will be liberalised. So in 5 to 10 years time, whether you have neo-financial dualism or not, capital account convertibility will gradually become a fact. And then the independence of monetary policy, capital mobility and a fixed exchange rate cannot go together. You will have to abandon one of the three, maybe the exchange rate, which does not need to be completely free but has to become more flexible. My suggestion would be that China adopts a sort of multiple currency basket whereby the effective exchange rate in real terms could be fixed with a 10 percent band.”

Xie Ping did not believe in the usefulness of a multiple currency basket. “A flexible RMB exchange rate with a multiple currency basket does not make much sense. The Chinese RMB has always been pegged to the US dollar. Over the last 20 years in the foreign exchange market, more than 95 percent of the trading has been between the RMB and the US dollar. The RMB and the Japanese yen have a very small trading value, not more than 5 percent every day. The Hong Kong dollar has always been pegged to the US dollar, and so gradually the RMB has also almost been pegged to the US dollar. This is the traditional formula.”

Yoshitomi agreed that the US dollar is the dominant currency, but said a distinction should be made between the exchange rate of the RMB vis-à-vis the US dollar as the main transaction currency, and the international competitiveness of the RMB. “When I talk about a multiple currency basket, the US dollar is obviously the main vehicle currency or transaction currency. But China should also be concerned about the rate of the yen, for example. If the yen depreciates, it will affect your international competitiveness. To mitigate this kind of concern, a multiple currency basket is far better than a fixed rate.”

Xie Ping still disagreed. “I am also talking about administrative convenience, bureaucratic convenience. I do not understand why China should be so concerned about a depreciation of the yen, even though it might have a small effect on our exports.”

Charles Adams, of the IMF, observed that both an appreciation or depreciation of the yen could have an impact on China’s exports depending on the import content of its exports. “You have to calculate the import content in China’s exports to find out whether

an exchange rate depreciation or appreciation is good for China or not.”

It struck Adams that there is no such thing as a single Asian view on the problems with the global financial system. “There is a multitude of different views about the problems and about the solutions. When one thinks about regional financial cooperation, for instance, we have some people advocating the Japanese chequebook model, where Japan writes the cheque and does the surveillance and China goes out and does the free trade agreements. Then there is another model where Japan is out of the picture and China pursues regional trade agreements, and, most importantly, China has an interest in regional financial stability because of the implied trade links. So we have very different conceptions of where things will go.”

Asked what he thought about regional efforts at crisis management, Adams responded: “On global versus regional crisis managers, I guess I have to give the IMF party line which is that, in a globalised world, it becomes very difficult if there are a lot of regional crisis managers. It becomes difficult for reasons of coordination and consistency. From a more general perspective, the idea might be that for some of the solutions to a crisis – be that debt restructuring or be that the provision of liquidity – at least global coordination of regional crisis managers is needed. So I would think that the first-best solution would be a well functioning global crisis manager. But if the interest is there for a regional crisis manager, then maybe people are not happy with the functioning of the global crisis manager or maybe they use a different cost benefit model that favours a regional rather than a global crisis manager.”

“What is your personal view?” asked Yung Chul Park.

Adams: “My personal view is that I think the party line is correct conceptually, in terms of the solutions. It seems to me that some of the interest in Asia for regional solutions is based on a view that the IMF governance voting structure is not giving adequate attention to Asian interests. I wonder whether this argument for a regional crisis manager is a second-best argument or a first-best argument, and I think that a regional crisis manager is extremely difficult.”

Geng Xiao, of the University of Hong Kong, argued that financial crises should not always be prevented. “Reform of the global financial system, regional cooperation and integration, global or regional crisis management – none of these is going to eliminate financial crisis, they cannot and they should not. Financial crises can

be quite useful, for the allocation and absorption of losses and to minimise the distortions. If a financial crisis does not interrupt the real resource flows and is consistent with the long-term structural changes in the real economy, then it is healthy and necessary. Look at the US economic system, the stock market crash and the citizens of the US taking losses. The real resource flows in the US, the real growth in the US, are not distorted, they are flowing less to the high-tech sector, and that is how it should work. You have a global economy, and if China fully integrates a lot of things will change. Resource flows have to adjust and without financial shocks or fluctuations you cannot change real resource flows. We cannot eliminate financial crises, we have to live with them and the best we can do is to reduce the impact on the real sector.”

Although Zdeněk Drábek of the WTO did not disagree with Xiao’s view on the eventual beneficial effects of a crisis, he put the occurrence of financial crises in a different perspective. “I don’t disagree with Geng Xiao that in a market economy there would be profits, losses, and occasional financial crises. But the point is that the crises we have seen over the past years have looked like the ‘Great Depression’, and that there has been significant collateral damage. So the work programme in terms of crisis prevention is certainly not intended to avoid all crises but to try and reduce the frequency and the amplitude of crises, and to deal with contagion and collateral damage. But certainly in a capitalist economy you are going to see financial crises and there is a role for these crises in terms of working out from past problems.”

Barbara Stallings, of Brown University, wondered whether incentives in China might be such that they would lead to overinvestment. “There is a large literature on overinvestment written in the context of incentives. If the incentives are of the kind of the formal central planning mechanism, firms are pushed into spending more than they would under cost-minimisation and profit-maximisation alternatives. My guess is that incentives in China are such that they push the banks to overinvest.”

Drábek followed up: “Incentives are a critical issue. The banks in China have incentives to keep spending credit for investment purposes. State enterprises are demanding more funds for investment and banks are lending the money for that purpose. Nobody is stopping them, even when the projects don’t justify the lending on economic grounds.”

Li-Gang Liu, of the ADBI, gave the incentive issue a different twist. “Wing Thye Woo mentioned that China was eager to join WTO because of risk issues. The other reason is that China is willing to converge its institutions to international standards so that trade transactions can be facilitated. When we talk about international financial arrangements, what are the incentives for China to enter such an arrangement, whether it is regional or global? What can a country gain by joining global or regional institutions? The IMF preached capital account convertibility and for many developing countries it turned out to be disastrous. By not converging to that incentive, China has saved itself from the Asian financial crisis. With regard to regional financial arrangements, what criteria could be developed to take care of this incentive issues and allow China to take a leadership role? Can China use a regional or international financial arrangement as a way for itself to further liberalise its domestic financial sector and make the banking sector more modern and things like that? If there would not be such a piece in a regional or global arrangement, I think China would be less interested in playing an active role.”

Wing Thye Woo, of California University, thought that China should become a prominent player on the world stage and take a more active role in leading the developing countries in efforts at reforming the international financial system. “For example, China could argue that the IMF role in a crisis should be to ensure the fast recovery of the countries rather than to collect overdue loans for the international banks. Regional cooperation is a mechanism that may help to improve the global situation and China has to be part of an Asian effort to change the international financial architecture. Regional financial institutions can also be useful instruments to complement and critically review global institutions. Two minds are better than one and a regional institution may be able to force better behaviour at the global level. China could play an important role in shaping WTO rules and it could act, together with Japan and Korea, towards changing the international financial rules.”

The Barbara Stallings Paper

Zdeněk Drábek stressed that many Central and Eastern European transition countries have made “the incredible step” of allowing the

banking sector to be taken over by foreign banks. “Virtually all Czech banks are owned by foreign banks. Hungarian banks are, with the exception of one, all foreign owned and market penetration by foreign banks in Poland is also very high. I am sure that China has the same problem in the financial sector as the Czech Republic and Hungary had, which is that there is virtually no historical experience of proper banking and, as a result, the banking sector has remained highly fragile. For that reason, I think the foreign banks should play a major role in the reform of the financial sector in China.”

Drábek did not agree with the idea that, given the initial conditions in China, capital account liberalisation would lead to a threat of capital flying from the country. “Again, look at what happened in the Czech Republic, Poland and Hungary. These three countries have liberalised their capital markets, had similar initial conditions, and there has not been any capital flight.”

Yung Chul Park added: “About this sequencing of the capital account liberalisation, we have been hearing from the IMF that one of the major causes of the crisis in Korea was that Korea failed to liberalise the long-term market prior to liberalising short-term flows. I just want to know some evidence suggesting that countries, which had liberalised the long-term market first and then the short-term market later, indeed prevented the crisis or suffered less from financial crisis. In fact, one of the studies I was involved in does not suggest any kind of causality between financial crisis and the maturity structure of foreign debt in emerging market economies. Even on a theoretical basis one can argue that the maturity structure has nothing to do with the susceptibility and vulnerability of an emerging market country to a crisis. Does someone know any study or have any anecdotal evidence on this issue?”

Charles Adams endorsed Park’s view and related that he had seen a study that showed that “there is no relationship, which is consistent with your view”.

Barbara Stallings said there was a huge debate in Latin America on whether one can determine anything on the basis of the liberalisation of short-term capital flows. “There is an article that came out a number of years ago in one of the World Bank publications claiming that you cannot even clearly identify a short term asset from a long-term asset. The IMF has now stopped making that distinction in the accounts, so clearly this indicates they

don't think it is a relevant issue. The anecdotal evidence is that things have worked well in the Chilean case, where short-term flows were not fully liberalised, and the feeling is that if you have a lot of short term debt and suddenly people stop to roll it over, you have got an immediate problem.”

Geng Xiao observed that there are likely to be “a lot of surprises” in China’s financial reforms, because of political reasons and because of the presence of Hong Kong. “China has been in Hong Kong for many years and the operation of the Bank of China in Hong Kong is actually very much integrated with the domestic banking. China is very lucky with the capital market development in Hong Kong, because many experiences can be transferred quickly to China. Of course, there are problems in the financial sector in China, but those problems are more outside than inside of the financial sector. Two-thirds of the shares of the companies in China are held by the state. So that is not really a problem within the financial sector, but within the entire economy. The country has not yet substantially privatised the economy.

Let me give you an example. A lot of Chinese companies are listed in Hong Kong, and Hong Kong probably has the best legal system in Asia. The regulation in Hong Kong is very good but we cannot deal with some of the private enterprises from China because the original certificates of land or contracts are wrong. We cannot do enforcement with a faked document, that should be done in China, and the Hong Kong police cannot go to China. China should fix its property rights system, which is a basic system. So the bottleneck does not lie in the financial sector itself, but goes actually beyond the financial sector. That is the point I want to emphasise.”

When Geng Xiao remarked that a lot of Chinese capital is flowing out of the country and then comes back in the form of foreign direct investment, Xie Ping stressed that China’s private sector sends its capital to the capital markets because of lower taxes and better property rights. “Taxes on foreign investments are much lower than for domestic enterprises. But the most important reason for these capital flows is that China gives more protection to property rights of foreign capital.”

Geng Xiao warned of a major problem with these capital flows going in and out of the country. “All this smooth trade, all these smooth financial flows are based on the important assumption that China has a stable exchange rate. The Hong Kong dollar is pegged

to the US dollar, the Chinese renmimbi is pegged to the US dollar, the dollarisation of liabilities and assets in China is so substantial that if there will be exchange rate volatility, like the volatility that happened in Japan, China would probably follow in the footsteps of Japan.”

Part IV

Future Challenges for China

16

Financial Challenges in China

Xie Ping

Thinking about the future role of China and the reform of its financial sector, I would like to say something about the issue of non-performing loans. This is a very hot topic inside the central bank, and it raises intense discussions. How can we settle the problem of non-performing loans of the big four banks? Some people say the government should pay the bill and transfer the non-performing loans to the asset management corporations. But this has not yet been decided because lately something has changed. China's big four state-owned commercial banks had a very good performance last year.

Why did they perform well? First, total loans have increased by 14.14 percent last year. Second, because the deposit interest rate is much lower than the loan interest rate.

The big four banks were very profitable last year. They increased their lending by nearly one trillion Chinese yuan and were able to write off a lot of bad loans. So the Ministry of Finance said: 'You can continue to use your own profits to write off your bad loans.' If the Bank of China, the Industrial and Commercial Bank of China, and the China Construction Bank can maintain this rate in writing off bad loans in the next five to seven years, maybe they can solve the problem themselves. The presidents of these three big banks have declared that their banks will become publicly listed companies in the next three to five years, and they see a promising future for their banks. However, another big bank, the Agricultural Bank of China, has some problems.

The central bank and the government are confused about how to

deal with the non-performing loans. We continue to give some preferential policies to commercial banks in order to cut non-performing loan transfers. We also continue to give some subsidies and we maintain a big spread so that the banks themselves can reduce the non-performing loans in the next five or seven years.

Another challenge for the future is capital account liberalisation. We have no timetable, nor do we have a very clear target. This is, in fact, an odd situation because China's foreign reserves have accumulated dramatically after we entered the WTO and promoted the operation of foreign banks in China. If the capital account cannot be liberalised after 2006, it means that the costs of capital account liberalisation are very high.

For example, last year, some foreign banks issued foreign currency credit cards to Chinese citizens. Normally speaking, Citibank Shanghai cannot conduct this business, but the Citibank branch at Shanghai simply says: 'It is not our business, it is the branch of Citibank in Hong Kong conducting this business.' What happens is that the Hong Kong branch every month just ships the money to the Shanghai branch, and Citibank in Shanghai says, 'We are not in the foreign currency business, we are just acting as the agency for the Citibank in Hong Kong.' There are a lot of businesses like these.

This means that we are almost creating an open capital account, because Chinese citizens can use foreign currency credit cards. I can go to New York and buy anything I want – a hamburger or stocks on the New York stock exchange. This means that foreign banks can do much business. The information-technology is so advanced that it is very difficult, almost impossible to stop this business. Therefore, I believe that capital account liberalisation is inevitable and will be fulfilled much more quickly than we expect.

The third challenge for the future comes from the observation that you cannot have an independent monetary policy, a fixed exchange rate and free capital flows. Because if capital flows freely, and China wants to maintain an independent interest rate at the same time, you will have difficulty in keeping the exchange rate fixed. This is yet another very big challenge to the Chinese government and the central bank.

Currently, we have at most fixed exchange rates between the Hong Kong dollar, the Chinese yuan and the US dollar. But if China's exchange rate changes, we don't know what might happen in Hong Kong. So the central bank is very careful about the exchange rate regime.

The fourth challenge is the domestic government bond market. In China, we have a very big domestic government bond market, which consists not only of Treasury bills, but also of policy bank bonds. The central bank issued a lot of bonds in the last few years, which are almost like Treasury bills. We call this whole market the government bond market. Who buys the bonds? Mainly the big four banks. The big four banks bought almost two trillion yuan of government bonds in the last few years. Why did the big four make large profits? Because they bought government bonds, and the balance is increasing very quickly since we have a lot of foreign reserves. China has a lot of domestic savings too, which are held almost completely by the big four banks. They use the money to buy government bonds, and to make loans to households, state enterprises and the private sector. Mortgage loans have become important business in China, especially the last few years. The banks now have a good quality portfolio.

My last point with regard to the future financial challenges of China concerns the not clear agenda of domestic interest rate liberalisation. The banking deposit and the banking lending rates are still controlled by the central bank and there is no clear agenda yet of how to liberalise the deposit and the loan interest rates. It will require a discussion with a long-time horizon, which we have not had yet.

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A Seven-Point Policy Proposal for Sequencing China's Financial Liberalisation

Masaru Yoshitomi

The Asian Policy Forum and the Asian Development Bank Institute have recently developed a risk-based approach to sequencing financial liberalisation and economic reform, as a part of its goal to explore appropriate development paradigms for post-crisis Asia.

Our approach sets pragmatic guidelines by identifying risk profiles for each step of specific liberalisation measures that may arise, and gauges these new risks in relation to overall systemic risk. In the case of China, we have developed a seven-point proposal¹ which gives top priority to restoring banking sector solvency through prompt resolution of large non-performing loans (NPLs) in the state-owned commercial banks (SOCBs).

Our first proposal is to substantially restructure the large state-owned enterprises (SOEs) and achieve successful privatisation. Second, we propose to stop the ever increasing NPLs by promoting market-based risk management, ownership diversification and clear property rights. Due to China's successful dual-track strategy for reform over the past quarter century, the ownership structure of SOCBs and SOEs has already been fundamentally changed, which

¹ ADBI, "Policy Proposals for Sequencing the PRC's Domestic and External Financial Liberalization", October 2002.

resulted in a very large accumulation of private savings and the development of strong entrepreneurship. Because re-capitalisation of the banks and establishing a minimum social safety net will require large fiscal commitments, it may be difficult to maintain fiscal sustainability. To avoid monetisation of the public debt, our third proposal therefore is that the central bank should be made independent from state interference, and that financial supervisory agencies should be given full independence to enforce legal, judicial, and prudential regulations over financial institutions

These first three points of our proposal should enable the Chinese authorities to effectively address the new risks entailed by domestic and external financial liberalisation. New risks arise because financial liberalisation expands both lenders' and borrowers' opportunities and may result in excessive risk-taking, particularly when coupled with an expansionary macroeconomic environment. Managing excessive risk-taking behaviour necessitates new institution building, which, however, generally tends to advance with a lag. Domestic financial liberalisation of interest rates should, in our view, be sequenced from lending to deposit rates and from long-term to short-term maturities. A carefully phased approach will provide banks with sufficient time to develop new profit-making opportunities compatible with their capabilities of managing such new risks – which is our fourth proposal. Relaxing domestic entry requirements for banking and other financial service industries would create a large number of new banks and also non-bank financial institutions who might engage in excessive risk-taking activities. Our fifth proposal therefore is that China develops an entry strategy which encourages reputable foreign participation, as a means of introducing better risk management skills and a credit culture to the domestic financial sector.

In our view, China should be cautious with opening the capital account. Given the current status of core institutions, further capital account opening, particularly for short-term, foreign currency denominated international capital movements, should not be on the short-run policy agenda. Ill-prepared capital account opening can exacerbate both maturity and currency mismatches, thereby increasing the possibility of twin financial crises (withdrawal of international liquidity, and domestic banking crisis). Such mismatches were the crux of the problem behind the Asian capital account crisis of 1997-1998. However, policymakers must also be

aware that domestic banking and financial services liberalisation (particularly via accelerated foreign bank entry, within the context of increasingly globalised financial markets and rapid financial products innovation) will speed up *de facto* capital account opening. This phenomenon underscores the need to speed up the establishment of the sound core institutions that would mitigate and better manage these double mismatches and twin crises – which is our sixth proposal.

When freer international capital flows are allowed, a more flexible exchange rate regime should be introduced to cope with the so-called “trilemma problem” of maintaining free capital flows, independent monetary policy, and a fixed exchange rate at the same time. Given the shallow nature of financial markets in China, large capital flows could easily translate into excessive volatility of China's exchange rate and domestic asset prices. Hence we propose a midway exchange rate regime between a free float and hard peg. Furthermore, because of the possibility of severe twin crises driven by currency depreciation and balance sheet deterioration over very short time spans, regional lender of last resort facilities should also be established with the help of China's active participation to prevent the collapse of exchange rates owing to a capital account crisis.

Thus, our seven-point policy proposal for China's financial liberalisation consists of (i) a strong banking system, (ii) robust core institutions, together with (iii) a flexible midway exchange rate regime combined with regional lender of last resort facilities, as well as (iv) sustainable macroeconomic policies, in a new era of domestic and external financial liberalisation after China's accession to the WTO.

18

The Future Role of China

Choong Young Ahn

I would like to talk about the Chinese economic profile and its impact on the regional as well as the global economy, by extending the time horizon two decades or even longer than that, say 25 years later.

Anytime I visit China, I see there exist 25 different countries of South Korean population size and varying from the peasant economy of the highland to the very sophisticated economy observable in Shanghai or in Shenyang. Therefore, the development literature describing China's economic transformation process must be rewritten totally, dividing from the usual pattern of the stages of industrial growth.

I would like to make essentially five points.

China's Role in Continuing the East Asian Miracle

In China we can observe a true full-set economy from one province to another. Ranging from totally labour-intensive agricultural activities to all the way to send a mission to the moon, as well as building a Chinese colony in Mars, as China's space scientists predicted. Therefore, to describe the future role of China, it must be perceived from very diverse and different perspectives from the normal wisdom we apply to a standard size of a country.

Because of the market size and labour-cost advantage, China is likely to grow at least 7 to 8 percent for another two decades or even more than that. Despite of what is going on in the world, and

irrespective of the outcome of the Iraqi War, China is likely to continue to grow. This has enormous implications for the region as well as for the global economy. In sum, China is going to change the economic landscape of not only East Asia but also of the entire world in the next two decades or so. According to a study done by the World Bank, China will nearly equal the GDP of the United States in terms of purchasing power parity in the next two decades or slightly longer than that. As a consequence, China is going to have an enormous impact on the global economic picture.

Observing the deepening and enlargement process of the European Union, which is extending its membership to ten additional countries by 2004, and observing the intended expansion of NAFTA to cover the entire Latin American region, East Asian dynamism will depend on how we can trigger intra-regional demand. In this context, I think the East Asian countries, especially the countries in North East Asia, are very fortunate to have a growing China, with such a great potential, as an immediate neighbour. This must be seen as a blessing rather than a threat, provided that these neighbouring countries are going to adjust their economic system and make sure it will be more competitive than before. I think that China is going to trigger the East Asian dynamism on a continuous basis so that we can continue to generate “the East Asian miracle” that we observed in the 1970s and 1980s.

As a result of joining the WTO in 2001, China can enjoy an additional 3 to 5 percent points of GDP higher than if it had not joined the WTO. The accession to WTO is a great blessing for China, which enables it to continue its own growth momentum and dynamism. However, it also provides a great challenge for China as a full member of the WTO. According to a KIEP study, China’s trade value will double within the next five years. In that sense, China is perhaps the greatest beneficiary of the WTO accession. A disturbing factor of China’s WTO accession is that China will become a more trade-oriented economy and that the trade disputes between China and its trading partners are likely to increase. For example, last year no country in the world was at the centre of more anti-dumping investigation than China. About a total of 18 cases were raised and in the same period there were 9 cases of anti-dumping measures imposed upon China’s export goods by various trading partners. Now that China is a full member of the WTO, a potential trade dispute should be resolved within the multilateral

trading system. In this regard, I think that China should carry on the standardisation and harmonisation of its legal and regulatory framework so that a trade dispute could be resolved harmoniously and will not cause trouble. I really hope that the kind of trade disputes experienced in the last two years, like the case that happened between Korea and China, will be avoided by means of a very concerned private sector. The settlement mechanism, for example, that China and its trading partners may form could be a private level dispute settlement mechanism which carries on a candid dialogue and points out some early warning signals. I think China will take full advantage of the WTO membership and will make a maximum effort to avoid a potential trade dispute with its neighbouring countries.

A Stable Exchange Rate Regime

Talking about the exchange rate regime, a long-term goal of the exchange regime in China is to reach free exchangeability of the RMB. Of course, to open up the capital account a country needs to wait until it meets certain macroeconomic conditions such as a stable macroeconomic climate and a healthy financial system. It might take some time, even a long time before the maturity of the macroeconomic conditions can ensure the free exchangeability of the RMB, but in due course I believe a partially free exchange rate mechanism with RMB in the near future can be expected from China.

China should continue to work with a stable exchange rate system to avoid a potential competitive devaluation, the phenomenon that we experienced in the early 1990s and which triggered part of this Asian financial crisis. As China becomes more trade oriented and tries to accumulate a trade surplus while adjusting to a free exchange scheme, maybe we run into exchange rate volatility especially between the RMB and the Japanese yen and perhaps along with the Korean won. So the future role of China should be: how can we work together to ensure a stable exchange rate mechanism.

Capital-Intensive Industries

The third point I would like to raise is related to the overcapacity problem. China will continue to pursue its own version of import-substitution policy towards the extremely capital-intensive industries such as iron, steel, ship-building, semi-conductors and automobiles. Of course, the number of foreign companies may evolve in this process but the point I am raising is that because of the low-cost advantage China should be able to produce a low-price and high-quality product in these areas. But in a macroeconomic sense, this will cause what we call a deflationary pressure on the neighbouring economies and exert a downward pressure on the general price level. The point I want to make is that can we talk about a concerted investment strategy on the part of China on the long-term horizon, in ship-building, iron, steel and semi-conductors. However, Japan and Korea together already are capable of producing enough to supply world demand. So if China joins to meet the potential demand on China's domestic market, the already existing capital stock in these industries is likely to augment to such an extent that it may cause a global downward pressure on the price level. So Korea, China and Japan should work on an internal division of labour in these capital-intensive industries.

China and Japan Competing for Regional Hegemony

The next point I want to catch upon is the competition of free trade agreements (FTAs) engineered by China, Japan and Korea. In October 2001, at the ASEAN+3 meeting in Singapore, China proposed an FTA with ASEAN. That really surprised a number of East Asian economists. In response to China's initiative, Japan also proposed an FTA with ASEAN, which generated FTAs with five key countries last year.

It seems to me that China and Japan are competing in concluding FTAs with ASEAN members. South Korea proposed the formation of an East Asian Free Trade Agreement. The question that I am putting out is: Are China and Japan struggling for the regional hegemonic leadership by proposing FTAs competitively to the ASEAN member economies? There is a very powerful overseas Chinese community in a number of the key ASEAN member

countries ranging from Malaysia, Indonesia to Thailand, and those overseas Chinese businessmen are the early pioneers who brought the green field FDI in China. So there is a very strong relationship between the overseas Chinese business community and China. The regional economic leadership struggle between Japan and China could be very harmful for the East Asian integration process. Perhaps it could lead to a spaghetti bowl of FTAs deviating from the original purpose of facilitating intra-regional trade. We need to work on a truly cooperative basis rather than carry on with this regional leadership struggle.

Political Pluralism and Socialist Market Economy

A final point I would like to make is that China will continue to pursue its own version of the socialist market economy to achieve the welfare society upfront. However, to become a truly advanced nation by the year 2050 the fundamental question I have always in mind is: Can China realise its own version of a socialist market economy without political pluralism? In other words, I think that a multiparty system should come into the picture to ensure that the market economy and political pluralism can work together to represent the various interests of society segments.

As Fukuyama mentioned in his book *The End of History*, many believed that in the post-cold war period, the political democracy and the market economy should work side by side. I think that the future role of China, in the long term, depends on how China is going to combine the market economy and political democracy.

Appendix

List of Participants in the Conference on “China’s Role in Fostering Financial Stability and Growth in the Asian Region and the World Economy”, held at the Research Park Main Centre of the Seoul National University (SNU) on 27-28 March 2003.

Mr. Charles Adams	Assistant Director, Regional Office for Asia and the Pacific, International Monetary Fund, Japan
Mr. Choong Yong Ahn	President, Korea Institute for International Economic Policy, Seoul
Mr. Young Rok Cheong	Assistant Professor, School of International and Area Studies, Seoul National University, Seoul
Mr. Un-Chan Chung	President, Seoul National University, Seoul
Mr. Zdeněk Drábek	Senior Counsellor, Economic Research and Analysis, World Trade Organisation, Geneva
Mr. Yongdeok Kim	Dean, Graduate School of International Studies, Seoul National University, Seoul
Mr. Chang Kyu Lee	Research Fellow, Center for Regional Economic Studies, Korea Institute for International Economic Policy, Seoul
Mr. Keun Lee	Associate Professor, Economics Department, Seoul National University, Seoul

Mr. Li-Gang Liu	Research Fellow, Asian Development Bank Institute, Tokyo
Mr. Robert McCauley	Deputy Chief Representative, Bank for International Settlements, Representative Office for Asia and the Pacific, Hong Kong SAR
Mr. Yung Chul Park	Professor, Department of Economics, Korea University, Seoul
Mr. Byung-Nak Song	Professor of Economics and Director, Institute of World Economy, Seoul National University, Seoul
Ms. Barbara Stallings	Research Professor and Director of the Political Economy of Development Program, Watson Institute for International Studies, Brown University, Rhode Island
Mr. Jan Joost Teunissen	Director, Forum on Debt and Development (FONDAD), The Hague
Mr. Yunjong Wang	Senior Research Fellow, Korea Institute for International Economic Policy, Seoul
Mr. Wing Thye Woo	Special Advisor for East Asian Economies, Millennium Project, United Nations, and Professor, Department of Economics, University of California, Davis
Mr. Geng Xiao	Associate Professor, School of Economics and Finance, Deputy Director, Institute for China and Global Development, The University of Hong Kong, and Adviser, Securities and Futures Commission, Hong Kong

- Mr. Ping Xie Director-General, Research Department, People's Bank of China, Beijing
- Mr. Masaru Yoshitomi Visiting Professor at the Wharton School of the University of Pennsylvania and Chairman of the US-Japan Studies Center at the Wharton School and former Dean, Asian Development Bank Institute, Tokyo
- Mr. Xiaojing Zhang Associate Professor at the Institute of Economics, Chinese Academy of Social Sciences and Research Fellow, National Economic Research Institute (NERI), China Reform Foundation, Beijing

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China's Role in Asia and the World Economy: Fostering Stability and Growth

Edited by Jan Joost Teunissen

"China has overtaken the United States in foreign direct investment inflows, becoming the most attractive FDI destination."

Given the size of China's economy – the second largest economy in the world in purchasing power parity terms – and the size of its population – 20 percent of the world's population lives in China – the country's prospects of financial stability and growth are of key importance to the developing world.

Considering the role China is playing in the Asian region and the world economy, there are even more reasons to analyse and discuss the challenges of China's economic performance.

In this book, renowned Chinese scholars and other experts in international finance and development discuss the challenges China is facing when dealing with domestic, regional and international economic issues. The first part of the book discusses China's economic reform agenda, the second China's role in regional financial cooperation efforts as well as in global finance, the third the functioning of the global financial system, and the fourth China's future challenges as seen by prominent Chinese, Japanese and Korean experts.

"China is becoming an engine of growth for the world, and its successes and problems should be seriously studied since they have profound implications for all of us," concludes one of the contributing authors.

The book is enriched by lively and in-depth discussions among the contributors and other international financial experts.

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