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CHINA: MANAGING FINANCIAL INTEGRATION

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I. FINANCIAL INTEGRATION AND VULNERABILITY

The outbreak of the Asian financial crisis in 1997 and its devastating aftermath have brought to light a host of issues concerning capital account management, liberalization and its implications for overall economic development. As a group of once high-performing, "miracle" economies in Asia[1] – notably Indonesia, Malaysia, the Republic of Korea and Thailand – were suddenly trapped into a sharp economic downturn and suffered the consequences of enormous income and welfare losses. An immediate question raised by policy makers and in academic circles was "What went wrong?" The subsequent contagion effects of the crisis, reaching not only some economies in the Asia-Pacific region but also countries as far away as Brazil and the Russian Federation, extended the inquiry into a closely related question: "What can be done, both domestically and internationally?"

Scholarly investigation of the issues involved has been wide ranging. Concerning the first question, a set of factors attributable to a varying degree to the outbreak of the crisis has been identified. Broadly, these include: macroeconomic management, particularly in the presence of a non-sustainable resource gap, and the manner in which it is financed; the leverage and governance of corporate and financial sectors; accounting and disclosure standards; regulatory and policy transparencies; the relationship between government and businesses, and between financial intermediaries and corporations; the behaviour of alternative types of cross-border capital flows and their implications for a receiving country; exchange rate regimes and their management; the conduct of sectoral policies and resulting structural imbalances; and too fast a pace of financial liberalization in the absence of prudent regulations. Weaknesses in these areas and their interrelationships are considered to be the main reasons why the crisis-affected economies were so vulnerable to external shocks, and they help explain what might have triggered a crisis of this magnitude in the first place. Studies on the second question have thus far focused on several interconnected aspects. What are the policy objectives and instruments needed for a proper handling of the crisis and its contagion effects? How may these policies be coordinated at the micro, macro, and international levels? What are the useful indicators that may signal an impending crisis with some degree of reliability? What forms of institutional infrastructure and monitoring framework, both domestic and international, do we need in order to reduce the potential risks associated with financial liberalization and sustain economic development in the increasingly integrated global economic environment?[2]

As to individual economies, the answers to these questions rest heavily on the diagnosis of the specific problems at hand, which tend to be highly case-sensitive. Financial and banking difficulties are not new phenomena, and are certainly not limited to developing countries and economies in transition. The banking problems encountered by some industrialized countries,[3] as well as by certain newly industrializing economies (NIEs) – such as Hong Kong (China), Singapore and Taiwan Province of China – are just a few well-known examples in recent memory. Of the crisis-affected Asian economies, Malaysia, the Philippines and Thailand had all experienced financial and banking difficulties prior to the 1997 crash. Likewise, the problem of external debt and corporate leverage was not unfamiliar to policy makers in the Republic of Korea. By most international standards – and those practised in some NIEs – perhaps none of today's developing countries and transitional economies can be considered free of at least some of the above-cited "vulnerabilities". Many of these economies have, since 1997, either steered clear of the financial storm or managed to weather its contagion effects fairly well. A closer look at these cases suggests that the presence of vulnerabilities in itself does not necessarily imply that countries will be inevitably dragged into a major crisis. Nor should the "vulnerable" economies forego the benefits of greater financial integration for fear of exposing themselves to too much potential damage. The key lies in how the process of integration and liberalization is managed, which, in its very essence is a country-specific issue. This burden ultimately rests on the policy makers in the economies in question.

China presents an important case in this regard. In many respects, the Chinese economy exhibits characteristics similar to those of the crisis-affected Asian countries, particularly in terms of weaknesses in the financial and corporate sectors.[4] Nevertheless, China not only survived the crisis, which was the worst external shock since its integration into the world economy – a process that began in 1979 – it actually achieved a very impressive rate of growth. Since 1997, annual rates of real GDP growth in China have exceeded 7 per cent. Although slower than the pace observed in some of the previous years, this is, nevertheless, in sharp contrast to some of the neighbouring economies, where contractions have been observed. The Chinese currency has remained stable, as has the net inflow of foreign capital. An interesting question, therefore, is how China, with an economy as "vulnerable" as that of its Asian neighbours – if not more so – has managed to accomplish this? Put more generally, given all the recognized structural and institutional weaknesses of the developing countries and economies in transition, how can a smoother process of economic integration and liberalization be facilitated, while keeping potential costs to a minimum? This question is especially relevant to individual developing countries and transition economies, given the fact that a well-functioning, developing-country-friendly, international financial architecture is still in the making.[5]

The present study attempts to explore this question, using the Chinese economy as a special reference. The main focus is on the essential issues concerning financial sector reforms and capital account management. To set the stage, section II provides a brief overview of economic transition in China since 1979. Section III examines in more detail the changing pattern of capital flows into China, and highlights some key characteristics.

Certain critical elements and mechanisms that have prevented China from being dragged into the Asian financial crisis are discussed in section IV. These include restructuring of the financial sector, the exchange rate system and management, and the structure and operation of equity markets. Section V concludes the study with some final remarks on the potential impacts on China of its entry into the World Trade Organization (WTO). The discussion does not attempt to provide a comprehensive assessment of all the above-mentioned areas in every detail, but rather to concentrate on those aspects that best fit the purpose of this study.

II. THE CHINESE ECONOMY IN TRANSITION: A BRIEF OVERVIEW[6]

The founding of the People's Republic on 1 October 1949 marked the beginning of modern economic development in China. Its subsequent development may be divided into two phases, according to the economic system installed, the strategies pursued and the country's economic relationship with the outside world. The first phase covers a 30-year period, from late 1949 to the end of 1978. The second phase began in 1979, when the leadership set out to reform and open up the economy.[7]

The development strategy implemented in the first phase was essentially one that called for rapid industrialization by concentrating on promoting heavy industry and economic independence. Economic activities were organized and managed under a central planning system similar to that of the former Soviet Union. The degree of reliance on foreign markets and assistance was kept low, with an emphasis on economic self-sufficiency. Since 1979, however, dramatic changes have taken place in China: the country is undergoing a period of rapid transition, turning away from the central planning system and moving towards a more market-oriented configuration. The pattern of economic growth has since been more balanced in terms of the sectoral structure of production and the relationship between accumulation and consumption. Equally important, China has become much more outward looking and is increasingly integrating into the international community.

A. Accomplishments in two decades of reform

Reforms introduced in China since 1979 have accelerated the process of industrialization and urbanization, and brought about impressive growth in production, trade and the standard of living. Despite the internal and external difficulties that the country has encountered, as well as the enormous social, political and economic challenges it still faces, the transition process has been, on average, remarkably smooth so far and, judging by most social and economic indicators, outstandingly successful.

During the period 1979–1999, real GDP in China grew at an average rate of about 8 per cent per annum – unmatched in any period in China's history and unparalleled by any other economy in transition. The country emerged as the most dynamic and fastest growing economy in the world and one of the most powerful driving forces in the development of the Asia-Pacific region. During this period, inflation was generally kept in check, productivity growth accelerated, and output and trade soared. As recently as 1996, industrial production was more than seven times higher than in 1978, and total trade 14 times higher. These upward trends have since been strengthened. In two decades, the overall size of the economy has increased more than fourfold.

This dynamic growth has been widely spread across most of the country. It has been estimated that if each of China's 30 municipalities, provinces and autonomous regions[8] were treated as an individual economy, then the 20 fastest growing economies in the world in the past two decades would have been Chinese (World Bank, 1997a: 3).[9] The result of this rapid expansion has been a substantial improvement in the standard of living for the population at large. Real income per capita in China has more than quadrupled during the period. In this respect, China has achieved in two generations what took industrialized countries centuries. More than 200 million people – the equivalent of about 4 per cent of the total world population – have been lifted out of absolute poverty during this short period (World Bank, 1997a: footnote 9). At the same time, the economy has largely avoided the unsustainable swings that are common to the developing countries that have undergone rapid economic expansion.

B. Economic reforms and systemic transformation

The robust growth over the past two decades has been both a cause and a consequence of China's ongoing process of economic reform and systemic transformation. China has made remarkable progress in reshaping its once highly centralized economic management system: the scope of central planning has been greatly reduced and market forces are playing an increasingly significant role in the country's economy. Less than 5 per cent of industrial production is now under central government planning, down drastically from more than 70 per cent in 1978. Virtually all consumer goods are sold at market prices, compared to less than 5 per cent two decades ago.

In the rural area, the commune system of collective farming was abolished in the early 1980s and replaced by the household production/ responsibility system, which later developed into the household contract system. The reform has boosted agricultural production and productivity growth. Sweeping reforms have also been carried out in a wide range of areas, including taxation, investment financing, banking, foreign exchange management and trade, wages, prices and in various social security and welfare systems. Private ownership is encouraged; the private sector has been playing an increasingly important role in the economy. Small and medium-sized, collectively-owned enterprises flourish in both rural and urban areas. The non-State-owned sector now contributes more than 50 per cent to the country's total industrial production, and commands a significant share in tertiary markets. Reforms in large-scale, State-owned sectors are well under way. Markets for capital, labour, raw materials and real estate, as well as for bonds, stocks, futures trading and insurance, are developing at an accelerating pace. Macroeconomic management has shifted from depending heavily on administrative controls to increasingly relying on indirect, market-oriented methods. The financial and banking sectors have been restructured and enhanced, and the legal and institutional framework has been formulated and strengthened.

C. Opening up to the outside world

The reforms have gone hand-in-hand with promotion of greater economic openness, bringing the country's foreign trade and exchange rate system closer in line with international practice, and substantially helping to promote foreign trade. On 1 January 1994 the practice of multiple exchange rates was abolished and a unitary exchange rate system put in place. Strict controls over foreign exchange transactions have been relaxed, trade in foreign exchange on the current account is now permitted,[10] and extension to liberalized items on the capital account is on the agenda. More and more tariffs and quotas, once levied on traded goods, have either been lifted or are being reduced. To meet conditions for entry into WTO, China has slashed tariffs on imported items four times since the end of 1992, lowering the country's average tariff rate to 17 per cent from the previous average of 43.2 per cent.[11] Progress has also been made in removing non-tariff barriers. Regulations and procedures concerning foreign transactions are being clarified and simplified. With the accession of China to WTO, the scope and depth of its opening-up efforts are expected to be even more far-reaching.[12]

China's degree of openness has increased significantly since 1979. Total merchandise trade (exports plus imports) surged to $323.9 billion in 1998 from a mere $20.6 billion in 1978, and accounted for more than 35 per cent of China's GDP. While it ranked thirty-second in 1978, China emerged in 1993 as the eleventh largest trading nation in the world, and now, just a few years later, it has advanced further to figure among the top 10. Its booming economy has attracted investors from all over the world. In 1998, for example, FDI in China stood at $45.5 billion, having grown more than 10 times since 1986, and even more significantly from its negligible level of $6 billion for the period 1978–1982, when the process of economic reform and opening had just begun. In 1993 China already ranked as the second largest FDI recipient in the world after the United States. That ranking has since remained unchanged.

Since the mid-1980s (and especially the early 1990s) more sectors and geographical regions in China have been opened up to foreign investment and participation. The sectors include those that were previously prohibited, such as energy exploration and production, infrastructure construction, telecommunications and banking and financial services. Geographically, FDI has expanded from a few designated small areas in the south-east provinces of Guangdong and Fijian in the late 1970s to the country's vast hinterland. The number of foreign-funded firms established in China has increased substantially over the past 20 years. The investing firms have brought not only the physical capital, but also technical, managerial and marketing know-how, thus enhancing China's efficiency in production and competitiveness in the world marketplace.

While active in attracting FDI, China has exercised greater caution in managing foreign commercial borrowing and portfolio investment inflows. As detailed in sections III and IV below, this is reflected both in its external debt management and in the way in which the Chinese equity markets operate. Nevertheless, capital inflows from these sources have increased. In addition, significant funds have been raised in foreign stock and bond markets, including Hong Kong (China), in recent years. Apart from private sources, loans obtained from foreign governments have contributed to capital inflows to China. This is in addition to the funds furnished by international financial institutions, such as the World Bank and the Asian Development Bank. As the process of opening up continues, Chinese enterprises are becoming more actively involved in investing overseas. The significantly greater economic openness has reinforced efforts towards systemic reforms as well as deepened and accelerated the pace of overall economic transition.

III. THE CHANGING PATTERN OF CAPITAL INFLOWS

Table 1 provides information on actual (paid-in) utilization of foreign capital in China, with a breakdown by category, for the period 1983–1998. Several observations may be made on the changing pattern of foreign capital inflows.

A. The predominance of foreign direct investments

The amount of total inflows has grown significantly during the period. As the second column of table 1 shows, the total amount of actual utilized foreign capital increased nearly 30 times during this period, from a mere $2 billion in 1983 to $58.6 billion in 1998, and the upward trend of foreign capital inflows was fairly smooth. This was the case not only for total inflows, but also for foreign loans, and especially for FDI. These two categories are shown in the third and fifth columns respectively, of table 1.

Interestingly, the relative importance of each category shifted during the period. The change in the share of foreign loans, as opposed to that of FDI, is particularly noteworthy. Foreign loans accounted for more than half of total foreign capital inflows to China throughout the 1980s, and reached a peak in 1986 at 68.5 per cent. The situation did not take a noticeable turn until 1992, when the share of foreign loans fell to 41.2 per cent of the total. The decline in percentage shares in this category continued thereafter, ending the period at 18.8 per cent – which is comparable to the lowest share of 18.6 per cent posted in 1997. In contrast, FDI gained enormous momentum, especially after 1992. In that year, the share of FDI in total inflows exceeded, for the first time, that of foreign loans. Thereafter, there was a surge in FDI to the extent that it accounted for more than 70 per cent of total inflows each year.

Other foreign investment inflows were rather small in absolute terms, and their share declined during much of the period. This is shown in the last two columns of table 1. The foreign investments that fall into this

Table 1

CHINA: ACTUAL UTILIZATION OF FOREIGN CAPITAL BY TYPE, 1983–1998

($ billion; percentage)

		Foreign loans		*FDI*		*Other foreign investment*	
	Total	*Amount*	*Percentage of total*	*Amount*	*Percentage of total*	*Amount*	*Percentage of total*
1983	2.0	1.1	55.0	0.6	30.0	0.3	15.0
1984	2.7	1.3	48.2	1.3	48.2	0.2	3.6
1985	4.7	2.7	57.5	1.7	36.2	0.3	6.3
1986	7.3	5.0	68.5	1.9	26.0	0.4	5.5
1987	8.5	5.8	68.2	2.3	27.1	0.3	4.7
1988	10.2	6.5	63.7	3.2	31.4	0.6	4.9
1989	10.1	6.3	62.4	3.4	33.7	0.4	3.9
1990	10.3	6.5	63.1	3.5	34.0	0.3	2.9
1991	11.6	6.9	59.5	4.4	37.9	0.3	2.6
1992	19.2	7.9	41.2	11.0	57.3	0.3	1.5
1993	39.0	11.2	28.7	27.5	70.5	0.3	0.8
1994	43.2	9.3	21.5	33.8	78.2	0.2	0.3
1995	48.1	10.3	21.4	37.5	78.0	0.3	0.6
1996	54.8	12.7	23.2	41.7	76.1	0.4	0.7
1997	64.4	12.0	18.6	45.3	70.3	7.1	11.1
1998	58.6	11.0	18.8	45.5	77.7	2.1	3.5

Source: Author's calculations, based on State Statistical Bureau (1994: 527; 1997: 605; 1999: 577).

category include international leasing, compensation trade, and processing and assembling. From the Chinese standpoint, these types of investments are less useful in terms of acquiring more advanced foreign technologies, but are beneficial in terms of job creation, particularly for the unskilled labour force. Relative to its diminishing weight in the later part of the period (with the exception of 1997 and, to a lesser extent, 1998), this category played a somewhat greater role during the preliminary stage of China's economic opening, when domestic and overseas investors were still getting to know to each other.

Interestingly, the upward movement of foreign capital inflows was not interrupted to any significant degree by the social unrest in 1989 and the subsequent economic sanctions that were imposed on China by some western countries. This event had some impact on the inflow of foreign loans, notably those from foreign governments. It might also have scared away some small investors. However, the impact was only marginal. The amount of foreign loans in 1989 declined to \$6.3 billion from \$6.5 billion in the previous year, and that of other foreign investments fell to \$0.4 billion in 1989 from \$0.6 billion in 1988. In contrast, the inflow of FDI continued: it reached \$3.4 billion in 1989, up by more than 6 per cent from 1988. This increase in FDI offset most of the losses incurred in other categories. As a result, the total amount of foreign capital inflow in 1989 declined only slightly from the previous year: down by less than 1 per cent, as the table indicates. Driven largely by the continued increase in FDI, total inflows recovered quickly in 1991, and have since shown a strongly upward trend. Thus, as far as foreign capital inflow is concerned, the political event of 1989 apparently did very little harm to China, and the economic sanctions that followed were completely ineffective.

One of the possible reasons for this somewhat surprising observation may have to do with the structure of foreign capital inflows into China. FDI, especially by multinational firms, tends to be forward-looking and motivated by long-term business considerations. This type of inflow may thus be less volatile, and comparatively less sensitive to a one-off, short-lived political shock. A relatively greater reliance on FDI, among other factors, appears to have enabled China to sustain a smooth stream of foreign capital inflows during this difficult period. The same argument applies to the period covering the Asian financial crisis and its contagion. As the table shows, the level of FDI in both 1997 and 1998 exceeded that of 1996, thus preventing a marked decline in total inflows.

The increase in “other foreign investments” between 1997 and 1998 was due mainly to a surge of inflows from Taiwan Province of China and the United States. This category of inflows from these economies jumped in 1998 by 157 per cent and 23.9 per cent respectively, from their corresponding 1997 levels. The moderate decrease in foreign loans in 1998 from their level of the previous year was primarily a result of the decline in intergovernmental loans (-20 per cent), commercial loans (-26 per cent), and in China's overseas bond issuance (-59 per cent). In contrast, loans from international financial institutions and export credits provided by foreign entities increased in 1998 by 84 per cent and 43 per cent respectively, from their 1997 levels, offsetting the above-mentioned loan declines (State Statistical Bureau of China, 1999: 596–8).

B. Growing significance of joint ventures and foreign-owned firms

Over time, joint ventures and wholly foreign-owned enterprises have emerged as the dominant types of FDI in China, as table 2 suggests. In the upper portion of the table, we compute, on a contracted base, the shares of FDI under alternative arrangements between 1992 and 1998 – the period during which the surge in FDI inflows was strongest. As the table shows, FDI under the arrangements of joint ventures and wholly foreign-owned enterprises, taken together, typically accounted for nearly 80 per cent of the total during the period. In comparison, the share of co-production in the total was relatively small. Of the three types of arrangements considered, joint ventures were the most popular for most of the period, accounting for more than 40 per cent of the total. But the significance of this form of FDI declined, as its share fell from 50.1 per cent in 1992 to 33.2 per cent of the total in 1998. Meanwhile, the share of wholly foreign-owned enterprises gained considerable strength, rising from 27 per cent in 1992 to 41.8 per cent in 1998.

Despite varying degrees of importance, the average size of FDI per project in all three kinds of FDI has increased significantly, as seen in the lower portion of table 2. A comparison of the figures for 1992 with those for 1998 shows that the average size per project under joint ventures increased to $2.13 million in 1998 from a mere $0.85 million in 1992, more than double. Similarly, the average size of wholly foreign-owned enterprises also increased strongly, up from $1.81 million per project in 1992 to $2.25 million in 1998. And the co-production category saw an increase in average project size from $2.32 million in 1992 to $5.82 million

Table 2

CHINA: CONTRACTED FDI BY TYPE AND SIZE, 1992–1998

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
As percentage of total FDI *(Total FDI = 100)*							
Joint ventures	50.1	49.5	48.6	43.5	43.5	40.6	33.2
Co-production	22.8	22.9	24.6	19.5	19.5	23.6	22.4
Foreign enterprises	27.0	27.3	26.6	36.9	35.2	34.6	41.8
Average investment per project *($ million)*							
Joint ventures	0.85	1.02	1.44	1.94	2.52	2.30	2.13
Co-production	2.32	2.44	3.06	3.72	5.02	5.09	5.82
Foreign enterprises	1.81	1.61	1.69	2.86	2.96	1.84	2.25
Total FDI	1.19	1.34	1.74	2.47	2.98	2.43	2.63

Source: Author’s calculations, based on State Statistical Bureau (various years).
Note: The sum of each column is not equal to 100 due to the omission of FDI inflows that are classified as “co-developments” and “foreign investment share enterprises” in the Chinese statistics. The categories, which are rather insignificant, account for about 2 per cent of the total in the period under consideration.

in 1998, again more than double. Taking FDI as a whole, the average amount per project rose some 2.2 times during this period, from $1.19 million in 1992 to $2.63 million in 1998.

The growth in average size of foreign-invested projects suggests, among other things, that there might have been a shift in investor mix. Over time, small and medium-sized, sometimes foot-loose, investors, were increasingly replaced by larger-scale, multinational firms with longer-term investment and business development strategies. An increase in capital and technology intensities accompanied the expansion of FDI and the enlarged average size of investment projects. Simple processing and assembling, labour-intensive projects gradually gave away to more capital-intensive ones with higher technology content, ranging from automobile and aircraft production to computer software development. The sectoral destination of FDI was also extended, from agricultural and manufacturing undertakings to projects in energy, transportation, communications and infrastructure development from the secondary sector, and to such tertiary activities as retailing, accounting, banking, insurance, financial and business consulting, and foreign trade and investment-related services. In the process, China has become much more sophisticated in screening foreign investment projects. Before the late 1980s, practically all types of foreign investment projects were welcomed. In more recent years, however, much attention has been paid to the quality, and not just quantity, of foreign investments. Foreign investment projects that fail to meet certain technical and environmental standards, that fall into the category of sunset industries, and that are inconsistent with the country's overall industrial policies are most likely to be rejected.

C. Managing the external debt

The external debt has grown significantly since 1979, from being nearly non-existent to $146 billion at the end of 1998.[13] Despite the surge in absolute amounts, the composition of the external debt, as well as debt-related risk indicators, appears to be quite manageable, suggesting a fairly conservative attitude towards the handling of the external debt.

As shown in table 3, loans from foreign governments and international financial institutions remained fairly stable, at about 30 per cent of the total between 1988 and 1998, and increased moderately from the early 1990s. Commercial loans accounted for about 50 per cent of the total, and loans from other sources made up the remaining 20 per cent, on average. Of the total loans made during the period, more than 86 per cent, on average, were long-term loans (i.e. with a maturity date of one year or longer), as indicated in the last two columns of table 3.

Table 4 shows three risk indicators of external debt for the period 1985–1998. The debt service ratio (shown in the second column of the table) is defined as the ratio of the payment of principal and interest on foreign debt to the foreign exchange receipts from foreign trade and non-

Table 3

CHINA: COMPOSITION OF EXTERNAL DEBT BALANCE, 1988–1998

(Percentage)

	By type of debt (Total debt = 100.0)				By repayment terms (Total debt = 100.0)	
	Loans from foreign governments	*Loans from international financial institutions*	*International commercial loans*	*Other*	*Long-term debt*	*Short-term debt*
1988	16.6	10.6	47.5	25.3	81.7	18.3
1989	16.8	12.9	52.5	17.8	89.7	10.3
1990	16.0	12.0	55.5	16.5	87.1	12.9
1991	15.7	11.7	52.1	20.5	83.0	17.0
1992	16.6	12.1	51.2	20.1	84.4	15.6
1993	17.1	12.5	49.2	21.2	83.8	16.2
1994	21.1	14.0	51.0	13.9	88.8	11.2
1995	20.7	13.9	49.4	16.0	88.8	11.2
1996	19.1	14.4	49.0	17.5	87.9	12.1
1997	15.9	14.7	49.4	20.0	86.1	13.9
1998	15.4	15.7	46.7	22.2	88.1	11.9

Source: State Statistical Bureau (various years).

trade services. Liability ratio is the balance of foreign debt as a percentage share of GDP. Foreign debt ratio refers to the ratio of the balance of foreign debt to foreign exchange receipts from foreign trade and non-trade services. Clearly, all three indicators have been kept very much in line with the commonly perceived "safety" ranges.[14]

It is important to note that, in spite of the rising foreign capital inflows over the past two decades, China has relied much more on domestic sources for funding its vast investment needs. As table 5 indicates, the contribution of foreign investment to the development of fixed assets in China since 1981 has been relatively minor. It accounted for less than 10 per cent per annum of the total investment in fixed capital for most of the period under consideration, except 1995–1997 when it exceeded 10 per

Table 4

CHINA: RISK INDICATORS OF FOREIGN DEBT, 1985–1998

(Percentage of GDP)

	Debt service ratio	*Liability ratio*	*Foreign debt ratio*
1985	2.7	5.2	56.0
1986	15.4	7.3	72.1
1987	9.0	9.4	77.1
1988	6.5	10.0	87.1
1989	8.3	9.2	86.4
1990	8.7	13.5	91.6
1991	8.5	14.9	91.9
1992	7.1	14.4	87.9
1993	10.2	13.9	96.5
1994	9.1	17.1	78.0
1995	7.6	15.2	72.4
1996	6.0	14.2	67.7
1997	7.3	14.5	63.2
1998	10.9	15.2	70.4

Source: State Statistical Bureau (various years).

cent. The same observation also applies to the public-sector debt structure. This is shown in table 6, which computes the share of foreign borrowing in total government debt, and the share of principal and interest payments on foreign debt by the Chinese Government during the period 1981–1998. These shares declined substantially in the second half of the 1990s. By 1998 the Government's foreign debt obligation was negligible.

The information provided in tables 5 and 6, combined with the characteristics of the capital inflow structure outlined above, suggests that even if there were to be a sudden massive withdrawal of short-term "hot" capital, its impact on the Chinese economy would probably be insignificant. But are there institutional mechanisms and regulatory frameworks that could prevent the economy from being exposed to such a possibility in the first place, and that would protect it if a sudden flight of capital were to occur? We turn to these questions in the next section, which deals with some relevant features of the financial sector and capital account management in China.

D. The role of the "greater Chinese economy"

Definitions of the "greater Chinese economy" vary. The narrowest one covers the mainland, Hong Kong (China) and Taiwan Province of China; whether Macao (China) is included depends on the purpose of the

Table 5

CHINA: TOTAL INVESTMENT IN FIXED ASSETS BY SOURCE OF FINANCING, 1981–1998

(Percentage of total investment)

	State budgetary appropriation	*Domestic loans*	*Foreign investment*	*Self-raised funds*
1981	28.1	12.7	3.8	55.4
1982	22.7	14.3	4.9	58.1
1983	23.8	12.3	4.7	59.2
1984	23.0	14.1	3.9	59.0
1985	16.0	20.1	3.6	60.3
1986	14.6	21.1	4.4	59.9
1987	13.1	23.0	4.8	59.1
1988	9.3	21.0	5.9	63.8
1989	8.3	17.3	6.6	67.8
1990	8.7	19.6	6.3	65.4
1991	6.8	23.5	5.7	64.0
1992	4.3	27.4	5.8	62.5
1993	3.7	23.5	7.3	65.5
1994	3.0	22.4	9.9	64.7
1995	3.0	20.5	11.2	65.3
1996	2.7	19.6	11.8	66.0
1997	2.8	18.9	10.3	67.7
1998	4.2	19.3	9.1	67.4

Source: State Statistical Bureau (1999: 185).

study.[15] The broader classification extends the coverage to the overseas Chinese business communities in the rest of the Asia-Pacific region, and sometimes also includes those in the rest of the world. Hong Kong (China) has played the most significant role since 1979 as the financier of the economic boom on the mainland. Its highly visible, long-standing function is as China's major gateway to the world commodity markets.

Table 7 shows the source of foreign capital inflows to China between 1992 and 1998 on a paid-in basis. The figures provided in the table combine the three categories considered in table 1. Hong Kong (China) stands

Table 6

CHINA: GOVERNMENT DEBT FINANCING, 1981–1998

(Percentage)

	Share of foreign borrowing in total government debt	*Share of foreign debt servicing in total government debt payment*
1981	60.0	92.1
1982	47.7	89.4
1983	47.6	86.1
1984	45.0	78.7
1985	32.5	82.4
1986	54.8	68.8
1987	47.6	65.1
1988	51.2	55.5
1989	35.3	63.3
1990	47.5	35.8
1991	39.0	32.5
1992	40.9	18.3
1993	48.4	26.5
1994	12.5	21.5
1995	2.5	8.2
1996	6.1	4.6
1997	2.6	3.7
1998	2.5	3.3

Source: Author's calculation, based on State Statistical Bureau (1999: 284).

out as the largest source of capital inflows throughout the entire period (except 1996), contributing more than 40 per cent, and sometimes much higher, to the total. When Hong Kong (China), Macao (China), and Taiwan Province of China are grouped together, they account, on average, for about 50 per cent of total inflows during the period considered. Annual shares vary within a range of 46–58 per cent. This has surpassed the shares of inflows from Japan, Singapore and the United States combined – the other three main sources – by a considerably large margin for each year during the seven-year period. Most of the investments on the mainland by the three Chinese-speaking territories fall into the categories of FDI and other foreign investments.The trends have been fairly stable,[16] with 1998 as the only exception, when a noticeable decline from its peak level of 1997 was recorded.

It is useful to note that the sources of foreign capital inflows to China have become more diversified in recent years. A comparison of the figures in 1998 with those in 1992 shows that inflows from non-traditional countries, both within and outside the Asia-Pacific region, have gained strength, albeit varying from country to country. For example, the shares of the Netherlands, Singapore, the United Kingdom and the United States in 1992 accounted for 0.7 per cent, 1.1 per cent, 0.2 per cent, and 3.0 per cent of the total, respectively. By 1998, the corresponding shares had

Table 7

CHINA: ACTUAL UTILIZATION OF FOREIGN CAPITAL BY SELECTED SOURCES, 1992–1998

($ million)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Asia							
Hong Kong (China)	8 416.5	18 893.0	19 835.7	20 401.8	20 873.0	21 551.1	19 399.8
Indonesia	20.2	65.8	115.7	111.6	93.5	80.0	69.0
Japan	3 179.9	4 906.0	3 060.9	5 113.3	6 097.0	4 390.4	3 444.1
Macao (China)	273.4	624.4	509.4	439.8	606.3	403.3	439.2
Malaysia	24.7	91.4	201.0	259.0	460.0	381.8	340.6
Philippines	19.1	122.5	140.4	105.8	55.1	155.6	179.3
Republic of Korea	120.3	384.5	794.9	1 190.5	1 566.1	2 227.6	1 804.3
Singapore	140.7	674.8	1 179.6	1 860.6	2 247.2	2 607.0	3 404.0
Taiwan Prov. of China	1 053.4	3 139.1	3 391.3	3 165.2	3 482.0	3 342.3	3 051.2
Thailand	84.3	234.4	234.9	288.2	328.2	194.0	205.4
Europe							
France	777.0	774.8	733.8	716.3	920.7	475.9	714.9
Germany	256.7	274.5	583.7	527.5	1 130.5	1 008.6	736.7
Netherlands	37.5	134.2	122.9	147.0	154.6	413.8	718.8
Russian Federation	16.3	41.9	35.8	22.9	19.8	18.0	19.4
United Kingdom	215.5	570.7	1 085.8	1 009.3	1 400.2	1 857.6	1 174.9
North America							
Canada	275.0	361.8	640.7	619.7	479.7	344.1	316.5
United States	581.1	2 662.5	3 026.9	3 134.7	5 050.7	3 461.2	4 173.6
Total	19 202.3	38 959.7	43 212.8	48 132.7	54 804.2	52 387.3	47 557.5

Source: State Statistical Bureau (various years).
Note: The sum of each column is not equal to the total due to the omission of investments from the rest of the world.

reached 7.2 per cent, 2.5 per cent, 1.5 per cent, and 8.8 per cent, as seen in table 7. The more diversified pattern helped to prevent overall foreign capital inflows from falling too fast when the Asian financial crisis hit. As table 7 indicates, with the onset of the crisis, investments by the crisis-affected economies in China decelerated, while other countries picked up the pace. As a result, the total capital inflow in 1997 and 1998 declined, on a year-on-year basis, by 4.4 per cent and 9.2 per cent, respectively; the figures would otherwise have been larger.

E. Capital outflows and the issue of "round-tripping"

Discussion of the capital account thus far has centred on capital inflows. Outflows also exist, as table 8 suggests. Two types are worthy of comment. The first has been a direct result of China's increased economic openness over the past two decades. In their attempt to diversify trade flows and to secure regional markets for both inputs and outputs, an increasing number of Chinese enterprises have sought to engage in overseas production and related activities. The Government has encouraged such activities, and the intensity of Chinese overseas undertakings has surged markedly in recent years. In 1998, for example, the number of such contracts reached about 26,000, with a total value approaching $11.8 billion (State Statistical Bureau of China, 1999: 603). This activity is often carried out in the form of FDI, with funds being furnished either at home or abroad under the authorization and supervision of the concerned government entities.

The second type of capital outflows tends to be more irregular, and, in some cases, illegal. These may either include foreign bank deposits or purchases of foreign equity shares by domestic entities, mainly institutions. Foreign exchange is sometimes obtained by the institutions through illegal channels, including through corrupt bank officials, as news reports have periodically revealed.

"Round-tripping" is another issue that has complicated capital account management in China. Typically, a domestic entity may obtain foreign

Table 8

CHINA: BALANCE OF PAYMENTS – SELECTED ITEMS, 1990–1997

($ billion)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Net direct investment	2.7	3.5	7.2	23.1	31.8	33.8	38.1	41.7
Net long-term borrowing	6.3	4.5	11.3	12.8	9.8	12.9	10.8	12.5
Net short-term capital	-3.2	0.4	-0.9	-3.9	-3.1	0.4	0.1	-11.4
Capital flows not included elsewhere	-3.0	-0.8	-17.8	-8.6	-5.9	-8.5	-9.1	-20.0
Errors and omissions	-3.2	-6.8	-8.2	-10.1	-9.1	-17.8	-15.5	-16.8
Change in net reserves	-12.1	-14.1	2.1	-1.8	-30.5	-22.5	-31.7	-35.9
Nominal official exchange rates (average yuan per $)	4.8	5.3	5.5	5.8	8.6	8.4	8.3	8.3
Index of real effective exchange rates	37.3	32.4	31.3	30.7	33.5	35.3	37.0	41.4
Resource balance	10.7	11.5	5.0	-11.8	7.7	12.0	17.6	40.5

Source: IMF (various years).

exchange by overstating invoices of its trade transactions, use the funds to register a dummy company outside China – often in Hong Kong (China) – and then re-enter the country as a "foreign investor". These round-tripping activities are estimated by some sources to comprise about 20 per cent of total inflows (World Bank, 1997b). The preferential treatment of foreign investments is a key motive behind round-tripping flows, and the magnitude of these flows is expected to shrink as China extends its recent experiment with granting national status to foreign-invested firms.

These complications are reflected in table 8, in particular under the items "capital flows not elsewhere included" and "errors and omissions". Since 1998, the authorities have stepped up measures to tighten control over irregular capital outflows, in addition to cracking down decisively on faulty reporting on items under current account transactions. Since 1979 China has enacted numerous laws and regulations governing activities in financial, banking and trade areas. The loopholes that have permitted the above-mentioned irregularities are mainly a result of inadequate enforcement of the law and regulations. Developing a competent law enforcement institution is one of the keys to eliminating these irregularities.

IV. FINANCIAL SECTOR RESTRUCTURING AND MANAGEMENT

Financial sector reforms began in the early 1980s, and recently have taken the centre stage in China's overall economic transition. The reforms instituted thus far have been broad based, placing the financial sector in a much more advanced and complex system than it was two decades ago. Three main aspects are considered below: (i) the exchange rate system and its management, (ii) operation of equity markets, and (iii) elements of financial sector restructuring relevant to management of the capital account. Focus is placed on those elements of the system that might have sheltered the Chinese economy from major external shocks. The shocks considered here take the form of speculative currency attacks, massive reversal of short-term capital inflows, and the collapse of equity prices under the weight of changing foreign sentiments – the crucial factors that contributed to the derailing of the crisis-affected economies in Asia.

A. The exchange rate system and management

When economic transition was initiated, the exchange rate system in China was subject to tight government controls. The conduct of foreign exchange transactions was limited to authorized institutions and administered in such a way as to protect those transactions from market influences and to adhere closely to foreign exchange plans. The official exchange rate of the Chinese currency, the yuan, was derived as a weighted average of a basket of internationally traded currencies, with weights chosen to reflect the relative values of these currencies in the international markets and their relative importance in China's external settlements. The Bank of China, the only authorized financial body at the time, served as the clearing house and broker for settling foreign-currency-denominated transactions among State-owned foreign trade corporations and other concerned entities.

To break away from the State monopoly of foreign trade, selected domestic enterprises engaging in the production of exportables were soon allowed to market their products directly overseas and to retain a certain percentage of their foreign exchange earnings. This was intended to provide an incentive to exporters as retained funds could be used to finance their import requirements. The experiment with the foreign exchange retention system, which began as early as January 1981, proved to be quite a success in boosting foreign trade, and the practice was subsequently adopted nationwide. The reform, however, necessitated an adjustment of foreign exchange holdings among participating enterprises, and this need further increased as foreign-invested firms in China started to grow. To meet demand, Foreign Exchange Adjustment Centres (sometimes referred to as "swap centres") were established in November 1986 at various locations, allowing foreign exchange transactions to be conducted at rates agreed upon between buyers and sellers. The swap centres' prevailing rates were not required to be the same as officially-determined ones. As a result, a "dual-track" exchange rate system emerged.

From the second half of the 1980s, foreign exchange retention quotas were gradually liberalized, and swap centres bloomed. By the early 1990s, the majority of foreign exchange transactions taking place through the swap centres were at market-determined rates. Transactions based on official rates, which were substantially lower than the swap market rates, lost their attractiveness and were limited to non-trading official settlements. On 1 January 1994, the monetary authority unified exchange rates at the prevailing swap market rates and terminated the issuance of retention quotas. The regional swap centres were integrated into a nationwide single market, known as the China Foreign Exchange Trade System. The exchange rate system in China has since been characterized as a managed float.

Under the current exchange rate regime, domestic entities are required to conduct their sales and purchases of foreign exchange through authorized financial institutions, mainly banks. Following the guidelines issued by the monetary authority – in particular the State Administration for Exchange Control – banks are responsible for verifying that proper documentation is provided by the domestic entities to justify the purchase of foreign exchange. Financing of items under the current account are approved under normal circumstances, including the currency requirements of individual residents for touring overseas and income repatriation by foreign-invested firms. For purposes of servicing external debt, domestic borrowers with foreign-currency-denominated loans may obtain the foreign exchange needed to fulfil their debt obligations when the principal or interest payment becomes due. Foreign-invested firms in China may choose either to retain their entire foreign exchange with banks or to enter the foreign exchange market, provided that the trading is in line with their pre-submitted foreign exchange plans. This applies to both initially invested funds and subsequent foreign-currency-denominated earnings.

Domestic banks may sell and buy foreign currencies for their clients in the foreign exchange market. Selling is permitted if the banks have foreign exchange holdings in excess of a required minimum. This requirement compels the banks to assume a foreign exchange risk position, since they have to hold liquid funds in order to meet unforeseen contingencies arising from retail transactions.[17] Foreign banks may conduct currency transactions in the foreign exchange market on behalf of foreign-invested firms and they can sell foreign currencies against the yuan in the market. Their yuan accounts have to be maintained with the central bank, the People's Bank of China. Foreign banks, however, are not permitted to enter the domestic money market, either to borrow from domestic residents or to offer yuan-denominated loans to domestic entities.

Interventions by the central bank are triggered when the market rates of the yuan against major foreign currencies (particularly the US dollar), fluctuate beyond a pre-determined, narrow band and when the rates begin to show signs of appreciating. The action taken by the central bank is not visible to other market participants.[18] The set-up of the exchange rate management system effectively precludes currency speculation, since it leaves little room for market participants to act on their own expectations concerning the future value of the yuan, or to assume short positions.

Furthermore, foreign banks and foreign-invested firms tend to act as sellers, not buyers, in the foreign exchange market.

B. Operation of equity markets

In line with its market-oriented economic transition, China opened two stock exchanges in the early 1990s: one located in Shanghai and the other in the Shenzhen Special Economic Zone. Soon after, qualified Chinese State-owned enterprises (SOEs) (known as "red chip" companies) began to list in the Hong Kong (China) stock exchanges ("H shares"), while others listed in overseas stock markets, including New York ("N shares").

In the Chinese stock exchanges, domestic companies are listed separately under the so-called "A share" and "B share" categories. A shares are issued to domestic investors and priced in the local currency, whereas B shares are reserved for foreign investors and priced in foreign currencies (US dollar-denominated issuance in Shanghai, and Hong Kong dollar-denominated shares in Shenzhen). In some cases, Chinese companies may choose to be listed jointly under the A and B share categories (thus labelled A&B shares), but accounts under the two categories must be maintained separately. Table 9 provides information on shares issued and capital raised in the two Chinese stock exchanges since their establishment. Figures concerning H shares are also given in the table. By and large, a rapid expansion is evident, as are large swings recorded under nearly all of the share categories.

Three interesting observations may be made here. First, both the shares issued and capital raised under the B share category were insignificant during the period under consideration, indicating rather limited foreign participation. Second, since B shares are traded in foreign currencies by foreign investors, market exit is considerably limited by market entry: that is, a would-be seller under the B share category cannot exit the market unless there are potential buyers who are willing to hold the foreign-currency-denominated shares (Lardy, 1998). Third, a changing market sentiment in B share trading has no direct impact on that of A shares, and

Table 9

CHINA: STOCK ISSUANCE, 1991–1998

	1991	1992	1993	1994	1995	1996	1997	1998
Shares issued *(Billions of shares)*	5.0	20.8	95.8	91.3	31.6	86.1	267.6	105.6
A shares	5.0	10.0	42.6	11.0	5.3	38.3	105.7	82.8
H shares	-	-	40.4	69.9	15.4	31.8	136.9	12.9
B shares	-	10.8	12.8	10.4	10.9	16.1	25.1	9.9
Capital raised *(Millions of yuan)*	5.0	94.1	375.5	326.8	150.3	425.1	1 293.8	841.5
A shares	5.0	50.0	194.8	49.6	22.7	224.5	655.1	443.1
H shares	-	-	60.9	188.7	31.5	83.6	360.0	38.0
B shares	-	44.1	38.1	38.3	33.4	47.2	80.8	25.6
A&B shares	-	-	81.6	50.2	62.8	69.9	198.0	335.0

Source: State Statistical Bureau of China (1999: 628).
Note: The sum of the sub-categories may not be equal to the total owing to rounding.

thus yuan-denominated equity transactions are insulated from outside influences. Although trading under A&B shares has grown significantly since 1997, a large portion of the shares is still yuan-denominated. These characteristics of equity market operation, together with the exchange rate management system discussed above, help to explain why the Chinese currency and equity markets have tended to be much less sensitive to changing external conditions.

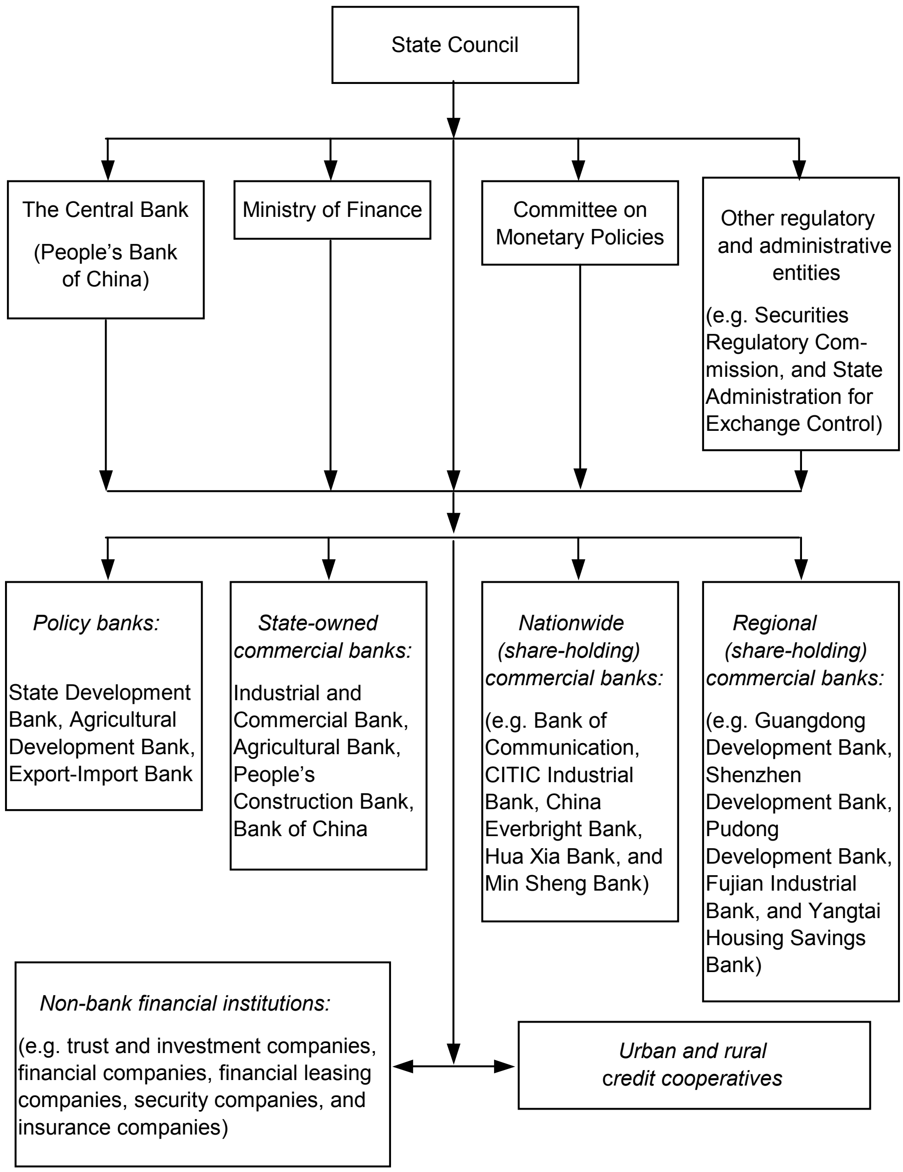
C. Financial sector reform and regulation

China had a mono-banking system in the pre-reform era, when the People's Bank of China functioned as both a central and commercial bank. It carried out the traditional functions of a central bank in issuing currency, managing foreign exchange reserves and allocating credits. It also played the role of a commercial bank in terms of receiving deposits, making loans and providing clearance services to its institutional and individual customers. Since the early 1980s, the banking sector has been undergoing numerous changes, and, as a result the overall financial system in China has emerged as a bank-centred multifunctional complex. The structure of the Chinese financial management system is highlighted in figure 1. Working closely together, the People's Bank of China, the Ministry of Finance, the Committee on Monetary Policies, and other designated commissions (for example, the Securities Regulatory Commission and the State Administration for Exchange Control) implement policy directives set forth by the State Council, and supervise and monitor the activities of policy banks, State and shareholding commercial banks, investment banks, non-bank financial institutions and credit cooperatives.

Aimed at tightening the so-called "soft" budget constraint of SOEs, the enterprise-funding source was shifted in the early 1980s from government budgetary appropriation to interest-bearing bank loans. To facilitate this development, four State-owned commercial banks were established, which took over the commercial banking business from the People's Bank of China. This also paved the way for the People's Bank of China to be transformed into a real central bank. Since the mid-1980s, shareholding commercial banks, both at the national and regional levels, began to surface along with various non-bank financial institutions. To meet the financial needs of collectively-owned, small and medium-sized enterprises, credit cooperatives also mushroomed in both the rural and urban areas. To further liberalize State-owned commercial banks and to allow them to perform banking functions on more commercial terms, three policy banks were set up in 1994 to assume the responsibility of carrying out policy loans, as well as to manage funds obtained from international financial institutions. The policy banks, like the State-owned commercial banks, were structured to specialize in certain types of financial dealings. However, the distinction between the business territories of these financial institutions – both bank and non-bank, State-owned and non-State-owned – has become increasingly vague in more recent years, as competition among these institutions is encouraged. The operation of foreign banks has so far been limited to certain business lines and confined to specified geographic regions. As a result, head-on competition between domestic and foreign financial institutions

Figure 1

THE FINANCIAL MANAGEMENT SYSTEM IN CHINA



Source: National authorities.

tends to be, at best, very weak. The situation, however, is expected to change as a result of China's accession to WTO. According to the bilateral WTO agreement of 1999 between China and the United States, for instance, foreign banks will be allowed to handle business in local currency with Chinese enterprises two years after the accession, and with residents five years after. Within designated areas and for servicing certain customer groups, foreign banks will be granted domestic status; but the geographic and customer restrictions will be removed only five years after accession.

The domestic banks command a rather large proportion of total financial assets, with the four State-owned commercial banks dominating the Chinese banking sector. For example, during the period 1993–1997 the assets of the State-owned commercial banks amounted, on average, to 78 per cent of the total assets held by all financial institutions in China. The shares of other banks, credit cooperatives and non-bank financial institutions were only 6.6 per cent, 14.5 per cent and 0.7 per cent respectively, during the same period. In terms of the holding of foreign assets, the four State-owned commercial banks captured 87.7 per cent of the total during that period, with the remaining 12.3 per cent going to other banks. Foreign assets held by non-bank financial institutions were negligible, and there were no such holdings by credit cooperatives. Household savings are the largest liability of the banking sector, and have grown enormously since the economic transition began in 1979, as shown in table 10. Enterprises, particularly State-owned ones, make up the largest group among bank borrowers; consumption loans did not exist until very recently.

To strengthen the legal framework for financial sector operation and monetary management, in 1995 China enacted a set of laws, including the Law of the People's Bank of China and the Law of Commercial Banks. The former provides the legal ground for the People's Bank of China to act as a fully-fledged modern central bank, while the latter sets detailed standards for commercial banking.[19] These standards include, for example, capital adequacy requirements, consisting of the Bank for International Settlements' Basel Standards, entry criteria, and asset diversification requirements. The law also separates commercial banking from investment banking; commercial banks are not allowed to engage in securities trading and underwriting or to invest in non-bank financial institutions and trust

Table 10

CHINA: HOUSEHOLD SAVINGS, 1985–1998

	Year-end outstanding as percentage of GDP (GDP = 100.0)	*Annual increase as percentage of GDP (GDP = 100.0)*	*Annual rates of real GDP growth (Percentage)*
1985	18.1	4.6	13.5
1986	21.9	6.0	8.8
1987	25.7	7.0	11.6
1988	25.5	4.9	11.3
1989	30.4	8.0	4.1
1990	37.9	10.2	3.8
1991	42.1	9.6	9.2
1992	43.3	9.2	14.2
1993	42.6	9.3	13.5
1994	46.0	14.5	12.6
1995	50.7	13.9	10.5
1996	56.8	13.1	9.6
1997	62.2	10.4	8.8
1998	67.3	9.6	7.8

Source: Author's calculations, based on State Statistical Bureau (1999: 55, 57 and 318).

funds. The separation reduces the risks associated with overexposure to speculative lending, and thus improves the quality of bank assets.

D. Financial sector weakness and policy responses

The close ties between the banks and their corporate borrowers give rise to some serious concerns about the health of the banking sector. For instance, the lending policy of the State-owned commercial banks is subject to the influence of government policies, instead of being based solely on commercial considerations. To replace the mandatory credit plans under central planning, a credit quota system has been put in place since the late 1980s for financial resource allocations. Through credit rationing, the system promotes priority projects, sectors and regions in accordance with overall industrial policies. It also provides the authority with a powerful tool for controlling broad money. However, the system tends to increase the banks' lending risks, as pre-set credit quotas may not be adjusted quickly in response to a changing economic environment. As many SOEs continue for various reasons to suffer losses, their ability to repay loans has been greatly undermined; this adds to the burdens on the banks. Even so, bank loans continue to be directed towards these enterprises in order to keep them afloat so as to prevent unemployment from rising too fast and threatening social and political order. Briefly, the resulting high ratio of non-performing and under-performing loans, coupled with inadequate loan classifications, low loan-loss reserves, and collateral rather than cash-flow-based lending practices, are just a few factors contributing to the financial weakness of the Chinese banking sector.[20] The situation in the non-bank financial institutions tends to be more serious owing to a weaker supervisory framework and regulation-enforcement mechanism.

Since 1998 the Chinese monetary authority has introduced a set of policy measures and made a series of institutional changes to tackle these problems. In the banking sector, national financial accounting standards have been introduced, and a risk-based loan classification system adopted. Credit quotas are non-binding and indicative. A system of asset and liability management has been established; several asset management companies have been set up to clean up the non-performing loans of banks and other financial institutions. Billions worth of funds, raised through the issuance of long-term, non-tradable Treasury bonds, have been injected into the State-owned commercial banks, boosting their capital base to meet the requirements of the Chinese Commercial Bank Law and the Basel Standards. The State banks can now write off an increased amount of bad loans. Troubled regional commercial banks are either being closed or merged with stronger ones. The recent closure of the Hainan Development Bank is a good example. It shows that the authorities are taking decisive steps in addressing the issue of moral hazard that has afflicted the Chinese banking sector, and signals that the days of unconditional government bailout are about to come to an end. To enhance competition, certain foreign banks have recently been allowed to carry out domestic currency-based operations and to participate in the Chinese inter-bank market. To improve the effectiveness of monetary management, the institutional set-up has also been strengthened. The central bank has been restructured along the lines of the United States Federal Reserve to reduce the influence of local authorities in monetary policy-making and implementation.

Many non-bank financial institutions have suffered losses in recent years as a result of unregulated expansion and overreaching in speculative investments. To clean up the loss-making institutions, mergers and acquisitions have become more frequent and a decision to shut down the insolvent ones has been forcefully implemented. This includes the closure of the Guangdong International Trust and Investment Corporation, the second largest foreign, debt-issuing international trust and investment company in China,[21] which reportedly had incurred an estimated 2 billion shortfall in repayments before shutting down. In addition, the supervision of credit cooperatives has been strengthened as has the legal framework governing the operation of equity markets, as demonstrated by the passage of the Security Law in December 1998. Steps are also being taken to promote long-term institutional investment; including the recent licensing of mutual funds.[22]

V. CONCLUDING REMARKS

The above discussion leads to several important observations. First, in spite of the remarkable progress that has been made in achieving greater economic openness over the past two decades, the Chinese economy remains largely domestically based. A high proportion of foreign trade consists of import processing. Foreign capital inflows have played only a minor role in meeting domestic investment needs. The complications resulting from capital outflows have further undermined the significance of net external financing. The domestic financial sector is fairly insulated from foreign influence and competition. A heavy reliance on domestic private savings, which have been among the highest in the world, prevents the economy from being overly exposed to the risks of a sudden change in external influences; it also eases the burden of conducting monetary policies, as changing interest rates in the international markets have only a limited impact on the domestic economic environment.

Second, the composition of foreign capital inflows provides additional protection to the domestic economy. Large inflows of FDI and the avoidance of excessive exposure to short-term commercial flows contribute to a steady capital inflow. The stable pattern of the inflow is also attributable to China's reasonably sound macroeconomic fundamentals and its orderly, evolutionary process of economic opening.

Third, the system of exchange rate management and the operation of equity markets tend to insulate the domestic currency and stock prices from external impacts, and leave little room for foreign speculation in these markets. It also provides a mechanism through which potential outflows can be monitored and, if necessary, curbed. This set-up, however, has not undermined foreign trade and trade-related service activities, nor has it affected capital inflows.

Fourth, in the context of the Asian financial crisis and its contagion effects, China did not run an unsustainable resource gap. Unlike some of the crisis-affected economies, the current account balance in China has been positive in recent years (see table 11), precluding the need for sizeable net external financing. The foreign exchange reserve position has been fairly strong, allowing the country to cover more than 10 months of its imports in 1997, and external debt services have remained manageable (table 12).

Fifth, the pattern of China's economic integration and liberalization has an interesting feature. The process began with the opening up of the trade account, together with allowing FDI inflows. The opening of the rest of the current account followed, as did the entry of foreign commercial and portfolio flows. In this respect, the pattern represents an alternative sequence to economic liberalization from the one that calls for the opening up of the current account to precede that of the capital account, as often cited in the literature and within policy-making circles.[23] The evolving pattern has been the result of trial and error, and the process has been accompanied by careful monitoring. Policies, instruments, the regulatory

Table 11

CHINA AND SELECTED ASIAN ECONOMIES: CURRENT ACCOUNT BALANCE AS PERCENTAGE OF GDP, 1992–1999

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
China	1.3	-1.9	1.3	0.2	0.9	3.3	3.1	1.6
Hong Kong (China)	5.3	7.0	1.2	-4.3	-1.4	-3.6	1.4	5.8
Indonesia	-2.2	-1.5	-1.7	-3.3	-3.4	-2.3	4.2	3.5
Japan	3.0	3.1	2.8	2.2	1.4	2.3	3.2	2.5
Malaysia	-3.7	-4.6	-7.6	-9.7	-4.4	-5.6	12.9	15.3
Philippines	-1.6	-5.7	-4.3	-4.5	-4.8	-7.2	1.9	10.0
Rep. of Korea	-1.3	0.3	-1.0	-1.7	-4.4	-1.7	12.4	5.5
Singapore	12.0	7.3	16.3	17.3	15.2	17.9	25.4	25.3
Taiwan Prov. of China	4.0	3.1	2.7	2.1	3.9	2.4	1.3	2.0
Thailand	-5.5	-4.9	-5.4	-7.9	-7.9	-2.1	12.6	8.7

Source: Based on IMF and national authorities. See Sachs (2000: 154).

framework and institutional mechanisms are not extended economy-wide until they have proved to be effective in a limited area and after going through various controlled experiments. In this regard, the special economic zones have played a central role as the testing ground for new reform initiatives (Ge, 1999a).

Based on various indicators derived from Western standards, many observers have viewed Chinese SOEs and the financial and banking sector in China as inefficient. With China’s entry into WTO, concerns have arisen, understandably, as to whether the weak and vulnerable sectors will be able to withstand the intense foreign competition that will arise from sweeping market opening measures. If SOEs are unable to do so, their failure could lead to a massive increase in unemployment, and there could be a serious run on domestic banks that are unable to match the services provided by their more sophisticated foreign counterparts. If this triggers social unrest, the course of China’s economic transition – in the worst-case scenario – could be jeopardized, and its implications for the world economy could be profound. Following this logic, some commentators had warned Western trade negotiators not to push too hard for greater market opening during

Table 12

CHINA AND SELECTED ASIAN ECONOMIES: EXTERNAL DEBT-RELATED INDICATORS, 1995–1997

(Percentage)

	China	*Indonesia*	*Malaysia*	*Philippines*	*Rep. of Korea*	*Thailand*
Debt-GDP ratio						
1995	15.2	61.6	38.6	50.9	16.0	49.5
1996	14.2	56.7	39.5	50.6	31.6	49.8
1997	14.5	62.2	44.8	55.2	33.2	62.0
Debt-exports ratio						
1995	71.6	262.4	48.0	216.5	62.9	149.3
1996	77.0	257.0	51.8	203.9	126.4	165.6
1997	71.7	238.0	57.9	180.0	114.1	164.7
Short-term debt-GDP ratio						
1995	1.7	12.8	8.2	7.1	9.2	24.5
1996	1.7	14.2	11.0	8.7	17.9	20.7
1997	2.0	18.0	13.0	10.2	13.3	23.1
Short-term debt-export ratio						
1995	8.0	54.8	10.2	30.3	36.4	73.8
1996	9.3	64.2	14.4	35.1	71.5	68.8
1997	9.9	68.7	16.8	33.3	45.6	61.4
Short-term debt-foreign exchange reserve ratio						
1995	16.2	177.0	28.6	69.5	138.5	111.1
1996	13.4	168.5	39.8	62.1	280.1	97.2
1997	13.0	221.8	62.2	97.7	309.8	129.0
Import coverage of foreign exchange reserves *(months)*						
1995	6.7	4.0	4.3	3.4	3.0	6.3
1996	9.1	5.1	4.6	4.4	2.7	6.6
1997	11.8	4.8	3.4	2.8	1.7	5.3

Source: HSBC (2000).

negotiations for China's entry into WTO. Such views were not uncommon, both within and outside China, as often aired in news reports. A fuller discussion of the related issues is beyond the scope of this study. However, several points may briefly be made in this regard.

Overstaffing and the excessive burden of various social responsibilities have long been recognized as key factors undermining the performance of China's SOEs. Allowing these enterprises to rationalize their input structure and to remove non-business responsibilities could, in principle, improve their performance indicators. This, in turn, would lighten the burden of non-performing and underperforming loans shouldered by the State-owned commercial banks, consequently enhancing their solvency. Taking the economy as a whole, the pace at which SOEs may be revitalized is constrained by the development of social safety nets and the expansion of non-State sectors. These issues need to be tackled in a coordinated manner. Given the complexities involved, it is unrealistic to expect either SOEs or the State banks to meet international best practices in the near future. Owing to the time and resources required to build up adequate human capital in these sectors, upgrading cannot take place overnight; thus the "vulnerability" of SOEs and the State banks is likely to persist for some time to come.

How serious, then, is the potential impact of WTO membership? As speculative as it is, the following is useful to keep in mind. First, the business performance indicators used in Western market economies may not be appropriate for assessing SOEs. For example, these enterprises typically provide employees with housing at subsidized rates; many also provide childcare, medical service, training and schooling, and cultural and entertainment facilities, to name a few. These services are provided not only to employees but also to their extended families. These outlays count as expenditures and, as such, do not reflect the value of the social benefits they provide. Similarly, a considerably large proportion of SOE operating costs incurred consists of wage payments to redundant workers, who, depending on the sectors, account for an estimated 30 to 50 per cent of the current employees on the payroll. In the absence of a well functioning social safety net, the "cost" to SOEs may be better understood, from a social viewpoint, as welfare benefits. These social returns generated by SOE operations need to be taken into consideration when evaluating the "true" efficiency of these enterprises. The same argument applies to the State banking sector as well. Viewed in this light, concluding that the State sector in China is grossly underperforming may be an overstatement.

Second, a successful business venture requires, among other things, proper adaptation to local market conditions, taking into account consumer preferences and expectations, which tend to differ from location to location. What might have worked, say, in Switzerland, does not guarantee that it will work equally well in Barbados. Learning to adapt is a time-consuming process, and requires deliberate efforts and real resources. Recognizing this, the extent to which foreign firms and banks may pose a threat to their Chinese counterparts needs to be discounted, and their superiority in competing successfully on the Chinese market may have been exaggerated. Evidently, even after a long period of operation, some foreign-invested firms in China are still making losses. The fear that the State's weak sectors – SOEs and banks alike – may collapse under the weight of forthcoming intense foreign competition is pure speculation.

It is worth pointing out that the State banking sector in China is large; its operation covers a wide range of businesses and a vast geographical and customer base. The confidence of domestic savers in the banks has been and continues to remain high. It is very unlikely that the entry of foreign banks and other financial institutions will substantially alter the situation, especially within a short time frame. Instead of forcing the domestic banks to go out of business, the intensified competition brought about by further market opening may serve as a strong force in motivating the State banks, which are still in their infancy, to upgrade and mature. The overall positive picture of economic transition and development, as depicted in the past two decades, is unlikely to turn negative following China's entry into WTO. The resilience and adaptability of Chinese society, as demonstrated in its long history, should not be underestimated, nor should the competence of Chinese policy makers in managing the economy.

China's experience has shown that adapting a pragmatic, step-by-step approach, suitable to local conditions, is critical in managing a smooth process of economic integration and liberalization. The criterion used in assessing the success of its integration and liberalization should be the extent to which these contribute to overall economic development, and not the reverse.

NOTES

1 The use of the term "miracle" to describe the progress in certain Asian economies in the 1990s was made popular following the publication of a policy research report by the World Bank. The study provided a comprehensive assessment of the contributing factors underlying the remarkable accomplishments of Hong Kong (China), Indonesia, Malaysia, the Republic of Korea, Singapore, Taiwan Province of China, and Thailand, among others (World Bank, 1993). Alternative views exist. For more recent studies, for instance, see Akyüz (1999).

2 There are many studies on various aspects of the Asian financial crisis. See, for example, Akyüz (1998); Fischer (1998); Klein (1997); Stiglitz (1998a and 1998b); Sugisaki (1998); UNCTAD (1998, chaps. III and IV: 53–110); UNCTAD and ICC (1998); and World Bank (1998).

3 These include, for instance, the cases of Finland, Japan, Norway, Sweden and the United States.

4 For a more detailed discussion on the "vulnerabilities" of the financial sector and State-owned enterprises in China see Lardy (1998). Assessments of various financial markets and institutions in China are provided, among others, by Chen et al. (2000).

5 Related issues have been the subject of heavy debate in recent years, prompted, in part, by the outbreak of the Asian financial crisis. For some recent discussion see, for example, Akyüz and Cornford (1999); and Akyüz (2000).

6 A detailed overview of economic developments in China since 1949 is provided by Ge (1999a).

7 The beginning of the second phase is usually considered to be the Third Plenum of the Central Committee of the Chinese Communist Party, held in December 1978. At that meeting, economic development was made the top national priority, and economic reform and opening up were established as complementary long-term policies. It should be noted, however, that efforts to reform and open up the economy actually began in 1977, within limited areas and sectors.

8 The 30 municipalities, provinces and autonomous regions considered here do not include: Chong Qing municipality, which was established on 1 July 1997; Hong Kong and Macao Special Administrative Regions (returned to China in 1997 and 1999 respectively); and Taiwan Province of China.

9 Note that certain other Asian countries, such as the Republic of Korea, also registered impressive growth during this period; hence the term "high-performing economies".

10 As noted in an official announcement, since 1 December 1996 China has assumed obligations under Article VIII of the IMF Agreement and made the Chinese currency convertible in current account transactions.

11 See *People's Daily*, 26 September 1997: 1.

12 For details on market opening, interested readers are referred to the bilateral WTO agreement between China and the United States reached in November 1999. Since the signing of the agreement, the Chinese authorities have been busy re-examining related

policies, regulations and legislation so as to bring them more closely in line with international norms and WTO rules.

13 The changing attitude in China towards debt financing and foreign investment has been profound since the economic transition began in 1979, as evidenced by the following official statement reported in the *People's Daily*, the official newspaper of the Chinese Communist Party, on 2 January 1977: "We never permit the use of foreign capital to develop our domestic resources as the Soviet revisionists do, never run undertakings in concert with other countries and also never accept foreign loans. China has neither domestic nor external debts". See Kleinberg (1990: 1).

14 For example, the debt service ratio falls consistently below the creditworthy gauge of 20 per cent, and the liability and foreign debt ratios are well below 100 per cent.

15 For studies on the greater Chinese economy, and the economic relationships between China and Hong Kong (China), and between China and Taiwan Province of China, see, *inter alia*, Naughton (1997) and Klein and Yu (1994).

16 Macao (China) is less so, when compared with Hong Kong (China) and Taiwan Province of China.

17 The point is well made by Mehran et al. (1996).

18 Ibid. for a detailed discussion of earlier developments in these areas. Details of more recent developments may be obtained from various country reports and studies published by the World Bank and IMF, in addition to research reports and releases by the Chinese monetary authority.

19 For a comprehensive review of the laws and international comparisons, see Mehran et al. (1996: 18–23).

20 A detailed analysis of these weaknesses is provided by, for example, Lardy (1998).

21 A more detailed discussion on the development of trust and investment companies in China is provided, among others, by the World Bank (1997c).

22 See World Bank (1999) and various issues of country updates.

23 For discussions on related issues, see Woo, Parker and Sachs, eds. (1997); Ge (1999b); and Feng (2000: 87–107).

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