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China's Response to the Global Financial Crisis: Implications for U.S. Economic Interests

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Summary

Since 1997, several East Asian economies (notably Indonesia, Thailand, and South Korea), and since 1998, Russia and Brazil, have experienced significant financial difficulties, including sharp currency depreciations, plunging stock market prices, and declining economic growth. The global financial crisis contributed to a slowdown in the growth of the Chinese economy in 1998, especially its export sector, although it fared better than most of its East Asian neighbors, many of whom fell into recession. However, many analysts have expressed concern that a deepening of the global financial crisis may induce China to devalue its currency, the yuan, in order to stimulate export growth. Such a move could lead to a new destabilizing round of currency devaluations throughout East Asia, which would further depress U.S. exports to the region. In addition, it would make Chinese products cheaper in U.S. markets and thus exacerbate the U.S. trade deficit with China. Another concern is that China might also choose to respond to the financial crisis by putting a hold on its plans to liberalize its economy and lower trade barriers. This could further complicate China's attempt to join the World Trade Organization and further strain U.S.-China economic relations.

The Global Financial Crisis and China's Response to Date

Since 1997, several East Asian economies, notably South Korea, Thailand, and Indonesia, have experienced significant financial difficulties in their economies, as have Russia and Brazil since 1998. Such difficulties have included substantial currency devaluations (as investors have transferred funds overseas), and significant declines in stock market prices.¹ Most of the other East Asian economies, including Japan, Hong Kong, Singapore, the Philippines, and Malaysia have also experienced varying degrees of financial difficulties (falling stock market prices and/or currency depreciation). The global

¹For background information on the crisis, see CRS Report RL30012, *Global Financial Turmoil: Contagion, Effects, and Policy Responses*, by Dick K. Nanto. Updated January 13, 1999.

financial crisis has also seriously weakened (or exposed weaknesses in) the financial institutions (such as banks) of several East Asian economies. The financial crisis has contributed to a sharp economic slowdown throughout much of the region.²

China's economy does not appear to have been as severely affected by the global financial crisis as most of its Asian neighbors. This is likely due to a number of factors: China's currency (the yuan) is not fully convertible; China maintains over \$145 billion in foreign exchange reserves; its foreign debt is relatively small compared to other Asian nations; its financial institutions (banks, stock markets, etc.) are tightly controlled by the central government (and foreign involvement is relatively minor); and most foreign investment in China is direct (such as joint ventures in China), rather than portfolio (such as stocks and bonds), investment.

Over the past year or so, Chinese government officials have made a number of statements (publicly, through the press, and in meetings with U.S. officials), and have implemented various policies, in response to the global financial crisis. First, Chinese officials have pledged not to devalue their currency during the crisis. Second, China has offered standby loans as part of the International Monetary Fund (IMF) financial assistance packages for Indonesia and Thailand to help stabilize their economies. Third, Chinese officials have pledged that their government will spend \$1.2 trillion over three years on infrastructure development (which may have been meant as a signal that China would use domestic spending, rather than increased exports, to promote future economic growth).³ Fourth, several officials have stated that the crisis will not deter China from making further economic reforms. Fifth, the government has attempted to clamp down on illegal smuggling and foreign exchange transfers. Finally, the Chinese government has expanded export credits and tax rebates to export-oriented industries which have been hit the hardest by a drop in demand, such as textiles.

Concerns Over Possible Future Chinese Reactions to the Financial Crisis

While China's economy to date has been relatively insulated from the effects of the global financial crisis, many analysts believe that the crisis could continue over the next few years and possibly deepen, which might seriously weaken the Chinese economy in 1999, due to a number of factors:

- Much of China's economic growth has been fueled by exports which, according to Chinese government data, grew at an average annual rate of 16% from 1979 to 1997. In 1998, exports grew by only 0.5%. Chinese exports to Asia fell by 10%, while exports to the United States and the European Union (EU) rose by 16.1% and 17.2%, respectively. An economic slowdown in the United States and EU in 1999 could result in negative export growth for China in 1999.
- Many analysts estimate that China's real GDP was significantly below the government's 7.8% estimate. For example, Standard & Poor's DRI estimates China's real 1998 GDP growth at 5.3% (the slowest annual growth since 1990),

²In 1998, the economies of Japan, Hong Kong, South Korea, Indonesia, Malaysia, and Thailand were in recession.

³In 1998, the Chinese government issued \$12 billion in bonds to fund new infrastructure projects.

and projects that it will slow to 4.3% in 1999.⁴ This indicates that China's economy may have slowed considerably, and that domestic spending alone may not be enough to achieve the government's GDP growth target of 7.0% in 1999.

- A major factor in the Chinese government's decision not to devalue the yuan in 1998 appears to have been the decline in Chinese imports (due in part to weak domestic demand). As a result, the sharp slowdown in China's export growth did not result in a deterioration in China's merchandise balance of trade. Chinese trade data indicate that China incurred a \$43.6 billion trade surplus in 1998, up 7.7% from the previous year. This enabled China to maintain a high level of foreign exchange reserves, estimated to have totaled \$145 billion at the end of 1998. Chinese officials believe maintaining high foreign exchange levels is critical to maintaining the stability of the yuan. A deterioration in China's trade balance might occur in 1999 if demand for imports outpaces exports.
- Further major East Asian currency devaluations, should they occur, could make many of their exports cheaper in foreign markets vis-a-vis Chinese products, which could displace many Chinese exports to the United States and other markets.⁵ In addition, East Asian currency devaluations would further depress their demand for Chinese products.⁶
- East Asian currency devaluations have made many of their exports to China cheaper. To some extent, this has likely benefitted some Chinese firms which rely on imports from Asia of raw materials and machinery used to make products for export. On the other hand, cheaper imports from East Asia have put competitive pressure on many Chinese firms, raising demand from Chinese industries for greater restraints on imports (such as steel).
- According to Chinese data, foreign direct investment (FDI) in China, which has been a major factor in China's economic development over the past several years, fell slightly in 1998 (from \$45.3 billion in 1997 to \$45.0 billion). A further decline in FDI could impede China's ability to raise capital in the near term for infrastructure development and economic modernization.

Chinese officials are deeply sensitive to the prospects of an economic downturn, due to concerns that if unemployment in China rises too quickly, social unrest will result -- a condition the government strongly wants to avoid. Many analysts argue that a sharp downturn in economic growth and/or a sharp deterioration in China's balance of trade could cause the Chinese government to devalue its currency and/or delay the implementation of economic and trade reforms.

⁴Standard & Poor's DRI, *World Markets Report, China*, December 1998, p. 3.

⁵It is not clear whether or not devaluations of East Asian currencies have yet displaced Chinese exports to the United States and other third markets. However, such devaluations have likely forced Chinese manufactures to lower prices on many items in which direct competition from East Asia exists.

⁶Chinese exports to East Asian economies (which account for about half of China's exports) fell sharply in 1998 over 1997 levels, including those to Hong Kong (-11.5%), Indonesia (-36.3%), Singapore (-9.1%), Japan (-6.7%), South Korea (-31.3%), and Thailand (-23.5%).

Chinese Currency Devaluation. Given the current shaky economic state of many East Asian economies, most analysts contend that a Chinese currency devaluation in the near term would likely further destabilize the economies of the region.⁷ A Chinese currency devaluation in 1999 would also likely entail economic and political costs for China. First, Chinese imports would become more expensive, increasing inflationary pressures, as well as raising costs for many inputs. Second, a devaluation might be interpreted in world markets as a sign that China would not defend Hong Kong's pegging of its currency to the U.S. dollar, which could significantly undermine investor confidence in Hong Kong's economy.⁸ Third, it would likely increase the level of Chinese exports to the United States, thus boosting the size of the U.S.-China trade imbalance (which reached about \$57 billion in 1998) — a politically sensitive issue in U.S.-China trade relations. Finally, a devaluation would undermine China's current image as a stable and responsible economic power in the region and could adversely affect its relations with other East Asian nations.

Analysts differ on whether China will devalue its currency in 1999. For example, Standard & Poor's DRI, estimates that competitive pressures from currency devaluations from the other East Asian economies will force China to devalue its currency by 20% against the U.S. dollar in late 1999, but only if the financial crisis in Asia has "stabilized so that the shock of devaluation will be minor."⁹ The WEFA Group projects that the chances of a Chinese devaluation in 1999 are low, due to Chinese concerns that such a move would further strain U.S.-China economic relations.¹⁰

Effects on China's Economic Reforms. A second major issue is how the Asian financial crisis will affect the future course of Chinese economic reforms. Most economists argue that China needs to make several major economic reforms in order to maintain rapid economic growth, including reform of its state-owned enterprises and financial institutions. The Asian financial crisis could complicate China's efforts to reform these sectors.

Reform of State-Owned Enterprises. State-owned enterprises (SOEs), which account for about one-third of Chinese industrial production, place a heavy strain on China's economy. It is estimated that 75% of China's largest 100,000 SOEs lose money and must be supported by state subsidies.¹¹ Many of the tariff and non-tariff trade barriers imposed by China on imports are intended to protect the SOEs from foreign competition.

In the past, the Chinese government, has been reluctant to cut off financial support to the SOEs out of concern that it would lead to widespread bankruptcies and significant employment disruptions that could cause social unrest. However, in recent years, the

⁷For example, the WEFA Group, an economic forecasting firm, states that a Chinese devaluation "could spark a new and possibly catastrophic round of currency devaluation." See the WEFA Group. *Asia Economic Outlook*, February 1998, p. 4.

⁸Maintaining Hong Kong's economic stability since its reunion with China in July 1997 has been a major priority of the Chinese government.

⁹Standard & Poor's DRI, *International Financial Bulletin*, December 1999, p. 1.

¹⁰The WEFA Group, China, First Quarter, 1999, p. 10.

¹¹WEFA Group, *Asian Economic Outlook*, February 1997, p. 4.9.

government has admitted that it cannot afford to support the SOEs indefinitely. In March 1998, the Chinese government announced that it would, in effect, privatize all but 1,000 “key” industries over the next three years. The government contends that exposing the SOEs to competition will make them more efficient and able to compete without government assistance, thus freeing resources for more productive uses.

The global financial crisis may complicate China’s planned reforms of the SOEs in a variety of ways. First, the Chinese government is counting on rapid economic growth to help find new jobs for workers displaced by SOE reforms; slower economic growth would make it much more difficult for displaced workers to find jobs in other sectors of the economy, and hence raises the prospects for possible social unrest. Second, it is likely that Chinese officials are counting on foreign investors to play a major role in restructuring the SOEs by becoming joint owners and thereby providing financing and management assistance to such firms. However, the global financial crisis could slow down the level of foreign investment in China, especially from Asian countries most affected by the crisis. As a result, less capital would be available for restructuring the SOEs. Slowing economic growth, less foreign investment, and a sharp increase in imports may prompt the Chinese to slow or delay reforms to open its markets to foreign imports in order to maintain protection of the SOEs.

Financial Institutions. China’s banking system faces several major difficulties, due largely to its financial support of SOEs and failure to operate sufficiently on market-based principles. The central government uses the banking system to keep money-losing SOEs afloat by pressuring state banks to provide low interest loans. Without these loans, a large share of the SOEs would likely go bankrupt. Currently, about 70% of state-owned bank loans now go to the SOEs; a large share of those loans are not repaid. The high volume of bad loans now held by Chinese banks (estimated to total more than 20% of China’s GDP) poses a serious threat to China’s banking system.¹² To a large extent, China’s state banks make loans on the basis of political, not commercial, considerations; this promotes widespread inefficiencies in the economy. However, in January 1998, the Chinese government announced plans to implement new reforms that would attempt to reduce the ability of local and provincial officials to use connections to obtain questionable loans.

The global financial crisis may complicate China’s plans to further reform the banking system. China needs a growing economy to help the Chinese state banks reduce their debt. In addition, many analysts argue that China’s banking system cannot become a purely commercial operation until it stops subsidizing the SOEs, a factor that becomes more uncertain, due to the recent slowdown in economic growth.

Implications of China’s Response to the Asian Financial Crisis for U.S.-China Economic Relations

China’s response to the global financial crisis has widespread ramifications for U.S.-China economic relations as well as for U.S. economic ties with other Asian nations. To date, U.S. officials have generally praised China’s response to the crisis, especially its pledge not to devalue its currency, noting that it has helped to stabilize the effects of the

¹²*Far Eastern Economic Review*, World Wide Web page, December 11, 1997.

crisis.¹³ However, should China later reverse this policy, it could lead to extensive devaluations throughout East Asia, which could further undermine the economies of the region. Should this occur, U.S. exports to the region would probably fall further, while imports would rise, and the U.S. trade deficit with China and other East Asian economies probably would increase sharply.

It is difficult to predict whether the global financial crisis will slow or accelerate the pace of China's economic reforms. On the one hand, the crisis may cause the Chinese leadership to approach further reforms with greater caution in the belief that it was the "openness" of the East Asian economies that made them susceptible to financial crisis; Chinese leaders may fear that China's economy, if reformed too quickly or extensively, could make its currency and stock markets susceptible to disruptive speculative forces outside of China. On the other hand the global financial crisis may cause the Chinese leadership to move ahead with planned economic reforms, especially if it is perceived that many of the causes of the financial crisis, such as government industrial policies, weak financial systems, and closed markets are also indicative of weaknesses within the Chinese economy. The crisis may also affect the way China approaches its goals of modernizing its economy, such as whether to try to emulate Japanese and South Korean business conglomerates (keiretsu and chaebols) to promote the growth of advanced and high-tech industries.

The pace of Chinese economic reforms in the wake of the global financial crisis will likely have a major impact on China's attempt to join the World Trade Organization (WTO), the international body that sets rules for most trade. The United States views China's WTO accession under "commercially viable terms" a critical factor in expanding market access for U.S. goods and services in China. Chinese officials have stated that they will continue to reform China's trade regime in order to gain WTO membership, despite the effects of the global financial crisis on China's economy. However, U.S. officials have raised concerns that China has recently imposed several new trade barriers (such as quotas, registration requirements, restrictions on foreign investment) on a variety of sectors, including agriculture, telecommunications equipment, and various services. In addition, new financial controls on trade (imposed in July 1998 in order to crack down on illegal foreign exchange transfers) have made it more difficult to export products to China. Should China continue to impose new barriers in 1999 or thereafter, and/or fail to make substantial new offers to liberalize trade, its accession to the WTO will likely be opposed by the United States and other WTO members. Failure on the part of China to make progress on its WTO application could also prompt the United States to use its trade laws, such as Section 301 of the 1974 Trade Act (as amended) to force China, under the threat of sanctions, to open its markets.

China's response to the global financial crisis will also likely affect congressional action on U.S.-China economic relations. For example, a Chinese currency devaluation or delay in economic reforms could increase congressional opposition to renewing China's normal trade relations (NTR) status.

¹³However, U.S. officials have been critical of China's increasing use of export credits and tax rebates, arguing that such policies constitute a de facto devaluation.