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Currency and financial crises - lessons from the Asian crises for China?

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Abstract

The Asian crises also led to a discussion about what China can learn from the destabilising developments observed in the neighbouring countries. The main intention of this paper is to focus on the probability whether China will also face a severe, financial and/or currency crisis. Two main conclusions evolve from the current economic conditions in China. First of all the danger of a currency crisis is not given for China as - apart from the still existing capital controls which avoided massive capital inflows - the interest rate differential to the anchor currency (US$) will not cause excessive short-term capital inflows and thus will not cause a destabilising volume of portfolio investments. Nonetheless a depreciation of the RMB Yuan is discussed in detail. In addition China should continue reforming its financial system by a deeper institutional foundation and solving the problem of bad loans the commercial banks are still struggling with. Reforms should start soon as further capital account liberalisation will raise foreign pressure and the costs of financing the higher debt caused by restructuring banks and enterprises.

Keywords: China, Asian crises, currency crisis, financial crisis, financial system reform, currency depreciation, capital account liberalisation

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1 Introduction

Since some of the East and Southeast Asian former „tiger economies” faced severe economic crisis in 1997/98 a lot of other emerging market economies followed them including some which were not expected to challenge this problems. The fact that developing countries have to cope with a severe financial crisis is nothing new at all as this crises are a phenomenon often occurring in countries which are pushing forward the development of their financial system. The real dramatic aspect are the high costs an economy has to pay due to disturbances in their financial system (Table 1).

Table 1: Total costs of banking and financial crises

Country	**Costs in % of GDP**
Argentina (1980-82)	55 %
Chile (1981-87)	41 %
Israel (1977-83)	30 %
Côte d'Ivoire (1988-91)	25 %
Venezuela (since 1994)	18 %
Spain (1977-85)	17 %
Mexico (since 1994)	12-15 %
Japan (since 1990)	10 %
Finland (1991-93)	8 %
Sweden (1991)	6 %
Norway (1987-89)	4 %
USA (1984-91)	3 %

Source: Goldstein/Turner (1996), pp. 5f.; Wyplosz (1999), p. 156.

The People’s Republic of China has up to now not shown any disturbances similar to that in other Asian economies and was thus during the first round of discussions seen as the main anchor in the whole region. High GDP growth rates, relatively low inflation and further sound fundamentals (Table 2) led to China being a reference model for other transition economies.[1] In the meantime a more critical opinion about China’s development is growing as there were many similarities between China and his neighbouring countries. In this paper I will discuss the structural features of a severe crisis (financial system disturbances) in addition to triggering problems (currency crisis occurring in the process of capital account liberalisation).

[1] See for example Angresano (1996), pp. 436ff., 526ff.; Goodhart/Xu (1996), pp. 51f.; Naughton (1995), pp. 309ff.; the discussion about whether East Asian and Eastern European and Post-Soviet transition economies are comparable or not is outlined in Quaisser (1995), or Sachs/Woo (1997).

Table 2: Economic development in China

	Real GDP growth[1]	Inflation[1]	current account[2]	saving ratio[2]	Investment ratio [2]	foreign reserves[3]	exchange rate[5]
1983-89	10.7	9.0	-1.0	-	-	18.0[4]	4.72[4]
1990	3.8	2.1	3.4	37.77	34.74	29.6	5.22
1991	9.2	2.7	3.5	37.84	34.77	43.7	5.43
1992	14.2	5.4	1.5	37.26	36.17	20.6	5.75
1993	13.5	13.0	-2.7	41.29	43.47	22.4	5.80
1994	12.6	21.7	1.4	42.04	40.88	52.9	8.45
1995	10.5	14.8	0.2	40.22	40.20	75.4	8.32
1996	9.6	6.1	0.9	39.25	38.73	107.0	8.30
1997	8.8	1.5	3.3	41.15	37.55	142.8	8.28
1998	7.8	-0.8	3.1	-	-	149.2	8.28

Source: Schlotthauer (2000), p. 5; [1] in %; [2] in % of GDP; [3] billions US$; [4] 1989; [5] RMB for 1 US$.

2 The „twin crises" - currency and financial crises

The main cause of the Asian crises was an underdeveloped regulation of the financial system. Due to the missing control of an state authority domestic banks were able to borrow high amounts in foreign currency.[2] The short term loans made it possible to avoid higher domestic interest rates and credit constraints and were even favoured by government policies.[3] This was able as long as a „exchange rate illusion" caused by a fixed exchange rate existed.[4] But once a reputation problem of the domestic currency arises (for what reason this may be) the behaviour of actors on the foreign exchange market leads to an extremely destabilising development.

2.1 Currency crisis

2.1.1 The trigger of a currency crisis - short term capital flows („you still have to pay back when the music stops playing")

The Asian crises were triggered by a „speculative escape" of portfolio investors which stood in line all the years before to invest their money although the crises did not erupt surprisingly.[5] The portfolio investments were made because of the higher interest rates one could realise in the

[2] Cf. Fernald/Babson (1999), p. 7; Goldstein (1998), p. 65.

[3] The government of Thailand arranged an offshore banking market through founding the "Bangkok International Banking Facility" (BIBF) which allowed domestic banks to swap loans by foreign investors denominated in foreign currency into assets in domestic currency which built up a hugh amount of currency risk; cf. Menkhoff / Teufel (1995), pp. 78ff.

[4] Cf. Bofinger/Wollmershäuser (2000), p. 15.

[5] In April 1997 the Economist published a paper on "Banking and finance in emerging markets" which dealt with the high risk building up in the financial systems of emerging markets; Economist (1997).

Asian economies combined with fixed exchange rates.[6] Starting with Thailand and Malaysia a fatal round of overshooting currency depreciations followed caused by a massive capital outflow. In this period one could observe an overshooting of exchange rates much higher than expected in an environment of uncertainty about reform and wide-ranging contagion.[7] During this massive depreciation the domestic borrowers faced a sudden increase of their debt denominated in foreign currency which in most cases led to insolvency although their nominal liability structure has not changed. The behaviour of investors was similar to former currency crises:

- Engaging in the countries the investors were already aware of the risk which could arise by a currency depreciation in the near future. But they all hoped to be able to get out once the stampede starts.
- In addition, the fundamental problems were not recognised but seem to be a reason for escaping (which once again shows that fundamentals do not matter at all when estimating the „right exchange rate”).[8]

As things stand now China will not suffer from a severe currency crisis because on the one hand it defends the fixed exchange rate by various capital controls preventing foreign banks and enterprises borrowing abroad like their Asian counterparts.[9] This controls were further deepened during the Asian crises although they once for all did not do their job as they were supposed to. A higher capital flight (measured by „statistical errors” in the balance of payments[10]) could be observed during the 90s and added up to more than $100 billion (Figure 1). Although the controls are not working efficiently, they are nonetheless a temporary instrument to avoid massive capital outflows.[11]

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[6] Cf. Bofinger/Wollmershäuser (2000), p. 20.

[7] Cf. Goldstein (1998), p. 66.

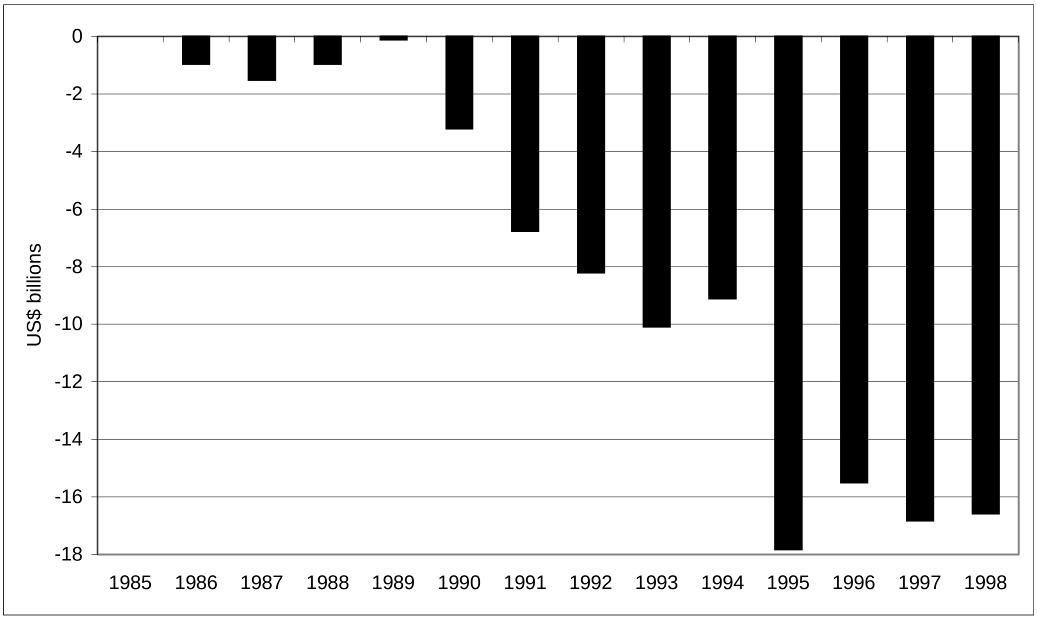
[8] A different explanation for this behaviour is that investors wait whether domestic reforms (especially in the financial system) continue and start worrying once the whole weakness is obvious; cf. Goldstein (1998), p. 65.

[9] Cf. Fernald/Babson (1999), p. 2.

[10] The statistical error measures the difference between debit and credit entries. All parts of the balance of payments have to sum up to zero. Thus a negative error could be regarded as not registrated capital outflows (however managed); cf. IMF (1993), p. 38.

[11] Cf. Schlotthauer (1999), p. 128.

Figure 1: Statistical Error in China's balance of payment

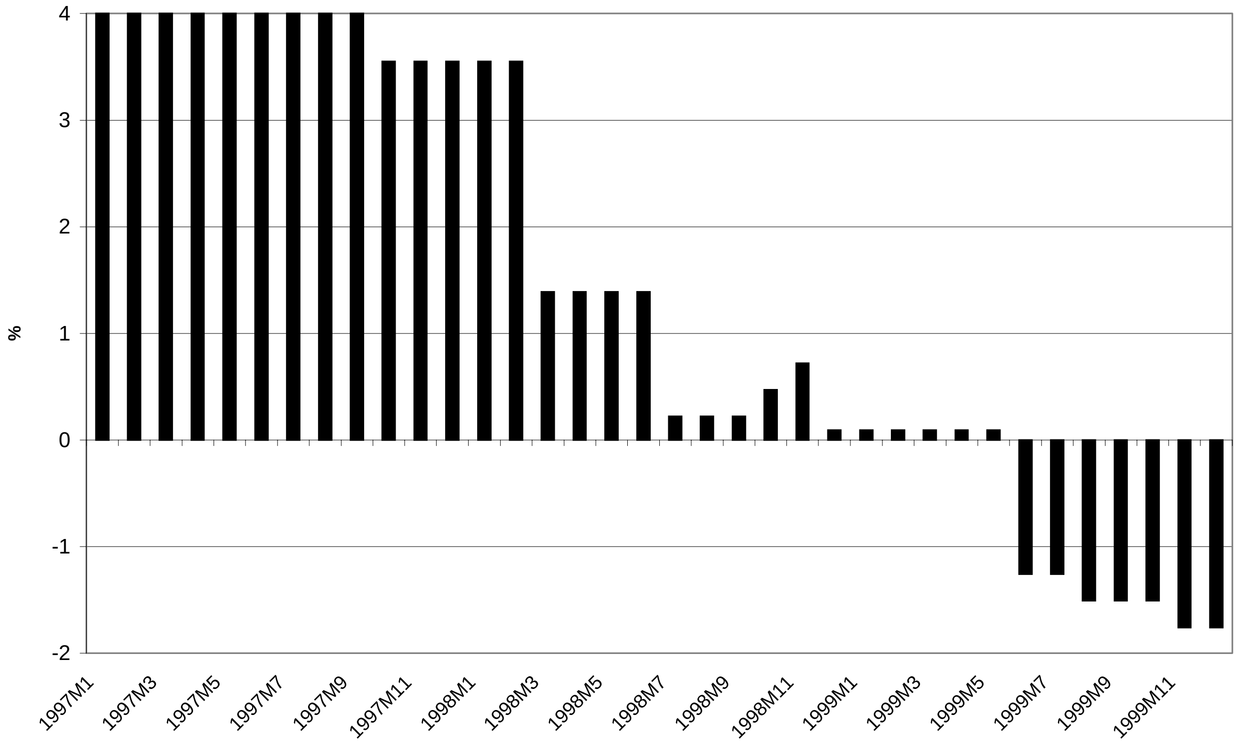


Source: IMF International Financial Statistics, March 2000, CD-Rom.

But on the other hand even without capital controls the probability of pressures for a depreciation of the Chinese currency would be very low regarding the interest rate differential between US and Chinese interest rates. A high interest rate differential to the anchor currency was identified as the main reason for massive inflows of short-term investments and the trigger of a currency crisis once their outlow started. Since 1998 the interest rate differential between Chinese and US bank rates has not only declined but even reversed (Figure 2).[12] Thus China will not be in danger of facing a currency crisis. It would not be attractive for foreigners to invest in short-term positions with lower interest rates so massive capital outflows in the future (after further liberalisations) will not happen. Today China's foreign reserves, accounting for $157.7 billions, are the World's third largest (after Euroland and Japan). They are also supplemented by further $96.2 billions of Hong Kong's currency reserves. This allows central bank interventions once the foreign exchange market is further liberalised.[13] As 80 % of the debt denominated in foreign currency is medium- and long-term[14] a sudden outflow will neither today nor in the future occur.

[12] The "bank/discount rate" is the interest rate banks have to pay when financing at the central bank. For regulated countries like China it is a proxy for a money market rate.
[13] Cf. Fernald/Babson (1999), p. 4.
[14] Cf. Corsetti et al. (1998).

Figure 2: Interest rate differential between Chinese and US bank rates



Source: IMF International Financial Statistics, March 2000, CD-Rom

Lessons from the Asian crises can be drawn for China on behalf of future deregulation which have to be done joining the WTO. A liberalisation of the capital controls the PRC requires an appropriate exchange rate system (fixed versus targeting versus flexible). The credibility of such a system depends on how foreign, short-term oriented investors assess the economic development. Earlier studies on indicators of currency crises show a strong relation between the build-up of a financial crisis and an outbreak of a currency crisis.[15]

Thus China has to create a sound and well-regulated financial system to avoid a severe crisis once a further capital account liberalisation is started.

2.1.2 Should China devalue its currency?

Even though China does not have to fear a currency crisis the question remains whether China should devalue its currency now apart from the reason avoiding a speculative attack but just to regain some competitiveness lost as the other Asian currencies devalued by over 25 %. Because

[15] Cf. Kaminsky/Reinhart (1999), pp. 475f.

even Chinese officials recently dropped the "no devaluation mantra"[16] a discussion about advantages and disadvantages of a devaluation of the Chinese RMB Yuan came up, and pros and cons are debated controversially. A devaluation would help Chinese companies regaining some of their competitiveness they lost during the Asian crises.[17] The declining competitiveness led to lower exports and deflation in China.[18] According to estimates the OECD published in summer 1999 a devaluation would help China increase its current account surplus in 2001 by nearly $12 billion if the other currencies in Asia, except of Hong Kong, will not devalue, too. Even if other East and Southeast Asian currencies devalue by 10 % the current account surplus of China will grow by $9 billion.[19]

Table 3: The impact of a RMB Yuan devaluation on the current account

	Impact on current account in 2001 (US$ billions)	
	20 % devaluation of Chinese RMB Yuan and HK$ only	**other Asian currencies also devalue by 10 %**
PR China	11.9	8.9
Dynamic Asian economies	2.2	21.4
Japan	-4.8	-12.6
USA	-3.9	-10.4
Europe	-2.8	-9.3

Source: OECD (1999), p. 14.

One disadvantage arises from the assumption that other Asian currencies will not devalue. Instead of this a „beggar my neighbour policy" might take place which means that other Asian competitor countries would devalue by the same amount, too, to avoid a reduction in their competitiveness. And even if they only devalue by 10 % (as estimated) there is still a major problem for Japan. As the Japanese Yen is currently facing a strong appreciation versus the US$ China and other Asian economies can cause even more problems for Japan which will get caught into a deeper recession which, the other way round, will also cause problems for the recovery of other Asian economies as the region's vehicle will not pull them out.[20] And additionally the non-rational behaviour of exchange market actors is another not yet solved problem which could

[16] Cf. Kynge (1999).

[17] Exporters' profits declined by $8.7 bn in 1998 due to the refusal of the authorities not to devalue; cf. Kynge (1999).

[18] The Chinese Ministry of Finance announced a decline of exports in the first half of 1999 by 4.6 % compared to the same period in 1998; the imports grew by 16.6 %. The consumer price index declined by 1,8 %; cf. http://www.mof.gov.cn/eng/tab-2.htm.

[19] Cf. OECD (1999), p. 14; the "dynamic Asian economies" are: Taiwan, Hong Kong, Indonesia, Malaysia, Philippines, Singapore and Thailand.

[20] Cf. Goldstein (1998), p. 66.

compensate the devaluation effects.[21] Even as problematic appears the situation regarding the currency board in Hong Kong. This exchange rate fixing, which is founded by special institutional provisions, might collapse as Hong Kong will not be able to maintain the peg.[22] A breakdown of the currency board would be a signal for many foreign investors which will loose their confidence in the stability of Hong Kong's financial system.

Less regarded is the fact that the Chinese government already implemented some measures that shall help exporting companies. For not-specified companies she announced a separate exchange rate which is about 35 % lower than the official one.[23] This will help stopping the decline of the profits many companies had to deal with as they faced a more severe competition on export markets. If China should decide to devalue this might be done in combination with the opening of the whole economy (e.g. as joining the WTO). The empirical evidence of many regulated countries show that a devaluation could compensate domestic companies for more competition they face on their home market (China) and thus will deepen their reform acceptance. It will also support the effect expected by a devaluation.[24]

A solution offered by Goldstein might be superior: after China survived the Asian crises without problems the time will be right to devalue now as a higher domestic debt ratio caused by structural reforms (see chapter 3) combined with higher risk premiums on China's sovereign debt can be compensated by a devaluation.[25]

2.2 A financial crisis in China?

2.2.1 Financial crisis - definition and causes

Historical experience shows that poor supervision is the main cause for a financial crisis (this is nothing new, the Asian crises is only another „brick in the wall"). While liberalising the financial system (combined with the capital account) developing countries often face severe financial crisis with high costs for the whole economy. The main aspects of what defines a financial crisis can be summarised by three views:

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[21] Some authors think that another round of sudden devaluations would only happen during another crisis. As the whole situation is under control they also believe that China should devalue; cf. Fernald/Babson (1999), p. 18.

[22] Cf. Goldstein (1998), p. 30f.

[23] The People's Bank of China offers a separate exchange rate for "special organisations". This exchange rate is quoted every month by the central bank and devalues to the official one by approximately 35 %; cf. http://www.pbc.gov.cn/data/data5.htm.

[24] Cf. Corden (1993), pp. 202f.; for a deeper discussion concerning China see Schlotthauer (2000), p. 21ff.

- Kindleberger defines a financial crisis as a sudden disruption of all or almost all financial indicators (stock prices, asset prices, liquidity constraints of financial institutions).[26]
- Mishkin refers to the problem of asymmetric information leading to loans for financing too risky projects.[27]
- The IMF also points out the sudden disruption of financial indicators but makes a distinction between financial and banking crisis. A banking crisis occurs when one bank or the whole banking system are not able to fulfil their liabilities.[28]

Some definitions do not distinguish between a banking and a financial crisis.[29] This also leads to different causes defined by the authors. Nonetheless some aspects can be regarded as main causes and thus have to be recognised while establishing rules for a sound financial system:[30]

- Volatility of macroeconomic indicators, e.g. interest rates and real exchange rate, are often observed together with financial crisis.
- Unfinished financial liberalisation (especially incomplete supervision, accounting standards, skill of bank staff and organisational structures);
- strong influence of state agencies and no control concerning „directed lending";
- expansionary borrowing in boom periods and sudden disruption of asset prices.

Observers fear that China might be threatened by a financial crisis.[31] The developments in Southeast Asian countries and Russia once again showed the fragility of financial systems in emerging market economies. China is different to this countries as fluctuations of macro-economic indicators will not hurt the domestic banks. A problem similar to other Asian economies is „directed lending" by banks to preferred enterprises which is another reason for a financial crisis.[32] This special aspects deal more with the probability of a banking crisis which shall be discussed for China in the following parts (as other parts of the financial system are still underdeveloped and thus the banking system is still the most important element).

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[25] Cf. Goldstein (1998), p. 31; a discussion about this rising risk premium is presented by Fernald/ Babson (1999), pp. 13ff.
[26] Cf. Kindleberger (1992), pp. 46f.
[27] Cf. Mishkin (1996), p. 17.
[28] Cf. IMF (1998), pp. 74f.
[29] See Goldstein/Turner (1996), pp. 5ff.
[30] Cf. Goldstein/Turner (1996); IMF (1998); Kindleberger (1992); Mishkin (1996).
[31] See Harding (1999); Kazer (1999); Lardy (1999).
[32] Other factors triggering a financial crisis, e.g. asset price bubbles, cannot be discussed here in detail for China; see Schlotthauer (1999), pp. 131f.

2.2.2 Loans and equity of Chinese commercial banks

Unlike other announcements the „credit plan” is still existing although not officially implemented, which leads to a preferential treatment of state-owned enterprises.[33] in 1997 more than 80 % of all loans in the portfolio of state-owned commercial banks (not including policy and regional banks) were granted to state-owned enterprises[34], although the share state-owned enterprises contribute to China’s GDP 1997 accounts for only 25.5 %.[35] Supporting this enterprises in their struggle by additional finance was normally the task of the state commercial bank. But now the only private bank (China Minsheng, founded 1996) also showed the same behaviour.[36] Although the state-owned enterprises’ relevance is declining more and more the growth rate of their loans is higher than that of non-state enterprises (Table 4).

Table 4: Loans granted by the China Minsheng Bank

	1997 (Mio. RMB)	1998 (Mio. RMB)	growth rate
state-owned	1,963.398	4,276.130	117.8 %
non-state	1,042.490	2,128.1	104.1 %
foreign invested	691.219	2,326.376	236.6 %
collective	526.517	606.405	15.2 %
small enterprises	737.223	1,470.880	99.5 %
total	4,960.847	10,807.891	117.9 %

Source: China Minsheng Bank (1998), p. 42.

In addition with the already existing loans from the pre-reform period before 1978 this loan granting process lasting for 20 years created a high amount of bad loans in all state-owned banks which further undermines the dramatic development of their equity situation. The Chinese officials and bank managers still do not discuss this subject frankly but instead try to manipulate the data leading to an official quota of 5 to 6 % of bad loans. Independent estimates calculate a quota of 30 % of all loans to be irrecoverable, a quota which is not identical to that announced by Chinese officials. This difference can be explained by the practice how to rate a loan. Having a closer look one can find practices like that described by the China Minsheng Bank:

[33] In 1998 the Industrial and Commercial Bank of China stated that supporting “well-performing enterprises in the non-state sector” is a main target, but in the same context she admits that state agencies still influence the loan decisions and ask for even more support of state-owned enterprises; cf. ICBC (1998), p. 15.

[34] Cf. Lardy (1999), p. 19. This is caused by the need of finance for state-owned enterprises as budgetary subsidies are no longer granted than the SOEs were used to before; cf. Xu (1997), p. 4.

[35] Cf. “China Statistical Yearbook 1998”, p. 431.

[36] The China Minsheng Bank is defined as private because it was not established by a central or provincial government agency. The shares are owned by 59 different, mainly non-state enterprises; cf. China Minsheng Bank (1998), p. 31.

„In conformity with International Accounting Standards, loans are placed on non-accrual status if principal or interest is not likely to be paid in accordance with the terms of the loan agreement, or when principal or interest is past due 180 days or more."[37]

This does not seem to be a sound practice. On the one hand the quote „is not likely to be paid" offers various opportunities to cover bad loans as normal. On the other hand it makes no sense to wait another 180 days for repayment and start a liquidation after this long period. Most of the loans are short-term (within one year) which means that waiting 180 days is in reality a renewal of a probably bad loan. Except of the Bank of China all state commercial banks' portfolios consist merely of short-term loans (Table 5). Thus the quota of bad loans is calculated with wrong data. Apart from first approaches observed in the last years the Chinese government still seems not willing to deal with the present difficulties the banks are facing. This might work in the near future but former experience of other countries show the severe disturbances a financial crisis leads to. China's government should not wait too long starting a deep reform of the financial system because once the debtors of banks loose confidence there might be a nation-wide breakdown of the state commercial banks.[38]

Table 5: Loan maturity of Chinese commercial banks 1998

	ICBC	BoC	CCB	ABC[1]	BoCom	China Minsheng Bank
loans (Mio. RMB)	2,271.54	1,447.31	1,257.9	1,018.2	258.83	10.808
share of short-term	79.01 %	57.2 %	-	90.18 %	70.39 %	83.04 %

[1] : 1997; Source: ABC (1997), Internet; BoC (1998), p. 46; BoCom (1998), p. 42; CCB (1998), p. 15; China Minsheng Bank (1998), p. 41; ICBC (1998), p. 40.

The development of state commercial bank's equity clearly shows the impact of bad loans and misled guidance. Tier 1- and Tier 2-capital quotas are far apart from reaching the standards given by the Basle Accord from the Bank for International Settlements.[39] The standard for developed countries is a ratio of at least 8 % (equity to risk-weighted assets), but Chinese banks do not meet them but in contrast are moving away from this target.

Table 6: Equity of Chinese commercial banks (in % of risk-weighted assets)

	1985	1997
Tier 1-Capital	12.1 %	2.2 %
Tier 2-Capital	13.2 %	2.7 %

Source: Lardy (1999), p. 22.

[37] China Minsheng Bank (1998), p. 32.

[38] '*In banks we trust*': „(By the time being) At the end of the day, Chinese depositors believe their deposits are safe in Chinese banks, [...]. But if the time were ever to come when Chinese depositors started to have their doubts, China could end up wishing it were more like, well, south-east Asia, Russia or Brazil."; Harding (1999), p. 13.

[39] The quota for Tier 1-capital shows the relation of "paid in capital/assets", for the quota for Tier 2-capital the profit retention ratio is added to the capital.

This data does not show another problem. Banks include all interest payments in their profit calculations even when the customer did not pay on their irrecoverable loans. Thus the profits of commercial banks are by far not as high as officially announced. The Bank of Communications, e.g., states that payments on interest are not included into the profit calculation only after they have not been paid for one year.[40] These stylised facts give a feeling for the real challenge China and the commercial banks will face in the future. The financial system reform has not really started and leaves a lot of questions unsolved.

2.3 The legacy of unfinished financial system reform and consolidation in China

One main aspect of economic transition and reforms is widely accepted in all discussions: to support reforms in all parts of the economy a country needs a stable, transparent and efficiently constructed institutional framework. The experience of various transition economies shows how important rules in an reforming economy are.[41] This is one of the main tasks the government has to deal with in the future as China still suffers from various problems:[42]

- The banking supervision and accounting standards are still underdeveloped and concentrate on aspects concerning the implementation of directed lending given by state authorities.
- Until now it is not determined whether deposits in the state-owned banks are insured or not. This might lead to a severe „bank run" if one bank gets in trouble. This argument should not be understood in favour of a deposit insurance system. Empirical evidence shows that deposit insurance will lead to a „moral hazard"-behaviour of banks and finally to a banking crisis.[43] But in combination with non-existing insolvency rules the whole system is still intransparent.
- Special insolvency rules concerning the breakdown of financial institutions do not exist. The bankruptcy law was designed for all kind of companies, is complicated and aims at only one target: due to the exceptions in the paragraphs the law should not be installed in reality.[44]
- The founding of several „asset management companies" (AMC) marks a first step towards recapitalising the commercial banks (chapter 3). CINDA (first AMC), for example, shall

[40] Cf. BoCom (1998), p. 38.
[41] See for example the first chapter of the 10th EBRD-"Transition Report"; EBRD (1999), pp. 4-19.
[42] Cf. Xie (1999), p. 96.
[43] Cf. Demirgüc-Kant/Detragiache (1998), pp. 99f.
[44] Cf. Hieker (1999), p. 96.

reorganise the loans of the China Construction Bank which will cost about RMB Yuan 140 Billions ($17 billions).[45] But it is not generally agreed who is going to pay the AMC's bills.

- Restructuring local financial institutions is going on more slowly than expected as local governments try to hinder central government institutions from closing down the local politician's „private financiers".

This is <u>the</u> important lesson for China from the Asian crises. Directed lending and poor financial supervision will cause severe problems and will lead to banking, financial and currency crises. Thus China suffers from the danger of a severe financial crisis.

3 How to avoid a financial crisis in China?

Establishing the asset management companies is a major step toward banking system reform and financial recovery in China. Without removing the high amount of bad loans from the banks' balances there will be no market-oriented credit business because the development of commercial banks is still linked with that of the state-owned enterprises (SOEs) as bankruptcies of SOEs will make banks insolvent as well (Table 7). This makes the banks continue granting loans to inefficient SOEs and not to newly-established and profitable private or collective enterprises.[46] One can also not be sure whether the banks will earn enough profits in future periods that make it possible to cope with a higher ratio of irrecoverable loans. By writing off the bad loans the banks' attitude might change and additionally they do not have to participate in the enterprise reform. But there must also be obvious signals to the banks that they cannot count on further recapitalisation if they will face liquidity problems again. Otherwise they will always expect a „bail out" by the state or the central bank (this is one of the main lessons from banks' behaviour during the Asian crises).[47]

The costs arising from restructuring the banking system have to be paid by the state. Especially in China this might be possible if the country is able to continue its remarkable growth. As the amount of bad loans is calculated around 27 % of GDP a recapitalisation via an issue of bonds (which the banks need to compensate the loss of assets transferred to the AMCs) with an interest

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[45] This numbers were anonymously estimated by a senior manager of the CCB in an interview; cf. Kazer (1999).
[46] Cf. Schmieding/Buch (1992), p. 4; they also point out that this behaviour will continue due to the close personal links between managers of banks and enterprises resulting from the period of centrally planning.
[47] Cf. Lardy (1999), pp. 32f.

rate of 6 % will produce yearly liabilities of 1.62 % of GDP for the state budget. Assuming that the GDP growth will not fall below 6 % and the tax system will be developed further on the amount of interest payments can be covered. The overall state debt will rise to around 40 %[48] which would be acceptable even for industrial countries (e.g. the EU countries). Another advantage of this approach will be the higher transparency about the real size of the costs for financial and enterprise restructuring (if the government wants this to be official at all?).

Table 7: Approaches for dealing with bad loans in Chinese commercial banks

	Advantages	**Disadvantages**
Central agency for loan recovery and recapita-lisation of banks	• Banks can act future-oriented. • Breaking up the links between banks and SOEs. • Independent experts deal with enterprise restructuring. • Less influence of politicians.	• State budget will face additional costs. • „Too easy solution for banks“. • Banks will continue granting loans to SOE and expect a „bail out“.
Banks have to deal with loan recovery themselves	• Lower administrative costs. • Banks learn to develop efficient loan granting and classification system.	• Banks have to carry burden of the past and cannot focus on new clients. • More bankruptcies of banks, depositors loose confidence in banks. • Banks will arrange debt-to-equity swaps which deepen the links to SOEs.

Source: Schlotthauer (2000), p. 24.

Some **legal reforms** are additionally required. Accounting standards for a transparent loan classification have to be established and should also be put in action (the latter being a well-known barrier in China). Especially for short-term loans the restrictions for classification and debt-write-off have to be hardened. China also needs special insolvency rules concerning the handling of a breakdown of financial institutions. Domestic depositors and foreign lenders to banks ask for clear and efficient rules about what will happen if a bank’s (or non-bank financial institution’s) liabilities are not covered by assets any more. The asset management companies should strictly not co-operate with commercial banks to avoid another „gang” working out incomplete or illegal reform steps. An independent state institution might be the only way to handle the more and more rampant corruption on different levels of the Chinese economy.[49]

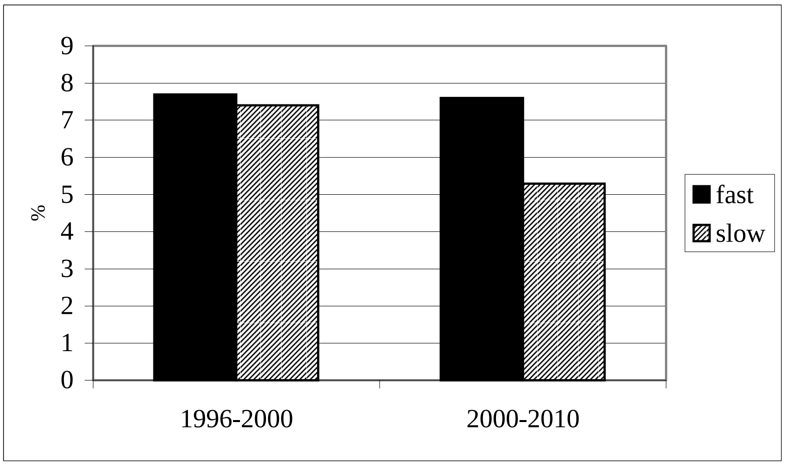
[48] CF. Lardy (1999), pp. 34f.

[49] Even on government level one cannot be sure that there are no corrupt politicians but the chance of finding correct ones will be higher than on provincial level; see also Sieren (2000), p. 40.

4 Conclusion

One argument why China has survived the Asian crises so well could be that there are too many differences between China and the other Asian countries. Thus there would be only few lessons for China from the Asian crises which can be transferred directly. Due to different macroeconomic conditions and regulations concerning capital account transactions China is not in danger of suffering from a currency crisis. One main lesson that remains is the relevance of a sound and stable financial system in an economy founded by various supervisory regulations. This is not special for the Asian crises but also relevant for developing and transition economies and might be another argument for China's high growth rates: while starting the reforms in the rural economy ("surrounding the cities from the countryside"[50]) which created a massive productivity leap the Chinese government failed to implement deep reforms concerning state-owned enterprises and the financial system in the meantime. Evidence from Eastern Europe and the Former Soviet Union shows that China therefore has to deal with this important challenge soon as fast reforms will help reaching higher growth rates than delayed reforms (Figure 3).

Figure 3: Different reform approaches and real GDP growth in China



Source: EIU (1999), p. 5; fast reforms are defined as a quick beginning with enterprise and financial system reform.

An important feature for China is that the Asian crises offer a closer look into the future when the bid for joining the WTO will make further reform steps (including a capital account liberalisation) necessary. Therefore China should benefit from the recent conditions by reforming its financial system without facing additional foreign pressure which further complicate this reform and the influence of economic policy (due to the behaviour of domestic and foreign actors).

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[50] Naughton (1995), p. 21.

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