

China Update

Conference Papers

1998

Copyright 1998 NCDS Asia Pacific Press
ISSN 1441 9831

Published online by
NCDS Asia Pacific Press
Asia Pacific School of Economics and Management
The Australian National University
Canberra ACT 0200
Australia
Tel: 61 26249 4705
Fax: 61 26257 2886
Email: publications@ncds.anu.edu.au

ASIA PACIFIC SCHOOL
ECONOMICS AND MANAGEMENT
THE AUSTRALIAN NATIONAL UNIVERSITY

Asia Pacific Press
<http://ncdsnet.anu.edu.au/online/>



China in the middle of the East Asian Crisis

Export growth and the exchange rate

Yongzheng Yang*

National Centre for Development Studies
The Australian National University

Introduction

Since the onset of the Asian financial crisis in July 1997, China's export growth has become a focus of many economic observers. The health of the export sector has two important implications: one for China's overall economic growth and the other for the yuan exchange rate. The pace of economic growth has further political as well as economic implications. With increases in unemployment arising from ongoing state-owned enterprise (SOE) reform, slow growth makes employment creation a more difficult task and could have serious political and social consequences. The stability of the yuan of course has been widely perceived to be critical to export-led recovery in crisis countries in Asia.

In this short presentation, I will try to assess the external conditions facing China's export sector. The purpose of this analysis is to shed some light on the prospect for China's export growth in the short to medium run. What will happen to exports in the next year or so will largely determine the yuan exchange rate. We will focus on the economic fundamentals for the yuan exchange rate and its likely path in the near future.

The impact of the Asian crisis on China's export growth

The impact on China's exports of the Asian financial crisis can be decomposed into two effects. The first is the income effect and the other is the price effect. The income effect refers to the adverse impact of slowing or negative income growth in the crisis countries and Asian countries in general. Slow income growth in these countries would lead to slow growth or declines in demand for Chinese exports. The extent of this effect would depend on the degree of trade links between China and its Asian trading partners. Table 1 shows the relative importance of China's major export destinations.

* I wish to thank Xinpeng Xu for his assistance with the graph presented in this paper.

Table 1 **Destinations of China's exports^a** (per cent)

	1990	1996
Crisis countries ^b	4 (4)	8 (5)
Asia	69 (56)	58 (56)
Japan	15 (14)	20 (16)
USA	8 (18)	18 (22)
EU	9 (14)	13 (12)
Rest of the world	14 (12)	12 (9)

^a Numbers in parentheses are calculated using imports from China reported by partner countries.

^b Include Indonesia, Republic of Korea, Malaysia and Thailand.

Source: IEDB, The Australian National University.

It is clear from the table that the trade link between China and its Asian trading partners is intensive, even though the four crisis countries are only a small market for Chinese exports. Given this strong trade link, one would expect a substantial impact on China's exports of growth slowdown in Asia. One indication of such impact is the growth of China's exports to these countries. Table 2 shows that despite strong overall export growth, China's exports to the Asian economies have experienced relatively slow growth in the first quarter of 1998. Compared with the historical trend of the period 1990–96, the growth of exports to Asia was indeed very slow in the first quarter of 1998.

Table 2: **China's trade growth (per cent)**

Exports to:	Q1 1998	1990-96
World	12.8	16.0
Asia	4.2	12.7
Others	17.0	21.9
Imports from:		
World	2.6	17.3
Asia	7.3	18.4
Korea, R.	11.6	62.3
Thailand	33.5	31.2
Others	Not known	15.9

Note: Export growth for 1997 was 20.9 per cent, and import growth was 2.5 per cent.

Sources: China State Administration of Customs (as quoted by *China News Digest*, 13 April 1998) and IEDB, the Australian National University.

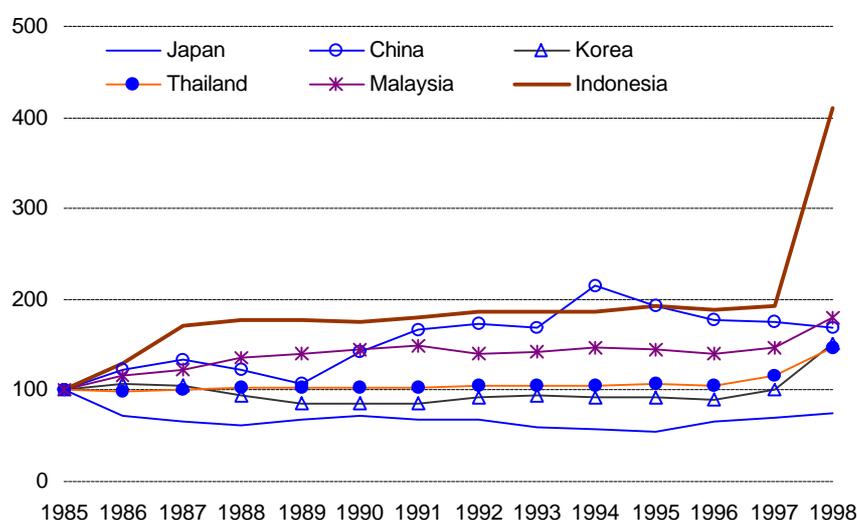
On the import side, the growth of imports has been slow in the last couple of years. The growth rate for 1997 was 2.5 per cent. Despite a substantial increase in the volume of imports from Korea in the first quarter of 1998, the growth rate fell dramatically from the historical trend. Imports from Thailand seem to have maintained their growth in the wake of the crisis, but it is difficult to tell whether this is sustainable in the longer run. This seems to suggest that up to the first quarter of 1998, the impact of the Asian crisis is still largely the income effect, rather than the price effect. This conclusion seems to be supported by the continuous strong growth of Chinese exports to North America and Europe and by the overall slowing down of the growth of imports from Asia.

In May 1998, China suffered a negative export growth (-1.5 per cent). Imports fell even further (-3.8 per cent). It was reported that exports to Southeast Asia, Japan and Korea dropped by 10.5 per cent, 5.7 per cent and 29.6 per cent, respectively. It is not clear whether export growth in other markets was maintained, but the total export value did increase. In June, export growth bounced back, recording a modest 1.6 per cent increase. This brings overall export growth in the first six months of 1988 to 7.6 per cent, much lower than the recent historical trend and lower than the government target of 10 per cent. Imports were up by 5.3 per cent in June, bringing overall import growth for the first half of the year to 2.2 per cent, only slightly lower than the historical trend. This perhaps reflects the overall slowing down of economic growth in China. How much this slower economic growth is due to external shocks, namely, reduced export demand, is debatable. Some argue that the austerity program introduced in 1993 was largely responsible for the economic slowdown.

It is not clear how soon the price effect will be felt and how strong it will be. That will depend on the extent of depreciation of the currencies of other Asian countries vis-à-vis the yuan and the extent of substitutability between Chinese goods and goods from other sources. Despite higher inflation rates in the wake of the crisis, the crisis-affected Asian currencies have experienced a substantial depreciation against the Chinese yuan (Figure 1). This will eventually translate into large relative price changes if the Chinese yuan maintains its peg to the major industrial economy currencies.

As the crisis countries continue to face liquidity constraints in the export sector, it will perhaps take a little longer before these countries can pose stronger competition to China's exports. How long exactly this will take is difficult to predict, but when it comes, it may be quite strong as Chinese exports seem to be relatively close substitutes for goods from ASEAN and NIEs (Table 3). Substitutability between Chinese exports and those from other Asian developing countries is greater because they tend to export similar commodities. It is likely that the substitutability between Chinese goods and those from Asian developing economies is even greater in industrial country markets.

Figure 1 Real exchange rates for selected Asian economies, 1985–98



Note: 1985=100; Exchange rate for Indonesia for 1998 is that of May 12, 1998 (1US\$ = 9480 Rupiah). Data for 1998 are point estimates.

Source: Garnaut (1998) and author's update.

Table 3 The Finger-Kreinin index of similarity between Chinese exports and their substitutes at the 4-digit SITC level

	1990	1996
ASEAN	43	46
NIEs	49	49
Japan	29	33
EU-12	41	44
USA	35	37
Developing countries	53	56
World	48	49

Source: Calculated from the data extracted from the IEDB, The Australian National University, Canberra.

Overall, it seems that the impact of the Asian Financial Crisis on China's export sector is far from over. It may get much worse before it gets better as the price effect is yet to be felt. When this comes, China will face stronger competition from Asian developing economies in the markets of North America, Europe and Japan, as well as in these economies themselves. The penetration in the Chinese markets by the exports from

Asian economies will probably not increase dramatically given the slowing down of the economy. However, if export growth continues to slide, even moderate increases in import growth could turn the trade account around and undermine the confidence in the yuan.

The impact of the Asian crisis on FDI

There has been considerable concern over the impact of the Asian financial crisis on foreign investment in China, and most importantly on foreign direct investment (FDI). So far there is little evidence on how FDI flows to China has been affected or will be affected. One would expect that the appreciation of the Chinese yuan would adversely affect FDI inflows with an expectation of devaluation in the future. While contracted FDI in China increased by 5.5 per cent in the first quarter of 1998, realised FDI fell by 1.3 per cent. One needs to be cautious to draw any firm conclusions from one quarter's data, even though realised FDI has experienced an annual increase every year since 1984.

It is not known which sources of FDI has led to the decline in the overall realised FDI. Presumably, it is a direct result of falling investment from Asia in the wake of the financial crisis. Many multinational firms based in crisis-stricken economies will probably need to consolidate their production capacity in the domestic market, which may mean that they have to rationalise their overseas operations. The crisis countries are a small contributor to China's overall FDI inflows, but Asia as a whole is the dominant source of FDI, despite the fact that a significant proportion of FDI from Hong Kong is recycled Chinese funds (Table 4).

Table 4 Sources of foreign investment in China, 1996 (per cent)

Region	Share in total investment
Asia	79.2
Hong Kong	49.5
Japan	8.8
Taiwan	8.3
Singapore	5.3
Korea	3.6
Indonesia	0.2
Thailand	0.8
Europe	7.2
North America	9.2
Others	4.5
Total	100.0

Source: China Statistical Bureau, *China Statistical Yearbook*, China Statistical Publishing House, Beijing, 1997.

There are several reasons why it is difficult to predict how in the long run the Asian financial crisis will affect FDI flows to China. Apart from the expectations on the exchange rate, many other factors are important. China's strong growth and its large domestic market have been the main attractions to foreign investment in recent years, but continuous uncertainty over economic and social reforms has been an important risk factor for foreign investment. If the prospect for exports is not promising, export-oriented FDI may decline. This of course has to be compared with the environment for FDI in other Asian developing economies. In the short run, foreign investors may be reluctant to redirect their funds from crisis countries to China. In the wake of the Asian crisis, most foreign capital seems to have moved out of these countries to North America and Europe. With time and economic recovery, foreign investment will return to Asia, but how it will be distributed among the Asian economies will depend on the domestic environment in individual countries.

Implications for the yuan and economic policy

The future of the yuan exchange rate will depend on the development of China's trade account as well as capital account. It is widely accepted that the strong yuan has been largely due to rapid export growth and large capita inflows in the capital account. In other words, Chinese exports have been competitive and the Chinese domestic market has been attractive to foreign investment. The pressure on the yuan will increase if China's export growth continues to decelerate in the second half of 1998. Continuous poor export performance beyond 1998 will eventually lead to a strong expectation of devaluation. At present, given China's huge foreign reserves, there is no immediate pressure for the devaluation of the yuan.

One must point out, however, a devaluation of the yuan does not mean an imminent currency crisis in China given the non-convertibility of the yuan on the capital account, although it may have considerable impact on regional currencies. On the other hand, a domestic financial crisis can happen if state banks continues to build up bad debts as a result of the poor performance of SOEs. The government has decided to write off many of the bad loans and has injected considerable funds to recapitalise state banks. This, however, cannot continue indefinitely if SOEs do not improve their performance. If the government continues to finance its ever-increasing bale-out of SOEs and state banks by debt accumulation, it will not only undermine sound macroeconomic management, but also eventually deprive state banks of household savings. In the end, the financial situation for state banks will not improve. The key to such improvement is to make state banks truly commercial entities and improve their own performance. Once this is done, financial market liberalisation can be carried out and foreign competition can be rigorously pursued. At the same time, SOEs also have to be reformed to prevent the continuous drain they impose on the state budget and on bank capital. Thus, how well and rapidly China can reform its SOEs and banks will not only determine China's long-term growth prospects, but also the confidence the market will have on the Chinese economy and hence its financial and currency stability in the short and medium run.

China's weak financial sector means that it will have a great need to maintain a high level of foreign reserves. Any significant fall in the reserves as a result of trade deficits

or capital outflows is likely to lead to the loss of confidence in the Chinese economy. Much will also depend on how tightly China can control capital outflow. Some suggest that the slight decline in the foreign reserves in June was partly due to capital outflow. Given the considerable trade liberalisation that has occurred, it will be difficult for the Chinese government to completely restrict capital movement. There are plenty of loopholes that can be explored.

China's export performance will therefore be important not only for achieving strong growth to keep unemployment from rapidly increasing, but also for maintaining macroeconomic stability. Several measures have been adopted to stimulate export growth. These include increases in tax rebates for selected export commodities and increases in bank credits for the export sector. Presumably, these policies will have some positive effects on exports, but it is by no means certain that these effects can offset the adverse effect of the Asian crisis. If such measures do not produce strong export growth by 1999, the pressure on the yuan will mount.

Another factor that needs to be taken into account is the trade policy response to the Asian crisis in North America and Europe. So far, strong growth in these regions, especially in North America, seems to have kept protectionism under control. The real test will come when export growth in Asian developing economies fully recovers. The pressure on the US and EU markets will be even greater if Japan's economy has not begun reform.

China needs much more broadly based policies to deal with the slow down of export growth. To formulate such policies, it is useful to reflect upon how China has managed rapid export growth in the past few years.

Since the unification of the dual exchange rates at the beginning of 1994, China's exports have grown strongly despite considerable appreciation of the yuan. There are four possible explanations. Processing trade constitutes a large part of Chinese exports. Processing exports tend to be affected by yuan appreciation to a much lesser extent than other exports as the domestic component of their inputs is small. The domestic inputs are largely labour costs and overheads. It is possible that wages in the export sectors are flexible as an increasing share of Chinese exports are undertaken by non-state sectors. In the wake of the Asian crisis, firms with foreign investment, which, together with township enterprises, are largely responsible for processing trade, continue to outperform state enterprises (Table 5). Strong productivity growth in the non-state sector has also offset part of the effect of yuan appreciation. Finally, considerable domestic reform and trade liberalisation have reduced the costs of export production.

Table 5 **Growth of trade by firm type, first quarter 1998** (per cent)

Firm type	Exports	Imports
Foreign	18.4	6.0
SOEs	7.8	-2.0

Source: China State Administration of Customs (as quoted by *China News Digest*, 13 April 1998)

If this analysis is correct, continuous export growth will have to continue to rely on these factors if the yuan exchange rate remains unchanged, as pledged by the government. With slowing down of growth in Japan and other Asian economies, these factors may not enable China to maintain strong export growth. The devaluation of the yuan may simply become necessary. In the current circumstances, it is politically difficult to contemplate the devaluation of the yuan. The economic benefits of doing so is not clear either, given its repercussion in the Asian region. If China's devaluation triggers another round of depreciation of other Asian currencies, then devaluation is self-defeating. On the other hand, if China can manage to maintain reasonable export growth in the short run through continuous reform, this will give it a breathing period and devaluation can come later when necessary and when the rest of Asia stabilises.

Conclusion

To summarise, the impact of the Asian crisis on China is far from over. Export growth will be weak for some time to come. However, the value of the yuan can be maintained in the short run. While some short-term policy incentives may help export growth, the key to maintaining yuan exchange rate stability in the longer run is to reform China's SOEs and banks. The efficiency gains arising from the reform and the confidence in the economy resulting from the reform is critical for sustained economic growth in the future.

Appendix

The Finger-Kreinin similarity index:

$$I^{AB} = \sum_i \min(S_i^A, S_i^B)$$

Where S_i^A is the *percentage share* of commodity i in country A 's exports, and S_i^B is the *percentage share* of commodity i in country B 's exports.

Clearly,

$$0 \leq I^{AB} \leq 100$$

Example

Product	Country A's exports		Country B's exports	
	<u>Value (\$)</u>	<u>Share (%)</u>	<u>Value (\$)</u>	<u>Share (%)</u>
1	\$100	10	\$400	50
2	\$900	90	\$400	50
Total	\$1000	100	\$800	100

$$I^{AB} = \min(10,50) + \min(90,50) = 60$$

Reference

Finger, J.M. and Kreinin, M.E., 1979. 'A measure of 'export similarity' and its possible uses', *The Economic Journal*, 89 (December):905–12.