A Soft Landing: China and the Asian Financial Crisis

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On July 2, 1997, the Thai Central Bank made a public announcement concerning the devaluation of their currency. Within a few short months, a combination of anxieties produced a full-fledged financial panic that spread to Indonesia, Malaysia, the Philippines, and South Korea, evolving into what became known as the Asian Financial Crisis. Within the first year of the crisis, the respective currencies in each of these five countries depreciated by 35-80 percent, and the long term effects of the loss of wealth are still being felt today.[1] In contrast to these five major economies, China was the only major country that was relatively unaffected by the crisis.[2] In fact, China continued to grow throughout the crisis with an economic growth of 8.8 percent in 1997, and 7.0 percent in 1998. The value of the renminbi relative to the United States dollar remained unchanged.[3] China was able to avoid the brunt of the 1997 Asian Financial Crisis and maintain a high rate of growth while the economic systems of the other countries fell apart because of its overall economic resiliency to external factors. This resiliency stemmed from the fact that China was resistant to the initial shock in the market and that its economy had already achieved a "soft landing" before the crisis.

Economic crises are usually characterized by a sudden change or shock in the market that creates mass panic, soaring interest rates and inflation, and currency devaluation. What separates countries that weather financial crises well from those that fall apart is their ability to resist the initial shock. There were four major factors at work in China in 1997 that effectively insulated their economy from the initial shock that destabilized

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[1] Karl Jackson, "Introduction: The Roots of the Crisis," in *Asian Contagion,* ed. Karl Jackson (Boulder: Westview Press, 1999), 1.

[2] Zhao Yanyun and Li Jingping. "China: A Giant with an Achilles Heel?" in *The Causes and Impact of the Asian Financial Crisis,* ed. Tran Van Hoa and Charles Harvie (New York: St. Martin's Press, INC, 2000), 141.

[3] Nicholas Lardy, "China and the Asian Financial Contagion," in *Asian Contagion,* ed. Karl Jackson (Boulder: Westview Press, 1999), 83.

a significant portion of the continent. First, China's currency was not convertible for capital account transactions. This meant that government regulations prevented people from converting their renminbi deposits into various foreign currencies, and then using them to purchase foreign assets. In order to purchase foreign exchange, buyers had to demonstrate "need related to trade, tourism, repatriation of profits derived from a prior direct investment, or repayment of a previously approved foreign currency loan."[4] If speculators could not rush in and out of China with "hot money," they could not profit off of devaluation of Chinese currency through methods such as short selling. This was significant to economic stabilization in the face of a market shock because it prevented a massive speculative run on the renminbi caused by lack of confidence in China's economy.[5] Other Southeast Asian markets did not have regulations to prevent this, and in 1997, the initial devaluation of currencies in Thailand, Indonesia, Malaysia, and South Korea caused foreign portfolio managers to rush out of the markets and trade that country's currency for dollars.
This rush contributed significantly to the plummeting of currency values in those countries.[6]

The second major factor in China's resistance to the initial shock in the market was that China's capital inflows were mostly foreign direct investments. This was because China had limited foreign participation in their stock market in shares that were dominated by foreign currency. These limitations forced foreign investors to invest mostly in physical investments such as factories and equipment instead of simply depositing money in an account.[7] These types of investments are harder to liquidate, and in general are less volatile because once companies have a direct investment they have more of an incentive to actually take advantage of the resources, establish market shares, and focus on more long term goals. For example, shortly before the Asian Financial Crisis, the American automobile corporation Ford Motors started a joint venture with China's Jiangling Motors Corporation; it was China's first attempt to expand beyond Europe.[8] Shortly thereafter, the Asian Financial Crisis threatened

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[4] Lardy, "China and the Asian Financial Contagion," 91
[5] Jeffrey Sachs and Wing Thye Woo. "Understanding the Asian Financial Crisis," in *The Asian Financial Crisis: Lessons for a Resilient Asia,* ed. Wing Thye Woo, Jeffrey Sachs, & Klaus Schwab (Cambridge: The MIT Press, 2000), 29.
[6] Lardy, "China and the Asian Financial Contagion," 91.
[7] Sachs & Woo, "Understanding the Asian Financial Crisis," 29.

the operation, but an article published in December of 1998 declared, "Ford Undaunted by Economic Crisis in Asia," and the vice-chairman of Ford was quoted saying, "we at Ford are looking beyond the short-term challenges by taking a long-term view to growing our business."[9] Ford Motors had made multiple direct investments into China in order to start this venture, mainly a $300 million factory, and were in a position where they would face huge losses if they pulled out of Asia.[10] So they stayed, and many other major corporations in the same situation ultimately made the same choice, giving China's economy the ability resist the initial shock.

The third factor in China's resistance to the initial shock was that over 80% of China's foreign debt had a long maturity.[11] This was because China borrowed mostly from international organizations and foreign governments, whose investment horizons were more long-term than the typical businessperson's. This became especially important during the summer of 1997. Long term investors viewed the market shock as temporary, and therefore did not pull out all of their funds during the crisis because they believed that the economy would recover in the long run.[12] Surprisingly, in spite of the crisis, foreign capital continued to pour into China during 1997, albeit at a decelerating rate. According to Ligang Song, "total foreign capital utilization reached $US62 billion for the whole year, up 13% over 1996… US$43 billion was foreign direct investment."[13] This continued willingness of investors to put their money into China

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[8] "Ford Celebrates Production of 7 Millionth Transit Van; Tough, Versatile Workhorse to Be Sold in 118 Global Markets." *Ford Motor Company: News Center.* June 20, 2013 http://corporate.ford.com/news-center/press-releases-detail/pr-ford-celebrates-production-of-7-38177, (accessed November 10, 2013).

[9] Tsukasa Furukawa, "Ford Undaunted by Economic Crisis in Asia" *American Metal Market* 106, no. 233 (1998): 6, http://trove.nla.gov.au/work/98834482?q=%22Jiangling+Motors%22&sortby=dateAsc&c=article&versionId=112197300 (accessed November 10, 2013).

[10] "Jiangling Motors venture is planned for Nanchang." *The Wall Street Journal Western Edition.* April 12, 1996 http://trove.nla.gov.au/work/102358503?q=%22Jiangling+Motors%22&sortby=dateAsc&c=article&versionId=115741899, (accessed November 10, 2013).

[11] Ligang Song, "China," in *East Asia in Crisis: From Being a Miracle to Needing One?* ed. Ross McLeod and Ross Garnaut (New York: Routledge, 1998), 106.

[12] Yanyun & Jingping, "China: A Giant with an Achilles Heel?" 145.

[13] Song, "China," 106.

during the crisis further increased China's economic stability, and served as a testament to international opinion that China would recover.

Another problem that the Chinese were able to avoid because of long-term debt was the issue of defaulting on major loans because lenders were not willing to roll-over the debt. Countries that were hit hardest by the financial crisis, such as South Korea, where 60% of the debt was short-term, were often pushed further down the path towards recession by lenders who refused to grant extensions on debt payments, forcing the country to default.[14] China did have some short-term debt, but it was a significantly smaller portion of their overall debt. The Chinese government was able to cover the loans that had to be paid off without seriously damaging the economy. Thus, the time factor of the debt that China did have increased their economic stability, and bought them the time that they needed to react to the crisis.

The fourth major factor that enabled China to resist the initial shock of the Asian Financial Crisis was that they had experienced a record trade surplus in the mid-1990s. This surplus led to the development of a federal reserve of about US$140 billion by the end of 1997.[15] This was significant because China was not dependent on continued capital inflows to finance its trade deficit, and was able to smooth over those imbalances and stabilize the domestic economy in the face of the initial shock.[16] China was then able to take advantage of the devaluation of other South East Asian currencies by importing goods at a lower price from the countries affected.[17] These lower prices decreased their production costs and increased their profit from exports. Thus, Chinese exports increased by 13.2% during the first quarter of 1998 because, even as Asian countries were buying less, China was able to expand its trade to other continents.[18] Therefore, China's large Federal Reserve enabled the Chinese to stabilize their domestic economy by allowing them to continue to spend money, and even started a cycle of continued economic success that allowed them to maintain that federal reserve throughout the financial crisis.

The nature of China's currency and foreign debt, in addition to a large federal reserve, enabled the Chinese economy to resist the initial shock in the market during the summer of 1997. This was ultimately critical to China's long-term economic resiliency and their success at avoiding the brunt of the Asian Financial Crisis because China was able to

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[14] Lardy, "China and the Asian Financial Contagion,"92.
[15] Song, "China," 105.
[16] Lardy, "China and the Asian Financial Contagion," 92.
[17] Yanyun & Jingping, "China: A Giant with an Achilles Heel?" 143.
[18] Song, "China," 116.

maintain foreign and domestic consumer confidence. Continuing consumer confidence allowed for the continuation of international trade throughout the crisis.

The other major reason that China was resilient enough to avoid the brunt of the crisis was because the Chinese economy had already achieved a "soft landing" before the crisis started. The term "soft landing" refers to an economy attempting to avoid a recession by shifting from rapid growth to slow growth over a period of time. China's leadership decided to take aggressive preemptive actions to achieve this soft landing because they had learned important lessons from the collapse of the Soviet Union, and because the situation in China allowed Chinese leadership to take necessary actions.

In December of 1991, China had watched along with the rest of the world as the Soviet Union was divided into fifteen separate countries. China learned important lessons from the collapse because there were important parallels between China and the Soviet Union in terms of both political and economic policies, and because the collapse of the Soviet Union drew China's attention to the flaws within their own political and economic systems.

Chinese leadership learned several key lessons from the Soviet Union and made unpopular financial decisions because they understood them to be necessary. The first lesson was that efficiency is critical to the success of a government. The Chinese concluded that a combination of excessive bureaucracy and ideological dogmatism caused the economic stagnation of the Soviet Union in the years leading up to its collapse. Soviet bureaucrats were more focused on theory than on being responsive to the needs of their people, and this lack of focus prevented the Soviet leadership from making the reforms necessary for their economic survival.[19]

In response, the Chinese government emphasized the increased need for efficiency between 1993 and1997 by denying "loss-making state- owned enterprises their accustomed allotments of credit, in order to force them to improve their efficiency."[20] In 1995, the State Council initiated a policy that focused on closing down loss-making state owned enterprises, and over the next few years the number of state owned and controlled

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[19]Christopher Marsh. *Unparalleled Reforms: China's Rise, Russia's Fall, and the Interdependence of Transition* (Lanham: Lexington Books, 2005), 112.
[20] Sachs & Woo, "Understanding the Asian Financial Crisis," 28.

enterprises fell by two-thirds.[21] This process of letting small enterprises that were not making a profit simply fail increased the incentives of those enterprises to maximize their efficiency and profits. In turn, this increase in efficiency enabled the Chinese economy to move towards a soft landing.

The other major change in monetary policy that the Chinese made was the devaluation of their currency in 1994. In the months before the collapse of the Soviet Union a lot of emphasis was placed on the devaluation of the ruble by massive percentages that threatened to, and ultimately did, destabilize the country. Two newspaper articles from 1989 and 1990 respectively, "Kremlin Plans to Sharply Devalue Its Currency: The ruble will lose 90% of its value in some transactions" and "Gorbachev Orders Ruble Devalued by 69%," strongly emphasized the negative effects of currency devaluation. [22] However, what Chinese leadership realized was that the devaluation itself was not harmful, "the real damage came from the depletion of foreign exchange reserves while trying to defend an overvalued currency."[23] So, instead of maintaining an overvalued currency for as long as possible, China's leadership elected to allow the currency to weaken before they spent their entire federal reserve, and lost international and domestic confidence, by trying to maintain the existing exchange rate. This decision allowed China to control inflation while still maintaining a small level of growth, a soft landing.

Chinese leaders were able to make the important changes that they recognized as necessary because China's central bank was powerful enough to be insulated from social and political forces, and because the government was powerful enough to propose reforms without endangering the regime. [24] China's leadership recognized the importance of insulating their major financial institutions from the whims of social and political

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[21] Xu Yi-chong, *The Political Economy of State-owned Enterprises in China and India* (Hampshire: Palgrave Macmillan, 2012), 5.

[22] Michael Parks, "Kremlin Plans to Sharply Devalue Its Currency: Soviet Union: The Ruble Will Lose 90% of Its Value in Some Transactions. Officials Hope to Curb the Black Market in Money." *Los Angeles Times*. October 26, 1989, http://articles.latimes.com/1989-10-26/news/mn-855_1_soviet-union (accessed November 7, 2013); Michael Parks, "Gorbachev Orders Ruble Devalued By 69%: Economy: He Acts to Force Soviet Industry to Become More Productive and to Squeeze State Subsidies from Prices." *Los Angeles Times*, October 27, 1990, http://articles.latimes.com/1990-10-27/news/mn-2885_1_soviet-union (accessed November, 7 2013).

[23] Sachs & Woo, "Understanding the Asian Financial Crisis," 18.

[24] Gregory Noble and John Ravenhill. "Causes and Consequences of the Asian Financial Crisis," in *The Asian Financial Crisis,* ed. Gregory Noble and John Ravenhill (Cambridge: Cambridge University Press, 2000), 11.

forces. This allowed the central bank to make important financial and regulatory reforms such as controlling investment on state owned enterprises and the devaluation of currency without having to answer to the people who were negatively affected. The ability to put the long term interests of the country above the immediate interests of the people was critical to China's making the necessary reforms.

In order for China's leadership to propose controversial reforms, they had to feel confident enough in their own power that they could withstand some public disapproval. China's government felt safe proposing controversial reforms because since political leadership within the Chinese state were also the leaders of the party, China had more centralized leadership than they had experienced prior to the 1990s. Other countries were unable to make these important reforms because "their content threatened the regime's very existence" so that they were politically immobilized.[25]

Ultimately, these important reforms specifically targeted the inflation rate through tight credit policies, and allowed the Chinese economy to achieve a soft landing before the crisis. This was critical to China's ability to avoid the brunt of the 1997 Asian Financial Crisis because it stabilized the renminbi currency and reduced the risk of asset bubbles. The burst of real estate and stock market asset bubbles was a primary trigger for the currency devaluation and recession of other Asian countries during the crisis, most notably in Thailand and South Korea.[26] Thus, the combination of China's monetary and fiscal circumstances, which enabled them to resist the initial shock in the market, and the preemptive actions taken by leaders who were able to learn and implement important lessons learned from the collapse of the Soviet Union, enabled China to have strong economic resiliency in the face of an external factors. And that resiliency was the key to avoiding the economic hardship of the financial crisis in Asia.

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[25] Jackson, "Introduction: The Roots of the Crisis," 11.

[26] Michael R. King, "Who Triggered the Asian Financial Crisis?" *Review of International Political Economy* 8, no. 3 (Autumn 2001): 453.