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APPROVED FOR RELEASE
DATE: 11-30-2009

24 December 1997

Assessing the Potential Impact of the Asian Financial Turmoil on China

China so far has been relatively unscathed by the East Asian financial crisis. Beijing's tight controls on capital flows, strong balance of payments, and the relatively small size of domestic stock markets have sharply limited damage in the near term:

- China's export growth has gradually slowed since mid-year, but this is mainly a base effect; exports accelerated in the second half of 1996. China's trade surplus in the first ten months of 1997 was over $35 billion and the Chinese *yuan* is still under pressure to appreciate.

- China's stock markets have dropped about 5 percent since October, but this was primarily caused by Beijing's decision to accelerate new stock issues, rather than any contagion from other East Asian bourses. [redacted]

During the next two years, however, slower growth in the region and the many currency devaluations of competitors will hurt China's export performance. [redacted]

Weaker export performance will complicate Beijing's efforts to address existing structural problems. Many Chinese industries are operating at less than 50 percent capacity, and declining prices for industrial goods have depressed profits. In addition, urban unemployment has risen sharply--unofficial estimates cited in Chinese press suggest it may be over 10 percent--and there have been increasing numbers of labor disturbances over unpaid wages. [redacted]

Moreover, Beijing's ability to compensate for slower export growth by stimulating domestic investment may be constrained by its reform goals:

- Vice Premier Zhu Rongji--the main driver of China's economic policy--has staked his political future on a promise to make most large and medium-sized state firms profitable by 2000, and has stressed limiting bad investments as a key method to achieve this goal.

[redacted]

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- Zhu also has set a goal of reducing the share of state bank loans that are nonperforming by two percentage points annually, and Chinese bankers are under substantial pressure to avoid new bad loans. Most Chinese banks are having difficulty finding qualified borrowers, according to press reports, and therefore are lending far less than their credit quotas. [redacted]

China's slowing growth and massive structural problems have led to speculation in the international press that China will follow the lead of its East Asian competitors and devalue its currency. Zhu and other senior officials, however, have strongly denied that China will devalue, according to Western press reports:

- The government's tight controls on capital flows and strong balance of payments position make such claims more credible than similar statements made by other East Asian governments before they devalued.

- Moreover, China in the past has absorbed blows to export performance without incurring substantially slower GDP growth, such as last year when export growth dropped to 2 percent. [redacted]

Nevertheless, should China's balance of payments position markedly deteriorate, economic growth slow, and unemployment rise to destabilizing levels, Chinese policymakers may reconsider a devaluation. Such a move probably would set off another round of competitive devaluations in Southeast Asia, and could well force other emerging market economies such as Brazil to follow suit:

- This could prolong slower growth in emerging market economies for several years, extend deflationary pressures to industrialized economies, and yield a substantial drop in world GDP growth.

- We judge that a large sudden devaluation by China within the next year is of low probability. Nevertheless, we cannot rule it out because of the potential for increasing labor unrest, political tensions, or financial instability as Beijing implements its ambitious economic reform program. [redacted]