Title: Weak Banks, Bad Debts and Failing SOEs: Why China Survived the Asian Financial Crisis?

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Abstract: The Chinese economy shows a remarkable resemblance to those of pre-crisis Thailand, Indonesia, South Korea and Malaysia—especially the asset bubbles, high reliance on banking intermediation, poor prudential supervision, and fragility of the financial system. Yet, China defied the common prediction and did not succumb to the financial crisis. This study address this complex question, besides elaborating the reform measures China must implement to immune itself from future financial crises or its contagion effects.

*Key Words***:** China; Asian financial crises; banking sector, SOEs: international financial system.

When the financial crisis unexpectedly hit the high-performing East and Southeast Asian economies in mid-1997, it was widely believed that the People Republic of China (PRC) would be the next domino to fall. China's extensive intra-regional trade and investment linkages with the rest of Asia, and the fact that the Chinese economy suffers from many of the same debilitating structural problems that long plagued (and ultimately did incalculable damage) to Republic of Korea (South Korea), Thailand , Malaysia and Indonesia—namely, fragile bank-dominated financial system, poor prudential surveillance and weak central bank regulation and supervision of commercial banks, a large buildup of non-performing loans due in part to excessive lending to inefficient, over-leveraged state enterprises and a largely state-owned financial sector that may be almost insolvent—led many observers to conclude that the contagion's virulent spread to China was imminent.

However, the middle-kingdom beat the odds. Although the Asian flu effected China on both its external trade account and external capital account, nevertheless, like the Great Wall, China not only remained conspicuously insulated from the region-wide financial meltdown of unprecedented severity, the mighty dynamo fueling its economy missed only a few beats during the crisis and since. China's ability to sustain a strong gross domestic product

(GDP) growth performance of 8.8% in 1997 and 7.8% in 1998 and over 8.0% in 1999, continued success in attracting foreign direct investment (FDI) and in running healthy current account surpluses (roughly 3% in 1998-1999), and maintaining the stability of its currency devaluations and precipitous asset price deflation elsewhere in the region and beyond, is simply miraculous. In a region where China's intentions are viewed with much suspicion, the PRC's handling of the crisis has earned it many plaudits. Chuan Leekpai, the Prime Minister of Thailand has, on more than one occasion publicly thanked China for maintaining the value of the *renminbi* and for contributing US$1 billion to the IMF package for Thailand, Similarly, Singapore's minister for information, the indefatigable George Yeo, while accusing Japan for abdicating its global responsibilities, noted that the determination of the Chinese government not to devalue the *renminbi* in order not to destabilize Asia further will long be remembered (Kelley, 1998)

How has China responded to the Asian financial crisis? Why has China come through such a severe region-wide economic contraction relatively unscathed? What explains the resilience of the Chinese economy, and can the PRC continue to remain insulated from the uncertainty that still pervades the region and beyond? What lessons can be learned from China's experience? And, what policy measures must China implement to further insulate itself form the seemingly unpredictable (and volatile) international financial and currency market. The following section discusses these interrelated issues. The core argument is that China's handling of the crisis, in particular, the country's ability to withstand the crisis, must be understood within the context of its domestic political economy. While it was arguably in China's interest not to devalue the RMB during the height of crisis, there are forces at work with the economy that may force China to rethink the strategy in the future.