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Notes from Meeting with State Counsellor (Mr. Zhang Jinfu)

(Tuesday, Nov. 4, 1986)

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We gave sessions over 5 days and 25 workshops. We did not answer the question of how much external debt; nor allocation. We have little expertise and those are complicated problems. We, instead, made a few basic points:

- First, we took the view that those who borrow have the potential opportunity for substantial economic growth -- if used wisely.
- But, when you borrow you put a great burden on future generations.
- Third, with external borrowing, the world knows your mistakes because of debt service payments.

Some recommendations in that context:

- (1) No matter who borrows, China is responsible.
- (2) Therefore central government should do a few things:

-- Set up monitoring system to know who is borrowing and exactly how much.

-- China should become a borrower in its own name.

(3) Government itself may consider:

-- advising outside world of borrowing plans for future year or two.

Q. & A. on Borrowing Strategy:

-- You should do it in substantial size and publicly.

-- Tell the market you are borrowing to build up liquidity.

-- Announce that the government has control over other borrowers, in terms of exchange risk and volume. We would even urge disclosure of a borrowing plan or program -- public/silent; fixed/floating; short/long; techniques to hedge currency exposure.

(4) One or two controversial matters on which we take no view but we want to share with you the view of the marketplace.

-- The first one, of course, is outstanding debt from previous regime. We are advised that Bank of England would like it to be resolved or have discussions begin. They do not view it as important issue but the need to assure financial markets that discussions have begun. In fact, recent U.S. court cases indicate that China today has no obligation. If discussions begin China will be able to have substantial access to one of the largest markets in the world -- Euromarket.

Market right now is not one where China would be likely to borrow in U.S. (Others also do not -- examples.) That is not a problem. But Euromarket should be available.

-- The other matter is Chinese borrowing in Yen. Not clear that exchange risk was carefully evaluated. That, too, must be coordinated at central level. (Reiterate point: volume and exchange risk need central control.)

-- The final point to make is that you need a borrowing plan that is flexible and diverse. There will be problems -- high interest rates, protectionism, political, unstable markets, currencies that devalue. All of which will make it difficult to fill the trade gap (with the capital). Therefore, we conclude by saying China should be flexible, use strength to build up liquidity now, etc.

Staff remarks:

(1) Need for central planning of borrowing and resolution of Bank of England issue.

(2) We draw on our own experience. Flexibility. Open markets before you need them. Also, liquidity. We stress maintaining and strengthening China's reputation in capital markets -- coordinated and consistent approach.

(3) As a relatively new borrower, China has a tremendous opportunity to establish itself as a borrower. For that, you will need an investment strategy. Feedback directly from investors will help China price and place its offerings. Direct involvement with end investor.

EHR: To do all of this, China must have staff and people like for engineers, etc. You need to fill your savings gaps outside.

Response of State Counsellor:

This seminar is not only academic. It is an occasion where you have offered us a lot of valuable suggestions which are in conformity with us. Colleagues have received a lot of help. We will do research and study on all your suggestions in order to improve our work. As Lim knows, our leaders, our Premier, find suggestions to the point and therefore valuable to us. You see in the past, all our doors were closed. Only since 1979 have we absorbed foreign capital. Therefore, we lack experience and personnel. In the past, we had three principles to guide borrowing capability to borrow; wise or good use; and ability to repay. In the past, we thought availability was not the problem. So we put emphasis on use. And found out sometimes it was unwise and we tried to correct that. But now you say it takes time and work to be able to borrow -- we have learned that. You have also mentioned that now is the time to borrow. And that has also occurred to us.

On outstanding debts of previous government: As you know, the old China was semi-colonial and semi-feudal. People were oppressed by so-called 3 mountains: feudalism, colonialism, imperialism. Therefore, we did not recognize the debts. Not question of old or new debts, but money used for wars against the people where a lot of people died. Under previous governments, the uses of funds were to buy weapons and guns and kill Chinese people. In various communiques, the establishment of diplomatic relations between U.S. and China, it has been stated that Chinese government recognized official debt. But on private debt, it remained as a problem and we paid attention to the solution of the problem. For instance, an electric power plant in Shanghai is a fixed

asset problem. After the Korean war, there were frozen assets. So Chou told Nixon we should have package solution. The problem was solved in 1979 when Mr. Zhang was finance minister and visited the U.S. And this was a satisfactory solution. There are still individuals who will raise problems. But USG can't raise it because problem is resolved.

Of course, we've taken notice of problem with Bank of England. We have had one discussion and early next month we will have another discussion.

Now Questions:

(1) Trends in international financial markets interest us. Trends in exchange rate between Yen and US\$. Especially revaluation question since Japan is largest counterpart and largest trade partner.

Answer:

Great risks in borrowing Yen. In 10-year period, Yen could revalue or devalue by 50%. In other words, great volatility. But we cannot predict. A wise borrower should protect against uncertainty. Matching assets and protection against adversity. Two examples: Bank of China could hold matching Yen reserves. New financial instruments to buy insurance.

(2) Surplus of capital in Japan. Japanese have bought securities in U.S. and made fixed investments. What is the trend for investing their surplus?

A: Japanese surplus is likely to continue. Therefore, they can export capital in Yen or other currencies. They have lost large sums in dollar devaluation. What China may wish to do is borrow increased amounts of dollars from Japan. If USG can finance deficit in Japan perhaps China can do this also in dollars. The problem is that Japan's purchase of USG bonds has not been profitable so they may have no appetite. That is what I mean by planning ahead. You should have borrowed dollars in Japan 18 months ago when your reserves were \$20 billion. That strategic decision cannot be made by Shanghai and CITIC; it must be made by China.

(3) Relationship of HK\$ and US\$. They are tied and devaluation caused chaos. Japanese view, etc.

A: In my view, should not rely on any fixed relationship between HK\$ and US\$ -- totally unreliable. Hongkong dollar is an artificial currency subject to political movements. Since those movements are unpredictable, you cannot predict the relationship.

(4) Evaluation of policy of linking HK\$ to US\$. And its impact. Japanese think it was a good move.

A: I don't know. We have spent very little time evaluating the Hongkong dollar. We have little expertise on the question. We know that HK is not a major supplier of funds, even to China. Funds pass through HK . It is not a source of wealth, but an intermediary.

HK is important. So is Leichtenstein. So is Switzerland.

Discussion: HK\$ vs. US\$. Euro vs. US Domestic.

EHR explains reasons for staying out of U.S.:

- a) disclosure requirements
- b) political resistance from investors
- c) very few governments have been able to borrow in U.S. (because of credit issues).

Examples.

Final question on training personnel. China would like to send students to WB and to other banks.

Answer: We would be delighted. Students should study Finance . After the study, we could help place them in N.Y./London/Tokyo, etc. And then come to

the Bank. If you could do this for 3 years with 25-30 men and women, you could have more expertise than almost any sovereign borrower in the world.