One of the striking, as well as neglected, aspects of the recent financial turmoil in Asia is the sharply different impact it has had on the three China domains: China Mainland, China Hong Kong, and China Taiwan (the latter, incidentally, is the formal name under which Taiwan registers as a member of APEC). Taiwan, despite its open markets, has maintained a remarkable degree of financial stability in the midst of the region’s turbulence. Hong Kong, notwithstanding its open markets and a monetary system pegged to the U.S. dollar, has been acutely volatile. China Mainland, by contrast, has displayed evident stability by restricted access to and exit from its capital markets.

So striking are the contrasts that it may be timely to replace the standard “one China, two systems” mantra with “one China, three systems,” instead! Taiwan’s notable ability to reconcile economic openness with financial stability may also provide some experience that should be useful to China Mainland as it charts its economic directions for the future.

Several salient financial indicators highlight the contrast among the three systems. On a year-over-year basis, in their respective own-currencies, Hong Kong’s stock index showed a decline in market value of 25 percent, while China’s restricted Shanghai and Shenzhen indexes (“restricted” in both access to and exit by foreign capital, as a result of regulatory controls as well as non-convertibility of renminbi

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capital assets), showed gains of about 30 percent, and Taiwan’s open market showed a gain of 11 percent.

The rise and fall of Hong Kong’s Hang Seng index in 1997 has been heavily influenced by the so-called “Red Chip” stocks—Hong Kong companies with headquarters in the Mainland or close links to Mainland entities such as the CITIC (China International Trust and Investment Corporation) conglomerates whose parent company in Beijing is a state-owned entity. Prior to Hong Kong’s formal reversion to China on July 1, 1997, these Red Chips sparked a bull market based on expectations that they’d receive both capital infusions and preferential market access from Beijing. The Hong Kong financial market reversed course following the transfer of sovereignty, when the magnitude and pace of support from China Mainland turned out to be less than the bulls had expected.

In considerable measure, the instability of Hong Kong’s financial market has been due to the presumed, although perhaps exaggerated, influence on the Hong Kong economy exerted, or expected to be exerted, by Beijing.

Taiwan, by contrast, has been relatively insulated from and unaffected by both the pre-reversion Hong Kong “bubble” (especially in real estate and equity markets), and its post-reversion bursting. Of course, Taiwan is and will be significantly influenced by developments both in China and Hong Kong, as well as in the Asian region more generally. Nevertheless the fact that Taiwan has been obliged (in part for political reasons) to maintain a degree of economic distance from its Asian neighbors, and to develop other trade and capital markets as well, has ironically redounded to its advantage in the midst of the region’s recent financial turmoil.

Another indicator of the difference and distance between Taiwan’s economic system, and those of China Mainland and Hong Kong, is provided by the contrasting behavior of their respective foreign exchange reserves, current account balances, and exchange rates.

Between 1996 and 1997, China’s foreign reserves swelled by nearly 40 percent (to $132 billion), those of Hong Kong rose by 55 percent (to $85 billion), while Taiwan’s reserves rose only 2 percent (to $88 billion). (China, Taiwan, and Hong Kong ranked in that order, after
Japan, as the largest holders of foreign reserves in the world economy.)

While both China and Hong Kong were boosting their reserves substantially, Taiwan was using its current account surplus to make direct investments outside as well as inside the Asian regions.

The current account balances of the three domains also show different patterns: Hong Kong’s current account was in deficit by about $3 billion, while the current account balances of China and Taiwan showed surpluses of $7.2 billion and $9.7 billion, respectively. In the same period, Hong Kong’s exchange rate, firmly pegged to the U.S. dollar through its monetary board, remained stable, that of Taiwan depreciated about 15 percent relative to the U.S. dollar, and China’s renminbi remained stable but without convertibility on capital account.

Still a further contrast is provided by the pattern of capital flows in the three instances. Long-term capital flows into China year-over-year were over $30 billion, those into Hong Kong were $32 billion, while Taiwan actually realized an outflow of nearly $8 billion, representing its foreign investments, including those in China, Hong Kong, and the United States.

Underlying and contributing to these markedly different patterns among Taiwan, China Mainland, and China Hong Kong are several other significant differences in their respective economic policies and circumstances. Again, on a year-over-year basis, in 1997 the broad money supply (M2, covering demand, savings, and time deposits) increased by 127 percent in China, 114 percent in Hong Kong, and only 10 percent in Taiwan. Inflation rates in China and Hong Kong were similar to one another, 5.2 percent and 5.5 percent respectively, while in Taiwan the consumer price index increased only six-tenths of 1 percent in the same time period.

In sum, the relative financial stability displayed thus far by Taiwan has been the result of evidently cautious macroeconomic policies, especially monetary policy, combined with the acquisition of foreign assets through long-term investments in Asia and elsewhere. By contrast, the monetary policies of both China and Hong Kong have been more expansionary under the influence of substantial inflows of foreign capital, resulting in both instances in somewhat higher in-
flationary pressures and price increases than those experienced by Taiwan.

The economic differences between Hong Kong and Taiwan are not inconsiderable, although perhaps no greater than those between the disparate members of Europe’s prospective Monetary Union. But the economic differences between China and both Hong Kong and Taiwan are much greater. For the vision of “one China” to become practicable, China’s economic system will probably have to move much closer to that of Taiwan.

Postaudit

The continued sharp diversity of economic performance among the three entities since this article was written attests to the validity of the central point. Still, the political relevance of these systemic economic differences has probably diminished.