China and the Global Financial Crisis: Assessing the Impacts and Policy Responses
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Abstract:
The paper explores the role of China in the formation of the current global financial crisis and the impacts of the crisis on its economy. It argues against the view that the “saving glut” by China (along with other Asian emerging economies) plays a significant causative role in the crisis. The global financial crisis did not cause much damage to China’s financial structure, thanks to the government controlled and relatively insulated bank-centered financial system. However, the impacts on the “real” side of the Chinese economy are hard felt. Growth and employment have been slashed due largely to the decline in exports and foreign direct investment. The crisis reveals the vulnerability of the export dependent growth pattern. Policy responses of the Chinese government, including monetary, fiscal and social policies, seem to work well in abating the downfall of the economy in the immediate term. But some of the policies did not address the structural problems of the Chinese economy and may well aggravate them over time. The paper proposes alternative policies to rebalance the economy and to sustain its growth in the longer term.

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1. Introduction

Sound economic conditions and capital account control helped China weather through the 1997-1998 Asian Financial Crisis. But whether or not China can again protect itself and recover rapidly from the current global financial crisis is still uncertain. To say the least, China’s deep involvement in the crisis demystifies the “decoupling” argument, which presupposes two independent economic spheres with Asian economies on the one end, and the US (and the advanced western European countries) on the other.

Tracing the origination of the crisis, some authors argue that global imbalances – overconsumption in the US and over-saving in China, caused the crisis. China is to be blamed because its excess saving led to persistent current account surpluses, which were in turn recycled into the US financial market, pushing down the long term real interest rate and inflating asset prices. Enticed by the low borrowing costs and the anticipated rising wealth, the US households recklessly piled up debts to finance consumption and housing investment, which eventually led to the crisis. The “saving glut” argument is widely received in the policy making circle and the academia. Fed Chairman Bernanke has coined and referred numerous times to the term - “global saving glut” to explain the US current account deficit, the decline of long-term real interest rate and the bloated housing market (Bernanke 2005, 2006, 2007). However, this view stands on very shaky theoretical and empirical grounds.

This paper argues that China hardly plays any significant causative role in the crisis; but China’s reliance on exports does place it onto a vulnerable position. China’s financial system is left
largely untouched by the crisis, but its real economy, employment and production, for example, is significantly undercut by the crisis. The global finance crisis does not generate the economic hardship; it simply aggravates China’s long-standing structural problems. The crisis reveals the unsustainability of China’s growth model.

In response to the crisis, the Chinese government has swiftly implemented a series of monetary easing, fiscal expansion and social policy reforms. Although these policies seem to successfully abate the downfall of the economy, as indicated by the recent resumption of growth; these policies are insufficient to address the structural problems in the Chinese economy. In fact, some of the structural pitfalls, such as the over-reliance on investment and exports and the deficiency of consumption, may well be exacerbated by the policies. Without amending these deficiencies, it is very dubious that China’s growth can sustain.

In what follows, we will analyze in detail three questions: what was the role of China in the origination of the crisis; how the global financial crisis has affected the Chinese economy; and to what extent Chinese government’s policy responses are effective in boosting recovery and long-term growth.

2. Global Imbalances, “Saving Glut” and China’s Role in the Financial Crisis

The most direct cause of the current global financial crisis is the US household’s overindebtedness and the ensuing fragile household financial position, which was wrecked havoc by frenetic financial innovations in the absence of government regulations. The destruction of household financial position invoked a cascade of subprime mortgage difficulties, money market freeze, securities market fallout, and eventually brought down the whole US economy.

However, it is argued that there is a deeper, root cause of the financial crisis, that is, the so-called “global imbalances”. The imbalances reflect most notably in the over consumption in the US and the over saving in China (or, the flip side of it, the persistent current account deficits in the US and surpluses in China). The argument goes as follows: China, along with other Asian developing countries, has embarked on export-led growth ever since the Asian Financial Crisis. China’s national saving in excess of investment has allowed China to net export and accumulate foreign exchange reserves, which are in turn invested in dollar assets, especially safe US treasury bills. The injection of foreign saving has pushed down the US long-term real interest rates and fueled up asset prices, to the extent that US households find the incentives to pile on debt to purchase everything ranging from houses to Chinese tires. As Bernanke (2005) puts it, “the key asset-price effects of the global saving glut appear to have occurred in the market for residential investment, as low mortgage rates have supported record levels of home construction and strong gains in housing prices”.

Bernanke’s argument finds no shortage of supporters. In a recent book, Ferguson unequivocally claims, "Chimerica [China and America]… was the underlying cause of the surge in bank lending, bond issuance and new derivative contracts … was the underlying cause of the hedge fund population explosion. It was the underlying why private equity partnerships were able to borrow money left, right and center to finance leveraged buyouts. And Chimerica – or the Asian ‘saving glut’, as Ben Bernanke called it – was the underlying reason why the US mortgage

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1 It is held that foreign exchange reserves accumulation serves both precautionary and mercantilist purposes. In other words, large foreign exchange reserves help to protect China from currency crisis on the one hand and to keep the exchange rate artificially low on the other.
market was so awash with cash in 2006 that you could get a 100 per cent mortgage with no income, no job and no assets" (Ferguson 2008, 336).

The “global saving glut” argument, however, can be attacked from theoretical and empirical fronts. Bernanke’s explanation of low long-term interest rates is clearly a loanable funds theory, and the problems with the loanable funds theory were very well explained by Keynes more than 70 years ago (Keynes 1937a, 1937b) and recently revisited by Bibow (2001) and Wray (2006). To begin with, realized saving cannot affect interest rate, because realized saving is by identity equal to the sum of realized investment and net exports in an open economy context. And the causality runs from investment and net exports to saving. As Keynes reminded us (in a closed economy scenario), “increased investment will always be accompanied by increased saving, but it can never be preceded by it. Dishoarding and credit expansion provides not an alternative to increased saving, but a necessary preparation for it. It is the parent, not the twin, of increased saving” (Keynes, 1937b, 281).

Although the evidence Bernanke has offered to support the global saving glut argument is the realized investment and saving, it is the desired saving and investment that drive real interest rate in his mind. This is also problematic. As Keynes colorfully put it, "If there is no change in the liquidity position, the public can save ex-ante and ex-post and ex-anything-else until they are blue in the face, without alleviating the problem in the least - unless, indeed, the result of their efforts is to lower the scale of activity" (Keynes, 1937b, 668). Because interest rate is a “reward for liquidity”, only changes in liquidity preference, i.e. the desire to hold liquid assets, can affect the interest rate. Changes in desired saving cannot directly change interest rate, unless it entails changes in portfolio preferences or the scale of economic activities (Bibow 2001). But even in the latter case, changes in interest rate still come from the changes in liquidity preference.

Empirically, Bernanke’s global saving glut argument erred in several aspects: first, the US net export to GDP ratio decreased ostensibly since 2001, right after the US lowered the Fed Funds Rate and increased government deficit spending to stimulate the economy. On the other hand, the Chinese net export did not register a significant increase until 2003 (see Figure 1). If Bernanke were right, we should have seen a much earlier surge in China’s current account surpluses. Second, as Bernanke observed, the reduction in the long-term real interest rates was not restricted in the US but occurred in many other OECD countries. Indeed, as shown in Figure 2, the 10 year benchmark government bond yield in the euro area has also trended down, even though euro area has maintained positive net exports. That is, their long term rates went down in the absence of net injections of foreign saving.

Third, it is clear that in an open economy, the following identity holds: \((S-I)+(T-G)=(X-Z)\), namely, the excess of saving in the private and government sectors must be equal to net exports in the external sector. When Bernanke (2007) argues that “the increase in the Chinese surplus can be attributed primarily to an increase in the saving rate between 2004 and 2006. The increase in China’s saving rate could, in part, be a consequence of the rapid pace of growth in the country”, he seems to suggest that the causation runs from excess saving to net exports. This is clearly problematic. Saving is a residual; it is determined by the level of income, as Bernanke also acknowledged in the second half of the above quotation. However, income is in turn generated by “exogenous” demand, be it government spending, investment or net exports. Given
that government spending did not change much in China in the past decade; it must be the growth of investment and/or net exports that drives income growth. If Bernanke were correct to say that the saving rate (i.e. the share of saving to national income) exceeds the investment rate (the share of investment to national income) (as a corollary, if the demand gap due to saving is not filled by investment), then income can continue to go only if net exports provide the demand impetus. Therefore, it is the net exports that allow China to “over” save, but not the other way around. This is significant because it means that China does not hold the string – only when the US decides to net import could China run a current account surplus, which in turn allows its income and saving to grow.

Fourth and finally, if China’s excess saving causes the US long term real interest rate to fall, this must be reflected mostly in the yield of government securities because the Chinese government invests its current account surpluses mainly in US treasury bills. This would then mean that we should see the widening spread between the yield on government securities and other fixed income assets. In fact, Bernanke himself acknowledged that but reckoned that the spread did not really fall. As illustrated in Figure 3, the spread between 10 year Treasury bond yield and Aaa corporate bond yield has narrowed since 2000 and did not widen until mid 2007 when the US economy was swirling into the recession. This suggests that the “global saving” could not explain the across-the-board declining interest rates.

In closing, although Bernanke’s global saving glut argument has sparked much academic debates and political excitement; it stands on a shaky ground. And even Bernanke (2006) admits that “reserve accumulation abroad is not the only, or even the dominant, explanation for their [US yields] recent behavior”. It requires separate research to probe into the genuine causes of the flatten yield curve despite the incipient monetary tightening in 2004; but suffice it to state here that the “global saving glut” is not the place to look into.

Although China did not create the household over-indebtedness and asset “bubbles” in the US, it did benefit from them. China was able to achieve rapid growth without having to generate sufficient domestic demand. The current global crisis, however, indicates the end to this growth model.

3. The Impacts of Global Financial Crisis on China’s Economy
The current global financial crisis has affected China’s financial and production systems. We will first look into the financial impacts then move onto the “real” impacts. The analysis below will show that the financial impacts of the financial crisis are far dwarfed by the real impacts.

3.1. Financial Impacts
3.1.1. The Banking System
Chinese banks had limited exposure to toxic assets issued by US financial institutions. Although large commercial banks all had Lehman Brothers’ securities (most of the securities were not collateral based) and hence incurred losses (see Table 1); these losses did not appear to threaten the overall health of these banks. According to Ma Delun, Vice President of the People’s Bank of China (PBoC, the central bank of China), Chinese banks’ international exposure is relatively insignificant and their holdings of subprime mortgage loans should not exceed $10 billion. This seems to be a miniscule loss for the Chinese banking system. For example, even with $151.8
million loss, it is only 0.01% of China Industrial and Commercial Bank’s assets or 1.6% of the $9.5 billion after-tax profits in the first half of 2008. The total losses on holding subprime mortgage securities of the three largest Chinese banks (Bank of China, Industrial and Commercial Bank of China and China Construction Bank) are estimated to reach $2.8 billion, which amounts to 1.08% of their total capital and 0.05% of their total assets combined (Kawai, Lamberte and Yang 2008).

Even if the loss is mild, it is possible that small external shocks may generate large ruptures if the banking system is weak and vulnerable. However, the current state of the Chinese banking system is quite healthy. The Chinese government has recapitalized and restructured the state owned commercial banks since the late 1990s with the attempt to clean up the immense non-performing loans (NPLs). As a result, the capital adequacy ratio of 192 commercial banks had exceeded 8 percent by the third quarter of 2008, up from 8 banks in 2003. The combined capital of these banks accounts for 85 percent of the total capital of all banks. The average NPL ratio of China's banking sector dropped below 5 percent in 2008 from 34 percent in 1999 (People’s Daily, October 28, 2008). Profits after tax of the Chinese banks reached 446.7 billion yuan, a 12-fold increase since 2002. The return on assets of banks in China has increased from 0.1% in 1999 to 1% in 2007/2008, comparing to 0.3% in Japan and 0.6% in the US (IMF 2004 and 2008).

However, even if direct exposure and losses are mild, some commentators worry that the drying up of liquidity of foreign banks may raise the costs of financing and funding of Chinese banks. This concern should not be overstated. Foreign banks have not played a significant role in China’s banking system. From 1998 to 2001, only 15 new foreign banking organizations established offices in China. Only after joined the WTO did foreign banks largely increase their presence in China. The number of foreign banks increased from 190 to 312 in five years after the WTO accession. But foreign banks’ operation is still restricted. A foreign institution can only own up to 20 percent of the equity of a Chinese bank, and the total ownership of foreign equity investors is restricted to 25 percent. The total assets of foreign-funded banks in China (mainland) reached $193 billion by the end of March 2008, which was a 55 percent increase from 2007. But despite this large increase, the asset of foreign-funded banks accounted for only 2.44 percent of the total assets of the banks in China. Figure 4 shows the liabilities of Chinese financial institutions to international financial institutions. It shows that the availability of international liquidity did reduce substantially in the third quarter of 2008. However, it also illustrates that international liquidity accounted for only a small proportion of the total funds of Chinese financial institutions, which decreased from 0.25 percent to 0.2 percent in the third quarter of 2008. All this indicates that although cross-border interbank markets have shrunk, it did not significantly raise the cost of funding of Chinese banks.

Unlike the liquidity crunch experienced by the US credit markets, interbank lending and private domestic credit expansion seem to function normally in China. Figure 5 presents the total loans extended by the Chinese financial institutions. It again seems “business as usual” as far as borrowing and lending activities are concerned2. Indeed, as some observers point out, the

2 Although a recent Financial Times article cites Coface, one of the world’s largest credit insurers, that banks restricted lending to export producers, who turned to their domestic suppliers for credit. Almost 90% of Chinese
exceedingly loose credit policy adopted by the PBoC has caused a surge in banks lending. Based on this view, the problem China faces is not the paucity of liquidity but the excessive supply and inefficient uses of credit, which may inundate the banks with NPLs in the near future. However, given that these big lenders are mostly state-owned commercial banks and that the central government has nearly infinite financing power, it does not seem that NPLs are a real threat to these banks.

<Figure 5 here>

3.1.2. Stock Market Rollercoaster

Compared to the relatively resilient banking system, the equity market has been more volatile and disturbing. The weak structure of the stock market makes it vulnerable to external shocks. The stock market is relatively underdeveloped and shallow. Over 70 percent of the stocks are State shares and legal person shares and hence not tradable. Changes in stock prices do not reflect the dynamics of the productive side of the economy but are largely driven by people’s expectations and their bet on government’s interventions in the market (for example, the idea that the government will not stand by and let the stock market fall was very prevalent around the time of the Beijing Olympics). Even though foreign control of the stock market is minimum, more and more Chinese corporations are listed in Hong Kong Stock Exchange and New York Stock Exchange. They are more heavily affected by the financial crisis, which in turn exerts a negative impact on domestic stock markets. Figure 6 displays the evolution of Shanghai Exchange Index (SSE), which shows a 65% decline from January to December 2008. Home economic slowdown contributed to the stock market fallout; but importantly, the endemic global stock market slumps pushed down the Chinese stock markets.

<Figure 6 here>

To calm the stock market, the Chinese government has taken several measures, including upbeat official speeches to boost confidence and reversing the increase of the stamp duty from 0.01% to 0.03% in 2007 when the stock market was booming. As China’s economy gradually recovered from the shock, stock market has appeared to be much more resilient and gradually inched up. Given the small scale and limited functions of the stock market, its fluctuations may not have a huge impact on the productive side of the economy.

3.1.3. Diminishing Reserves?

The global financial crisis has an impact on China’s foreign exchange reserves and the performance of China Investment Corporation, a sovereign investment fund founded in September 2007 with initial capital of $200 billion. China’s foreign exchange reserves had reached $2.1 trillion by June 2009. Although the Chinese government does not disclose the investments of the reserves, it is well known that a large share of the foreign exchange reserves is invested in the safe and liquid dollar assets, particularly, the US Treasury and Agency securities. As Figure 7 shows below, by June 2009, China had accumulated $776.4 billion US Treasury securities, a 45% increase from June 2008. The share of China’s holding of Treasury securities increased from 20% to 24% between January 2008 and June 2009. Moreover, China held $340

suppliers extended credit to their domestic customers on over half of their sales, up from 70% a year ago (Kwong, April 12, 2009).

The capitalization of the B share market, where foreign investors are allowed to invest in Chinese stocks, is miniscule as compared to the A share market.
billion of securities issued by the troubling Fannie Mae and Freddie Mac as of June 2008, according to Standard & Poor’s.

It is concerning that given the sizeable holdings of US dollar assets, large losses would be incurred should dollar depreciate significantly. However, the US dollar has been rising against the euro since July 2008 when the crisis started to worsen. The dollar then depreciated against the euro during December 2008 but it soon rose again. This may be explained by two factors. First, although the US has been the epicenter of the financial tsunami, it is clear that the entire world economy has been engulfed. Given the long standing status of the US dollar as the world’s reserve currency, it is unsurprising that the US dollar is still considered relatively safe compared with other currencies, especially with uncertainties regarding the euro, as Germany and France are struggling with their banking and financial disorder. Second, as the Times Magazine correctly points out, as uncertainties rising and trust evaporating, there is an acceleration of de-leveraging of dollar debt by hedge funds and non-bank financial institutions, which increases the demand for the US dollar by the rest of the world. This buttresses the value of the dollar in the short term.

Certainly, there are also forces that put downward pressure on the US dollar. For example, the decision of the Federal Reserve to purchase $300 billion longer term Treasury securities made the dollar depreciate by 2.6 percent in ten days after the release of the decision in March 2009. Moreover, the recent Chinese central banker’s high-profile essays about creating a new supranational reserve currency to replace the US dollar added extra pressure on the dollar4. However, without any practical and immediate plans to establish a new reserve currency and to re-structure the IMF, it is unlikely that the dollar will lose its status as the international reserve currency in the foreseeable future.

In any case, how to better manage and utilize the large reserves has been a heated topic in China5. Some commentators suggest that China should use its wealth to acquire strategic resources, such as oil and foodstuffs. However, with its large purchases, China may push up the prices of these strategic commodities, causing perilous consequences for the rest of the world and sabotaging China’s own profits. A more advisable solution is that China may use the wealth to purchase technologies, which are not exhaustive. Moreover, as a surplus country, China should take more effective steps to adjust the global imbalance and hence moderate the accumulation of reserves, a point we will examine in more detail later.

3.1.4. Hot Money Movements

4 There is some fear that China will opt out of the dollar in a large scale whereby depressing the dollar; however, this fear seems to be misplaced. It is obvious if China starts to dump its dollar assets and sets off a significant depreciation of the dollar, it would suffer a tremendous loss from holding the large amount of dollar assets. But more importantly, there is no easy alternative to park its reserves. It is suggested that China should diversify its reserves and increase the share of its gold reserves, given that the share of gold in official reserves is only 2 percent in China, but the share is as high as 75 percent in the US and 60 percent in Germany and France. The difficulty of stocking up gold is that the expectation of China’s large purchase of gold would simply push up the price of gold to such an extent that it is no longer a profitable investment.

5 One of the salient examples of the difficulties to manage the large amount of sovereign wealth is the failure in investment by China Investment Corporation. In June 2007, China Investment Corporation bought $3 billion worth of shares from Blackstone LP (a U.S. private equity firm) at $31 each, but the value of those shares fell to below $8 as of October 2008 (Morrison 2009).
The final aspect of financial impacts concerns hot money movements. Some commentators estimate that hot money in China exceeds $40 billion while others argue for a much larger magnitude of the hot money, ranging from $158 to $528 billion (Galbraith et al. 2007). McNally (2009) asserts that over the 18 months from early 2007 to the middle of 2008, about $386 billion “hot money” poured into China to speculate against yuan appreciation.

Although the size of “hot money” is hard to accurately measure, the abnormality in the balance of payments accounting does suggest the existence of “hot money”. Take the first two months of 2008 as an example, the trade balance and FDI inflows summed to $31 and $15 billion in January and February, respectively. But the reserves growth recorded by the PBoC was $61 and $57 billion, respectively. This means that there were $72 billion capital inflows to China in January and February combined, but the origin of the inflows was not recorded and could not be explained. The unexplained capital inflows, however, were reversed in October and November. The trade balance in the two months was $6.7 and $5.3 billion, respectively; and the FDI inflows were $35 and $40 billion, respectively. But the reserve growth was -$25.9 and $5 billion, respectively.

In other words, in these two months, a total of $108 billion capital flowed out of the country through unclear channels (another $79 billion and $11 billion unexplained outflows also occurred in January and February of 2009) (see Figure 8). Two reasons may explain the large reversal of international hot money. On the one hand, the room for yuan appreciation against the US dollar has been declining. Since June 2008, the exchange rate has been stable at the level of 6.8-6.85 yuan per dollar and speculators may no longer find buying yuan at the spot attractive. On the other hand, the de-leveraging process in the US and other European countries may force the reversal of overseas positions and cause capital repatriation.

The unusual movements of “hot money” and the potential disruptive impacts arouse the attention of policy makers. Ministry of Foreign Exchange Management points out in a recent issue of China International Balance Report in the first half of 2008 that it is very likely that China’s international balance is at a transition point. The government should strengthen the monitoring of cross-border capital movements in the second half of 2008 and improve the balance of payments. It should also work out a prevention and coping plan in case of an adverse turn in the balance of payments. Although unexplained capital inflows again reversed course since March 2009 and hence dissipated the fear of capital flight, the recent events suggest that China’s capital control is not impermeable and that more vigilant regulation and monitoring are required to ensure stable and orderly capital flows.

3.2. “Real Linkages”

The above analysis resonates with McNally’s argument (2009), “China’s financial institutions have largely escaped the global credit contagion because of capital account controls and limited exposure to global financial markets”. However, he continues, “China’s high export dependency and status as the world’s premier manufacturing platform create vulnerabilities as Americans and Europeans drastically reduce consumption”. At the current juncture, it seems that the impacts of global crisis fall mainly onto the “real” side of the Chinese economy through FDI and trade linkages.

Figure 9 shows inward FDI flows to China. It appears that inward FDI has been quite volatile, declining from $11.2 billion in January 2008 to only 5.36 as of July 2009. Not unlike FDI, China’s exports have declined on a year-to-year basis since November 2008 for 9 consecutive months, see Figure 10. Thanks to the large decline in imports, China’s trade balance has
remained positive. However, the decline in exports directly reduces aggregate demand and depresses foreign and domestic investment in the industrial sector.

China has long depended on exports to drive economic growth. As shown in Table 2, the share of net exports in GDP increased from less than zero in the 1980s to 2 percent in the 1990s, and further to a astounding 9% in 2007 and 8% in 2008. Even though the most significant driving force in China has been private investment, the share of which in GDP increased from 35 percent to over 40 percent from the 1980s to the present; the growth of net exports plays a key role in sustaining the investment growth. This is because investment and hence the expanded production capacity need to be absorbed or utilized by other forms of final demand, such as consumption, government spending or net exports. However, the share of consumption to GDP has been declining from more than 50% in the 1980s to less than 36% in 2008; and the share of government spending has remained at around 14% during the same period. Therefore, net exports have been the demand-of-last-resort that validates the growth of investment.

With the falling exports, the decline in manufacturing accelerated since September 2008. The PMI index fell from the pick of 63.1 in March 2008 to 38.8 in November 2008 before it rose sharply and returned to the above benchmark level in March 2009 (see Figure 11). It seems that despite the continuous export decline, manufacturing production has been stabilized. However, there are some concerns that the recovery of the manufacturing production is due largely to the extraordinarily expansionary policies, which will eventually level off. Without export expansion, manufacturing growth will slower or even come to a halt. Some observers also point out that aggregate profits of large Chinese enterprises declined by 37.3% in the first two months of 2009, as compared to the same period of 2008 (Anderlini and Dye, February 3, 2009) Declining profits would make further investment unattractive. Finally, given that FDI accounts for roughly 57% of industrial output, a decline in FDI would undermine industrial production. It is reported that some Asian manufacturers are faced with tight credit and obliged to cut down on their investments. Therefore, even if the PMI has passed the boom-bust benchmark for 6 consecutive months, it is still too early to claim a full recovery of manufacturing production.

In light of the falling exports, FDI and manufacturing production in the early 2009, the IMF revived downward the projected GDP growth rate in 2009 to 6.5% and the World Bank reset its projection to 7.5%. It turned out that in the first quarter of 2009, the growth rate was only 6.1%, a 4.5 percentage point reduction from the first quarter of 2008. But by April, a number of financial institutions have revised upward their projections of China’s growth. Despite the signs

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6 It is controversial whether or China relies heavily on exports. Some commentators argue that given the low domestic value-added of China’s exports and that net exports still accounts for less than 10 percent of GDP, the contribution of exports to growth should not be overstated. However, this view fails to take into account the indirect, investment-promoting effects of exports. In a recent article, Cui, Shu and Su (2009) found that the largest impact of declining exports was on corporate investment, as weakening demand compelled businesses to contract.

7 Morgan Stanley raised its forecast for Chinese GDP growth in 2009 from 5.5% to 7.0%, while Goldman Sachs increased growth forecasts from 6.0% to 8.3%. UBS has revised its forecast from 6.5% to between 7% and 7.5%. RBS’s forecast jumped from 5% to 7% and Barclays’s from 6.7% to 7.2%. On the other hand, Standard Chartered
of recovery, the lack of good news on employment is concerning. According to *South China Morning Post*, the Federation of Hong Kong Industries (which represents export-oriented factories with 10 million employed workers) recently estimated that 2.5 million Chinese workers employed by Hong Kong firms in the Pearl River Delta region could soon lose their jobs (Morrison 2009). By February 2009, job losses had deteriorated to the extent that 20 million of rural migrant workers were sent home. A CLSA survey showed that manufacturers shed jobs in January 2009 at the fastest rate since the survey began in 2004 (Anderlini and Dye, February 03, 2009). It is also reported that 147 million migrant workers had moved to urban areas for jobs by June 2009 but over 4 million had not been employed, along with 3 million college graduates who had yet to find a job (*The Sydney Morning Herald* 2009). According to the Federation of Hong Kong Industries, only one half or one-third of the previous layoffs were re-employed in the export oriented plants during the recent recovery in export manufacturing (Ibid.). Data paucity prevents a timely study of China’s employment situations; however, it seems that the fast recovering sectors have been the ones that receive large government support and these sectors tend to be capital-intensive. Therefore, unemployment still poses an immense challenge to the Chinese policy makers.

In short, the negative impacts of the global financial crisis on China’s economy are channeled mainly through trade and FDI. China’s reliance on export to generate demand and provide jobs has contributed to its rapid growth in the absence of sufficient consumption demand. However, this growth model is highly undesirable because it exposes the economy to external shocks; it is also unsustainable especially now that the US buying machine has stopped working. Indeed, a recent study (Aizenman and Jinjarek 2009) projects a substantial decline in the Chinese current account to GDP ratio to 6% by 2013, which is markedly lower than the IMF’s forecast of nearly 10%. This means that it is urgent for China to rebalance its economy and to boost domestic demand. Clearly, the Chinese government must play a lead role in the rebalancing. We will now turn to examine government’s policies.

**4. An Examination of China’s Policy Responses**

The Chinese government was praised for its swift and effective reactions to the crisis. At the beginning of 2008, the Chinese government raised bank lending rates, reserve requirement ratios and stamp duties on stock transactions to cope with inflationary pressure, stock market fever and real estate speculation. As global economic outlook turned sour, policy makers quickly undertook a series of simulative monetary, fiscal and social policies.

With regard to monetary policy, the PBoC has been cutting interest rates and funneling loans to government-backed infrastructure projects. On September 16, 2008, the PBoC announced a reduction in the benchmark interest rate for one-year yuan denominated loans by 0.27 percentage points, the first cut since October 2004. The PBoC continued to cut rates in the last four months of 2008, pushing the benchmark one-year loan rate down from 7.47 percent in September to 5.31 percent in December, with the one-year deposit rate down from 4.14 to 2.25 percent. In addition, the reserve requirement ratio was reduced by 1 percentage point in September 2008, the first cut since 2003. After three further cuts, as of December 2008, the reserve requirement ratio finally kept its 2009 GDP growth forecast at 6.8% for the uncertainty of the “rebound”, and the IMF kept the forecast at 6.5%.
reached 14% for large deposit-taking financial institutions\(^8\). These cuts helped to lower the cost of bank lending and to some extent boost credit flows.

But more importantly, answering the call of policy makers, Chinese banks lavishly gave out loans, which registered on average 1.1 trillion yuan every month in the first half of 2009. Most of the loans were invested in government-backed infrastructure (Anderlini, May 11, 2009). The surge in bank loans unquestionably contributed to the rapid recovery in investment but it also caused some anxiety about whether the money is efficiently used or it is used for speculation and wasteful projects. For example, Michael Pettis of Peking University asserts that “Somewhere between a fifth and a third of total new lending may have ended up in such things as stock market speculation, real estate speculation and even a measurable amount may be showing up in the casinos in Macau” (CNN, June 24, 2009). In contrast, Tao Wang, a UBS economist, reckons that the new money flows into the stock market and the total imports of metals amounted to only 660 billion yuan in the first half of 2009, which is less than 10% of the total new lending (and only a fraction of the 660 billion yuan can be financed by borrowing). Although a large share of lending, around 12%, went into property, it seems that this is due to the purchases by first-time home buyers instead of speculators (\textit{Economist}, August 27, 2009). In any case, the second half of 2009 saw much more moderate bank lending – total lending dropped from 1.53 trillion yuan in June to 356 billion in July and further down to 200 billion yuan and August. This may be due to government’s credit tightening or it is simply because lending usually slows down in the second half of a year.

Concerning fiscal policy, the government has moved towards handing out stimulus packages, despite some skepticism about whether or not a big stimulus is needed. A number of initiatives were announced by the government in October 2008, including an expansion of construction projects; new export tax rebates\(^8\); tax and interest rate cuts on real estate transactions; increased agriculture subsidies and new loans for small and medium-sized enterprises; and finally, elimination of taxes on interest income and dividend. The government also approved a two-trillion-yuan (US$ 292 billion) plan for the construction of a series of railway projects\(^10\). Finally, the government instituted a stimulus package, pledging to spend estimated $586 billion (2% of the GDP) by 2010 on a wide array of national infrastructure and social welfare projects, including constructing new railways, subways, airports and rebuilding communities devastated by an earthquake in southwest China in May 2008 (Barboza, November 9, 2008).

Reckoning the problems with the weak domestic consumption demand, the Chinese government strove to stimulate consumption. The government announced 2 billion yuan subsidies on trade-in cars in major cities. Small car taxes were also reduced from 10% to 5%. As a result, car sales in August increased by 82% on a yearly basis. The government also handed out 5 billion yuan subsidies on home appliances (to replace old models). Rural residents received extra subsidies of up to 5000 yuan. One last important piece of the policy is the government’s pledge of 850 billion yuan ($123 billion) spending on health care reform to provide basic universal health coverage to

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\(^8\) The PBoC pays 1.62% interest rate on required reserves and .72% on excess reserves.

\(^9\) In November 2008, the government raised the rate of value-added tax rebates for 3,770 export items. For example, the tax rebate rate on tires was increased from 5 to 9 percent, glassware 5 to 11 percent, various labor-intensive products from 11 to 13 percent, and textile and garment from 14 to 15% (later in February 2009) (\textit{China International}, Nov 18, 2008).

\(^10\) Ministry of Railways estimated that the plan would provide 1.5 million jobs. Furthermore, these projects will fuel growth in industries such as iron and steel, cement and the like (\textit{People’s Daily}, November 2, 2008).
additional 4 million Chinese by 2010 (Reuters January 22, 2009). This is deemed an important policy to reduce precautionary saving by the Chinese households.

These policies together seem to efficiently pull the economy out of recession, as suggested by the envious growth rate of 14.7% in the second quarter of 2009. However, it is important to note, much of the policy effects were still made to boost investment growth, which seems to be an expedient way to pull the economy out of recession. But investment growth cannot sustain, as mentioned above, unless it is validated by other forms of final demand. Moreover, investment growth will aggravate excess capacity, which will again force China to find ways to export its excess capacity and hence make rebalancing more difficult. Realizing these problems, many commentators have voiced the need to boost consumption in lieu of investment and export. The difficulty, however, is that consumption is very much dependent on income, income growth depends mainly on employment growth (assuming that wage growth measures up to productivity growth), and employment growth in turn largely depends on private production expansion and investment in China. In short, consumption growth requires income growth but income growth in turn necessitates consumption growth. Therefore, to escape the conundrum, the key seems to be the government’s direct job creation. Chinese government’s emphasis on investment and export and opponents’ focus on consumption both seem to miss the point; the point is to generate sufficient well-paid, stable jobs in order to sustain income and hence consumption growth.

Job creation in the services sector is particularly important. The services sector has been slow to grow and accounts still for a small share of the economy (see Figure 12). Services are highly demanded in China but undersupplied, partly due to government’s biased policies toward industry to the neglect of services. Some commentators argue for government provision of health care, education and elderly care services as a way to reduce precautionary saving and increase consumption; but the provision of these services is itself an important push for the economy. Enhancing government’s investment and job provision in the services sector not only helps to drive the economy (services jobs provide an income and the development of the services sector allow for more services consumption) but improves the standard of living of the people and reduces the pressure on the natural resources and the environment (as compared to raising consumption of goods). From this vintage point of view, the argument for reducing (government-lead or government-support) investment is misplaced; the point is that investment should be reduced for the industrial sector but elevated in the services sector.

In addition to rebalancing investment and consumption as well as industry and services, it is also important to rebalance the urban and rural development. The Chinese government has been biased toward urban development, which has led to the underdevelopment in the rural areas. Between 1999 and 2005, the proportion of rural population receiving an income of $0.50 a day increased from 1.9% to 2.8%. The ratio of per capita disposable income in the urban areas to that in the rural areas increased from 2.47 in 1997 to 3.28 in 2006, much higher than the average in other developing countries (UNDP 2008). Impoverished rural residents would mean low consumption at the aggregate level given that rural residents still account for more than 60% of the total population. In October 2009, the government announced a landmark policy that allows farmers to lease their contracted farmland or transfer their land-use rights in order to “boost the scale of operation for farm production and provide funds for them to start new businesses” (Chinese Government’s Official Web Portal, October 19, 2008). It is believed that the measure would enhance income and consumption levels in the vast rural area of the country, and thus
create more domestic demand and jobs. This policy is a step in the right direction to rebalance the economy and to enhance domestic demand, but more needs to be done. The government not only needs to implement effective policies to reduce tax burden on peasants and provide more subsidies but invest more in rural industries.

Finally, rising inequality would also mean relatively low consumption simply because the consumption propensity is lower for the rich than the poor. The Gini coefficient jumped from 0.16 before China’s market reform to 0.447 in the early 2000s and further to 0.469 in 2007 (UNDP 2008). Therefore, income, taxes and financial policies are required to reduce inequality, which would not only improve social stability but go a long way to boost consumption.

5. Conclusion

China has been increasingly relying on an export-led growth model since the Asian Financial Crisis. This has allowed it to grow rapidly without needing to generate sufficient domestic demand. China’s reliance on export did not cause the US consumption binge but rather, the US consumption binge allowed China to continue falling back on export-led growth. However, as the global financial crisis unveils, China’s real economy is vulnerable to external shocks exactly because of export dependency. As the US consumption spree was brought to an end by the crisis, the Chinese economy has no choice but to abandon the old growth model and search for a new one. Although the government’s monetary and fiscal stimulus has effectively orchestrated a fast recovery; some of the policies focusing on investment in industrial production will only aggravate excess capacity and create more problems in the longer term. What the Chinese government really needs to do is a series of rebalancing. China needs to reduce its dependency on external demand but nurture its own domestic demand. The key is not to reduce investment, but to shift investment from the industrial sector to the services sector. Moreover, the government needs to play a more active role in direct job creation, in rebalancing urban and rural development and in equalizing income distribution. Crisis breeds opportunities. It is time for China to embark on a balanced and sustainable growth pattern.

References


Figure 1: Net Exports to GDP Ratios and US Policy Changes

Sources: Federal Reserve Bank and Burea of Economic Analysis.
Figure 2: Long-Term Interest Rate and Net Export-to-GDP Ratio in Euro Area

Source: European Central Bank.

Figure 3: Spread on US Yields

Source: Federal Reserve Bank.

Table 1: Losses of Large Chinese Banks from Holding Lehman Brothers Securities

<table>
<thead>
<tr>
<th>Banks</th>
<th>Losses ($ mn)</th>
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<tbody>
<tr>
<td>China Construction Banks</td>
<td>191.4</td>
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<tr>
<td>China Industrial and Commercial Bank</td>
<td>151.8</td>
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</tbody>
</table>
China Merchants Bank 70.0
Industrial Bank Co. Ltd. 3.36
China Citic 76.0
Bank of China 75.62
China Communication Bank 70.02
Total 638.2


Figure 4: Liabilities to Foreign Financial Institutions and Ratio of Foreign Funds to total Funds of Chinese Financial Institutions, January 2007 – July 2009


Figure 5: Lending by All Financial Institutions and State-Owned Commercial Banks
Note: data on loans made by state-owned commercial banks are not available before January 2009.

Source: People’s Bank of China (2009)

Figure 6: Daily Shanghai Stock Exchange Index (Adjusted Closing Price), 09/06/2008 – 04/16/2009

Source: Shanghai Stock Exchange (2009)

Figure 7: China’s Holdings of US Treasury Securities ($ billion) and China’s Share in Total Foreign Holdings of US Treasury Securities (%), Jan 2008 – June 2009

Note: In June 2008, new benchmark survey was conducted. New series reflect new benchmark survey and estimated positions based on the old survey are shown for comparison.

Source: US Department of Treasury (2009)

Figure 8: Growth of Foreign Exchange Reserves Net of FDI Inflows and Trade Surplus, Jan. 2008 – June 2009
Figure 9: Total FDI Inflows, Jan 2008 – Jul 2009

Source: China Customs (2009)

Figure 10: Annual Growth Rate of Exports and Imports, Jan 2008 – Jul 2009

Source: China Customs (2009)

Table 2: Demand Structure of the Chinese Economy (Share of Total, %)

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<tbody>
<tr>
<td>Consumption</td>
<td>50.8</td>
<td>51.6</td>
<td>50.6</td>
<td>46.7</td>
<td>46.2</td>
<td>38.0</td>
<td>36.4</td>
<td>36.1</td>
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<tr>
<td>Gross Fixed</td>
<td>34.8</td>
<td>38.1</td>
<td>14.1</td>
<td>13.8</td>
<td>15.8</td>
<td>14.2</td>
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<td>Capital plus</td>
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<td>Changes in</td>
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<td>Inventory</td>
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<td>14.7</td>
<td>14.3</td>
<td>36.1</td>
<td>41.9</td>
<td>35.1</td>
<td>44.5</td>
<td>43.1</td>
<td>44.4</td>
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<td>Government Expenditures</td>
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<tr>
<td>Net Exports</td>
<td>0.3</td>
<td>4</td>
<td>3.5</td>
<td>1.6</td>
<td>2.4</td>
<td>7.9</td>
<td>9.1</td>
<td>8.0</td>
</tr>
</tbody>
</table>

Note: the sum of the shares does not add up to 100% due to statistical discrepancy.

Source: Asian Development Bank (2009)

Figure 11: Manufacturing PMI in China, Jan 2007 – Aug 2009

Source: IDS (2009)

Figure 12: Structure of the Chinese Economy by Sector and Sectoral Growth Rates (Lower Panel), 1990-2008
Source: Asian Development Bank (2009)