

Responding to the global storm: resilience and China's ascendancy

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It is important to understand how the global economic storm is affecting China. Not only because it is the most populous nation, the world's third-largest economy, second-largest trading nation, a key outbound investor, an important destination for investment and holder of the largest foreign reserves, but because China offers the best hope for keeping the Australian economy going and providing the engine of growth after the global economy bottoms out. China also provides new understandings of how an emerging economy responds to crisis. It is currently revealing a new mode of development that has implications for other developing economies, but also for the wealthy developed states. A key theme in China's development is its ability to transform crisis into opportunity by retaining the momentum for sustained growth and development without risking social and political instability.

This paper attempts to go beyond the weekly statistics and quantitative data coming out from China during the current crisis and undertake an analysis of the strategic issues pertaining to China's current and future predicament. Such an analysis goes beyond the one-dimensional economy to consider broader social and political issues. It therefore proposes four key questions:

1. What has been the impact of the global economic crisis on China?
2. How has China responded to the crisis?
3. How will China emerge from the crisis, both domestically and internationally?
4. Can China once again turn a challenge into an opportunity?

This paper offers four tentative conclusions. Firstly, that the economic crisis will result in a short-term 'back to basics economy' dominated by investment in industry and infrastructure and a continuing decline in consumer spending. Secondly, the crisis has accelerated China's active participation on the global and regional stage. Thirdly, while many challenges remain for shifting China's economy away from its currently 'capital-intensive, industry-led' pattern of development, it is taking substantial shifts towards achieving social, environmental and economic sustainability. Finally, if the global downturn is deeper and longer than expected, then it will result in a rebalancing of the economy with an acceleration of significant structural adjustments in China's domestic economy.

1. Background context - Patterns of growth

Before describing the impact of the current global economic crisis it is useful to briefly introduce the structure of the Chinese economy.

While there has been a broad acceptance of describing China's post-1979 economic development as a 'transition'. It is less clear where the transition is actually heading. The state wants to be a middle income developed economy by 2030. The route to this status, however, remains vague. Typically the central government's policy approach has adopted Deng's dictum of 'crossing the river by feeling the stones'. This gradual, cautious and pragmatic approach has to date served China very well.

China's post-Mao reforms have resulted in the replacement of political ideology with an 'ideology of economic growth' as the key driver of development. This ideology has fundamentally altered the core function and management of government. The economic reforms have stimulated enormous local innovation and economic growth, but they have simultaneously promoted a more myopic and short-term view of development. Although the economic reforms have freed up and decentralised decision-making to the local level, typically short-term economic gains take priority for governments over social and environmental priorities.¹

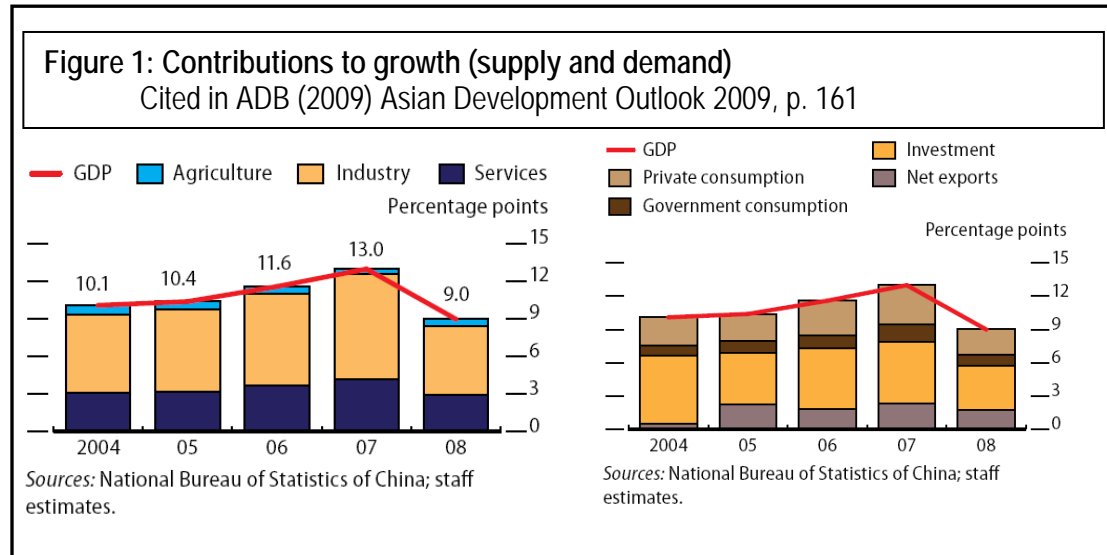
China's economic development can be described in terms of decadal cycles. Commencing in the 1980s, early development was driven by the rural reforms which led to rapid price rises and inflation before being slowed by government policies. The 1990s were characterised by market liberalisation and foreign direct investment which were slowed this time by the East Asian crisis. The 2000s have witnessed an acceleration of China's export driven growth boosted by WTO entry in 2001 and slowed by a combination of government policies and the global economic crisis. The next decade will most likely experience an intensification of urbanisation, a growing service industry and the emergence of the Chinese consumer.

The rapid rise of China's economy on the global stage needs little introduction after 30 years of annual GDP growth averaging 9%. According to the ADB (2009), China's 2008 GDP was US\$30,067 billion or US\$3,200 on a per capita basis. As shown in Figure 1, GDP growth accelerated between 2004 and 2007 when it reached 13%. Much of this growth is fuelled by industrial expansion. Industry is the key contributor to GDP growth making up nearly 60% compared with around 32% growth in services and agriculture less than 10%.² The export of manufactured goods has played a central role in China's rapid economic growth during the past thirty years. While manufacturing contributes 40% to China's economy, exports make up 34% of GDP. In 2007, exports grew by 26% and another 21% in 2008.

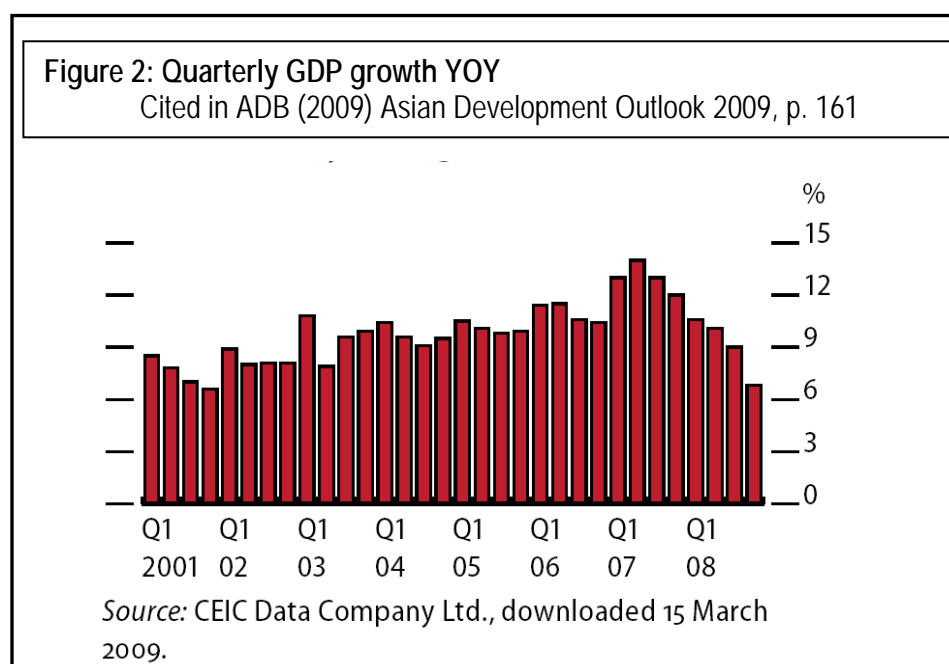
¹ The prevalence of an 'ideology of economic growth' within government decision-making poses a number of serious challenges to non-economic policy areas, particularly China's environment.

² China's own statistics are slightly different. See for example, the Statistical Communiqué of the PRC on the 2008 National Economic and Social Development (27 February 2009)

Despite attempts to rebalance growth between industrial and service sectors, industry continues to outpace services and investment outpaces consumption. China's pattern of economic growth is therefore described as capital intensive and industry-led, which has contributed to 60% of GDP growth during the past decade.

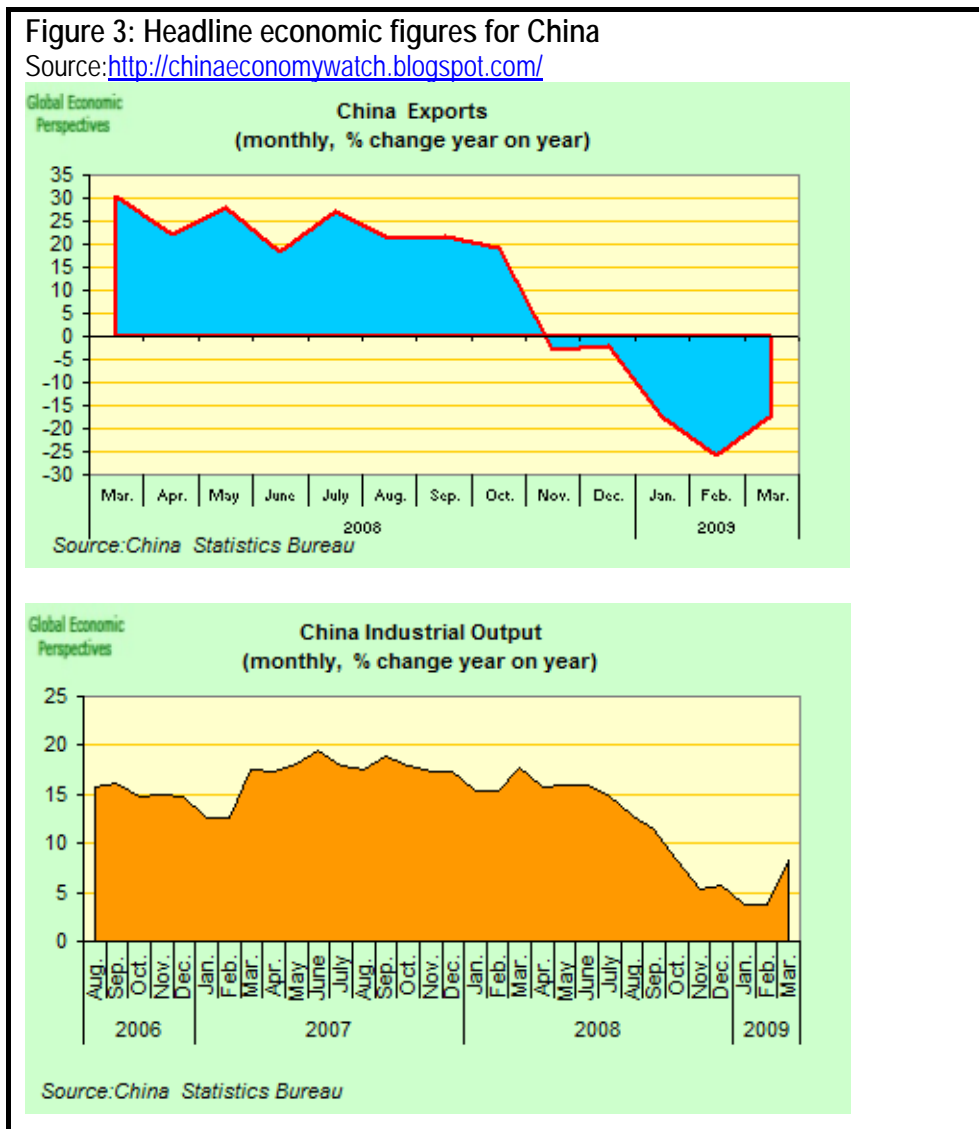


While the growth in industry has played the key role in boosting GDP, it has also resulted in many of the imbalances in the economy with regards to natural resource use, energy consumption and environmental degradation. The current economic crisis has occurred at the same time as the Chinese government is attempting to correct this imbalance in economic development. At this stage it is difficult to determine whether or not the crisis will curtail the rebalancing of the economy or act as a stimulus towards a sustainable path of development.



2. The impact of the global economic crisis on China

The World Bank, IMF and OECD continue to revise down their estimates of global development, including reducing the rate of China's economic growth in 2009 to around 6.5%. However, these institutions remind us that global shrinkage would be worse without the modest growth of China. Economic growth in China slowed to 6.8 per cent in the last three quarters of 2008, compared to 13 per cent in the corresponding period the year before (see Figure 2).



While most of the headline economic figures coming out of China have been negative, there have been some positive signs in the past three months that the economy has possibly bottomed:

- Trade figures have slowed to a 17% five month decline (see Figure 3).

- Industrial production is up 8% in March after a reported 11% growth in February and there has been increases in some sectors (notably cars, concrete, metals and household appliances)
- Inflation has declined 1.8% in February compared to a high of 8.7% for the same period of 2008.
- The CFLP purchasing managers' index (PMI)³ actually rose above 50 points in March reflecting a return in confidence. However, the seasonally adjusted CLSA China PMI (see Figure 3) remained in negative territory for the eighth consecutive month at 44.8 point compared with 45.1 in February and 42.2 in January.
- Fixed asset investment was up over 30% in real terms compared with 2008 following a 26.5% increase in January and February (YOY). This figure is used as a key determinant of the state of fiscal spending.
- Retail sales (consumption) experienced a 15% growth in January and February with 9-10% growth predicted through 2009.
- At least 25 million job losses have been reported with official unemployment rising to 4.2%.

The following section will identify where the slowdown is occurring in more detail.

2.1. Banking sector & investment

China's financial institutions experienced significant losses stemming from the financial crisis, including write downs on stocks, sub-prime lending, foreign currency transactions and bankruptcies. However, they remain stable due to sound management and strong balance sheets with losses representing only a small share of their capital and assets.

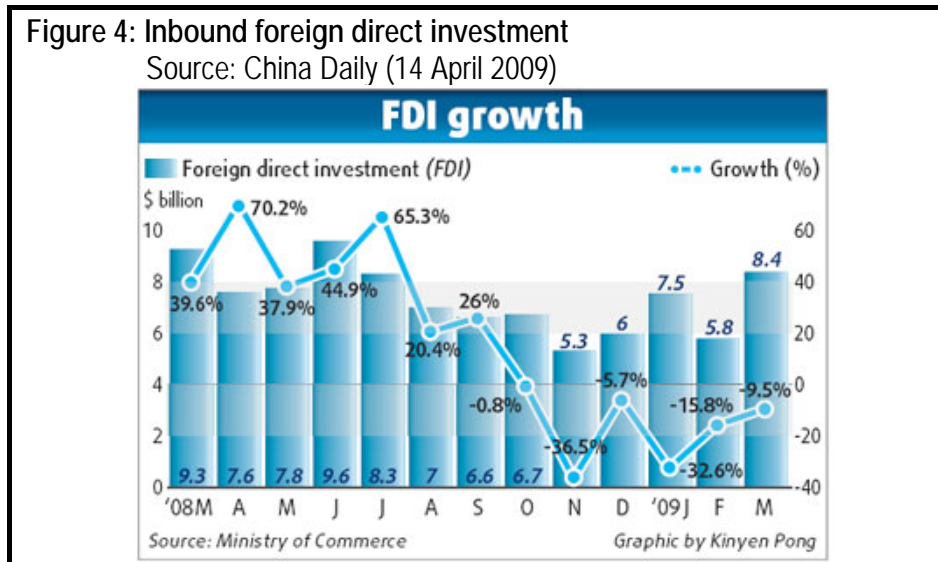
- China's sovereign wealth fund, CIC, and foreign exchange administration, SAFE, experienced losses on US stock investments.
- Sub-prime losses for big four Chinese banks (ICBC, BOC, China Construction Bank & Agricultural Bank of China) were significant with estimates of around US\$3-5 billion. ICBC: US\$1.2 B; BOC US\$1.3b (up to \$3b); China Construction Bank (\$630m of \$1b).⁴
- CITIC lost around US\$2 billion on foreign currency bets.
- The Industrial Commercial Bank of China and Bank of China lost a further 280 million following the collapse of the Lehman Brothers Bank.

Despite the losses, liquidity with new bank lending has rebound strongly with a record growth of Y4.58 trillion in the first quarter of 2009.⁵

³ China Federation of Logistics & Purchasing (CFLP)

⁴ There were other losses, for example China Investment Securities have written down the value of their 10% stake in Morgan Stanley after its value dropped by 2/3.

As shown in Figure 4, inbound foreign direct investment continued its downward trend with March figures revealing the sixth consecutive decline in FDI growth (YOY). China remains the leading recipient of FDI amongst developing economies. In March, FDI was US\$8.4 billion, down 9.5% compared to 2008. The figures do show a steadying of FDI from the lowest levels in November 2008 when they declined by 36.5%.



2.2. Production & activity

There has been a sharp decline in China's industrial production growth with signs of rising excess capacity (see Figure 5).



⁵ Historically, bank credit in the first quarter usually accounts for 60% of annual totals.

Growth in industrial production dropped to 3.8% over January and February compared with growth of 5.7% in December. Industrial production is an important driver of commodity demand and is the key indicator for Australia's resource exporters.

Inventories are important to watch and so far, steel and base metal inventories continued to grow during the past five months. The key driver of this growth has been Chinese government purchases to assist producers.

The property building bubble of 2007 was reined in with a slump in private construction driven by tight monetary lending and a 25-30% drop in commercial property rates in Shanghai, Beijing and Shenzhen. The timing of the property downturn could not have been worse, coinciding with the global economic crisis.

Industrial company profits fell 37.3% in January and February of 2009. Profits at SOEs dropped 59.2% and foreign-funded firms experienced a 39.3% drop in profits. Steel mills, manufacturing companies and non-ferrous metal processors were the biggest losers in the January and February data with steel mills recording a Y7.7 billion loss in 2008 compared with a Y25.5 billion profit in 2007.

Consumption has continued to decline in its contribution to growth, but there are recent positive figures with ongoing growth of 25% in consumption during January and February.

2.3. Trade

Trade has been hardest hit by the global economic crisis, because China's economy is closely connected and dependent upon the global economy. Moreover, the ongoing decline in the health of these economies is closely linked to further weakness in China's economy. However, it is important to factor in the government's late 2007 cooling of the economy in the trade figures.

Exports: China has experienced five months of declining exports with a 20% drop in October followed by another drop of 17% in January, 26% in February and 17.1% in March; bringing the value of manufactured exports back to around 2004-05 levels.

The economic crisis and drop in exports is affecting four main areas: reduced orders for goods; declining employment; the closure of factories (both short-term and regionally); and reduced revenues for government.

A combination of a freeze on trade credit and the destocking and clearing of overseas and domestic factory stockpiles have probably exacerbated the poor trade figures in recent months. While it is likely that trade will recover in the next few months, NDRC estimates suggest a 10% decline in exports through 2009 following a 17% gain in 2008. Declines in exports have been more than off-set by declining imports, so that China's trade surplus continued to grow to Y127 billion in February.

Imports: The situation for imports has been similar to exports with a 24% drop in February and 25.1% in March. However, some imports have experienced large fluctuations. For example, iron ore imports from Australia experienced two months of decline in October and November, most likely due to the early tightening policies, before a 25.7% surge in December (worth \$3.4 billion). However, orders in January and February were subdued.

Domestic trade figures seemed to have bottomed with cargo shipping figures slowly returning to positive growth in February after a sharp drop in August 2008. These figures are probably more indicative of the impact of the stimulus.

2.4. Responding to crisis

Given this predicament, can China continue to maintain growth in 2009 and 2010 when there is little optimism in the global economy? Prior to answering this question, it is worth recalling that the current economic crisis is not the first challenge for China's developmental state. During the past three decades of economic reform, the Chinese economy has experienced many challenges. It is important to understand the current global economic crisis and recent domestic sharp export downturns against this background of dealing with one crisis after another.

1997 The East Asian crisis raised the leadership's concern and awareness of economic vulnerability to a fully liberalised economy. Since 1997, China has rapidly built up its foreign reserve holdings as a form of insurance through persistent and large current account surpluses. In addition, the crisis enhanced China's awareness of the narrow political and ideological focus of the IMF.

2003 SARS hit the China's economy hard in the first half of 2003 with tight restrictions on personal movement. Rather than idly sit by, most local governments and private companies undertook professional training and road and infrastructure rebuilding projects during 2003.

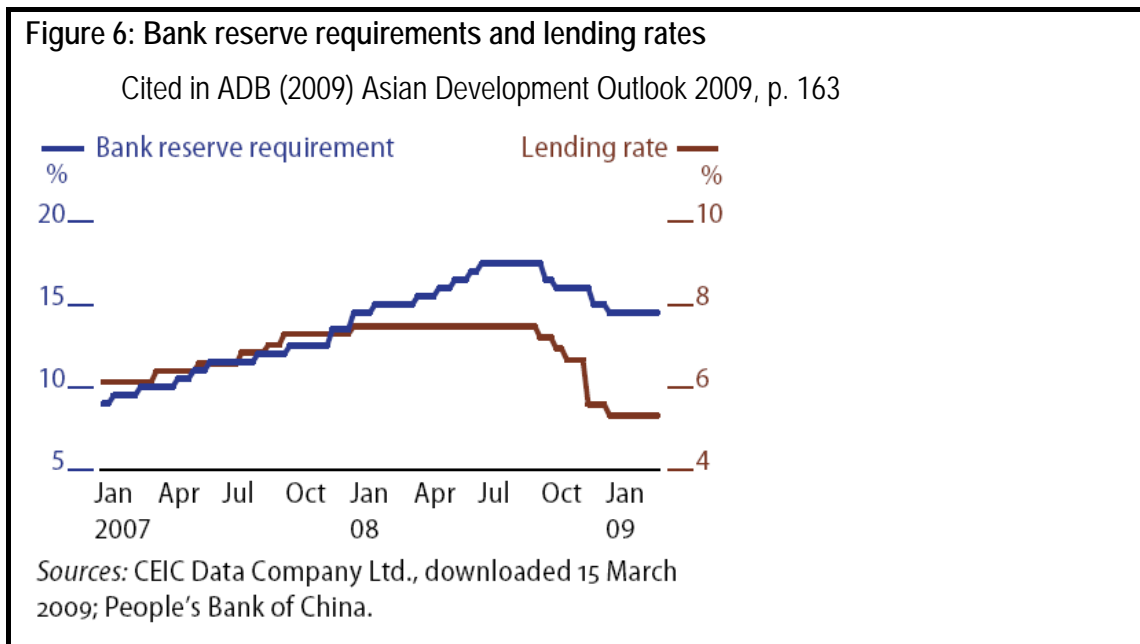
2008 Snowstorm and flooding: revealed the need to review transport priorities following bottlenecks due to the severe snow storms and floods in 2008. Many of the weaknesses were identified during these natural disasters and are being tackled as part of the stimulus package.

In each case, China has strategically shifted each challenge into an opportunity.

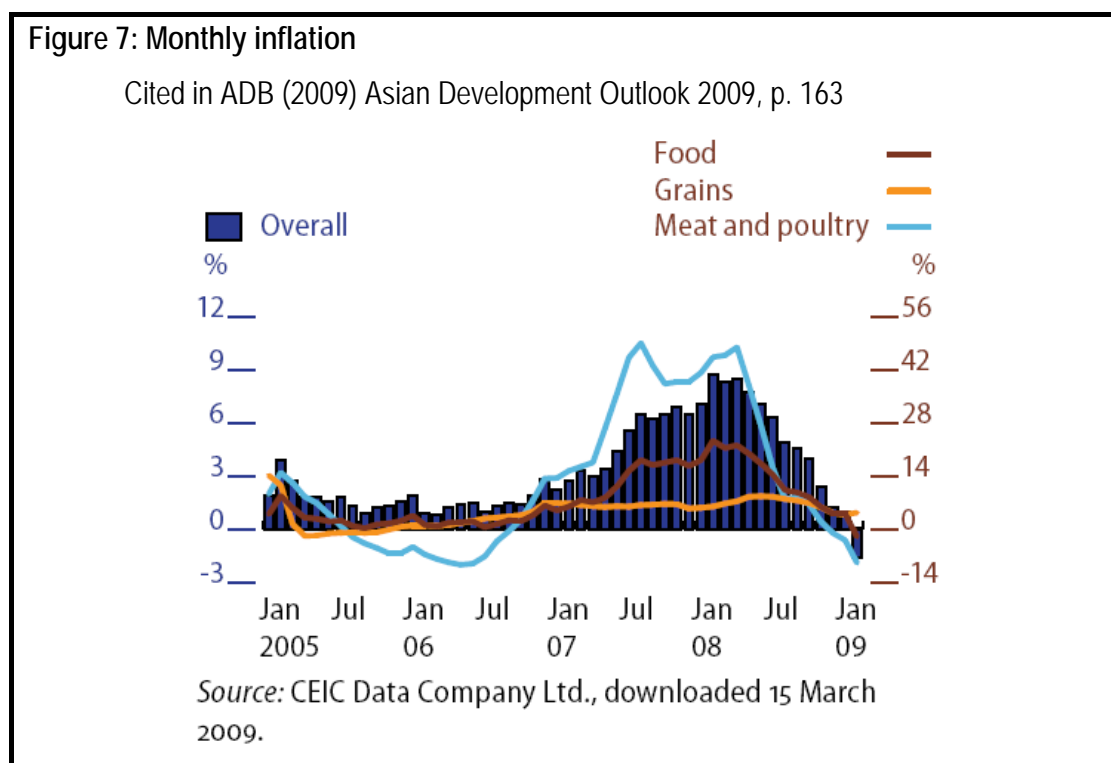
2.5. Pre-crisis monetary and fiscal tightening

In the two years prior to the 2008 Olympics, there was enormous investment in new infrastructure, a booming property market, a stock market bubble and high inflation (see Figure 7). In order to cool the economy, the government introduced a series of measures towards the end of 2007. This included introducing banking quotas on lending, raising bank interest rates and reserve requirements (see

Figure 6), restricting access to land for project developers, price controls on essentials and tighter lending requirements for property investors.



The government's fiscal and monetary tightening policy was largely aimed at dampening the property bubble and inflation. Another aspect was reducing excess production in manufacturing which was distorting prices. While the government's measures were successful in cooling the economy, perhaps



they were too successful. Commercial and residential property sales declined dramatically with the average price of real estate dropping for the first time since 2005. The depressed property sector resulted in a slow down in building materials such as steel and cement. The downturn was accentuated

by the Olympics which slowed tourism and closed down many polluting industries. The cooling of the economy was also aided by slowing inflation figures, especially of food, oil and resources.

2.6. Convoluted statistics

Many analysts are closely watching the weekly figures emerging from China. Before making too many leaps of faith in reading this data it is important to consider a few final complicating factors. Firstly, most economic activity occurs in the fourth quarter yet the figures remain difficult to gauge due to the changing timing of the Lunar New Year festival and discrepancies between seasonal adjustments and year on year figures. In addition, the global slowdown resulted in many producers destocking their inventories before engaging in new production which exaggerated the initial strong negative export figures and the drop in prices of many commodities in late 2008, but also makes comparisons difficult from month to month. 2008 was a tumultuous year for many Chinese with three major natural disasters (winter snowstorms, summer floods and Sichuan earthquake). These events distorted economic activity and infrastructure spending during 2008 and will also make comparisons more difficult. Finally, the strong first quarter growth in GDP during 2008 will probably deflate the YOY growth figures for the first quarter of 2009.

3. China's stimulus package

In November 2008, China announced a Y4.4 trillion stimulus plan to be spent over two years to counter the negative impact of the global economic crisis. The stimulus plan contains four strategic goals:

1. Rebalancing the economy: develop a long-term growth strategy increasingly led by domestic consumption rather than exports.
2. Efficiency: modernise and restructure industry to achieve higher productivity and efficiency.
3. Social balancing: strengthen and expand social welfare and employment
4. Stability: maintain the broad goals of the economic reforms

Spending is planned to be frontloaded with Y120 billion in spending during the fourth quarter of 2008 and a further Y110 billion in the first quarter of 2009. The World Bank estimates that government-directed spending will lift GDP growth by over 4% points or more than half of GDP growth in 2009. The State Council estimated that the stimulus will contribute between 1.5% and 1.9% to national economic growth. The cost of the plan will contribute to a record budget deficit of nearly Y1 trillion (less than 3% of GDP) compared with Y180 billion in 2008.

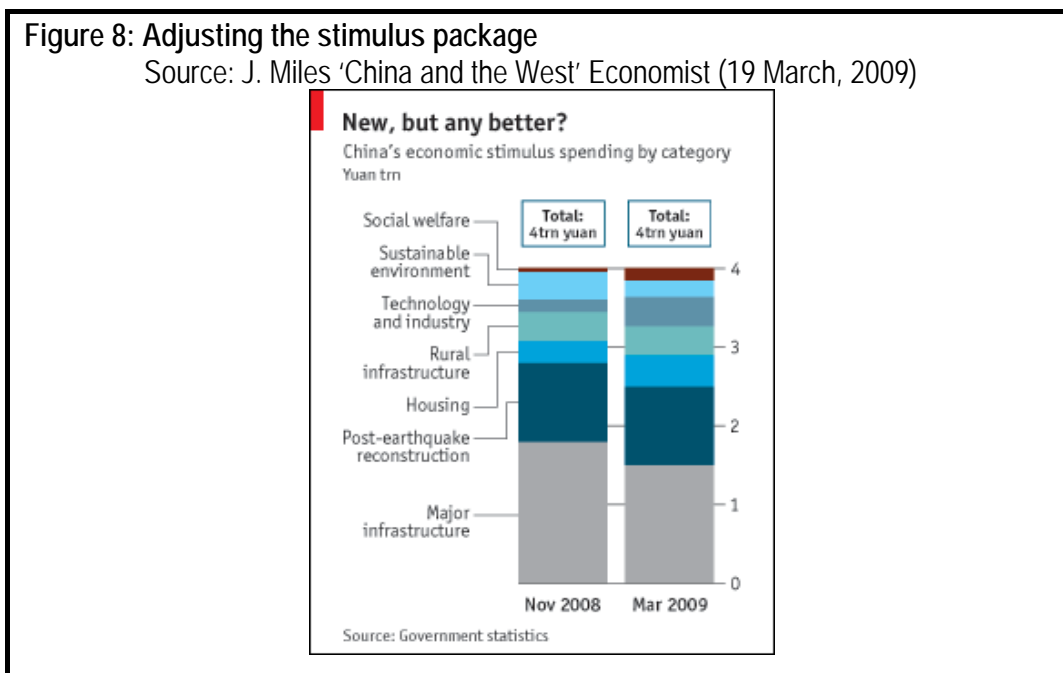
Much of the burden for implementing the stimulus package rests with provincial and local governments rather than Beijing, which is only contributing around 25% or Y1.2 trillion of the total. The rest needs to be raised through regional revenues, issuing bonds and bank lending. Since the fiscal reforms of the mid-1990s and the banking reforms of the 2000s, China's sub-national governments and domestic financial institutions have been in reasonably good financial condition. Moreover, strong economic growth has increased government revenues. However, the stimulus will be a real test of the government's ability to efficiently and effectively allocate the funds.

The four strategic goals of the stimulus package (rebalancing the economy away from industry and export manufacturing and towards strengthening the social safety net and promoting domestic consumption) are core features of China's 2006-2010 11th Five Year Plan (FYP). Reducing the precautionary motive for spending by expanding the social safety net as well as increasing access to education and health are seen as a prerequisite for boosting domestic demand. The government also aims to increase incomes and promote company dividends to boost spending and to decrease the level of savings. Presently, savings account for 28% of GDP and have doubled since China entered the WTO in 2001. Most of these savings are generated by companies.

Much has been said about China's desire to achieve at least 8% GDP growth during 2009 and beyond despite the deepening global recession and downward revision of China's growth prospects.

"Protecting 8%" growth was first introduced during the 1997 Asian Financial Crisis as a target for local and provincial authorities. Given that China's 2008 GDP was worth Y30 trillion, the government needs to generate a further Y2.4 trillion in growth to reach its 8% target. In response, government spending will need to increase 25% in 2009. According to the National Development Reform Commission, if the government's stimulus plan is fully implemented then growth could even reach 10% in 2009. Such a turnaround will not be easy considering most sectors of the economy are still in decline, including exports, manufacturing, employment, and property. It will be difficult, but not impossible. Protecting 8% GDP growth is both a symbolic measure for ensuring ongoing wealth and a clear directive to local officials in decision-making. In effect, it allows these officials to perhaps neglect some other targets and measures, such as environmental pollution controls, so long as they achieve 8% growth. If local governments only achieve 4% economic growth, then the symbolism becomes reality and there will be repercussions. The implications for the central government are more serious. Therefore, there is a lot riding on the outcome.

A key component of the stimulus is the need for policy flexibility to the changing domestic and global economic conditions. Already the initial November 2008 spending plan was reworked during the National People's Congress meetings in March 2009 (see Figure 8). It is likely that further stimulus measures will be announced through 2009 to rebalance domestic consumption by boosting social services and welfare provisions. Premier Wen Jiabao and NDRC chair, Zhang Ping, have both commented on the need to closely watch the Chinese economy and respond accordingly.



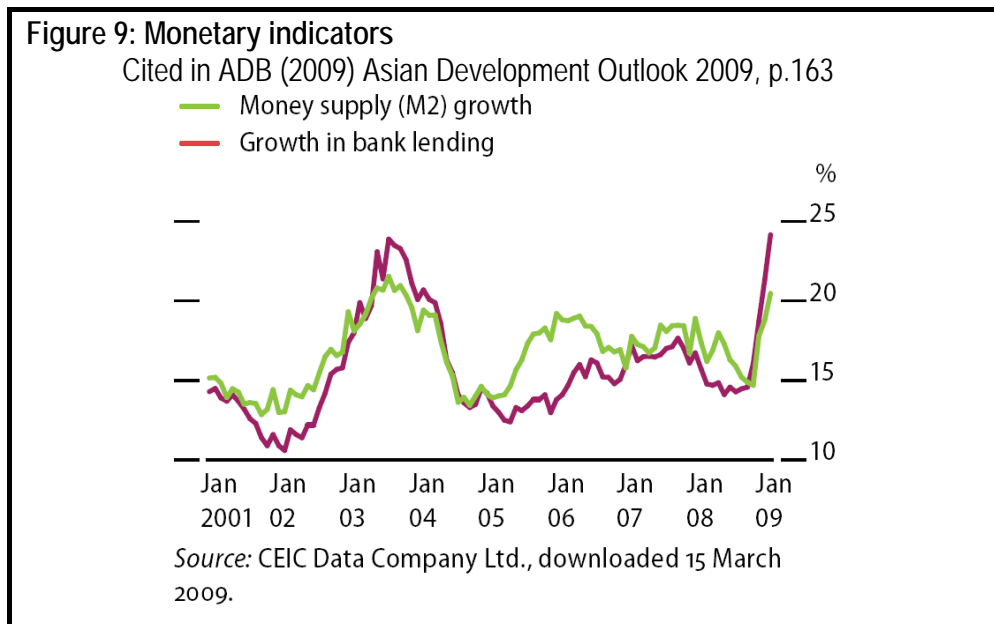
The following sections provide some key details of the stimulus package. It is necessary to understand that there is significant overlap in many of the funding arrangements and pronouncements and most of the specific details are yet to be released and will most likely be adjusted throughout 2009.

3.1. Monetary measures

The stimulus package includes an aggressive spending program and the easing of monetary policy. This has involved removing previous quotas on bank loans, central directives to banks to increase lending, reducing the reserve-requirement ratio for banks, legalising the private lending market and lowering interest rates between September 2008 and March 2009 from 7.47% to 5.31% (see Figure 9). Further reductions in interest rates will be considered to further stimulate economic growth.

Boosting bank lending has been a central part of the stimulus with a Y2.6 trillion rise during January and February or 300% more than during the same period in 2008 and half of the government's new

lending target. The strong bank lending is hoped to avoid deflation with China still targeting 4% inflation for 2009. The government has also slowed its gradual program of appreciating the Yuan.



The state has also directed banks to open up lines of credit for SOEs to invest in new capital and equipment. There remain concerns that the large growth in loans to SOEs during a global downturn will result in the reappearance of non-performing loans. Any increase in bad debt will further extend the timing of the rebalancing of the economy and the development of the financial sector.

The government's flexible and direct monetary controls enable it to increase or speed up the stimulus package if the downturn turns out to be deeper or longer than originally anticipated. This is in contrast to the US and the UK which are faced with fiscal and monetary limitations.

3.2. Social welfare

The biggest fiscal item of the stimulus plan was announced in March 2009 with a Y850 billion health program spent over three years. This equates to a 38% increase in health spending compared to 2008 and a 24% increase in total spending. As part of the program, health insurance coverage will expand to 90% of the population by 2011 and each of China's more than 2,000 counties will have a new hospital. Social welfare services have received a 29% boost in funding above 2008 figures. Initially welfare only received 1% of the stimulus but this was increased to 4% in March. An additional Y42 billion will be used for creating social service jobs for university graduates to assist migrant and urban workers. A further Y43 billion is allocated for housing projects for low income households.

3.3. Research funding

In a further boost to restructuring the economy, Y600 billion has been allocated to research and technical innovation. While the state will provide some of this, most funds are expected to come from private companies. It is however, an important shift not only in rebalancing the economy, but it will provide a boost for China in terms of responding to the challenges of climate change.

3.4. Additional fiscal measures

Additional fiscal measures were announced following the dramatic drop in exports including an increase in export VAT rebates on 3,800 items (see Figure 10). This was the fifth increase in the export rebate since August 2008 when the government realised that exports had been initially impacted by the government's earlier fiscal and monetary tightening. Many of these increases in rebates were originally phased out under the government's plan to gradually move away from resource intensive manufacturing and processing economy. However, according to the Ministry of Commerce, "it was an extraordinary measure taken under extraordinary conditions".

Figure 10: Temporary Value Added Tax rebates (1 April)

Item	VAT	Export rebate
Textiles	17%	16%
Plastic, woods, glass		11%
TVs & components; optical fibre		17%
Steel, Construction ceramics & metal exports		9%

Reducing unemployment so as to maintain social stability is probably the key priority of the central government in managing the impacts of the economic crisis. Therefore, it has returned to the basics of boosting production. For example, SOEs have received a significant boost from the stimulus plan with government-directed lending for purchasing industrial resources, including copper, iron ore, aluminium, lead, nickel and zinc so as to keep the factories and mills operating. In January and February 2009, the State Reserve Bureau purchased 590,000 t of aluminium, 159,000 t of refined zinc as part of the metals stimulus plan.

3.5. Rural development

The rural economy has re-entered the spotlight of the central government during the past five years due to the increasing gap between urban and rural incomes, which continue to grow despite attempts to boost rural incomes. While rural incomes have grown, the pace has not been as rapid as urban

incomes. Growing commodity prices during 2007 and 2008 boosted incomes, but the higher oil price affected transport and fertiliser costs.⁶

The rural economy will be one of the biggest beneficiaries of the stimulus package. Not only will there be a boost in employment from infrastructure projects, much of the social spending will target rural regions with a poor provision of educational and health facilities. Moreover, the direct fiscal handouts target poor rural households. Therefore, funding of rural services has been budgeted to increase from 1.6% to 2% of GDP in 2008. Rural incomes and living standards have been boosted by policies under the 11th FYP, including the abolition of agricultural taxes and fees in 2005; the roll out of the rural cooperative medical system; the introduction of free compulsory education in the countryside; and, the extension to the minimum living standard allowance. However, despite the 75% increase in recent government spending to rural areas, the gap in incomes and quality of life continues to widen due to rapid progress in urban areas.

Rural consumption has been boosted through an extension to a Y20 billion subsidy for purchasing household appliances, such as fridges, televisions, motorcycles and even cars. In December 2008, the scheme was extended and enlarged from the initial three provinces to cover nine more provinces and now includes a broader range of household appliances. The largest Chinese appliance maker, Haier, is confident the scheme, which is estimated to generate Y150 billion in sales, will fill the vacuum left by drops in exports. While the subsidised household appliances program shall boost rural consumption by taking up some of the slack from excess production, it is less likely to be sustainable in the long-term. While the gap in incomes continues to grow and there is a drop in commodity prices, rural incomes will continue to remain significantly behind urban incomes.

3.6. Infrastructure

The stimulus is infrastructure heavy with plans for more railways, highways, hospitals, schools, affordable housing and environmental projects. Around 38% of the stimulus will involve spending on infrastructure (down from the initial 45%). Such construction will boost demand for steel, cement and other raw materials as well as boost employment. For instance, the railway expansion program is estimated to generate 6 million new jobs. In January and February 2009, investment in fixed assets, such as roads, buildings and power plants rose 26.5%. Most of this spending was financed by the big increase in bank lending. Environmental projects will mainly go towards infrastructure, such as

⁶ Additional measures were also introduced to strengthen land tenure and rural household bargaining in land disputes with the introduction of the Property Law in 2007 followed by central policy document in October 2008.

wastewater treatment plants and water piping, contributing a further 5% (down from an initial 9% of the stimulus). Rebuilding rural areas of earthquake devastated northern Sichuan and Gansu will be a key component of the stimulus. In total, Y1 trillion or 25% of the stimulus will go to the reconstruction effort. So far, Y130 billion has been allocated from the central government for the reconstruction program of earthquake devastated areas of Sichuan. Much of this will go into the construction of roads, schools, hospitals and similar key infrastructure.

3.7. Industrial consolidation

Industrial modernisation and consolidation is a core part of the stimulus plan to transform China's largest companies into South Korea style, *chaebol*, or Japanese, *zaibatsu*. The justification for the program includes the 'rationalisation' of production, strengthening domestic brands and consolidating global leverage. The government wants to turn the majority state-owned, Baosteel Group, Anshan Iron and Steel Group and Wuhan Iron and Steel Group, into globally competitive steel producers with annual output capacity of over 50 million tonnes each by 2011.⁷ However, steel production would be cut in 2009 by around 8% to 460 million tonnes to reduce excessive production. The consolidation and expansion program is also meant to result in the modernisation of the plants to improve quality and reduce energy use. There have been some doubts about the implementation of this program as similar plans were announced in 2003.

Similar consolidation plans have been unveiled for the 14 major carmakers, which currently have a 90% market share, to merge into two or three major producers with a 2 million vehicle capacity by 2011. Current domestic capacity is already 12 million units yet only 9.4 million vehicles were sold in 2008. Current plans are for FAW Group (No.1 & VW), Dongfeng Motor, SAIC Motor and Changan Automobile to commence a mergers and acquisitions program across the country. Targets outlines in the car industry stimulus plan aim includes the manufacture of 10 million cars in 2009 with 10% growth and the production of 500,000 electric cars with no timeframe. In March 2009, a record 1.08 million vehicles were sold according to the China Association of Automobile Manufacturers representing a 25% increase in vehicle sales (YOY).

3.8. Assessment of the stimulus plan

"Compared with other major economies, the Chinese government has taken prompt, decisive and effective policy measures, demonstrating its superior system advantage when it comes to making vital policy decisions"

– Zhou Xiaochuan, Bank of China Governor, 'On savings ratio'

⁷ The world's largest steel producers in 2007 were: 116.4 Mton ArcelorMittal (India / Global); 35.7 Mton Nippon Steel (Japan); 34.0 Mton JFE (Japan); 31.1 Mton POSCO (South Korea).

While Zhou Xiaochuan was blunt in his comments on the merits of Chinese state controls on the economy, most Chinese leaders have avoided using the crisis as an excuse to criticise the west. The Chinese authorities have encountered and responded to several serious 'crises' during the past decade. Rather than resulting in serious disruption to the economic reforms, the challenges have in fact consolidated and strengthened the resolve of the leadership to set clear priorities in a timely manner. The strategic positioning of the state in managing the Chinese economy is probably the envy of many western governments.

Figure 11: Impact of stimulus package in developing Asia (simulation)

Cited in ADB (2009) Asian Development Outlook 2009, p. 47

Economy	Package as a share of 2009 GDP (%)	Impact on GDP (% change from baseline)		
		2009	2010	2011
China, People's Rep. of	1.2	1.3	2.0	1.5
Hong Kong, China	1.4	1.1	0.5	0.3
India	1.6	0.5	0.3	0.3
Indonesia	1.3	1.3	0.8	0.4
Korea, Rep. of	2.5	1.6	1.2	1.0
Malaysia	2.6	3.1	4.1	1.5
Philippines	4.1	2.4	3.5	1.7
Singapore	5.9	3.6	2.8	0.4
Taipei,China	2.1	1.4	1.2	0.7
Thailand	6.4	6.5	7.9	7.4

Source: Oxford Economics. 2009. "Emerging Asian Fiscal Policy: A Limited Boost, but China Could Yet Do More." *Emerging Markets Weekly*, 16 March.

The strong hand of the Chinese state in the economy is acknowledged. Less evident is the government's ability to fulfil its ambitious goal of restructuring the economy, let alone maintaining strong growth. Figure 11 presents a simulation model of the impact of the stimulus packages on several Asian economies by Oxford Economics. They estimate that China's stimulus plan shall increase GDP by just 1.3% in 2009 and 2.0% in 2010. These figures are based upon the assumption that only 30% of the stimulus is new spending. If this figure increases to 50% of new spending, then, the impact on GDP rises to 2.2% in 2009 and 3.4% in 2010. Given the broader monetary loosening and directives to increase bank lending and private spending it is important to consider that these figures overlook the majority of the stimulus figures. A further study by the Hong Kong Monetary Authority estimated the multiplier effect of the Chinese stimulus package on the economy would be around 0.84. Therefore, Y1 trillion of spending in 2009 would produce additional output of Y1.7 trillion. The study found that the benefits of the stimulus were limited and very short term.

Employment figures will provide the most accurate indicator of the success or otherwise from the stimulus plan. While employment growth has been strong during the 2000-2007 period with nearly 14 million non-farm jobs created annually. According to government estimates, 9 million urban jobs will be created through 2009 from measures in the stimulus package. The slow development of the services sector may actually provide China with an advantage during the next decade with very favourable employment capacity. However, there are already an estimated 25 million unemployed migrant workers and recent university graduates looking for work. Moreover, these figures do not include the large numbers of under-employed and migrant workers who did not return to the factories and construction sites after the Lunar New Year. According to estimates from the Chinese Academy of Sciences, total urban unemployment rate reached almost 10% at the end of 2008. This is twice the official figure of 4.2%, which excludes most migrant workers.

“The PRC will emerge from the crisis in better shape than it was before if it can rise to the challenge of rebalancing its economy”

- Lee Jong-Wha, ADB Acting Chief Economist

According to the ADB, China needs to press ahead with market liberalisation to boost incomes and promote entrepreneurialism. In addition, price and tax distortions on land, energy and water should be removed to promote smaller more efficient private companies over resource heavy export-orientated SOEs. Furthermore, capital needs to be liberalised with lower borrowing costs and greater accessibility for private companies. The ADB also encourages China to broaden ownership of companies with greater share offerings with companies paying dividends to raise incomes. China remains cautious about privatisation and will continue to be reluctant to embrace such a broad policy shift in the short-term. It is unlikely given the high level of global economic uncertainty that further pricing and tax reforms of resources will go ahead until after the economy has started to rebound. The speed of reforms to the steel and car industry will provide a gauge on whether further market orientated reforms to government monopolies will follow.

In contrast to predictions that social and political weaknesses in the Chinese state would result in challenges to its legitimacy and rule, the quick and thorough response of the state has in fact consolidated its grip on power. For example, the central government quickly reversed the policy of fiscal and monetary tightening in August 2008 when the first signs of the global slowdown were occurring. The Y4 trillion stimulus was announced in November, less than two months after the collapse of the financial markets in mid-September.

It is clear that the slowdown in the Chinese economy in 2008 was due to a combination of domestic measures tackling inflation and the property market together with the dramatic drop in exports in late 2008. Extrapolating the two factors will be a job for later analysis. However, the rapid turnaround in government fiscal and monetary policies in late 2008 will probably result in a return to higher levels of economic growth in the second half of 2009. Two factors will work towards a quick turnaround in growth. Firstly, the drop off in exports and foreign investment will free up capacity and production for the stimulus. Secondly, most of the actions in the stimulus package were already contained in the 11FYP and are therefore easier to implement.

“Confidence is more precious than gold”

- Chinese Premier, Wen Jiabao, March 2009

A new term has entered the Chinese lexicon during the global economic crisis: confidence. As part of the initiative to boost consumption, the leadership have realised the importance of retaining confidence in the economy. Stability and confidence have featured prominently in the government’s response to the financial crisis. Stability has always been a central tenet of government policies, but confidence is a more recent addition to government reflecting growing concerns about the economic situation, maintaining stability and the desire to expand domestic consumption. Much of the confidence campaign boils down to the “Protect 8” campaign targeted at local officials to remind them of the most important target when they are balancing a growing range of expectations and responsibilities. Moreover, retaining confidence is necessary if the government wants to increase private consumption. Unemployment will have the biggest impact upon confidence levels. Therefore, while people are concerned about employment, personal savings will most likely grow as a form of insurance during hard times.

Figure 12: The Economist’s Intelligence Unit (EIU) forecasts for China (March 2009)

Key indicators	2008	2009	2010	2011	2012	2013
Real GDP growth (%)	9.0	6.0	7.0	8.4	8.7	8.9
Consumer price inflation (%; av)	5.9	-0.2	2.5	3.5	4.1	4.1
Budget balance (% of GDP)	-0.1	-3.6	-2.1	-1.6	-1.1	-1.0
Current-account balance (% of GDP)	10.2	6.1	4.5	3.6	2.9	2.0
Commercial bank prime rate (%; year-end)	5.6	5.4	6.6	7.0	7.1	7.4
Exchange rate Rmb:US\$ (av)	6.95	6.84	6.66	6.51	6.41	6.33
Exchange rate Rmb:¥100 (av)	6.72	7.39	7.24	7.16	7.12	7.03

While the GDP forecasts from the World Bank, IMF, OECD and EIU differ with the government's 8% growth for 2009 (see EIU data in Figure 12), they remain confident that China's economy will gradually recover momentum. However, many hurdles remain on the way to recovery both domestically and internationally. China's ability to access strong national savings and the few concerns about short-term debt will make achieving Beijing's "8%" goal much easier. While achieving 8% seems increasingly difficult, given the sharper and deeper than expected global downturn, the Chinese will not be far off target. However, if the figure is markedly below 8% (less than 6%), then there will be social and political ramifications for the leadership.

Early data provides a mixed picture on China's economy making interpretation difficult, but most analysts expect the stimulus to take hold mid-way through 2009. As noted, there are signs the economy has reached the bottom in early 2009 with surging bank lending, a rebound in resource demand and higher consumption figures. The return to a positive CFLP PMI amongst industrial manufacturers and the rebound in resource imports all point to a strong positive impact from the stimulus package. However, the global economic crisis has significantly reduced domestic economic activity, especially amongst manufacturers and exporters with manufacturing contracting for 5 straight months between October and February. However, it is likely that manufacturing, especially the production of textiles, garments, footwear and toys, will experience the slowest turnaround compared with other sectors.

A risk remains however, for China, in its attempt to stimulate domestic demand. If the high investment results in excess capacity without domestic demand or a rebound in the global economy for some time, then there are going to be some serious implications for policy makers. Therefore, China needs to ensure that the initial rebalancing objects of the government are not lost in the desire to achieve high levels of growth.

4. Rebalancing the economy: finding 'harmonious development'

While China's economy continues to experience rapid economic growth, increasing global integration and an expansion of market and private sector orientation, the capital intensive industry-led pattern of growth has resulted in growing social, economic and environmental imbalances. China cannot escape the reality that growth needs to be broad based; aimed at improving living standards and tackling poverty as well as reducing disparities. Therefore, China is increasingly focusing on implementing further corrective measures to move towards a more 'harmonious' mode of development.

The plans to rebalance the economy through increased funding for social welfare, health, education and environmental protection received a significant boost in the Y4 trillion stimulus plan. A central tenet of the harmonious development strategy is to attempt a double 'rebalancing' by investing more resources in social spending, and therefore, simultaneously encourage the public to reduce savings and increase consumption. The aim is to move the economy away from resource intensive and polluting industries towards greater value added production and a service economy.

The World Bank recently evaluated China's economic rebalancing targets which were initially raised in the 11th FYP and then incorporated within the stimulus plan. So far, China has only met one of the four structural indicators measuring the 'rebalancing': increasing its urbanisation rate. In contrast, China's share of the services sector's value added to GDP, share of employment in the services sector, and share of research and development spending in GDP were all below the targets. While progress was overall positive, the share of household consumption in China's GDP remains the smallest of all major economies. In 2008, its share of GDP fell to 36.3% or about half US levels.

The Chinese consumer is typically modest in spending and very good at saving. A two pronged policy was incorporated in the stimulus plan to strengthen the social security net to reduce the growing disparity in incomes and promote consumption. Several of social welfare programs set up under the 11th FYP were strengthened and expanded as part of the stimulus package. These were aimed at providing a minimum basic living standard or *dibao*. It is difficult to know how much these programs will result in consumption and a move away from high household savings.

Household and company savings rates are relatively high in China making access to liquidity much easier. China's savings ratio increased from 37.5% in 1998 to 49.9% in 2007. The governor of the Bank of China, Zhou Xiaochuan, added to the debate on China's high savings rate by explaining the situation from a Confucian cultural perspective which he argues promotes thrift, self-discipline and anti-extravagance. Yet, he also offered an equally pertinent historical explanation for China's high level of corporate and personal savings:

"The rate of corporate savings to GDP in China is high compared with other countries in the world. This is closely related to the unsolved distortion of cost/profit of enterprises during China's economic transition. Under the planned economy, housing, healthcare, and pension were provided by the enterprises and the government, and weren't accounted for in wages. This had dampened people's incentives to save. Savings were even considered "involuntary" as people had to regularly line up in queues at shops for consumer goods in short supply. After the reform in the 1990s, the "iron bowl" (lifelong secure job and welfare) system was smashed and the enterprises stopped providing pension and housing for free.

However, effective social security system had not been in place either. These significantly increased the incentive for precautionary savings.”

- Zhou Xiaochuan, Central Bank Governor ‘On savings ratio’,

Two other key rebalancing targets in the World Bank’s evaluation, improving energy efficiency and pollution control, also fell short. China’s capital-intensive industry-led economy remains inefficient in its use of resources, especially water and energy. Moreover, despite government pronouncements on curbing resource use, primary energy consumption grew by 62% between 2000 and 2005. Resource conservation is an area of government perceived to offer only indirect and long-term benefits. As a result, policy areas, such as the management of air and water pollution remain a low priority, because too many human and financial resources need to be invested with little immediate gain. In contrast, the political resources devoted to single policy areas, such as the promotion of short-term economic growth, remain a priority for local officials.

The 11th FYP marks a turning point for the Chinese leadership with the inclusion of environmental considerations into the range of key targets. Such measures were not driven by the environment alone, but were also connected to strategic, social and economic programs. There has been an acknowledgement within the Chinese leadership that current economic growth is deleterious to the nation’s natural resources and environment. Therefore, the stimulus has included rebalancing measures to aimed at improving energy efficiency, reducing pollution discharges and including environmental and social costs in resource use. However, progress to date remains lagging especially in shifting investment towards an efficient, low-carbon mode of development. The stimulus plan has made important commitments to improving the environmental infrastructure, but in the short-term the status quo of environmental degradation appears to remain. If China is able to make important structural adjustments in rebalancing its economy, then it will emerge from the economic crisis stronger, both economically and politically.

5. The “peaceful rise”: geo-political implications of the ‘global storm’

During the past 30 years of economic reforms, China has traditionally maintained a low key approach to international relations. However, there are signs that China is no longer willing to take a back seat at the negotiating table.⁸ There is a growing sense that the global economic crisis provides China with an

⁸ The current Chinese leadership now refer to China as a “great power” whereas the English version provided by Xinhua preferred to us the term “country”. This shift has led some commentators to refer to the March G20 meeting in London as actually a “G2” summit between Obama and Hu. While some of these statements may be an exaggeration, the West and China need to adjust to the changing reality of China’s growing significance.

important opportunity to shift the power dynamics of the global economy. Part of this relates to improving China's presence and participation in multilateral and regional institutions, but also pertains to shifting values.

5.1. Post-Bretton Woods order

"The outbreak of the [current] crisis and its spillover to the entire world reflected the inherent vulnerabilities and systematic risks in the existing international monetary system"

Zhou Xiaochuan, Chinese Reserve Bank governor.

Prior to the March G20 meeting in London, there was a sudden out-flowing of very public comments calling for substantial reforms to the international economic system from China's financial leaders, including the Reserve Bank Governor, Zhou Xiaochuan, the Director of the Foreign Exchange, Hu Xiaolian, Finance Minister, Xie Xuren, and Vice-Premier, Wang Qishan. Several key reforms were outlined in their comments, including:

- An international financial treaty outlining the 'rules of the game';
- Tighter financial regulations;
- Enhanced cash on hand held by the IMF;
- Enhanced monitoring and accountability;
- Greater representation and funds from emerging economies, such as BRIC⁹;
- A new global currency.

One of the most controversial and publicised comments was the recommendation to replace the existing dependence upon a single global currency with the IMF's Special Drawing Rights (SDRs).¹⁰ According to the Zhou Xiaochuan, SDRs would remove the existing monetary contradiction between domestic and international considerations. Zhou's argument is that the costs of maintaining the existing system outweigh the risks and benefits. The Chinese proposal is for a gradual move away from the US dollar as the global reserve to avoid a sharp drop in its value. There is US resistance to such a move, but in reality there has been a gradual but important shift away from the US currency during the past decade. Zhou argued that such a reform will be beneficial to the US in the long-term by reducing its unsustainable access to liquidity and unlimited debt funding. Not only would such a move reduce the pressure on China with its high savings rate, but it would avoid the current risk of the US responding to high debt through quantitative easing by issuing more Treasury bonds so that the US can inflate or devalue their way out of debt.

⁹ BRIC refers to Brazil, Russia, India and China

¹⁰ SDRs were set up under the Bretton Woods system in 1969 comprising four currencies: the Yen, US dollar, sterling pound and Euro.

It is ironic that China is raising concerns about the value of the US dollar after it has been the target of sustained US criticism for not appreciating the value of its own currency. In response to US pressure, China has gradually appreciated the Yuan against the US by 21% during the past five years.¹¹

Adjusting the value of the Yuan has become a key part of the government's policy equation in achieving exchange rate stability to boost GDP growth. A low Yuan makes China's exports more competitive and is blamed for both the high trade surplus between China and US and the massive accumulation of foreign reserves by the Chinese. The trade surplus remains another area of friction between China and the US. In the first three months of 2009, China's surplus has continued to grow with estimates that its foreign exchange reserve are now worth US\$2.2 billion and will grow to US\$2.5 billion in 2010. These reserves are held in a mix of currencies, with at least half in US dollars. The ongoing problems with the US financial market and the growing levels of US debt led the Chinese Premier openly raise concerns about China's US\$1 trillion holding of Treasury bonds in March:

"We've lent a huge amount of capital to the US, and of course we're concerned about the security of our assets. And to speak truthfully, I am a little bit worried"

Wen's concerns resulted in immediate reassurance from US President Obama about the stability of the US economy. The Chinese do not want to sell off their US government bonds and treasuries, because this would bring down the US economy: an economy that imports 21% of China's exports. It appears that the crisis has elevated mutual understandings of the inter-connectedness of trade and debt relations between the US and China.

An interesting aside in the currency debate is the growing status of China's Yuan. During the past few years, China's regional trading partners are increasingly attracted to trading in Yuan. The trend towards trading in Yuan has expanded from Hong Kong to ASEAN (especially Malaysia, Vietnam and Indonesia), South Korea, Belarus and most recently Argentina. While the ascendancy of the Yuan will not directly threaten the US dollar in the short-term, because it is still not fully convertible, its growing presence will accelerate the debate about the emergence of a post-US dollar global currency.

According to the World Bank, developing countries will be hardest hit by the credit crisis leaving them with a \$700 billion shortfall in access to liquidity. China may be able to enter the fray and pick up some of this funding and investment shortfall during the departure of the European, Japanese and North

¹¹ The Yuan has appreciated by 18% in trade-weighted terms during the past year. If the Yuan's value continues to appreciate then the price of goods, especially imports and components of manufactured goods will decrease and also provide a further stimulus to domestic spending. However, it is possible that the value will depreciate in the short-term to boost exports.

American banks. This would be a major victory for the Chinese on the global stage. China's massive liquidity is increasingly attractive to many countries struggling to access finances during the financial crisis. During the Chinese Premier's trip to Bangkok in April 2009 to attend the ASEAN summit, Wen Jiabao, announced that the Chinese will establish a US\$10 billion investment fund and \$15 billion line of credit to ASEAN members. It is clear that the Chinese see the strategic advantages of strengthening regional relations during a period of limited and weakened US and EU capacity. This shift will play an important role in strengthening economic growth and development in the region during a period of tight liquidity. It is most likely that the current economic crisis will result in a realigning or reinforcement of interests towards China in the Asia region, especially if China is able to play a key role in lifting the region out of recession.

A less contentious issue was the recent Chinese call for greater involvement of emerging economies in the decision-making of the IMF. According to the plan, China will also contribute to greater funding through the IMF. China argues that instead of its high savings funding US debt, such funds should instead be directed to assist developing economies. Such a redirection would provide a welcome boost in lending, but also have a significant impact on the US's ability to fund its massive debt. Both outcomes rock the boat of bilateral Sino-US relations. Despite criticism in the US of China's high savings rate, the US remains dependent upon the Chinese taking up more of their debt, with expectations that they will fund a further third of the new debt arising from the current US stimulus program.

The IMF is currently desperate for capital expansion and China has the funds. The deputy governor of the People's Bank of China, Hu Xiaolian, added to the debate over reforming the global financial system when she said that China would fully support an expansion of the IMF role and reserves and that China would finance part of this expansion by purchasing IMF bonds. China will increase its contributions to the fund in return for increased voting rights. Moreover, any Chinese contributions, according to the Finance Minister, Wang Qishan, should be based upon per capita GDP rather than foreign reserve holdings. Presently, the IMF is essentially managed by the US and the EU with the latter determining the position of president and the former wielding veto power over decisions. China and other developing economies exercise minimal influence and have for a long time been lobbying the IMF for a greater say and a reduction in the ideologically myopic policy prescriptions and conditions attached to loans. China is interested in a greater role and it will want to appear to be exercising this new power with responsibility. China is now ready to flex its 'soft power' and it would be wise for the rest of the world to take note and listen carefully.

6. Conclusion

“We face unprecedented difficulties and challenges”

- Premier Wen Jiabao, March 2009

China is taking the global economic crisis very seriously, seeing it as a significant challenge confronting the nation. It is concerned with finding the quickest and most sustainable way to get the economy going. In the short-term, it is likely that the government's plans to rebalance the economy away from resource intensive industries and manufacturing and towards services and high technology has taken a backward step. A large proportion of the stimulus package has gone into infrastructure projects and benefited large SOEs, especially the surge in bank lending. There have been some domestic and international concerns that the stimulus is too one sided, neglecting the private sector and SMEs. While the stimulus plan remains weighted to investment by SOEs, then the rebalancing adjustments towards private consumption and private investment will be slow to realise.

There is a clear need to rebalance China's economic reforms with a changed emphasis on the pattern of consumption and role of the service industry. While the government's rhetoric is focussed on such an approach and the World Bank, OECD, ADB and IMF recommend a similar line, the impact of the crisis is more likely to result in the reinvigoration of the tried and true mode of economic development: high investment in infrastructure, heavy industry and manufacturing. The key ingredients to China's industrialisation were the provision of easy access to credit and the under pricing of inputs, including resources, capital, land and the environment. It is a recipe that guaranteed rapid economic growth in the past and it will be hard for China's decision-making to change. That being said, the crisis provides an interesting occasion for a strategic repositioning of China's economic and perhaps even the global economy.

China “would rather speed up reforms... [and] give full play to market forces in allocating resources”

- Premier Wen Jiabao, 13 March 2009

It is possible that China's response will reposition the country's fundamentals in the mid-term due to the impact of the global financial crisis. The large focus on boosting investment in infrastructure will distort and delay the rebalancing of China's economy in the short-term so that it will not meet the targets in the 11th FYP. However, it is likely that another round of stimulus-led investment in strengthening the social and environmental welfare of the country will occur in mid-2009. This second attempt will no doubt make a more significant contribution to achieving sustainable development in the decades to come. Moreover, the repositioning of China's relationship to international and regional economies will accelerate the shift towards greater investment in services and consumption.

The global financial crisis is providing China with an opportunity to pause and consider its mode of development and the future direction of the economy. It is argued that China will need to move beyond the paradigm of growth for growth's sake if it is interested in taking advantage of the present challenges. Such a shift is essential for China's future development, but is also important for the rest of the globe.