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China's Economic Policy in the Time of the Global Financial Crisis: Which Way Out?

Margot Schüller and Yun Schüler-Zhou

Abstract: This contribution analyses the impact of the global financial crisis on the Chinese economy and the policies implemented by the Chinese government to cope with it. We argue, first, that China has not been able to decouple its economic performance from that of the U.S. and other developed countries. Second, although economic growth in the second quarter of 2009 showed that the stimulus package is working, the current development does not seem to be sustainable. In order to avoid another round of overheating, the government needs to adjust its stimulus policy. Third, the current crisis offers opportunities to conduct necessary structural adjustments in favour of more market-based and innovative industries, more investment by private companies and a stronger role of private consumption in economic growth. Fourth, with the external demand from the OECD countries declining, Chinese export companies need to further diversify their international markets and reorient their production and sales strategies to some extent towards the domestic market.

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Keywords: China, global financial crisis, China's stimulus package, decoupling, economic recovery

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Introduction

Integration into the global economy has been one of the major policies that has triggered China's economic ascent. The strong dependence on foreign trade and know-how-related foreign direct investment (FDI) has, however, made the country vulnerable to external shocks. As the global financial crisis started to have an impact on the demand for goods and services from China's major trading partners, especially the U.S. and the European Union (EU), Chinese foreign trade growth collapsed and economic growth slowed down. This proved wrong those scholars who saw China as an independent growth pole that would not be affected by crisis in other parts of the world (He, Cheung, and Chang 2007: 24; Huang 2008; Pisani-Ferry and Santos 2009: 8).

The serious impact of the global financial crisis on China's economic growth has revealed a number of structural problems in the Chinese economy. In this contribution we will start with an analysis of China's current economic development and how the global financial crisis has hit the country. In the second part of the paper we look at the policy measures applied in order to find a way out of the crisis. The third section highlights a number of structural problems which still impede a sustainable recovery. In section four we discuss the policy adjustments necessary. The final section offers some conclusions.

The Impact of the Global Financial Crisis on China's Economy

The global financial crisis hit China in the middle of a government-initiated slowdown of its economic growth. With the help of a more restrictive monetary policy and direct market interventions, the government was able to cool down the speculative bubbles in the real estate and stock markets by the middle of 2008. The stronger government control over land supply and housing loans also reduced overheated growth in the up- and downstream industries, especially the steel, cement, transport, and electricity industries (World Bank 2008: 3-4). As economic growth in the U.S., the EU, and Japan dramatically declined and their import demands rapidly dropped, most countries in East Asia started to feel the impact of the crisis.

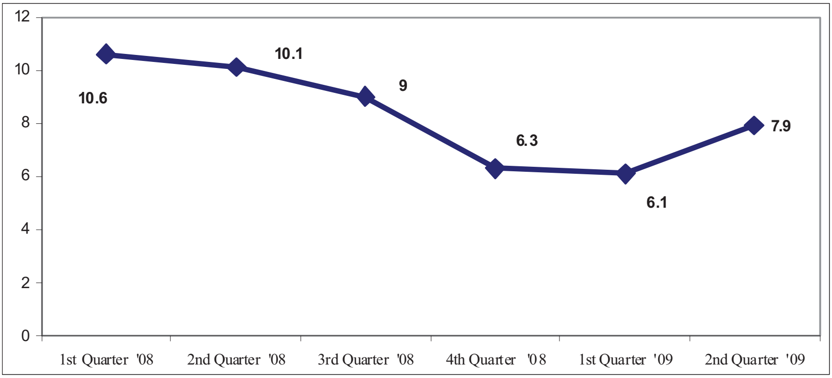
In contrast to the U.S., Japan, many European economies, and other emerging markets, China's financial sector was not affected by the global shock waves following the collapse of the U.S. investment bank Lehman Brothers in the middle of September 2008. The strong linkages between many countries' financial sectors and the U.S. banks and stock exchange directly influenced the performance of the former's financial institutions. Some Chinese banks, however, also reported losses, especially those which held U.S. sub-prime mortgage-backed securities. Among them, the Bank of China (BoC) reported the highest volume (approximately 8.9 billion USD) of this type of securities, followed by the China Construction Bank (CCB) (approximately 2 billion USD) and the Industrial and Commercial Bank of China (ICBC) (approximately 2 billion USD) (*Caijing* 2009b).

That trade became the major channel of transmission for China and East Asia can be explained by the region's strong export dependence on North America and Europe (exports accounted for 12 per cent of the region's GDP in 2007) (Pisani-Ferry and Santos 2009: 10). Due to China's high export dependency (40 per cent of GDP in 2007, 20 per cent in terms of value added, World Bank 2008: 7), the slowdown in demand from its largest trading partners, the U.S. and the EU, led to a dramatic reduction in export and import growth rates.

Between October and December 2008 the monthly export volume shrank continuously. Light industry exports such as toys and textiles were hardest hit by the downturn, while exports with a higher value added such as machinery and equipment continued to grow (World Bank 2008: 2). Despite the collapse in foreign trade within specific industries and regions such as the Pearl River Delta, overall export growth amounted to 17.2 per cent in 2008 and the trade surplus to 295.46 billion USD (+12.7 per cent compared to 2007) (NBS 2009a). In 2009 the slowdown in export growth continued. In the first half of the year exports shrank by 21.8 per cent and imports by 25.4 per cent (compared to the first six months of 2008) (*Xinhua* 2009a). A recovery in export demand will depend mainly on economic development in the U.S. and the EU. According to the latest report of the European Central Bank (ECB), economic activity in the euro area in the second half of 2009 will remain weak; positive quarterly growth rates are expected by mid-2010 (ECB 2009: 5).

As already noted above, the collapse in export growth overlapped with the government-initiated slowdown of the real estate and stock markets. It has led to a drastic decline in GDP growth since autumn 2008. The quarterly growth rate declined from a high level of 10.6 per cent in the first quarter of the year to 10.1 per cent in the second quarter, 9 per cent in the third quarter, and 6.8 per cent in the fourth quarter. In 2009 first-quarter GDP growth was only 6.1 per cent. In the second quarter, however, economic growth rebounded and the growth reached 7.9 per cent (see figure 1).

Figure 1: China's Quarterly GDP Growth Rates (Q1, 2008-Q2, 2009)



Source: National Bureau of Statistics 2008 and 2009c.

An economic growth rate of approximately 8 per cent has often been described as being necessary for the absorption of new workers entering the labour market and those being displaced by the ongoing industrial restructuring. As capital-intensive industries have expanded in the last decade at the expense of labour-intensive industries, a high level of growth has become even more necessary (*The Economist* 2008). The decline in exports in 2008 translated into the closing of 670,000 small companies in China by the end of the year. Migrant workers were the most affected by this development. Government agencies also feared that with the decline of foreign investment, demand for highly skilled urban workers could decrease as well, especially for university graduates. The official statistics of the Ministry of Human Resources and Social Security showed an unemployment rate of 4.2 per cent and 8.9 million people registered as unemployed at the end of 2008 (NBS 2009b). According to the *Social Blue Book 2008* of the Chinese Academy of Social Sciences, unemployment reached 9.4 per cent in late 2008 (*China News* 2009). Taking the various groups of unemployed in the urban and rural sectors into account – especially migrant workers, the registered urban unemployed and the graduates expected this year – Günter Schucher (2009: 128) estimates that the Chinese labour market will face approximately 37-42 million job seekers in 2009. In order to avoid the social unrest associated with a prolonged recession and growing unemployment, in autumn 2008 the government responded to the pressure to create jobs and expand the social security net with a huge stimulus package (Schucher 2009: 137).

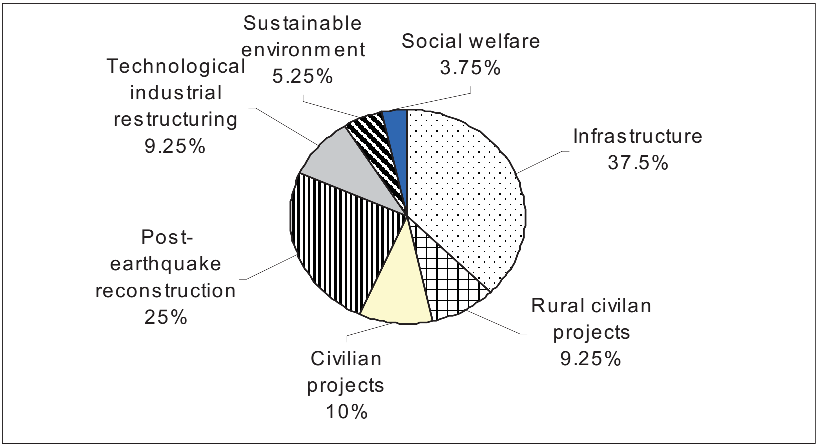
The Economic Stimulus Package

To cope with the negative impact of the global financial crisis on the Chinese economy, the government announced a fiscal stimulus programme of 4 trillion CNY (486 billion USD) in November 2008. Following public pressure to announce more details of the stimulus package, the National Development and Reform Commission (NDRC) subsequently published a breakdown of the package on its website (see figure 2). Due to the strong impact of the crisis on the labour market, the stimulus package underwent some adjustment in favour of social welfare expenditure and investment in the technological restructuring of industrial enterprises. The largest share of the stimulus package, 38 per cent, is intended for infrastructure projects; the second largest share, 25 per cent goes to the post-earthquake reconstruction of Wenchuan in Sichuan Province. Public utilities in rural areas and the construction of affordable housing in urban areas receive shares of 9.25 per cent and 10 per cent respectively. The funding of the projects relies heavily on local governments and private companies, as they are expected to cover approximately 70 per cent of the 4-trillion CNY package (*Caijing* 2009a).

The details of the stimulus package include very ambitious goals for the expansion of infrastructure and aim to support domestic consumption and job creation. Until the end of 2010, for example, 400 billion CNY will be allocated for the construction of 50 new airports and the modernization of 90 already existing airports. An additional 600 billion CNY is designated for the modernization of the railway system, and another 1,000 billion CNY for the expansion of the network of roads, local transit systems, and seaways (Germany Trade & Invest 2009). Labour-intensive public infrastructure projects offer the prospect of jobs for both urban and rural workers (Schucher 2009: 136-137).

The stimulus package also allocates 850 billion CNY to the health system, including the establishment of a health insurance system in rural areas (Germany Trade & Invest 2009). Currently, private households' economic demand is restricted due to the high level of savings necessary for old age provisions and health insurance. This is especially the case for rural households. The earning prospects of these households are restricted because of low agricultural prices and limited employment opportunities for migrant workers. Here, the government can step in by supplying basic social security, allowing private households to then spend more on consumption. Part of the stimulus package is designed to meet this challenge. In addition, government subsidies for rural households' consumption of electrical appliances has been another measure to support consumption growth and related industries (World Bank 2009: 10).

Figure 2: Breakdown of the 4-Trillion-CNY Stimulus Package



Source: *Caijing* 2009a.

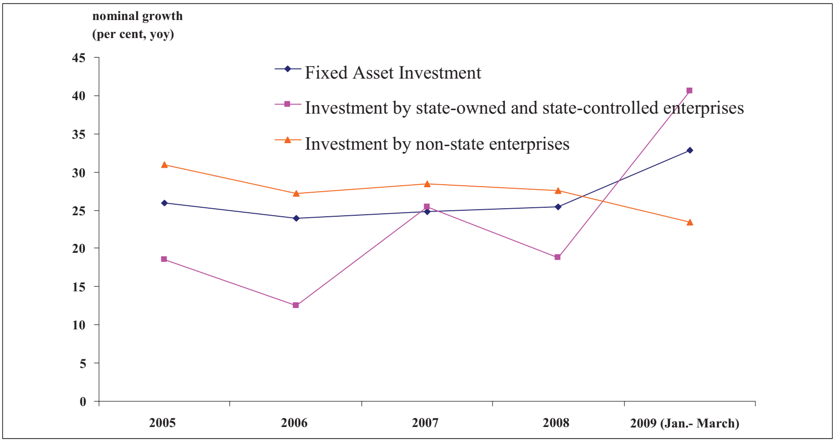
In addition to the fiscal stimulus package, the government is also applying some monetary policy instruments. In December 2008, interest rates for loans and savings deposits with a one-year duration were lowered to 5.31 per cent and 2.25 per cent respectively. In order to make sure that no credit crunch occurred, the government directly requested the banks to facilitate access to loans for companies and private households. The four major state-owned banks were asked to increase their lending to small and medium-sized enterprises (SMEs). By the end of May 2009, the ICBC reported that 61 per cent of its credit extension in the first five months went to SMEs; this share amounted to 44 per cent for the BoC, 42 per cent for the CCB and nearly 50 per cent for the Agricultural Bank of China (ABC) (*China Daily* 2009a). In addition to relaxing control over bank lending, the China Banking Regulatory Commission (CBRC) issued new regulations easing the establishment of companies that offer consumer loans to private households for the purchase of consumer durables (*China Daily* 2009b).

Other policies to tackle the slowdown in demand for Chinese exports include, first, rebates on value-added export tax that target low-cost goods, such as textiles and furniture, which are popular in the cost-conscious emerging markets. These have been designed to support exports to emerging economies in the same way they supported exports to Europe and the U.S. during the last global downturn in 2001 (*Financial Times* 2009). Second, the government has supported the preferential treatment of Chinese firms in government procurement. Foreign institutions such as the World Bank and the European Chamber of Commerce immediately criticized this announcement as a protectionist policy. The "buy China" call of the NDRC stressed that, whenever possible, government agencies should favour the procurement of locally made products (*The Straits Times* 2009).

On the Way to Sustainable Development?

Whether the stimulus package will lead to sustainable economic growth and employment creation has been a controversial subject. Official media reports tend to stress the positive impact, while the threats to the economy as the result of the huge spending flush should not be underestimated. The fact that economic growth in the second quarter of 2009 was higher than in the first quarter was mainly due to the strong growth in government expenditure and state-owned enterprises' (SOEs) spending and was not based on private sector investment. Based on an analysis of fixed asset investment (FAI) in the first five months of 2009, the total amount invested in urban fixed assets amounted to 5.3 trillion CNY, an increase of 32.9 per cent compared to the same period of the previous year. State-owned and state-controlled enterprises' investment growth rates amounted to 40.6 per cent, while investments by non-state enterprises (in the period January to March 2009) grew by 23.5 per cent (see figure 3).

Figure 3: Fixed Asset Investment (2005-2009)



Note: 1) The definition of non-state enterprises is based on that of the NDRC and includes private enterprises, the self-employed, collective-owned enterprises, jointly owned enterprises, shareholding enterprises, and foreign-funded enterprises. 2) Investment by non-state enterprises in 2009 covers the period January to March. 3) The volume of investment by state-owned and state-controlled enterprises in 2008 was estimated by the authors.

Source: Authors' own compilation of statistics based on annual reports on the development of non-state enterprises by the NDRC (NDRC 2005-2009); NBS 2006, 2007, 2008b; NBS report on social and economic development in 2008 (NBS 2009a).

Between January and May 2009, investment in the building of railroads and other transportation networks grew by 110.9 per cent year-on-year (yoy), pointing to the strong impact of the government stimulus package. In contrast, in several key manufacturing sectors, especially export-oriented industries (textiles, computers, and electronic equipment), FAI growth continued to slowdown or had decreased. Investment in the real estate sector contributed to overall FAI growth (World Bank 2009: 3). Property-related fixed-asset investment grew by 6.8 per cent yoy in the first five months in 2009. Compared to last year's growth rate, the recovery was still slow (25.1 percentage points lower). In contrast, housing sales recovered in the first five months, with sales of commercial and residential real estate rising by 45.3 per cent (Wang 2009).

The easy access to loans resulted in an explosion of the total credit volume. Bank lending in the first half of 2009 was much greater than expected and had already exceeded the year's target of 5 trillion CNY in May. In June, China's four largest state-owned commercial banks recorded a total lending volume of 497 billion CNY, nearly twice as much as in May (*Caijing* 2009c). This massive lending spree could lead to a strong deterioration in next year's balance sheets at Chinese banks. Critics also point to the use of loans for stock market and commodities speculation, which reduces the support for the recovery of the real economy and could lead to inflation (Xie 2009).

Some indicators on private consumption are promising; for example, sales of automobiles and cosmetics increased by 37.4 per cent and 18.2 per cent yoy in April; passenger air transportation grew by 14.6 per cent in the first quarter (Bottelier 2009a). Despite these positive signs, the reports of the consumer confidence index show a contradictory trend. Consumer confidence appears to be as low as during the SARS period. Since the beginning of 2009, the index has continued to fall. It stood at 86.7 points in May, compared to 94.3 in the same month last year (NBS 2009d). However, consumption data are regarded as being not very reliable, and uncertainty over China's consumption growth remains (Bottelier 2009b).

The problem of weak export performance has not been solved and threatens the survival of many SMEs. A recent survey by the Chinese Academy of Social Sciences (CASS) asked whether domestic consumption will be able to replace the role of exports in bolstering economic growth. The survey included 70 SMEs in the coastal provinces of Jiangsu, Zhejiang, and Fujian. About 90 per cent of these companies have been affected by a decline in new orders from the U.S. and Europe; 40 per cent have either closed or are considering shutting down. As client payments are slow and accessing bank loans is difficult, many of these companies face the prospect of a lack of working capital or bankruptcy if the crisis continues until 2010. Although many of them have increased their efforts to develop domestic business, they have not been able to compensate for the loss of exports (Ding 2009). The fact that China's import volume has grown since March 2009 can be related to the strong increase in imports of raw materials, whose prices have reached a relatively low level. In contrast, the import volume for manufactured goods is still low (World Bank 2009: 4). This could indicate that incentives for further expansion of production are still lacking.

Discussion of Necessary Policy Shifts

It is too early to state that China has achieved sustainable recovery. We can expect that in the second half of 2009 government-led investment will further support economic growth and stabilize employment. Notwithstanding some preliminary positive results of the stimulus package, a number of structural adjustments are still needed in order to sustain rapid growth. The current crisis provides opportunities for necessary changes to the Chinese economic development pattern. But can the country, together with the government and companies, adjust successfully? The following discussion takes up some of the arguments often put forward regarding the necessary changes to Chinese economic policy.

Shift towards a More Domestic-oriented Development

Overcapacity in manufacturing is often regarded as one of the major global economic challenges. China has contributed significantly to this development. Chinese companies were able to enter the global production networks of multinational enterprises (MNEs), which then relocated parts of their manufacturing processes to China and created the "factory of the world". Easy access to bank loans allowed companies to increase production capacity well above the domestic demand. With high competition in the domestic market, restrictions on mergers and acquisitions (M&A) or other forms of market adjustments, and low profit margins, companies were forced to export.

On the other hand, Western economies such as the U.S. and the EU welcomed Chinese products and accepted a growing deficit in bilateral trade with China. Many of their domestic companies had set up production facilities in China or relied on the Chinese market to purchase their products. The linkages between export-driven economies and consumer-driven economies were strong and led to mutual interdependence. The global financial crisis has put this pattern into question. Its strong dependency on exports represents a high growth risk for China. At the moment it is uncertain whether the previous consumption patterns of the U.S. consumer will be revived.

If export growth does not recover, China will only be able to achieve high growth by shifting its focus towards the domestic economy, relying more on private consumption. This re-orientation towards a growth strategy based on domestic demand cannot be achieved without considerable reforms to the social security system.

Adjustment of the Government-led Investment Strategy

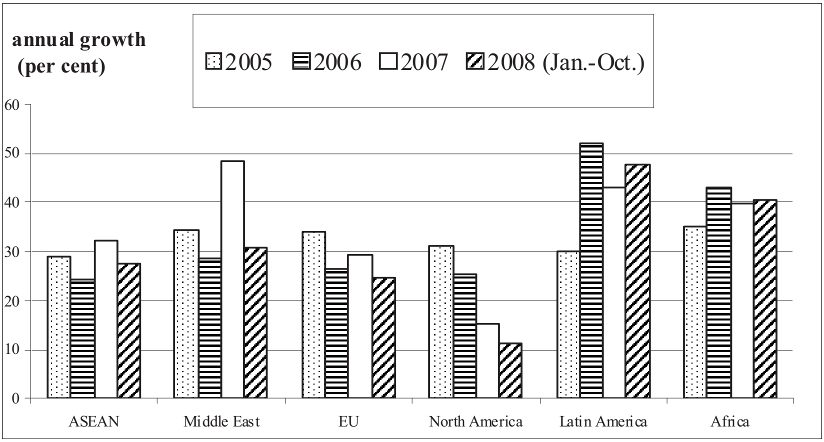
Despite the positive impact of government investment on economic growth, the government-led investment strategy took place at the expense of the private sector. Today, however, private companies are most important for job creation and the absorption of surplus labour from SOEs. These companies contribute approximately 60 per cent of total exports and employ approximately 75 per cent of the urban workforce (The Central People's Government website 2007). Without the expansion of the private sector, China may face an employment crisis. How vulnerable SMEs are – most of them are privately owned companies – has become obvious during the global financial crisis. Therefore, the strengthening of the private sector is regarded as the key to solving the unemployment problem.

Despite the official recognition of the crucial role played by the private sector, these companies are still discriminated against by formal financial institutions and have difficulties obtaining loans. In 2008 the percentage of loans allocated to private enterprises in total short-term lending was only 3.37 per cent. While companies in the state sector enjoyed easy access to bank loans, the share obtained by private companies even fell below the level of 2008 in January and February 2009 (ChinaStakes 2009). Therefore, the above-mentioned government decision to push the state-owned banks to expand their portfolios to include private companies seems to be a step in the right direction. To support the banks, the Ministry of Finance set up a fund of 1 billion CNY intended to be used for SMEs in March 2009 (*Xinhua* 2009b).

Diversification of Foreign Trade

With the slowdown in demand from the U.S. and the EU, Chinese exporters have begun turning to other emerging economies. This reaction partly reflects problems at home, such as overcapacity and low profit margins, and is welcomed by the Chinese government. Exports to Africa, Latin America, and the Persian Gulf region (six states) grew faster in the first ten months of 2008 than those to the EU and the U.S., with growth rates of 40.4 per cent, 47.6 per cent, and 41.6 per cent respectively. This trend had already begun in 2005 and was reinforced by the weakening of demand from the traditional markets for Chinese exports (see figure 4). China has already overtaken the U.S. as the world's largest exporter to the Middle East.

Figure 4: Growth in Chinese Exports by Region (2005-2008)



Source: MOFCOM 2006-2009.

Conclusion

China's latest statistics point towards a strong rebound in economic development in the second quarter of 2009. Despite the initial success of the stimulus package, we have expressed our doubts regarding whether this recovery will lead to sustainable development as economic growth has mainly been driven by state-led investment. In the first half of 2009, investment accounted for 6.2 percentage points of GDP growth, while consumption accounted for 3.8 percentage points. The export sector accounted negatively for 2.9 percentage points (Shu 2009: 8). In 2007, the year before the global financial crisis, investment, consumption, and exports accounted for 4.3 percentage points, 4.4 percentage points, and 2.7 percentage points, respectively, of GDP growth. The 2009 figures show the strong imbalance between investment and consumption, which is being driven by a loose monetary policy.

While the stimulus package has been helpful in achieving a high level of growth, this policy cannot resolve the structural problems that are hampering a sustainable recovery. The fact that SOEs' investments have increased most rapidly since the stimulus package has been introduced is leading to a further distortion between the state and private business sectors. China's monetary and fiscal policies since November 2008 have favoured SOEs at the expense of the private sector. There is a need for a policy adjustment which will enable private companies to participate more in the stimulus package. Only very recently has the government pushed the banks to offer private enterprises better access to loans. However, private companies account for most of the employment in China, even though SOEs account for a larger share of GDP. While government support to boost employment is important in the short run, the long-term labour demand of a growing private sector is needed for a recovery.

We have shown that China's growth model has been based on government-led investment and foreign enterprise-led exports. If export demand remains weak for several years, high growth can only be achieved through a shift towards domestic demand. A precondition to boosting domestic consumer spending is broader coverage by the social security system, which would allow households to increase their consumption.

While foreign trade might continue to play a crucial role for the Chinese economy, regional diversification of export markets seems to be necessary. Whether the shift in export markets will be welcomed by other emerging economies is, however, doubtful. Chinese low-cost manufacturers already compete with producers in emerging economies, putting much pressure on their market shares. The Federation of Indian Chambers of Commerce and Industry, for example, recently noted that two-thirds of SMEs in India suffered under the sudden rise in Chinese capital and consumer exports. Syria's government has imposed tariffs on Chinese textile exports in reaction to factory closures in Aleppo, the country's historic textile production centre (*Financial Times* 2009).

The global crisis might also give China the opportunity to assert its international economic influence. It has been testing the ground with the recent expansion of CNY-trade settlements with other economies. Announced in April this year, the first cross-border CNY-trade settlement took effect in July. The pilot programme is first restricted to exporters and importers in Shanghai, Guangzhou, Shenzhen, Zhuhai, and Dongguan and aims to facilitate trade with Hong Kong, Macau, and the neighbouring ASEAN countries. The economies in this region represent 32 per cent of China's trade with Asian countries. The overall goal of this policy is not only to reduce transaction costs for traders but also to become less dependent on the U.S. dollar (Fu and Jin 2009).

The global economic crisis has triggered the international expansion strategies of Chinese companies, especially natural resources companies. In contrast with the worldwide decline in foreign direct investment of 20 per cent, China doubled its overseas investment in 2008 and the growth has continued to accelerate in 2009 (Davis 2009). Petrochemical companies from China, for example, are trying to acquire firms in those countries that have previously been restrictive to Chinese companies' demands. The NDRC encourages domestic companies to develop energy cooperation overseas with special funds. So far, only a few oil or chemical companies have been able to acquire firms abroad. Sinopec Group, CNPC, CNOOC, ChemChina, and Sinochem count among the stronger firms that have been active in this respect in recent years.

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