

The Impact of the Global Crisis on China and its Reaction (ARI)

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Theme: The current global financial crisis is having a significant negative impact on the Chinese economy.

Summary: The current global financial crisis is having a significant negative impact on the Chinese economy, affecting exports, foreign exchange reserves and structural adjustments. The Chinese Government's reaction has so far been effective in boosting short-term economic growth, but has been insufficient to ensure sustainable long-term growth and new risks could arise. Policy suggestions include how to stimulate household consumption effectively, how to mitigate the pressure of unemployment and how to diversify China's foreign exchange portfolio.

Analysis:

Introduction

The US subprime crisis which broke out in the summer of 2007 evolved into a global financial crisis after the bankruptcy of Lehman Brothers in September 2008. The subsequent liquidity squeeze and credit crunch caused a world-wide economic slowdown. The US, the Euro Zone and Japan all slipped into recession in 2008, a situation that is likely to persist at least into 2009. The emerging countries have faced not only a dramatic decline of economic growth, but also a surge of capital outflows. A financial crisis could break out in the central and eastern European economies, driven by significant current account deficits, heavy debt burdens denominated in foreign currencies and a sudden stop or even reversal of capital inflows.

As the largest developing country and an export-driven economy, it would have been impossible for China to dodge the impact of the global financial and economic crisis. First, China is over-dependent on exports to stimulate its economic growth and the weakening of external demand will be a heavy blow for the Chinese economy. Secondly, at the end of 2008 the People's Bank of China (PBoC, the Chinese central bank) had foreign exchange reserves worth US\$1.95 trillion, of which a large part were denominated in US dollars, especially US treasury bonds and agency bonds. The potential devaluation and downgrade of its US treasury or agency bonds resulting from the deepening of the subprime crisis will erode the international purchasing power of China's foreign exchange

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reserves. Third, to prevent a slowdown of economic growth, the Chinese government might postpone or even cancel some structural adjustment policies which are necessary to ensure the sustainable growth of the Chinese economy, such as bursting the price bubble in the real estate sector and increasing the flexibility of the RMB's exchange rate mechanism, among others.

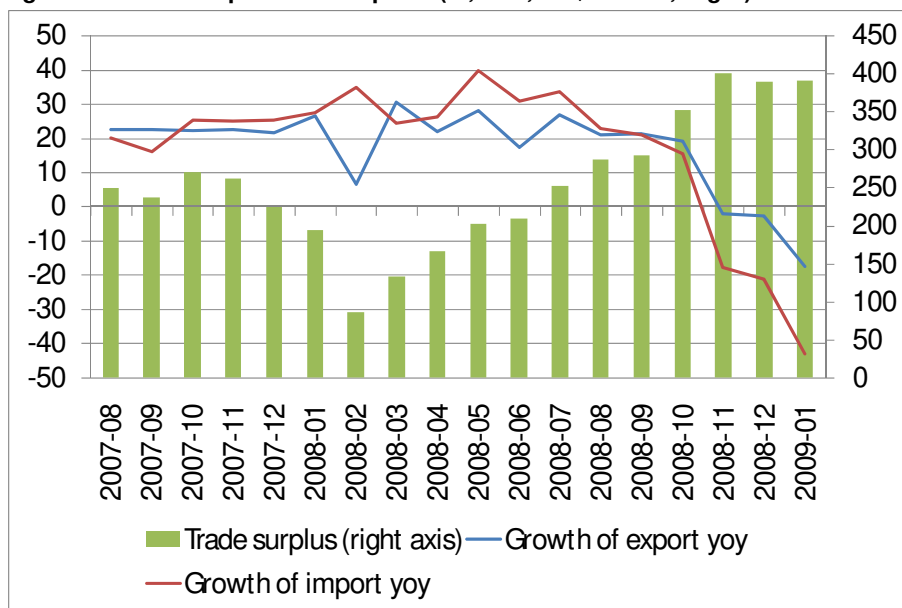
The Chinese government has taken timely and bold countermeasures to mitigate the impact of the global financial crisis. Since the third quarter of 2008, the Chinese authorities have adopted a combination of an active fiscal policy and a loose monetary policy. The appreciation of the RMB against the US dollar has been halted since the second half of 2008. Although these measures are quite useful to stimulate short-term economic growth, they cannot ensure long-term sustainable growth and might generate new risks. Therefore, the Chinese government should speed up the structural readjustments which will help to transform China's growth model and stimulate domestic consumption.

The Impact on China's Exports

China's economic growth is over-dependent on the growth of net exports. In 2008, its export-to-GDP ratio reached 32%, and its exports-and-imports-to-GDP ratio was 59%. The contribution of net exports (goods and services) to GDP growth was over 20% in 2007. Moreover, as a labour-intensive sector, exports absorbed a mass of non-skilled workers from rural areas.

The G-3, which account for 46% of the external demand for China's exports, have all slipped into recession due to the impact of the global financial crisis. Emerging markets, such as Hong Kong, Taiwan, South Korea and the ASEAN countries, which are China's major export markets, have also slowed down dramatically. As a result of the weakening external demand, China's exports have declined significantly since the fourth quarter of 2008. Both exports and imports have registered a contraction (yoy) since November 2008 (see Figure 1). However, due to the decline in world energy and commodity prices and to China's shrinking internal demand, imports have decreased much faster than exports, causing a surge in the trade surplus.

Figure 1. China's exports and imports (% , Left; US\$100 mn, Right)



Sources: Ministry of Commerce of the PRC.

As a result of the global financial crisis a large number of export-led private enterprises in China's coastal provinces have gone bankrupt, with around 20 million unskilled workers losing their jobs. Furthermore, the slowdown in China's exports, along with the decline in real estate investments, has led to a decrease in GDP growth from 13% in 2007 to 9% in 2008.

The exact reason why the Chinese government has put export growth at the top of its list of priorities is that the export sector can absorb excess labour. The huge number of workers released from bankrupt or poorly-operated enterprises has caused a surge in the real unemployment rate, which could lead to social unrest. Hence, the Chinese government has continued to apply tax rebates to export goods, increasing its intervention in the foreign exchange market to prevent the further appreciation of the RMB against the US dollar, and lowering its environmental and energy-consuming criteria. However, external demand is an uncontrollable variable so the Chinese government's capacity to stimulate exports is facing great challenges, especially in an environment of protectionist pressure.

The Impact on China's Foreign Currency Reserves

At the end of 2008, China's foreign exchange reserve had reached US\$1.95 trillion. Although the PBoC does not disclose the proportion of currency and assets of its foreign exchange reserves, it is possible to make a rough estimate based on external data. For instance, according to the IMF's COFER statistics, up to the third quarter of 2008, assets denominated in US dollars, euros, pounds Sterling and yen in the portfolios of developing countries' reserves totalled respectively 61%, 28%, 6% and 3%. There is no evidence to show that China's reserves are significantly different from those of other developing countries. The asset composition of China's foreign exchange reserves can also be estimated through the statistics disclosed by the US treasury on the overseas holdings of US securities. According to the preliminary report on foreign portfolio holdings of US securities at the end of June 2008, China held US\$535 billion in US treasury bonds, US\$544 billion in US agency bonds, US\$27 billion in US corporate bonds and US\$100

billion in US equities. Even considering that the PBoC sold agency bonds and bought short-term treasury bonds in the second half of 2008, it can still be concluded that China's foreign exchange reserves are heavily allocated in US dollar-denominated assets, especially US treasury and agency bonds.

Following the subprime crisis, the US government has applied very loose fiscal and monetary policies. Paulson's US\$700 billion TARP programme, Obama's US\$789 billion stimulus package and Geithner's US\$2 trillion financial stability plan will together create a record-high fiscal deficit, which should reach an estimated US\$1.75 trillion in 2009, over 12% of the US GDP. The Fed has cut the benchmark rate from 5.25% to 0-0.25% and has been pumping money and credit into the economy through various types of innovative mechanisms. From the bankruptcy of Lehman Brothers in mid-September 2008 to the end of the year the Fed's balance sheet has grown from US\$950 billion to US\$2.27 trillion.

To finance the rescue package, the US government has only two choices. The first is to issue more treasury bonds, at least US\$2 trillion in 2009. If the demand for US treasury bonds is unable to keep pace with the supply, their market value will decrease. As the largest holder of US treasury bonds, the PBoC will therefore suffer a significant loss. The second choice is that, if other investors are unwilling to continue to buy US treasury bonds, the Fed will become the buyer of last resort, meaning that the US government will take up the printing of bills. Unavoidably, the inflation rate will surge and the US dollar will depreciate against other major currencies. Therefore, the international purchasing power of China's portfolio of US dollar-denominated assets will shrink markedly.

The Impact on China's Structural Adjustments

An indirect but critical effect of the global financial crisis on the Chinese economy is that, to mitigate the impact on the domestic economy and to stimulate short-term economic growth, the Chinese government might postpone or even cancel some of its structural adjustment policies. However, these structural adjustments are absolutely necessary for the sustainable growth of the Chinese economy.

One example is that, to stimulate short-term economic growth, the Chinese government might resort to reviving real estate investment, which means that it might give up trying to burst the property price bubble. Obviously, from the third quarter of 2008, both central and provincial governments have loosened the controls on property sector. The percentage of down payments and the interest on loans to buy a second home have been reduced. The criteria by which commercial banks grant loans to developers have been lowered. Property developers can again obtain easy financing, reducing the possibility for them to drive down property prices. Considering that there are still obvious bubbles in the property markets of many coastal cities, to loosen controls means that the Chinese government will postpone the necessary adjustment in property prices. However, bubbles always burst at some point. The longer the adjustment is postponed, the greater the final impact of the collapse will be. The Chinese government should take note from the Japanese experience in the late 1980s.

The misalignment of the RMB's exchange rate has been one of the major factors to have caused the Chinese economy's external and internal imbalances. To solve this problem, the Chinese government started to reform the RMB's exchange rate mechanism in July 2005. Its *de facto* pegging to the US dollar was replaced by managed floating with reference to a basket of currencies, and the pace of the RMB's appreciation against the dollar accelerated from July 2005 to the first half of 2008. However, after the aggravation

and spreading of the global financial crisis, China's exports declined significantly. To sustain the relative competitiveness of China's export goods, the PBoC increased its intervention in the foreign exchange market to prevent the further appreciation of the RMB from the third quarter of 2008. In an environment of declining external demand and increasing trade protectionism, it is doubtful that managing the RMB's exchange rate will help stimulate China's exports. To make things worse, the bank's heavy intervention in the foreign exchange market will sustain or even aggravate the country's external and internal imbalances.

The Chinese Government's Reaction to the Global Crisis

Following the bankruptcy of Lehman Brothers, the Chinese government changed its policy emphasis from curbing inflation to ensuring stable economic growth. The macroeconomic policy combination includes an active fiscal policy, a loose monetary policy and a stable exchange rate policy. In terms of fiscal policy, a RMB4 trillion (US\$588 billion) investment plan was released in November 2008, one of the largest fiscal rescue packages worldwide. As for monetary policy, the RMB's deposit and loan interest rates have been cut from 4.14% and 7.47% to 2.25% and 5.31% respectively. The required reserve ratio has declined from 17.5% to 13.5%. The credit quota applied by the central bank on commercial banks was cancelled in the fourth quarter of 2008. Bank loans increased by RMB1.62 trillion in January 2009, one third of the increment recorded in 2008. As for its exchange rate policy, the PBoC has increased its intervention in the foreign exchange market since the third quarter of 2008, halting the appreciation of the RMB against the US dollar.

We do not doubt the Chinese government's capacity to stimulate short-term economic growth. Over 80% of the RMB4 trillion investment package was allocated to infrastructure and property investments, and the effect should gradually unfold in the second half of 2009 and in 2010. The surge in bank loans in the fourth quarter of 2008 and the first quarter of 2009 will further facilitate these investments. After a time lag of two to three quarters, the expansive macroeconomic policies will push the economy to rebound. Hence, we are relatively optimistic that China's GDP growth might reach 8% in 2009.

However, the countermeasures the Chinese government has adopted so far might not ensure sustainable economic growth and could entail some new risks. First, China should transform its growth model from export-driven to domestic demand-driven in order to sustain long-term economic growth, which means that the government should try to increase household consumption. However, the fiscal resources to increase household income and provide social welfare are very limited. Secondly, too many resources have been allocated to infrastructure and property investments, and there is a potential risk underlying them. As for infrastructure, there is already an over-investment and excess capacity in certain fields, such as motorways and hydroelectric power stations; in property investment there are still obvious price bubbles in many coastal cities. A surge in investments might aggravate resource misallocation and property price bubbles. Third, the huge amount of banking loans granted from the fourth quarter of 2008 to the first quarter of 2009 might trigger a new surge in non-performing loans (NPLs) on the balance sheets of China's commercial banks, and NPLs will eventually become a fiscal burden. Fourth, the PBoC has done little to diversify its foreign exchange portfolio from US treasury bonds and agency bonds, although these assets are becoming increasingly dangerous in the mid-term and long-term.

Conclusions

The Right Path: Speeding up Structural Adjustments

The global financial crisis is both a tough challenge and a precious opportunity for China. Although the crisis is affecting China's exports, employment and foreign exchange reserves, it is also generating external pressure for China to carry out structural adjustments and providing a window of opportunity to expand overseas investment. The Chinese government should fully utilise this opportunity not only to sustain short-term economic growth but also to achieve long-term strategic objectives.

To stimulate short-term economic growth and to speed up structural reforms, China should make increasing household consumption its top priority. The most effective way to boost consumption is to increase household income. Since the mid-1990s, the proportion of household income in national income has been declining, while the proportion of government and corporate income in national income has been rising. This is the root cause of China's low consumption. Therefore, the idea is to increase the proportion of household income in national income. On the one hand, the Chinese government should cut personal income tax. On the other hand, it should urge state-owned enterprises to disburse dividends to its major share-holder, central or provincial government, in order to then increase unilateral transfers from government to households. Moreover, the Chinese government should employ more fiscal resources to provide social welfare, such as education, health care and social safety nets, which could significantly reduce the uncertainties in household expectations about future income and expenditure.

To mitigate the pressure of unemployment, the Chinese government should not over-rely on maintaining export growth, because declining external demand and soaring protectionist pressures will weaken any measure by which exports are stimulated. Alternatively, China should promote employment by opening up and developing the service sector. The latter is labour intensive, just like the export sector. Therefore, the service sector has a great potential to absorb unskilled workers released from the export sector. To boost investments in the service sector, the Chinese government should first break up the monopolies of state-owned enterprises in such fields as finance, education, medical care, telecommunication and transport and open these activities to private capital. Secondly, the Chinese government should increase the flexibility of the RMB's exchange rate mechanism, because an undervalued real exchange rate will tend to exacerbate the resource misallocation between the tradable and non-tradable sectors, ie, too many resources will flow into the tradable sector.

The Chinese government should speed up the diversification of its foreign exchange reserves exploiting the window of opportunity thrown open by the global financial crisis. First, the PBoC should stop buying US treasury bonds unconditionally. The Chinese government needs the US government to provide some sort of guarantee on the market value of US treasury bonds. For instance, the PBoC should henceforth only buy TIPs. Another example is that the Chinese government could require the US to issue convertible treasury bonds, giving creditors an option to transfer the bonds into shares of US commercial banks held by the US government, with the strike price not being much above the price the US government paid to previously purchase the shares. Secondly, a large proportion of China's foreign exchange reserves should be invested in the energy and commodity markets and the global stock markets, because their valuations are far more reasonable now than hitherto. Especially, investing in the energy and commodity markets now will help the Chinese economy to hedge the risk of price hikes in the future.

Third, China should adopt some innovative financing mechanisms to combine providing assistance with the RMB's internationalisation. For example, China could agree with foreign countries to issue RMB-denominated treasury bonds ('Panda Bonds') on the Chinese domestic market, with foreign countries then using the RMB to purchase US dollars from the PBoC. The proposed 'Panda Bonds' can not only provide foreign countries with necessary funding but also strengthen the status of the RMB as an international currency. Moreover, they could provide new incentives for China to develop a RMB forward exchange-rate market.

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