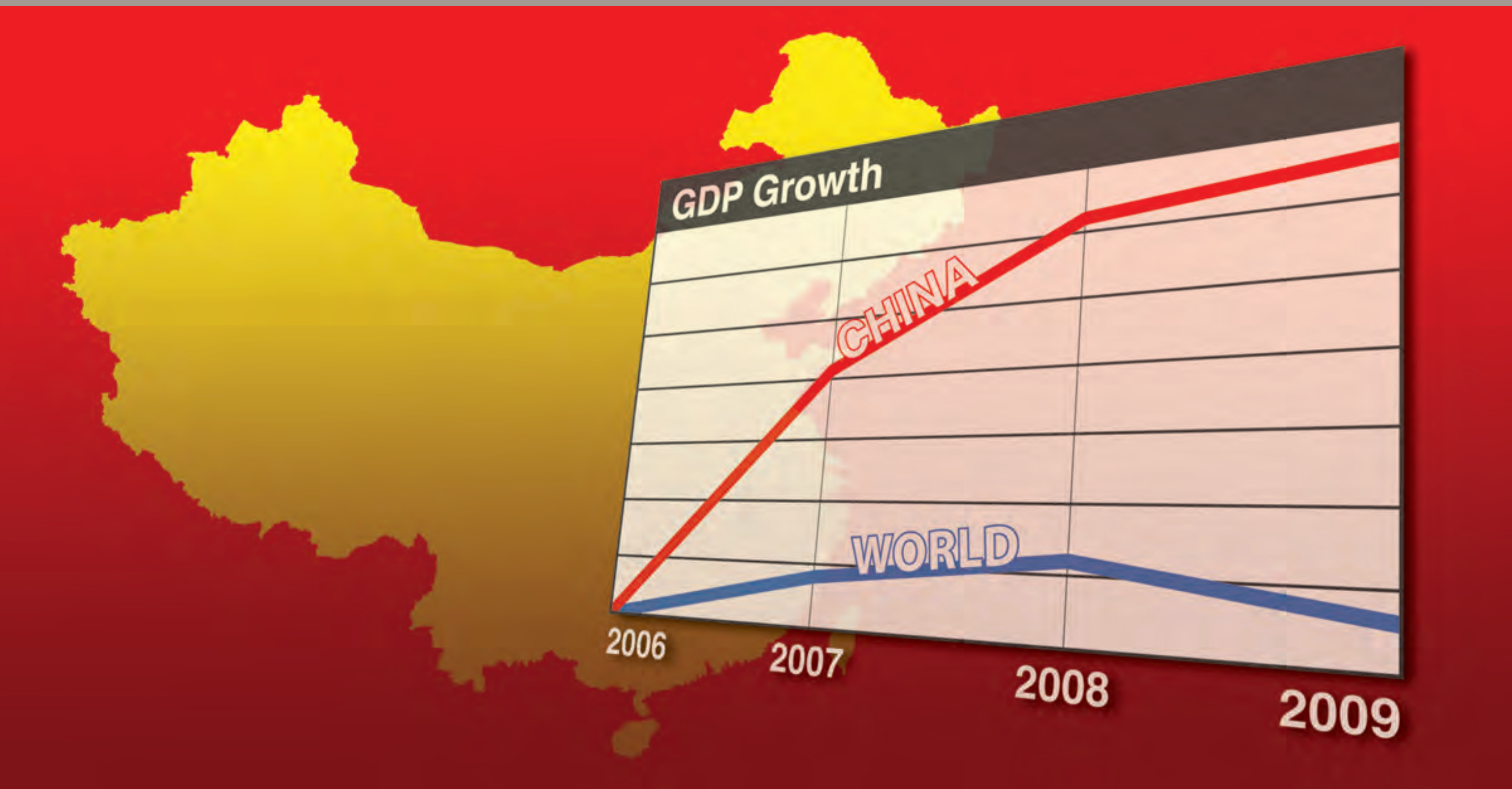
CIGI/Chinese Academy of Social Sciences Task Force

China and the Financial Crisis



John Whalley, Manmohan Agarwal, Yuezhou Cai,
Yan Dong, Huifang Tian, Li Wang

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Addressing International Governance Challenges

About the Task Force

This report has been produced by a task force, chaired by John Whalley, organized under the Chinese Academy of Social Sciences/CIGI Young Scholars Network for Chinese Public Policy.

Summary

This report, produced by a task force under the aegis of the Chinese Academy of Social Sciences (CASS) and the Centre for International Governance Innovation (CIGI), assesses the impact of the global financial crisis on China. The report suggests that China has been perceived as relatively well insulated from the crisis, but along with other trade-dependent countries outside the Organisation of Economic Co-operation and Development (OECD) its integration into the global economy means exposure to the negative effects of the economic downturn. This is evident in China's economic performance, though the report finds that China is relatively well positioned compared to the OECD economies.

Challenges will arise from an increased integration into the global economy, a dependence on exports, uncertainty in housing prices, and a potential turn to protectionist policies. The report outlines the options for policy response by China in areas such as construction and real estate, exchange rates, regulatory change, management of financial reserves, and the approach to market-oriented development. The task force suggests that China has an interest in the emerging global financial architecture and in maintaining openness in the trading system, and predicts that a point of contention will be deciding the purpose and objectives of those systems.

Introduction

This report discusses the impacts of the current global financial crisis on China and has been produced by a small task force from the Centre for International Governance Innovation, Waterloo, Ontario, and the Chinese Academy of Social Sciences, Beijing.

Much of the commentary on China and the crisis thus far has characterized China as being relatively well insulated from the worst effects of the crisis and outperforming other larger economies and now as seemingly bottoming out. GDP growth in 2009 is widely forecast to be in the 6-9 percent range. China has a strong banking system, large foreign reserves, and China was not (like the United States and Europe) at the epicentre of the crisis. On the other hand, China is heavily trade-dependent, with pre-crisis exports reaching around 40 percent of GDP and export growth of 20-30 percent per year. The significant downturn in world trade growth has impacted China's growth performance but not in a major way. The sharp run-up in house and apartment prices in the last few years in major cities could pose a challenge if this were to plateau or reverse, but in recent months house prices have risen again after falling. In what follows, we discuss the impacts of the crisis on China's trade performance, on potential Chinese growth rates, and on the overall management of the economy.

The Dimensions of the Crisis and Scenarios for its Further Development

The current global financial crisis is, at root, an unwinding of financial excesses that have occurred globally over a number of years and even decades. It is the unwinding of a global housing price bubble, an oil bubble, low interest rate policies, trade surpluses and deficits, low savings rates in some parts of the global economy and high savings rates elsewhere. The cumulative effect has been a financial and liquidity crisis located primarily in the financial systems of Europe and the US, but it threatens to become a much wider and major global macroeconomic upheaval with significantly negative global GDP growth, perhaps for two to three years, with sharply increased unemployment, pressures on public revenues, and deflation. Even though the origins have been concentrated in the economies of North America and Europe, its effects will be felt globally – especially in trade-dependent countries outside the OECD, including China, where the development strategy has been one of export-led growth and ever deepening integration into the global economy.

Background to the Crisis

The financial dimensions of the crisis first became evident in the difficulties with sub-prime mortgages in the US in mid- 2007. But as these mortgages began to work their way through the financial system, wider problems became evident. These mortgages had been advanced to low-income households at initial interest rates below the prime interest rate, hence the designation "sub-prime." But after a few years, interest rates were to rise. Whereas perhaps two percent of all mortgages in the US were of this form during 2000-2002, nearly 30 percent were of this form by 2007.

The rapid increases in US house prices after 2001-2002, by as much as 30 percent per year in some areas, were behind this increased use of sub-prime mortgages. The issuance of these mortgages was in part a response by US financial institutions to congressional legislation which mandated lending for home acquisition by low-income households. Sub-prime mortgages were taken on by low-income households on expectations of ever-rising house prices because, realistically, these mortgages could only continue to be serviced on the basis of further capital gains and hence further growth in mortgages. But, inevitably, difficulties arose, when house prices began to plateau and then fall. Estimates suggest a 30 percent fall or more in house prices in certain parts of the US and that this would put perhaps 40 percent of households in the US with mortgages into negative net equity in their homes.

In other parts of the world, broadly similar events occurred in different forms. In the UK, there had been an even larger run-up in house

John Whalley

John Whalley is one of Canada's preeminent experts in the field of global economics. He joined CIGI as a Distinguished Fellow in 2004. Currently, he holds a number of academic positions, including professor of economics and director of the Centre for the Study of International Economic Relations at the University of Western Ontario, and professor of International and Development Economics and director of the Development and International Economics Research Centre at the University of Warwick. He is also the co-director of the ESRC Centre for the Study of Globalization and Regionalization (CSGR), a research associate at the National Bureau of Economic Research in Cambridge, Massachusetts, and a former visiting fellow at the Institute for International Economics in Washington, D.C.

Manmohan Agarwal

Manmohan Agarwal is a visiting senior fellow at CIGI and a former dean of the School of International Studies, Jawaharlal Nehru University, New Delhi, India, where he taught graduate economics for many years. He has taught graduate students in macroeconomics, both open and closed; international trade; investment finance; and development economics. His research has been mainly in international and development economics, though he has also worked in the area of environmental economics, and he has published extensively in these areas. He has extensive experience working in international organizations such as the International Monetary Fund and the World Bank. Dr. Agarwal studied at the Delhi School of Economics and the Massachusetts Institute of Technology.

Yuezhou Cai

Yezhou Cai completed his PhD from the graduate school of the Chinese Academy of Social Sciences in 2005. He is now an associate senior research fellow & associate professor at the Institute of Quantitative & Technical Economics, Chinese Academy of Social Sciences. Having served in the Ministry of Finance, P.R.C. as well as the China Orient Assets Management Corporation for a couple of years, Dr. Cai is quite familiar with the fiscal regime and financial system of China. His current research interests are mainly numerical general equilibrium technique and international technology transfer.

prices over the same period. The so-called old "building societies" took deposits as banks but loaned only for housing based on assumptions of continued house price appreciation. But the downturn in UK housing prices created severe problems for these specialized financial institutions. Northern Rock, an institution of this type, had to be nationalized in early 2008, and later the Bradford and Bingley Building Society.

Securitization of the debt intensified the impact of these questionable mortgages. The mortgages that had been issued in the US had been repackaged and resold through complex financial instruments. One of these was the so-called asset backed commercial paper," and rating agencies had often graded this paper as AAA, treating it as completely safe. Banks in the US and elsewhere held this paper. When the worth of this paper became questionable, the stability of the entire banking system was threatened. Elements of financial excess in other areas of the global economy began to become apparent and similarly unwind.[1] There were large swings in commodity prices, especially oil, and in exchange rates. Smaller economies such as Iceland, Hungary, Argentina and others, which had large amounts of US dollar-denominated debt, experienced enormous difficulties that, in the Icelandic case, were compounded by deregulated banks that had taken deposits at high interest rates in Europe and made aggressive loans.

All these developments reached climactic proportions in September and October 2008 as sharp falls in stock prices and major liquidity problems in country banking systems posed major problems of solvency for companies worldwide. These threatened to plunge the world into recession, if not depression. A fourth quarter of initially negative 3 percent growth was revised to negative 6 percent growth, and two US automakers, General Motors and Chrysler, filed for bankruptcy.

The possible severity of these events for the whole global system can be envisaged. With perhaps 50 percent of the worldwide capital stock of US$180 trillion in residential construction and housing of various forms, a one-third reduction in house prices worldwide in a relatively short time and a similar fall in stock prices, in effect the world financial system becomes insolvent. Fear of global financial insolvency was the major factor precipitating the large declines in stock prices that occurred worldwide in 2008.

On the day before the Group of 7 finance ministers met in Washington in the middle of October 2008, a complete meltdown of financial arrangements in the UK seemed possible. This threat led the UK government to announce a guarantee of all deposits in the banking system and exert political pressure on European leaders to follow. At the weekend G7 meeting, there was an agreed statement of an underwriting of all deposits

1 The situation became reminiscent of the so called "Goldsmith's Law" named after Raymond Goldsmith, a national accountant who wrote an influential book in the 1970s documenting episodes of growth in Latin America in the nineteenth century and how they all ended after various forms of financial excess.

to the sum of €1.7 trillion. This was subsequent to a US bailout package of US$900 billion passed by the US Congress. At stake was the credibility of the banking system of the entire world. For now, commitments by national governments seem to have largely removed the issue of the credibility of banks being able to meet their deposit liabilities. But the additional issue of a liquidity crisis remained as banks, unsure of each others' viability, were reluctant to lend to each other.

Government actions have calmed financial markets, LIBOR rates have fallen to maybe half their peak levels and liquidity has begun to move within the world banking system. But the situation remains fragile. Worldwide dollar liabilities total around US$50 trillion: around US$10 trillion of government debt; US$10 trillion of deposits in the banking system; and around US$30 trillion of commercial paper. In addition, there are large credit default swap arrangements of perhaps US$70 trillion. All of these liabilities cannot be honoured on the basis of current income accruing to US governments and US corporations, and hence the viability of the global banking system is dependent on the credibility of government commitments to honour withdrawals of deposits. To date (September 2009), the credibility of these commitments has held, and hopefully this will remain the case.

The full implications of the situation have yet to be manifested. Many US corporations have significant pension liabilities, which will be difficult to honour due to reduced asset values. There still seems substantial disarray on the real side of the economy as consumers defer purchases of durable goods, including cars; precautionary savings (and savings to replace lost retirement assets) sharply increase; unemployment rises; GDP growth goes negative and world trade falls. Parallels are drawn between today and the experiences of the 1930s in the US and in central Europe, where income compression may have been in the region of 50 percent over two years; certainly so in central Europe, perhaps less so in the US. The plunge in the stock market which struck in September 2008 ultimately saw a fall in stock prices by 80 percent. World trade also plummeted by 80 percent in two years, major bank failures occurred with a large number of bank closures, and the subsequent turmoil and disorder created macroeconomic compression of major proportions.

The academic literature about the 1930s has suggested that the tightness of the monetary policy pursued by the US Federal Reserve greatly compounded the situation, and along with retaliatory trade protective policies and competitive devaluations was a major factor precipitating the further decline after 1929. Others argue that the instability associated with the turmoil following the financial events of September 1929 played out in the years that followed. Other episodes of relevance are the Russian implosion from 1991 to 1997 and that which occurred in Indonesia after the Asian financial crisis. Recovery from the financial crisis of 1997 took nearly 10 years in the Indonesian case, but recovery was surprisingly rapid in South Korea and Thailand.

Yan Dong

Yan Dong is a research fellow at the Institute of World Economics and Politics, Chinese Academy of Social Sciences. She is currently a post doctoral fellow working with John Whalley at the University of Western Ontario, and is a research fellow at the Center of International Government Innovation (CIGI). Her research focuses on trade policy and general equilibrium models. She has published a series of papers on subjects of regional integration, especially China's free trade area strategy. Her current focus is trade policy and climate change, and using general equilibrium techniques to analyze trade policies.

Huifang Tian

Huifang Tian is a researcher in the Development Center of the Institute of World Economics and Politics, Chinese Academy of Social Science, the think-tank of government and the top research center in China. Tian's research mainly focuses on international economics, environmental economics and related development issues. Since February 2008, Huifang Tian has been a visiting scholar at the University of Western Ontario, cooperating with John Whalley on the project "Carbon Trade Policy, global environmental negotiation and China's participation." During her visit, she also worked on international finance and the developing economy.

Li Wang

Li Wang is one of China's rising younger economic researchers. Based at the Institute for Quantitative Economics, Chinese Academy of Social Science, she specializes in computer based policy modeling, and has written on China's tax structure and China's foreign exchange regime.

The degree and form of the disturbance and turmoil which have followed the events of September and October 2008 render highly uncertain the period of recovery for the global economy. Some large firms in the OECD economies have had substantial layoffs and large manufacturing entities in Europe have suspended production for varying periods. Since March 2009, however, there has been strong recovery in global stock markets.

Impacts on China's Economic Performance

A prolonged slowing of China's growth could cause a reconsideration of the broad developmental strategy.

The impacts of the financial crisis thus far on China's economic performance are reflected in many indicators, including GDP, trade, the trade and current account balances, inflation rates, interest rates, unemployment rates, measures of consumer confidence, housing prices, tax revenues and government expenditures.

The GDP growth rate in China fell with the onset of the financial crisis, though not to the extent in other large economies. Quarterly growth rates in 2008 were 10.6 percent, 10 percent, 9 percent and 6.8 percent, with an overall average of 9.3 percent, whereas in the first quarter of 2009 the growth rate dropped further to 6.1 percent. This was 4.5 percent lower than the first quarter of 2008 and down 0.7 percent from the previous quarter.

Industrial output grew 5.1 percent year on year in the first quarter of 2009 and in March had a rise of 8.3 percent, reflecting the bottoming out that is characterizing the more recent stages of the financial crisis.

The Consumer Price Index (CPI), the main measure of inflation, fell 1.2 percent year on year in March. This compares to a 1.6 percent decline in February, the first monthly fall since December 2002. China's Producer Price Index (PPI) fell by 6 percent in the first quarter, year on year, while retail sales grew 15 percent as China started to implement the stimulus package announced in November to counter the impacts of the global slowdown.

On the trade front, China's exports have been badly hit as the global financial crisis has intensified, particularly in the manufacturing sector. China's exports fell 17.5 percent in January 2009 and 25.7 percent in February 2009, compared to the corresponding months a year earlier. This was the worst performance in a decade. After partial recovery in March and April, exports were down in May by 27 percent on a year on year basis. Similar falls have occurred in imports. The positive Chinese trade balance throughout the whole of 2008 totalled nearly US$300 billion. The balance in the initial months of 2009 has remained in substantial surplus despite falls in exports, as imports also fell sharply.

In the housing market, China's urban property prices continued to decline in March and April compared to the previous year but showed a rising trend on a monthly basis. The government priority throughout has been to support the economy amid fears that rising unemployment could generate social unrest. The government has injected a large fiscal stimulus and implemented a relaxed credit policy that helped to raise total bank lending by over 27 percent in the first quarter of 2009, compared to the first quarter of 2009, and propelled investment. .

Chinese interest rates continuously and significantly fell from the 7.47 percent of August 2008 to 5.31 percent in May of this year. The unemployment rate has risen, but only by the relatively small amount of 4 percent.

Implications for China

China seems relatively well positioned compared to the OECD economies to weather the initial financial crisis and its evolution into a wider economic crisis. Performance is improving and China has large foreign exchange reserves. China was not at the epicentre of the crisis, and its financial institutions seem sound, with clear restrictions on the use of derivatives and other sophisticated financial instruments, which may have intensified the volatility in Europe and the US. This, together with the more limited reach of Chinese financial institutions, particularly into rural areas, suggests that the potential impact on China may be much more muted than in Europe and the US. In turn, the European and US hope would be that China can remain as a growth engine, bolstering a flagging global economy. China may not be able to play this role as there are some potential negatives that need to be noted.

First is China's dependence on exports for growth. China's developmental strategy has depended on ever-deeper integration into the global economy. Exports grew at 30 percent per year in the last three pre-crisis years to result in China becoming the second largest exporter worldwide. Given the depth and speed of China's integration, the Chinese economy may require a major and large adjustment due to the global recession.

The large declines of 20 to 30 percent belie some analysts' expectations that the falls in Chinese exports would be relatively small because there would be substitution in OECD countries from high-quality, high-priced consumption of designer branded goods to lower-priced consumption of Chinese products. There are reports of closures and bankruptcies in coastal zones related to Chinese export activity. In the summer of 2008, these were associated with various changes in labour laws and concentrated in sub-segments of export markets, such as toy makers. But the additional component coming from the financial crisis and the impact on exports raises questions over the likely rate of continued Chinese GDP growth. The fall in commodity prices (in oil and metals) has helped on the input side but raises the relative significance of wage costs compared to other costs for Chinese exports. There are offsets to the decline of input costs. One is the devaluation of currencies for China's competition from non-OECD sources. An important concern is the size of overall export reduction. In the good years of 2005-2008, world trade growth was nearly three times world income growth. If these multiples work in reverse, a 3 percent fall in GDP corresponds to a roughly 10 percent decline in world trade. If GDP fell by 5 percent, world trade would fall by 15 percent. One scenario is that China takes a larger share of a shrinking world pie in exports.

But this raises another concern: a rise in protection. This trend has been evident in the US congressional debates on buy and hire American, and China has seen a further increase in antidumping actions against her exports in many markets. The Chinese interest in global open markets is strong, and will set priorities for China.

A further element in the Chinese situation is house prices. House prices in the large cities had increased substantially in the several years before the crisis, perhaps by a factor of two in major urban areas in Beijing and in Shanghai. A plateauing or reduction in house prices could cause distress and disarray in China's financial institutions. But larger down payments than in the OECD economies, typically of the order of 30 percent, will limit the exposure of households to negative net equity situations.

China's developmental strategy seeks to quadruple income per capita between 2000 and 2020. A slowing of China's growth rate to 6-7 percent for a few years need not imply a major disruption of this strategy. But a prolonged period of slow growth and a significant further slowing clearly could cause some reconsideration. Such reconsideration might raise questions as to whether the broad developmental approach should place greater reliance on the domestic market than on exports and associated foreign direct investments.

Policy Responses in China

We identify a number of possible policy responses for China in this situation and discuss the pros and cons of each. We focus on policies to stimulate the domestic market to offset weakening trade performance, stimulus packages and interest rate policies, policies to underpin the domestic housing market, and policies toward exchange rate and reserve management.

One of the areas of potential policy response for China lies in exchange rate policy. Chinese policy for the last few years has been to seek stability first vis-a-vis the US dollar and then relative to a basket of currencies as a key element for macroeconomic stability and to create an environment for sustained high growth. With its large reserves, China should be able to maintain exchange rate stability if that remains an objective of policy. Any significant appreciation of the renminbi would make the domestic market more attractive, helping a shift towards greater reliance on the domestic market. This would also reduce further accumulation of foreign reserves, representing accumulation of paper by China in return for goods exports. However, this policy response would potentially cause substantial further distress for exporting firms, particularly in the coastal zone, where many bankruptcies have already occurred and unemployment has risen in export enterprises. The policy response so far, in the form of a small increase in tax rebates for exporters under China's VAT system, will have only a limited impact in shifting the relative importance of markets.

There are also issues of response for helping the critical real estate and construction sectors. The construction sector accounted for over 10 percent of GDP in 2007, as expectations of higher growth fuelled a building boom. Further expansion in this sector now seems likely to be put on hold, perhaps for several years. Government seems to have responded by encouraging new building programs for government entities. However, these programs will take significant time to implement and are capital intensive mechanisms for maintaining employment. A further issue is whether the implementation can be speeded up and the impact increased.

China is seemingly managing its response well, but the full dimensions of the crisis may not yet be fully revealed.

There are also issues of policy towards the housing market. While down payments on mortgages in China are higher than in the OECD, limiting the prospects of negative householder equity, significant falls in house prices have occurred in only some cities and sharper falls may occur in the next few years. The current government response of reducing the stamp duty from 1.5 percent to 1 percent may be inadequate. Other measures, including interest rate subsidies to apartment buyers and some degree of co-financing of purchases by government agencies, may be needed and could prove costly in budget terms and in the long run mainly serve to draw government into what was targeted as a largely private sector activity.

There are also issues of the direction of regulatory change in the overall Chinese financial system. The nature of change in this system of regulation, its impact on moral hazard in risk taking, and the growth of the financial system are important issues. Increasingly, China has been moving down the route of liberalization of the financial system along OECD lines. This may be slowed because of recent events. Furthermore, there is the question of the impact of financial development on Chinese growth performance.

Chinese government policy may well also increasingly focus on ways to stimulate the domestic market, especially to offset slowed export growth. There are calls in some circles for further increases in infrastructure spending beyond the November 9, 2008, stimulus package. Tax measures which discourage further saving and stimulate consumption are another possibility.

Management of China's reserves is also a key part of the policy mix. The reserves can be used to stabilize the renminbi exchange rate, provide some degree of stability to the global economy by loans to foreign governments or foreign financial institutions, or even purchase of foreign assets at depressed prices. But if China seeks to dispose of its reserves too quickly, there could be a fall in the US dollar and new global instability. If China does not and the US dollar falls, then China suffers capital losses.

The range of possible suggested policy responses for Chinese government agencies will no doubt grow and these will all add to the arsenal of activities that government can engage in. Early in the crisis, the thinking was that China could perhaps escape with only a modest downturn in growth to perhaps 8 percent per year for two years. But if the dimensions of the crisis in the OECD intensify and are eventually more fully mirrored in the Chinese situation, the capability of the Chinese government to respond on a comprehensive basis could be challenged. Hence, some degree of reorganization in Chinese economic activity would follow as growth performance eroded further.

Perhaps the broader-ranging issue is how far China should continue to rely on market-oriented development. If the market is seen as the culprit in this major global downturn, then support for market-oriented development would weaken. Market-oriented development has been credited with achieving rapid rates of income growth and poverty alleviation. But it is acknowledged that it has been accompanied by increasing inequality and environmental and other problems. If the market process itself comes under question, because of perceived risks of major instability and weakness in the global economy that China is integrating into, the balance between the market and regulation in China may shift. This would be a wider outcome in terms of policy response.

Chinese Interests in International Architecture

This crisis will, in the longer term, no doubt lead to a new international architecture which defines global rules of conduct in financial and other arrangements. This was the focus of the first G20 meeting on November 15, 2008 in Washington, which China attended and participated in at the highest political level, and then the April 2009 London and September 2009 Pittsburgh G20 meetings.

China clearly has a substantial interest in these debates on architecture and has views on possible outcomes. For now, these discussions continue to be largely put in terms of the design of a post-Bretton Woods global structure. The Bretton Woods System put in place in 1944 was based on country currencies fixed at realistic parities, with a fund of money to be moved between national central banks to defend parities in the event of speculation against these parities. The provision of liquidity was to permit gradual adjustment and to prevent a return to the experiences of the 1930s of competitive devaluations and protectionism in order to maintain the openness of the trading system.

This Bretton-Woods system effectively ended in 1971 when the US abandoned the gold standard. After 1971, the International Monetary Fund (IMF) effectively became a management entity for country financial crises and to provide balance of payments assistance to the poor and small economies that are not connected to global capital markets.

The crisis management performance of the IMF came under severe question in the Asian financial crisis in the 1990s, where the view in Asia and in other circles was that the IMF was not able to respond adequately to the crisis. Asian countries responded with substantial accumulation of reserves as self-insurance. In addition, the funding resources available to the IMF (and to the World Bank) relative to the problems at issue today seem very small. Hence, to seek to build on top of the Bretton Woods institutions as a way of remedying the current situation seems to us unlikely to yield much by way of meaningful response.

China has a substantial interest in the debates on international financial reforms.

The more central issues would seem to be the global regulation of domestic and international banks and financial institutions. The current regulatory arrangements, which are nationally based and not internationally coordinated, are a problem. There has been regulatory competition to attract very mobile capital and money. This competition has reduced regulation and encouraged excessive risk taking. The resulting flows have threatened the stability of the system. As a result, one call now is for heightened international coordination of regulation and with it tighter regulation.

However, the counter-argument is that globalization has not gone far enough. This argument would build on the assertion that on the real side of the OECD economies we have integrated large multinational companies, but we do not have large globally integrated banks. With more globally focused banks, the argument is that there could be more diversification of risk, larger pools of resources to draw on in the event of financial difficulties, and the global banking system would be strengthened. Hence, a debate may occur as to the appropriate global regulatory regime to be pursued in banking, and China will have substantial interest in its outcome.

In addition, the non-OECD countries, both individually and as a group, will no doubt argue (and with, in our view, justification) that the focus of global architectural restructuring should not just simply be global financial arrangements. The interest of these countries is in global structures which will, in the long run (and beyond the crisis), facilitate their growth and development. They will seek increased aid and private capital flows, increased access to markets for their goods and even global environmental arrangements which reflect their interests and special circumstances. As such, the pressure may build from them (including China) not only for negotiations on new global financial arrangements, but new global arrangements in totality. The European element as a driver in all this suggests that a precursor may be the evolution of a Europe-wide regulatory regime for financial institutions. China will have great interest in all these matters. The overriding Chinese interest will be one of maintaining openness in the trading system to allow for trade-fuelled future growth, as much as for a narrower focus on the conduct of financial arrangements and financial architecture for its own sake.

A central point of contention, no doubt, will be discussion of what the purpose and objectives of financial systems should be. In the OECD, and generally in Western economic thought, banks are seen as intermediaries between borrowers and lenders. But traditionally in Asia, and going back to the Mejii Restoration of 1867, banks have been seen as instruments of state-driven growth and industrialization which take deposits and then use these through prioritized allocation of credit to drive development in predetermined sectors of the economy. As such, the underlying objectives and form of financial structure will be part of this discussion, and the Chinese interest will be to be centrally involved and engaged and articulate a Chinese view not only on how Chinese financial structure may evolve, but how the global structure with China centrally integrated into it might also evolve.

Conclusion

In this report the task force discusses scenarios for the evolution of the global financial crisis as it may affect China, possible policy responses, and Chinese interests in a reformed global financial architecture with the pros and cons of various options involved articulated.

China is seemingly managing its response to the crisis well, but the full dimensions of this financial and wider economic crisis may yet not be fully revealed. One scenario is that the major financial liquidity shocks are behind us and now it is a question of simply adjusting and accommodating to the real-side dislocation that will occur over a period of time, possibly several years. Another scenario involves further decompression of asset prices and more major solvency crises to follow, with growing global policy competition in exchange rate policy, protectionism, and other areas, adding to the problem.

Whichever of these scenarios is the outcome, assessing scenarios for the potential impacts on China and discussion of those potential impacts seems to us to be a useful way to proceed. The task force hopes that this report fulfills their objectives as a contribution to public debate.

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Who We Are

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CIGI's work is organized into six broad issue areas: shifting global order; environment and resources; health and social governance; international economic governance; international law, institutions and diplomacy; and global and human security. Research is spearheaded by CIGI's distinguished fellows who comprise leading economists and political scientists with rich international experience and policy expertise.

CIGI was founded in 2002 by Jim Balsillie, co-CEO of RIM (Research In Motion), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario. CIGI gratefully acknowledges the contribution of the Government of Canada to its endowment Fund.

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Centre pour l'innovation dans la gouvernance internationale

57 Erb Street West
Waterloo, Ontario N2L 6C2, Canada
tel +1 519 885 2444 fax +1 519 885 5450
www.cigionline.org