Asie Visions 15

The Global Economic Crisis: a Golden Opportunity for China

Françoise Nicolas

June 2009

Centre Asie Ifri

Contents

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Introduction

The current global economic crisis was initially thought to be a financial problem exclusively affecting rich countries. As a result, the contagion to emerging Asia came as a surprise for a number of analysts and governments. A major reason why East Asian economies were expected to stay immune is because they had deeply reformed their financial systems in the wake of the so-called Asian crisis which unfolded a decade earlier. As for China, it was also thought to be protected from the vagaries of international capital flows because of its low involvement in financial globalization and the persistence of capital controls. By late 2008, however, two factors began to quickly undermine these assumptions. The first factor was the flight to safety in capital markets which led to sharp capital flow reversals and the second factor was the impact of the rapid decline in international trade volumes.

In China, economic growth began to fall sharply in the second half of 2008; by the end of the year, growth had collapsed from 2007-based projections of 13 percent for the year to 6.8 percent year-on-year, with national output virtually stationary in the last quarter. After a protracted period of strong economic growth (close to three decades at 9 percent per annum), China has thus entered a zone of turbulence, starting in the last quarter of 2008. These difficulties were further compounded by home-made problems. Before the global crisis spread to China, the country was faced with the risk of inflation and overheating, as a result Chinese authorities had engaged in a set of contractionary policies in the first half of 2008. But the abrupt slowdown in the last quarter of 2008 prompted them to suddenly backtrack and embark on a loose monetary policy and a multi-billion fiscal stimulus package aimed at lifting the economy out of the slump and putting it back on a strong growth path.

According to the Webster dictionary, a crisis is defined as "an unstable or crucial time in which a decisive change is impending, especially one with the distinct possibility of a highly undesirable outcome". The objective of the paper is precisely to examine whether the current crisis will constitute a turning point in China's development strategy, as is often argued, and whether the change will be for the better or for the worse.

Françoise Nicolas is a senior economist at Ifri and an assistant professor at Université Paris-Est.

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The paper is organized in three parts. It starts by analyzing the nature and depth of the challenges associated with the current economic turmoil. As a next step the paper examines in details the response given by Chinese authorities, including the stimulus package as well as other accompanying measures. The last section sketches the potential short-term and longer-term impacts of the current crisis with a view to highlighting the possible changes in the development strategy of the country. A key issue to be addressed is whether the current turbulence will give rise to a new model of development in China and usher in a new era for the Chinese economy as well as for the whole of East Asia and even, perhaps, for the rest of the world. To that end, the changing role of China within regional as well as multilateral fora is examined.

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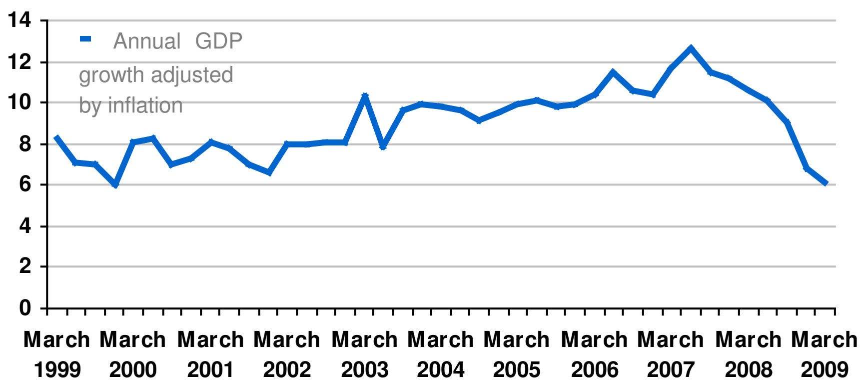
The Chinese version of the crisis

The facts

Starting in the last quarter of 2008, a number of red lights started to flash in China and the economic situation deteriorated significantly. China's GDP growth tumbled to 6.8 percent year on year in the fourth quarter of 2008 (the lowest in five years), down from 9 percent in the third quarter and more than 10 percent in the first two quarters.[1] On a quarter to quarter basis, growth was close to 0 during the last quarter of 2008. For the whole of 2008, the economy grew at about 9 percent, putting an end to a series of five years of double-digit economic expansion.

Figure 1: China's real GDP growth rate, 1999-2009



Source: National Bureau of Statistics

Underlying this deterioration the decline in China's export growth was particularly dramatic. Chinese exports grew at 17.2 percent in 2008, down from 23.5 percent in 2007, and they dropped for the first time in seven years in the first months of 2009.[2] Interestingly enough, both "normal" exports and processing exports were negatively affected. As a result of drawing down stocks of raw

[1] 10.6 and 10.1 percent respectively, according to SERI (2009).
[2] On a monthly basis, they were reported to drop by more than 21 percent in early 2009.

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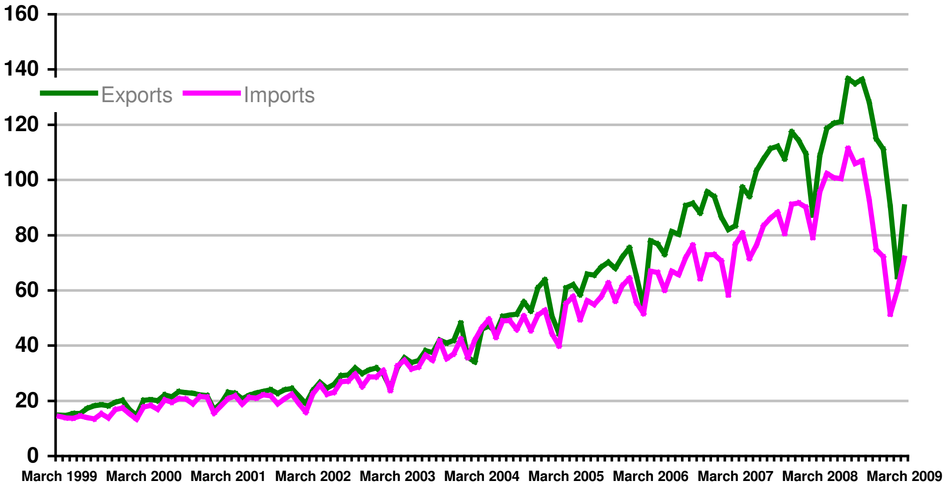
materials, Chinese imports were even more deeply depressed than exports so that China's overall trade surplus widened in late 2008. Further signs confirmed the deterioration of the economic situation: private consumption slowed down as a result of dropping revenues, industrial production dropped to 8.2 percent for the sixth month in a row in October 2008 (down from 16 percent in May), and electric utility use[3] was down nearly 8 percent in December from a year earlier in Guangdong and across China.

The economic situation deteriorated further in early 2009. China's manufacturing contracted for a sixth consecutive month in January as shrinking global demand hit the country's export-driven economy. The CLSA China Purchasing Managers' Index rose to a seasonally adjusted 42.2 from 41.2 in December. Since any reading below 50 indicates contraction, even though the rate of contraction dropped (and has been dropping since November) China's manufacturing sector (and hence China's economy) was still contracting.

Figure 2: China's exports and imports, 1999 – 2009

(US$ billion)



Source: Customs General Administration

Although one may quibble about the accuracy of the figures, the slowdown is undoubtedly substantial. Anecdotal evidence confirmed the severity and depth of the crisis. Thousands of firms closed down in the export-oriented southern provinces of Guangdong and Fujian and millions of workers were laid off from one day to the next. In particular over half of the toy makers in Guangdong province (over 3900 factories) had gone out of business before Christmas,

[3] Electricity is an excellent barometer of the Chinese economy because most usage is industrial.

according to custom officials.4 To be fair, as recalled earlier, even before the global financial meltdown China's manufacturers were facing difficulties as a result of rising production and transportation costs, as well because of the strengthening Chinese currency. But it is only in the last quarter of 2008 that the scale of the crisis became fully apparent. To make things worse, the corporate response to economic difficulties were sometimes particularly tough, with reports of numerous cases of firm owners vanishing without paying their workers.

These poor performances led to the downward revision of 2009 growth forecasts by all economic institutions. The IMF for instance adjusted its forecast from 9.3 percent in October 2008 to 6.7 percent in January 2009. Although other estimates are more optimistic, such as Nomura International (HK) Limited, which believes that China should be able to maintain a growth rate of 8 percent or even higher,[5] the growth prospects are well below the recent Chinese growth performances.

Why and how the crisis spread to China

There were, at first, good reasons to believe that China would remain unscathed by the global financial turmoil. In particular, the limited participation of China in financial globalization and the minimal direct exposure of its banks to toxic assets seemed to validate this claim (see Table 1).

Although direct exposure was minimal, there was a risk that China may suffer indirectly if some of its banks had substantial exposures to ailing US and/or European banks. First, as a number of Chinese banks had indeed bought bonds or equities in the infected western financial institutions, they were likely to share in the losses incurred by these institutions and to come under pressure (James et al. 2008). Two of the largest Chinese banks (ICBC and BoC)[6] were indeed exposed to Lehman Brothers for instance. Further indirect effects could be expected through stock markets in particular. Most of Chinese banks' stock prices, as well as the overall stock index dropped dramatically throughout 2008, reflecting a sharp drop in confidence. Through its capital controls, China is not yet fully open to the vagaries of international capital flows and did not suffer as much from the so-called "flight to quality" as other Asian economies such as

[4] "China's Toy Makers Face Bleak Christmas as Factories Shut Down ", *The Telegraph*, November 2, 2008.
[5] Forecast reported by Liqing Zhang, "Is the Pessimism About the Chinese Economy Warranted?" February 18, 2009.
[6] The exposure of the Industrial and Commercial Bank of China amounted to US$152 million, and that of the Bank of China to US$129 million.

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Korea or Indonesia for instance where a substantial share of the stocks are in the hands of foreign funds.

Table 1: Asia's Sub-prime Losses

	United States	Japan	Korea	China	Malaysia	Total Asia
Sub-prime losses (in billion US$)	157,7	8,7	0,4	2,8	0,1	19,5
Total bank assets	15 492	11 350	1 184	5 950	267	20 965
Capital of banks	1 572	572	85	256	29	998
Sub-prime losses as share of capital (in %)	10,03	1,52	0,52	1,08	0,30	1,95
Sub-prime losses as share of assets	1,02	0,08	0,04	0,05	0,03	0,09

Source: James et al. (2008).

The major channel of contagion was through the real economy and through trade.[7] In contrast to what a number of people argued, China (and the rest of East Asia for that matter) could not be spared and the so-called "decoupling" hypothesis was soon found to be a myth. This argument for decoupling is primarily founded on the observation that the share of intraregional trade in East Asia's total trade has risen significantly since the 1997-98 crisis and that the share of extra-regional trade has fallen accordingly, together with the belief that business cycle co-movements are a function of trade linkages. Representative of this view are statements by Anderson (2007) about China, to the effect that "there is no reason to argue over whether the mainland is decoupling from the global cycle - as far as macro growth is concerned the economy is and always has been effectively "decoupled", and China has little to fear from a global demand slowdown." It is worth stressing that this argument had proven to be true in the early 1990s when China remained unscathed by the US recession. This time around however, things played out differently.

In reality the sharp rise in intra-Asian trade has been fueled by rapidly growing trade in parts, components and intermediate products that is a reflection of greater vertical specialization and the dispersion of production processes across borders.[8] This has been described as

[7] Another channel of contagion is FDI on which China is also heavily dependent. Foreign investors tend to adopt a wait and see attitude these days and contribute to holding back economic activity.
[8] For detailed empirical evidence, see Kimura (2005).

the "Asian integrated circuit". However, the rise in intra-East Asian trade has been much stronger in imports than in exports, thus reflecting the persistence of a strong outward orientation for the region as a whole. Trade among East Asian countries is largely based on the segmentation of the production process, with the US and the EU as the ultimate destinations. China plays a specific role in the integrated circuit because it is being largely used as an outward processing region for goods developed elsewhere in Asia.[9] The tight correlation between China's exports to the US and East Asian exports to China confirms the existence of this integrated circuit.

Because the US was still China's main export market, it should not have come as a surprise that the collapse in US demand immediately impacted the Chinese economy, and indirectly the rest of East Asia. In this respect, the current global economic crisis hit export-dependent China much harder than the 1997-98 Asian financial crisis. Moreover, prospects for recovery look bleak for the region because it will not be able this time to export its way out of the crisis, unlike ten years ago.

Interestingly enough, however, in contrast to what is often claimed, some categories of Chinese exports proved particularly resilient. This is the case of apparel exports to the US for instance. In this sector, China managed to increase its exports in absolute terms and even to raise its market share in the US, primarily at the expense of other low-cost Central and South American producers such as Guatemala, Honduras, Costa Rica, Mexico, as well as a number of Asian exporters (Cambodia, Bangladesh, Sri Lanka, and even Thailand)[10].

Altogether China appears to be less seriously affected than neighboring countries such as Japan and South Korea whose exports are heavily specialized in capital goods. While US demand for capital goods plummeted as a result of investment slowdown, demand for low price consumption goods seems to be more resilient. As a result, Chinese exports are less hardly hit than both Japanese and Korean exports. Overall, however, China's exports did fall year on year in the first quarter of 2009 (-19.7 percent).

The challenges associated with the economic slowdown

As a result of the economic slowdown, Chinese authorities found themselves in a particularly delicate position with the need to switch

[9] As a result, China runs a trade surplus with East Asia in consumption goods and a deficit in intermediate goods (Gaulier et al. 2005).
[10] Interestingly enough, Vietnam has managed so far to maintain its market share.

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from a restrictive to an expansionary policy stance in the course of 2008. Moreover, they are faced with a double-faced challenge.

A recession which hides its name

Despite the slowdown, a positive growth rate will most probably be maintained in China (unlike in industrial countries and even some emerging economies such as Singapore, Taiwan and South Korea). Although China will technically avoid a recession[11] *stricto sensu*, the impact of the sharp slowdown is almost equivalent to a recession.

Prima facie, China is still doing much better than industrial economies and most emerging economies, but its growth performance needs to be kept in perspective. By the standards of about any other country, at 6.8 percent year-on-year in the fourth quarter of 2008 and 9 percent for the full year, China's economic performance would still be a source of jubilation. However, by Chinese standards the slowdown in growth is a major matter of concern for a number of reasons. First, because China had been growing at two digits over the past few years such a sharp slowdown in its growth rate is necessarily problematic as it involves huge adjustments and adjustment costs. Secondly, as explained by Prasad (2007) before the crisis contaminated China, a high rate of growth was a way of papering over some of the economy's weaknesses and it provided "one of the best tonics for solving structural problems as they diminish their scale in relative terms and also create resources to deal with them." But with a much lower growth, structural problems necessarily loom much larger and call for a swift reaction. Thirdly, China could see growth dipping as low as 6 percent, dangerously short of the 8 percent limit which is widely regarded as the minimum level needed to generate enough jobs to accommodate new entrants into the workforce. Although this threshold is not that well-founded technically, it is highly symbolic and the implications may be far-reaching in case it is not reached.

Unemployment and the risk of social unrest

In China the major risk associated with the current economic slowdown pertains to the rise in unemployment which is likely to fuel social unrest and as a result to undermine the stability of the régime.

The magnitude of unemployment cannot be easily nor precisely gauged. According to the World Bank's March China Quarterly Update, "the official urban unemployment rate rose by 0.2 percentage points to 4.2 percent in the year to the fourth quarter of 2008." Again, this may not look alarming by industrial economies' standards, but since the official jobless rate does not take into

[11] A country is said to be in a recession when its GDP falls (negative real economic growth) for at least two quarters in a row.

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account factors such as mobile migrant labor and the urban poor, it does not reflect the full reality. In the current downturn, the group of people who have been hit most is migrant workers[12] who are not eligible to register as unemployed because they go back home. According to estimates by the Chinese Academy of Social Sciences (CASS), the unemployment rate in urban areas was about 9.4 percent.

Whatever the exact number of unemployed, anecdotal evidence suggests that the situation is serious. “According to a survey held by the Ministry of Agriculture, before the Chinese New Year festival 20 million migrants had lost their job (10 percent of the total)[13]. The Ministry of Human Resources and Social Security (MHRSS) estimates that, of the 70 million rural migrant workers who returned home for the Spring Festival, about 80 percent, or roughly 56 million, came back to urban areas after the Festival, but of this group, about 11 million had not yet found a job in early March.” (World Bank 2009). It is also worth underscoring the potential spillover effects of migrants’ job losses due to plummeting remittances. In Henan, for example, the net per capita income among farm families grew to RMB 3,851 in 2007, up 12 percent year-on-year, but two-thirds of the increase was linked to remittances from salaried jobs outside the province.[14]

The rise in unemployment is all the more problematic since the pre-crisis situation was already rather tense, with substantial unemployment among fresh college graduates. According to the latest CASS "Blue Book of Chinese Society", more than 30 percent of the 5.6 million university graduates last year had failed to find a job as of August 2008. In 2009, some 6.1 million university graduates are going to enter the labor market – about a half million more than the previous year - but their job prospects are looking increasingly dim with the deteriorating economic situation.

It is commonly argued that China has gone through a similar unemployment crisis before[15] without social implosion and that there is no reason why it may not sail safely through the current turbulence. This time around, however, things are different and the comparison between the two periods is thus not fully relevant. On the whole, however, the current situation is probably less risky. First, people losing their jobs today are primarily migrant workers, and not SOE workers who thought they had a job for life and felt they had been cheated by the government. As a result, today’s unemployed may not

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[12] According to official statistics, the number of migrant workers is about 210 millions (or 15 percent of the population).

[13] This figure is double the previous estimate by the Ministry of Human Resources and Social Security, which said in December that up to 10 million migrants lost their jobs in 2008 due to the financial crisis. But analysts say the actual number of unemployed migrant workers is probably closer to 26 million.

[14] *Caijing*, issue 229, January 23, 2009.

[15] China shed some 50 million jobs between 1998 and 2001.

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be in a position to complain much. Moreover, they are unlikely to react in a coordinated way because they are geographically scattered. Lastly, long overdue restructuring was the reason for the lay-offs in the 1990s, while sluggish economic activity is the reason this time. The Government's responsibility is thus less clear today.

Be it as it may, the risk of social unrest cannot be easily downplayed and the Chinese Government is keen to show a strong commitment to act forcefully in favor of the unemployed. As a result, priority is given to stimulating growth so as to preserve jobs.

The need to rebalance growth.

The crisis may also be taken to prove that the development strategy followed so far by China was deeply flawed. The second major lesson to be derived is the need to rebalance growth and to reduce the economy's vulnerability to external demand shocks.

In China the consciousness of the need to move away from an allegedly excessive reliance on export cum investment-led growth and to enhance the expansion of domestic consumption is nothing new. To make the country's growth model more sustainable, the government has been trying, especially since 2003, to promote consumption growth relative to income and investment growth. The objectives of the 11th five-year plan (2006-10) pointed in this direction and recent regulations reflected a shift away from systematic export promotion. By way of illustration, in the revised catalogue for the guidance of Foreign Invested Enterprises (FIEs) issued in November 2007, projects whose products are to be wholly exported have been removed from the encouraged category.[16] For the time being, however, the structural reform has remained elusive. The crisis may constitute a turning point by swelling the pressure for reform.

Although the dependence on exports and foreign investors is often deemed to be a source of vulnerability that needs to be corrected, a point of clarification is in order at this stage. Strengthening domestic demand does not imply abandoning the export-led growth strategy altogether (He, Cheung and Chang (2007) but merely requires a better balance between the different engines of growth. This implies removing obstacles to stronger spending, altering the composition of aggregate demand in favor of domestic demand, and facilitating changes in the production structure in favor of non-tradable goods and services. In order to expand domestic consumption in China, priority needs to be given to reducing household savings. In this respect it is worth noting that household saving is only one driver of high Chinese savings, next to government

[16] See Nicolas (2008b) for more details on this issue.

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and corporate savings.[17] Of course, curbing these various forms of savings may call for the use of different instruments.

The last challenge facing Chinese authorities pertains to priority management. In response to the crisis, Chinese authorities are faced with two, to some extent, contradictory tasks which belong to two different time horizons: on the one hand they have to rekindle growth as quickly as possible so as to curb the rise of unemployment and of potential social unrest, and on the other they need to push through a long overdue reform so as to help the economy shift from an export-cum-investment-led growth strategy to a consumption-driven growth strategy. This second set of measures can be expected to have far-reaching and long-lasting effects but they will need time to take effect.

[17] China's total savings rate rose from 37.5 percent around 1998 to 49.9 percent in 2007. In the United States, the savings rate is about 4.2 percent.

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Responses to the crisis

Before the global crisis hit China in the fall of 2008, the Chinese Government was already faced with a number of domestic difficulties associated with the appreciation of the yuan, the real estate bubble, the occurrence of natural disasters (in particular the Sichuan earthquake), and plunging stock markets. However, when the slowdown in economic activity throughout the industrial world started to be felt in China, the probability of a hard landing started to rise, leading the Chinese Government to respond vigorously with an unprecedented economic stimulus package.

Fiscal stimulus package

China starts from a very strong fiscal position: in 2008, the ratio of fiscal deficit to GDP amounted to a mere 0.6 percent. China's fiscal revenues as a share of GDP increased from 11 percent in 1997 to 21 percent 2007, providing a solid base for fiscal expansion.

How large?

In November 2008, the State Council announced a RMB 4 trillion investment (about US$ 586 billion or € 460 billion) effort to be spent over more than two years (from the fourth quarter of 2008 to the end of 2010), with the aims of boosting economic activity. When compared to the US stimulus effort this may not seem a lot but relative to the size of China's economy, the RMB 4 trillion package is larger than that of any other country including the US (Lardy 2009)[18]. At first glance it is equivalent to 12.5 percent of China's 2008 GDP. However this figure is to some extent deceptive and tends to overstate the magnitude of the stimulus. First of all most of the money would have been spent anyway (as in the case of the post-earthquake reconstruction projects in Sichuan); the only difference is that a number of the planned expenses are being front loaded. According to estimates by Macquarie Securities China, only a third of the announced package can be considered as "fresh money". On the other hand, however, the official figure would probably understate the

[18] According to some calculations it is analogous to a stimulus package of US$3 trillion by the US government.

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true stimulus, because some public-infrastructure investment will be done by state-owned firms or local governments and financed by banks.

The Chinese central government is not expected to cover all of the RMB 4 trillion for the stimulus package. Most of the funding requires inputs from local governments, companies and individuals. (SERI 2009). The 4 trillion RMB figure merely means that the government (read NDRC) is ready to approve 4 trillion worth of investment. The financing will be through central bond issuance, bank loans, and local budgetary expenditure. The central government merely committed to directly fund RMB 1.18 trillion, about 30 percent of the overall program.

The correct measure of a fiscal stimulus is the change in public expenditures adjusted for the impact of already planned expenditures as well as for the impact of the economic cycle. With these considerations in mind, the size of the fiscal stimulus is usually agreed to be equal to about 3 percent of GDP in 2009, and this is well above the 2 percent of GDP recommended by the International Monetary Fund. Adding in bank-financed infrastructure spending might lift the total to 4% of GDP. (*The Economist*, March 12, 2009).

The sheer size of the stimulus is not the only thing that matters. The announcement of the RMB 4 trillion stimulus package should also be seen as a public relations move: the Government wants to show it is doing a lot for its citizens.

Where is the money going?

The National Development and Reform Commission (NDRC) unveiled a breakdown of the stimulus package spending in November 2008, followed by a revised breakdown in March 2009.[19] Of course, the whole of the RMB 4 trillion package cannot be expected to be spent at once. A first RMB 100 billion batch of central government financing was announced in November 2008 and a second RMB 130 billion batch of investment was announced in February 2009. The breakdown of the initial and revised packages, as well as of the first and second batches, is given in Table 2.

When analyzing the content of the stimulus package, the amount devoted to post-earthquake reconstruction projects should be set aside. It was probably included in the total package in order to make it sound more substantial but it does not really qualify as stimulus funding because it had already been committed to and would have been spent anyway. In Table 2 the corresponding RMB 1 trillion is singled out for this reason.

[19] Details of the press conference available at: http://www.eeo.com.cn/ens/finance_investment/2009/03/07/131626.shtml

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Table 2: Breakdown of the fiscal stimulus package (in RMB billion)

	November 2008	**March 2009**	**First batch** **November 2008**	**Second batch** **February 2009**
Roads, railways, airports and power grids	1800 (60%)	1500 (50%)	25	27.5 (21%)
Rural development and infrastructure	370 (12.3%)	370 (12.3%)	34	31.5 (24.2%)
Environmental protection	350 (11.7%)	210 (7%)	12	11 (8.5%)
Low-rent housing / Social welfare	280 (9%)	400 (13.3%)	10	28 (21.5%)
Technical innovation and industrial restructuring	160 (5%)	370 (12.3%)	6	15 (11.5%)
Public healthcare, culture and education	40 (1%)	150 (5%)	13	17 (13%)
Sub-total	3000	3000	100	130
Sichuan post-earthquake reconstruction	1000	1000	…	…
Total	4000	4000	100	130

Source: NDRC
Note: For the reasons highlighted in the text, the percentages are calculated as shares of the sub-total (excluding Sichuan post-earthquake reconstruction).

The comparison between the initial and the revised allocation and between the first two batches is indicative of the changes in priorities. It suggests that more emphasis is being placed on investments that have a more direct impact on people's livelihood (social welfare projects, and public healthcare and education in particular)[20] as well as on technology advancement, while infrastructure investment and environmental protection are being scaled down to some extent.

[20] They now account for 18.3 percent of the total, up from 10 percent in the initial breakdown.

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Despite the revision, public infrastructure development still takes up the biggest portion (with RMB 1.5-trillion, or 50% of the total package – excluding Sichuan reconstruction). The projects lined up include railway, road, irrigation, and airport construction.

Next comes funding for social welfare plans (RMB 400 billion), including the construction of low-cost housing, rehabilitation of slumps, and other social safety net projects.

Rural development and technology advancement programs share the same amount of allocation (at RMB 370 billion each). Rural projects in the pipeline include building public amenities, resettling nomads, supporting agriculture works, and providing safe drinking water. Technology advancement is mainly targeted at upgrading the Chinese industrial sector, gearing towards high-end production to move away from the current export-oriented and labor-intensive mode of growth. This is apparently in line with the government's latest Blueprint for revitalizing 10 selected industries. However, of the RMB 370 bn reserved for innovation, RMB 170 bn is to be invested in 2009 in the construction of 3rd generation mobile telecommunications infrastructure.

To ensure sustainable development, the Chinese government also allocated some RMB 210 billion, or 7% of the stimulus package for promoting energy saving and poison gas emission cuts, and environmental engineering projects. Officially, the stimulus package confirms the sustainable development orientation taken in the 11th five-year plan but it is worth noting that the share of funds devoted to this end has been scaled down from close to 12 percent to 7 percent of the total.

Last but not least, RMB 150 billion is allocated for educational, cultural and family planning purposes.

Although the share of expenditures devoted to infrastructure appears clearly dominant, this impression needs perhaps to be qualified. Since local governments are to find matching funds for social investments, the reorientation in favor of sectors directly affecting people's livelihoods may be more substantial than meets the eye. For infrastructure in contrast, the Central government tends to be the only player. (Naughton 2009).

The objectives of the stimulus package

The official objectives of the stimulus package were officially said by Prime Minister Wen to fit into five categories as follows:[21]

- enlarging domestic demand;
- adjusting and boosting 10 key industries;

[21] Interview published in the *Financial Times*, February 2, 2009.

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- promoting technological upgrading;
- building up a more comprehensive social welfare system; and
- preserving financial stability to support economic development.

Actually next to the relatively vague indications of the fiscal stimulus package, another document was issued and circulated by the Party Center in November 2008. This document, Central Document No 18, has never been published but its content has been widely abstracted and commented (Naughton 2009). This document laid out 10 core measures to "further expand domestic demand and assure stable rapid growth" (see Box: 10 Core Measures to Boost Domestic Demand). As a result, local governments engaged in negotiation with the central government to obtain approval for their favorite local projects provided they fit with the priorities and restrictions defined in the document. The two batches mentioned earlier are based on this document.

10 Core Measures to Boost Domestic Demand

1. Accelerate housing construction:

Strengthen support for the construction of low-priced rental houses, speed up efforts to rebuild houses in shanty towns, and expand reconstruction business for rural backwater areas.

2. Expand infrastructure in rural areas:

- Encourage the use of methane gas in rural areas and speed up efforts on safe drinking water and road construction.

- Improve power grids, accelerate the project to supply water of the Yangtze River to northern China, expand a massive irrigation facility to eliminate risk factors in reservoirs and save more water, and strengthen support for the poor.

3. Expand construction of large-scale infrastructure such as railroads, roads and airports:

- Mainly focus on passenger trains, coal transportation project and building main railroads in western China while improving a superhighway network and expanding electric power grids in cities.

4. Further improve medical, culture and education services:

- Build more solid medical service system for lower income class, reconstruct middle school dormitories at rural areas in the middle and western regions, build schools for special education and culture centres in rural towns.

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5. Strengthen ecosystem protection:

- Toughen regulations on building sewage and waste facilities in cities, expand protection projects for protective and natural forests, and support energy saving and reducing the amount of pollutants.

6. Promote industrial restructuring and technical innovation:

- Promote developing high tech and service industries and encourage technical innovation.

7. Strengthen reconstruction projects for areas damaged by earthquakes

8. Increase income for residents in cities and rural areas:

- Raise minimum grain prices for 2009 and increase subsidies for purchasing superior seeds and agricultural machinery.

- Expand social safety net for lower-income class, provide aid for poor people in cities and rural areas and increase old-age pension for retirees and supplementary living allowance.

9. Expand reform on value-added tax over entire regions and industries in China:

- Reform value-added tax on China's entire industries to encourage companies' technical innovation and cut 120 billion yuan in annual tax burden.

10. Strengthen financial support for an economic growth:

- Abolish lending regulations for commercial banks and make a reasonable expansion on credit lending scale.

- Increase credit lending for major projects, agriculture industry/rural areas/farmers, small and medium-sized enterprises, technical innovation and merger/acquisition.

At least RMB 500 billion worth of project investment (part of the stimulus package, including RMB 100 billion from central government and RMB 400 billion from local governments) was expected to be in place by the end of March 2009, and such was indeed the case.

Stimulus packages by local governments

Provincial governments complemented the State Council's stimulus package with their own economic stimulus packages. As of March 2009, investment planned by cities and provinces were reported to stand at RMB 25 trillion. These projects tend to focus on infrastructure such as transportation (gas pipelines, oil refining facilities, railroads). It is worth stressing, however, that actual expenditures by the provinces and cities will be much less than the

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announced RMB 25 trillion because the investment plans are primarily aimed at getting financial aids from the central government (SERI 2009).

Other accompanying measures

Next to the fiscal stimulus package *per se*, Chinese authorities also committed to spend RMB 600 billion on scientific and technical innovation and technical upgrading and to invest RMB 850 billion for the improvement of medical and health care system. Moreover they have recently taken a number of measures or taken up a number of overdue reforms which are likely to help stimulate the economy and address the social implications of the crisis. In particular, Chinese authorities have promised subsidies for purchase of various consumption goods, slashed fuel prices and pledged to improve social services such as health insurance and schooling.

Subsidies

With a view to boosting domestic demand, supporting domestic industries hit by the slump in export demand and encouraging the use of more energy-efficient, less polluting cars and appliances, Chinese authorities have launched a vast program of subsidies.[22] As part of the campaign "to send electronics down to the country side", a 13 percent rebate is given to rural households on purchases of TVs, cell phones and computers.[23] According to the state Council, a total of RMB 5 billion (US$ 732 million) is to be spent on subsidies for car purchases, and RMB 2 billion (US$ 290 million) on subsidies for appliance purchases. These subsidies are distributed to about 74 million people. It is unclear whether such measures are part of the RMB 4 trillion stimulus package.

Subsidies for the purchases of cars and home appliances to replace older models have been tested in a number of rural areas before being extended to all rural areas and lastly to major cities. Areas qualifying for the program now include Beijing, Shanghai, Tianjin and several provinces in China's affluent coastal regions (The China Post, "China expands rural subsidies for cities", May 20, 2009). The policy is to be in effect for four years.

Health care system reform

The weakness of the social safety net is traditionally said to be the primary driver of household savings in China, because people are

[22] 80 percent of the funding is provided by the central government and 20 percent by the provincial authorities.
[23] The rebate is provided for up to two items per household.

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thought to self insure against unexpected healthcare costs,[24] as well as save for their retirement and their children's education. As explained earlier, a major objective for the Chinese authorities is to manage to reduce the economy's dependence on exports and to expand domestic consumption. As a result, a reform of the Chinese health system can be expected to contribute to reduce savings and hence to rebalancing of the economy.

The draft of China's first Social Insurance Law was released in late 2008 for public consultation. It specifies a common right for citizens, urban and rural, to social insurance for medical care, unemployment, work injuries, and childbirth.

After over five months of debate and revision, the Central Committee of the CPC and China's State Council jointly issued a guideline on fixing the ailing health care system on April 6, 2009. According to the new plan, the government will set up diversified medical insurance systems in order to have urban employees, urban residents who do not work or are self-employed, and rural residents covered by some sort of insurance plan in the next three years. China plans to push forward the implementation of basic medical insurance for urban residents in 2009, particularly for the old, the disabled and children. The plan aims to reduce the percentage of uninsured from 70 percent now to about 10 percent by 2011--and pledges to improve health care for all citizens by 2020. The construction of some 2000 country hospitals and construction or expansion of 5000 township-level clinical centers are also part of the plan (Naughton 2009).

Tax policy changes.

Along with fiscal spending, reform of the tax system is also under way to stimulate the economy. First, the tax refund on exported goods has been increased since November 1, 2008 in order to encourage exports. Also, a reform on value-added tax for entire industries started to be implemented on January 1, 2009. Value-added tax was cut or scrapped for corporate purchasing of new or imported facilities, value-added tax-refund was abolished for FIEs purchasing Chinese facilities, value-added tax for small tax payers was cut to 3 percent and VAT rate for mineral products was restored to 17 percent. Altogether, this reform is expected to save businesses in China RMB 120 billion.

Moreover from January 20, 2009 to December 31st, 2009, the purchasing tax on vehicles of 1.6 litre engines or below is being halved.

[24] Statistics show that while only 20 percent of medical fees were covered by the patients themselves in 1978, the percentage had risen to 52 percent in 2005 (Statistics available at http://www.fmprc.gov.cn/ce/cebn/eng/zgxw/t556231.htm).

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Also authorities introduced a minimum wage law aimed at increasing consumption by guaranteeing income for low-wage earners. But the law is a double-edged sword in the sense that it will result in increasing labor costs for firms at the same time.

Monetary and exchange rate policies

In order to help maintain economic growth Chinese authorities have combined relaxation of monetary policy with aggressive support of lending.[25] In a complete turnabout from its previous stance,[26] the Bank of China cut the interest rate four times between September 16 and November 27, 2008, with one year deposit rates and reserve requirement ratio falling 1.89 basis point and 3.5 basis points, respectively (SERI 2009). Moreover, while banks had been instructed to curb lending in response to fears of overheating and inflationary pressures in the first half of 2008, they were told in the last quarter to boost lending to accommodate demand for infrastructure investment. In particular, the government urged commercial banks to increase lending to smaller businesses.

The reduction in the interest rate and bank reserve requirement ratio, the loosening of controls on mortgage loans, the elimination of quota controls on lending by commercial banks (temporarily introduced in early 2008), the accelerating development of credit guarantee services, and other financial promotion measures have no doubt led the rapid recovery of new loans. Since the announcement of central government stimulus efforts bank lending has indeed been growing at an explosive pace, by 21.3 percent year-on-year in January 2009, up from 18.8 percent in December 2008, and by about 30 percent in March and April 2009. In the first quarter of 2009 total bank loans outstanding grew by RMB 4.6 trillion. The pace is much higher than what was observed in the past and much faster than the pace of nominal GDP.

[25] This was the last of the ten measures contained in Central Document no. 18.
[26] The interest rate was raised five times consecutively in the first half of 2008 in response to inflationary pressures and asset market bubbles.

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Whither the Chinese economic miracle?

The short-term prospects

So far so good…

Although the economy grew a mere 6.1 percent in the first quarter of 2009, the prospects for future growth are positive because the drop has slowed. Moreover, a number of indicators point to a recovery. March's economic data, compared with those of the January-February period,[27] showed clear evidence of improvement. The Purchasing Managers' Index (PMI) for the manufacturing sector, which had risen to 45.3 in January (up from 41.2 the previous month, reflecting a positive turn in business sentiment), reached 52.4 in March, a level above 50 implying expansion of economic activities. Industrial production expanded 8.3 percent in March from a year earlier, up from 3.8 percent in the first two months.

Meanwhile, retail sales expanded 15 percent in the first quarter and 15.6 percent year-on-year after being adjusted for inflation. The performance of the auto and property sectors largely confirmed these figures, with both auto sales and housing sales rebounding sharply during the first quarter. Auto sales rose 24.97 percent in April to 1.15 million units, hitting a fresh record and making the country the world's largest light vehicle market for the fourth consecutive month,[28] according to the China Association of Automobile Manufacturers. Housing sales also rebounded: according to industry specialists, the sector's sales volume grew more than 100 percent year-on-year in the first quarter in Beijing, Shanghai and Shenzhen.

The government's efforts to promote home appliance sales also started to have an impact: total sales of these products rose by 72 percent from the previous quarter and reached RMB 4 billion in the

[27] In early February, Chinese stocks hit their highest in four months to rise up by about 15 percent from November lows.
[28] In January, China became the world's largest car market, ahead of the US, for the first time in history.

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first quarter of 2009. Home appliance sales reached RMB 2.24 billion in March alone, while sales grew 17 percent in China's countryside, outpacing urban areas for the first time.[29]

Seasonally adjusted figures showed a 32.8 percent jump in exports from the previous month and a 14 percent increase in imports. Chinese ports' cargo traffic rose for the first time this year in March while the decline in container traffic slowed. Similarly, the decline in power generation eased from -3.2 percent to -0.7 percent. Lastly, a 30 percent surge in urban fixed-asset investment in March[30] added to evidence that the government's stimulus plan is taking effect.

According to the National Bureau of Statistics, consumption accounted for 4.3 percentage points of China's 6.1 percent GDP growth, compared with 0.2 percentage points for net exports and 2 percentage points for investment. Consumption rose to become the largest contributor to China's GDP growth over the period.

The sudden investment boom was obviously the result of aggressive stimulus policies.[31] Growth of residential investment accelerated from 1 percent during the first two months of this year to 7.3 percent in March. All these contributed to a new boom of the construction sector and accounts for the recovery of steel consumption.

All this explains the very optimistic stance taken by Premier Wen Jiabao at the Boao Forum in April 2009, who said that the stimulus has shown "better than expected" results. As a result, growth forecasts for China have recently been revised upwards by some (Morgan Stanley's forecast has increased from 5.5 percent to 7 percent), although others such as the IMF remain extremely cautious.

… but caution is still warranted

The apparent success of the stimulus package should not come as a surprise. Despite the fact that China has been implementing market-oriented reforms for thirty years, the authorities' ability to mobilize resources in order to support growth has not been weakened. As recalled by Professor Williamson of the Judge Institute of Management in Cambridge "because of China's structure, the government has direct levers to spend money quickly. Whereas in Britain it can take years to get an infrastructure project going, in China things can happen immediately.[32]" If export performance severely deteriorates in the coming few months, more fiscal stimulus measures are very likely to be announced. Premier Wen Jiabao explained in

[29] Yan Xianpu, "Spend Way Out of Economic Woes?", *China Daily*, June 4, 2009.
[30] Up from 26.5 percent a month earlier (National Bureau of Statistics of China).
[31] In early 2009, Chinese investment in railways tripled compared to a year earlier (*The Economist*, March 2009).
[32] Quoted in the *Gulf Times*, May 20, 2009.

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February that more money would be added to the package to help stem the rising tide of unemployment in the country if necessary.[33]

To be sure, China is in a better position to rebound earlier than most other Asian export-led economies because its export dependence is more limited when expressed in value-added terms. Also, as stressed by Drysdale (2009) wage and price flexible China can react swiftly to difficulties and prove more resilient than most of its competitors.

However, a number of caveats lead to guarded optimism. First, it is far too early to tell whether the positive signals observed in the first quarter are indicative of a trend reversal. Actually, some indicators for April are to some extent in contradiction with the earlier trend (with exports plunging while investment is still soaring). A major reason for caution has to do with inventories dynamics. While the production slowdown during the last months of 2008 probably overstated moderation of underlying demand due to the drastic adjustment of inventories, especially in resource-related sectors, similarly the recovery may also be overstated because of the mechanical impact triggered by the need to restore drawn down inventories. This mechanical impact accounts to some extent for the recent sharp reacceleration of production activities.

Some positive developments may also not be well-entrenched. For instance, the rise in rural consumption resulting from the support measures put in place, may be quickly offset by forces working in the opposite direction such as the rise of unemployment among migrant workers and the resulting fall in their remittances.

Secondly, as explained earlier, the bulk of the stimulus package consists of infrastructure investment the impact of which is unlikely to be long-lasting unless it is followed by recovery in other sectors. In this respect the faster fall in imports than in exports conflicts somewhat with the picture of a sustainable rebound given that a large share of imports were reprocessed into exports. Commenting on China's unexpectedly strong first-quarter car sales, Li Shufu, chairman of one of China's largest private carmakers (Geely), pointed to government stimulus measures including tax cuts and subsidies for rural buyers, but he was quick to add that "last month's 10 percent rise in passenger vehicle sales is driven by a temporary policy and represents superficial growth. As a result only a strong recovery of the economy can help the Chinese auto market.[34]" In addition, in the first quarter of 2009 fixed asset investment was heavily concentrated in SOEs and holding companies, and investments in central projects surged while investments in regional projects stayed put compared to one year earlier (SERI, May 20, 2009). All this point again to a somewhat artificial growth.

[33] Interview published in the *Financial Times*, February 2, 2009.
[34] Patti Waldmeir, "Geely Cautions on China's Car Recovery", *Financial Times,* April 19, 2009.

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As a result, a W-shaped (rather than a V-shaped) recovery cannot be excluded at this stage. Such a development is all the more likely if complacency sets in as a result of a "too quick" recovery. Recent episodes, such as the post-financial crisis period, suggest that the pressure for reform tends to ease very quickly if conditions improve. In the case of China, the real challenge for the Government is to be able to maintain the reform drive even if economic performances improve.

Another source of concern relates to the social dimension of the economic crisis. The stimulus package is apparently not generating that many jobs, leaving the social unrest issue unsolved.[35]

Lastly, confidence about the short-term performances of the Chinese economy does not imply that China will easily shift to another development model and that it will be in a position to maintain strong and sustainable growth in the future (medium- term). Far to the contrary, the stimulus package may give rise to additional difficulties by delaying long overdue structural reform.

Beyond the short-term

The unlikely shift in growth model

In principle, the stimulus package combines immediate responses to the crisis with an attempt to reach long-term objectives, namely a better balanced growth with a bigger role for domestic consumption and a more sustainable form of development.

The Chinese government has been discussing measures to redress the structural imbalance for quite some time, but they have met with limited success so far. This time the crisis swelled the pressure for reform so that a positive outcome can be expected. However, the reform effort is unlikely to deliver the expected results for a number of reasons.

First, a key issue is how to address the trade off between immediate growth and longer-term sustainability. Preserving jobs is becoming an increasingly pressing issue and the measures applied to reach this goal may be in contradiction with more fundamental reforms. The risk is high that short-term political and social stability will be chosen by Chinese authorities at the expense of long-term economic growth. Of course that priority should be given to growth in the short term is understandable but there is a need to gradually shift to the longer-term objective.

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[35] East Asia Forum, April 2009.

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One important shortcoming of the stimulus scheme is the contradiction in the central and local governments' priorities. The former tend to privilege social welfare and environmental protection while the latter are emphasizing infrastructure spending. This is to a large extent due to the quick impact of such investment on growth, which is the criterion used by the central government to evaluate local governments. This inherent weakness of the mechanism is likely to bias the stimulus effort in the direction of investment with short-term or immediate growth impacts.

Most of the spending is in the hands of provincial governments which have a tendency to be much more short-sighted than the central government. As a result, relatively painful efforts are likely to be avoided. In the past, a major problem had to do with the fact that local authorities found it easier to boost growth by undertaking large capital goods investment (Woo 2007, quoted by Zhang, Li and Shi 2009). The same tendency seems to prevail today. In Guangdong province for instance, the priority is being given to infrastructure investments as well as to export-oriented activities. This is in contradiction with the objective of shifting away from labor-intensive export-oriented activities and towards more high tech or service-oriented activities.[36] It remains to be seen whether the central government will succeed this time to convince local leaders not to over invest and go for the "easy solution".

Similarly, Premier Wen Jiabao had vowed to move China's economy away from its dependence on environmentally harmful manufacturing industries such as paper, chemicals and textiles, and to build instead an innovation and knowledge-based economy that would make breakthroughs in computing, biotech and other sciences. This policy now appears relatively ill-timed politically and socially. With millions of workers losing their jobs, the priority has shifted to job creation and growth preservation. Here again, there is an uneasy trade off, this time between environmental protection and social stability.

Anecdotal evidence suggests that under the pressure of the current crisis, China may be turning away from previous pledges to improve its record on environmental protection. An example is provided by the Fuan textile factory which was closed down for dumping waste from dyes into a neighboring river and turning it red, but was recently reopened in the wake of the current economic difficulties. Such a tendency is also observed in other parts of the world where priorities have shifted away from long-term environmental concerns to short-term/immediate concerns linked to growth preservation.

Second, there is uncertainty as to the ability of the planned measures to contribute to a paradigm shift. In particular the theory

[36] *China Analysis*, no. 1, 2009.

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that fixing health care will lead to a consumption-based economic stimulus assumes that China's high savings rate is due (to a large degree) to a lack of effective insurance. And this is debatable. The reason for high savings is not simply a lack of access to healthcare. In addition, in contrast to India, households savings do not account for the largest share of national savings in China; corporate savings rank higher.[37] As the high saving rate is not exclusively due to high households' savings, the expected impact of the healthcare reform is probably overdone.

The planned reform of the health care and medical system is also unlikely to deliver the expected results. In spite of the far higher levels of funds that will soon be in the system - the new Chinese medical system remains fundamentally flawed as an economic stimulus for two reasons. The first is that the new system makes patients pay to see the doctor up front, *then* be reimbursed. Pumping trillions of yuan into insurance will not deliver the expected positive result on savings because if people have to pay up front they still need to save enough money to pay for their health care before being reimbursed. Thus, the new funds, although they account for 37 percent of the total budget, are unlikely to affect savings rates. Also due to the fact that the new system remains the only social health insurance scheme in the world which is voluntary, healthcare costs are likely to also rise under the new stimulus package.[38]

Third, the shift in growth model would require a number of further reforms that are not part of the global package. In particular a deeper reform of the financial system is warranted in order to help the economy shift to a different and more sustainable development model. A broadening of the financial system would indeed create alternative sources of funding for firms and alternative investment opportunities for households and firms (Prasad 2007). Such a reform would in particular affect the SMEs whose growth is hindered by lack of finance.[39] High corporate saving levels can be accounted for by the inadequacy of financial intermediation. This holds true in particular for Chinese SMEs, or rural entrepreneurs which are unable to tap bank credit.[40] To compensate SMEs tend to rely heavily on the informal (hybrid) financial sector (Allen, Qian and Qian 2007). Facilitating their access to finance would no doubt help them strive.

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[37] In India, households savings account for 69 percent of gross national savings, while in China, they merely account for 44 percent (McKinsey report on India's middle class, p. 53).
[38] Manuel (2009).
[39] Although new loans have risen quite fast in the first quarter of this year to reach nearly RMB 4.6 trillion, millions of SMEs nationwide were still struggling to raise funds (Zhang Xiangdong , "Millions of Small Businesses Still Starved of Credit", Economic Observer Online, April 17, 2009).
[40] Incidentally, improving financing opportunities for private SMEs may also be a way of reducing dependence on FDI if, as argued by Huang (2003), the large FDI inflows into China are not primarily due to policy incentives but rather to ineffective financial mechanisms.

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This would be killing two birds with one stone. As argued by Pettis (May 2009), “the growth of smaller businesses, many of which are in the service industry, is one important way for Chinese net consumption to grow.” As a result lifting barriers to finance is key to consumption enhancement. Moreover, SMEs are usually thought to be the key to reducing unemployment, improving people's welfare and increasing social stability. Priority should thus be given to the development of local financial and capital markets which could then enhance intermediation of savings and credit access for local firms and encourage them to modernize. Further measures may be needed to ensure a rebalancing of the economy. For instance, tax increases to improve the energy efficiency and environmental friendliness of economic activity in China should be considered.

Further sources of concern

A number of things can go wrong in the implementation of the stimulus package and lead to unwanted negative impacts.

First, the darker side of dynamic bank lending is the risk of rising nonperforming loans (NPLs). Recent breakneck credit growth is problematic, because anecdotal evidence tends to suggest that banks lend not because borrowers need money for specific (hopefully profitable) projects but rather because they want to show loan growth, and the safest way to do that is to convince large companies and projects with explicit or implicit government guarantees to borrow massive amounts of money. This may not create too many problems as managers are not accountable to the shareholders, but this may lay the ground for a surge in NPLs. Although the risk of a banking crisis is usually deemed to be very low, the implications of deteriorating banks’ balance sheets cannot be ignored.

Second, as explained earlier, much of the lending continues to end up in large SOEs, leading to potential excess capacity in sectors such as steel production or petrochemicals. More importantly perhaps, with SMEs remaining deprived of desperately needed funds, the chances of a rebalancing of China’s industrial structure with a larger SME sector remain bleak. If public investment crowds out non-state and private investment, which now accounts for about 70 percent of total fixed capital formation in China, there is a risk of a great leap backward. It is certainly not a good thing for China’s medium- and long-term growth that one of the consequences of the fiscal stimulus is an increasing role for SOEs and public investment and a relative decline in the SME sector. According to some this trend has already set in and the State actually started its comeback in the early 1990s.[41]

[41] This is an argument developed by Yasheng Huang (2008).

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Third, there is also a risk of rising inter-regional inequalities which is in contradiction with the official objective of promoting more homogeneity within the country. As explained earlier, all the projects will be implemented locally by local governments, and rich regions are more able to provide financing.

Impact on China's global (and regional) clout

The current global economic crisis may also provide an opportunity for China to further assert itself as a regional leader as well as emerge as a responsible and unavoidable power on the global economic stage.

China's emergence as a regional leader…

On the regional stage, China has been taking an increasingly assertive stance since the 1997-98 financial crisis. At the time, various initiatives taken by China reflected the country's resolve to become a regional leader instead (or ahead) of Japan. The first such move was when China actively publicized its refusal to devalue the renminbi, allegedly in order to protect its neighbors from a new round of contagious devaluations. At the same time, Beijing provided some financial assistance to ailing economies such as Thailand and Indonesia, as a way of showing its rising sense of solidarity. China also contributed to initiate the ASEAN+3 mechanism and gave its support to the Chiang Mai initiative (CMI) that was launched in 2000. On this latter point, it is worth stressing that China gave full support to the CMI, which it probably viewed as a more balanced framework than the initial Japan-sponsored Asian Monetary Fund (AMF) proposal[42] to which it had been opposed two years earlier.

In the following years, Beijing pursued its charm offensive. Chinese officials kept trumpeting that their refusal to let the renminbi appreciate was motivated by their concern about the possible negative impact this may have on neighboring economies. More recently, they further supported the multilateralization of the CMI. After long and intense discussions, and under the pressure of the current global economic crisis, an agreement has finally been reached at a summit meeting of the ASEAN+3 finance ministers held in May 2009 in Bali, on a "self-managed reserve pooling" arrangement governed by a single contractual agreement. At the same time, the mechanism has been expanded to US$ 120 bn,. This

[42] In the very early stages of the crisis, Japan suggested the creation of an Asian Monetary Fund which would provide a mechanism for the regional supply of funds as a complement to existing international financial facilities. The proposal met strong opposition from the IMF, the US, the EU and, to some extent, China, and was quickly abandoned.

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so-called CMI Multilateralized (CMIM), although it falls short of a full-fledged Asian Monetary Fund, constitutes a major step on the way to tighter financial cooperation in the region. China (including Hong Kong) is an equal contributor with Japan (each with 32 percent of the total contribution, or US$ 38.4 billion)[43]. This agreement is indicative of how far China has come over the past ten years and the current situation is in sharp contrast to the one ten years ago when China lagged systematically behind Japan in regional institutions, such as the Asian Development Bank.[44]

There are however good reasons to think that the rise of China may not be perceived positively by its neighbors. The competition with Japan is only one aspect. South Korea also seems uneasy with China's growing economic power. Moreover, as the stimulus package is heavily biased in favor of infrastructure investments, China's recovery will not necessarily provide a lot of comfort for China's neighbors, as the rebound will have limited benefit beyond China's borders.

… and as a responsible global power

Even if China does not succeed to shift to a different and more sustainable growth model in the wake of the current global economic turmoil, the crisis may still be a decisive moment for the country if its new world role is now officially recognized.

The centre of gravity of the world economy has been undoubtedly and irresistibly shifting to the East for some years now and it was increasingly anachronistic that the only Asian country represented in the G8 is Japan. China was occasionally invited to join G8 meetings but not as a full-fledged member.

Taking account of the rising role of the so-called BRICs, the G20 (including the then G7 as well as the largest emerging economies) was initiated in 1999 to discuss a number of global economic issues. But it was not perceived at the time as a possible alternative to the G8 or G7.

Once the financial crisis was found to be genuinely global starting in October 2008 after the collapse of Lehman Brothers, resorting to the G20 rather than the G8 emerged as the most appropriate solution. Interestingly enough China did not prove particularly enthusiastic at first. Far to the contrary, Beijing was initially rather reluctant and its rhetoric at the time of the first G20 summit in Washington in October 2008 underlined the limited role it would play in dealing with the crisis and stressed that it would merely contribute "according to its capabilities". As the crisis spread and

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[43] Next comes South Korea (with US$ 19.2 bn) and the 10 ASEAN member-states (with a total of US$ 24 bn).

[44] J. Rathus, "The Chiang Mai Initiative: China, Japan and Financial Regionalism", *East Asia Forum*, May 11, 2009.

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deepened further China's stance changed and it now sees its responsibility in dealing with the crisis not only as stabilizing its domestic economy but also as taking an active part in a concerted global action. Beijing's proposal to put an end to the dominance of the dollar as the world's reserve currency and to replace it with the SDR is indicative of this change in stance. Although China accepts to shoulder an increasing share of the burden of the global response to the crisis, it still refuses to take center stage. Actually Chinese authorities are pragmatic and do not claim to replace the US as the world leader; they simply expect to participate in the process of reforming international regulatory institutions and this is what is being done through the G20.

A major, and perhaps the most important, change brought about by the current crisis is the fact that China's new world role is now officially recognized.

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Conclusion

China did not prove to be crisis-proof in contrast to what the supporters of the decoupling hypothesis loved to claim. And the major reason why China suffered is because its export dynamism lost steam. Of course, given its comfortable fiscal position, as well as thanks to the freedom of maneuver of its government, China is no doubt in a much better position to stimulate its economy than most other economies, industrial and developing alike. As a result, its short-term performances are relatively reassuring, but they are not surprising.

More importantly however, is the impact of the crisis from a longer-term perspective. The crisis has stirred a debate about the wisdom of China's past development strategy and provided the chance to wind up the momentum of reform in 2009. Re-balancing growth has been discussed for a number of years in China but the pressure of the global slump may give some substance to the rhetoric. In this respect, the current crisis could turn out to be a blessing in disguise if it contributed to help the government push through a number of long overdue reforms allowing China to emerge stronger than ever.

The paper has shown however, that a number of signs do not point in the direction of market-oriented reform, far to the contrary. The risk is substantial that export cum investment-led growth resumes with no major change because the temptation is quite strong to return to standard recipes (export promotion, Government-driven investment, etc.). Moreover, the stimulus package (at least the way it is implemented) may prove to be in contradiction with (and undermine as a result) other objectives that had been privileged earlier (such as reducing the local governments' involvement in the growth process, shifting to green growth, etc.). Structural reform may end up being delayed as a result of the crisis.

The importance of the current crisis is difficult to overstate. Even if China does not seize the opportunity it is offered to become a modernized market-oriented economy, the crisis can still be a decisive moment for China because the need to fit China (together with the other top emerging economies) into the global governance equation can no longer be questioned and reversing this trend will be as difficult as putting the toothpaste back into its tube.

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