LOWY INSTITUTE
FOR INTERNATIONAL POLICY

Griffith UNIVERSITY

The Griffith – Lowy Institute Project on the Future of China

Dealing with the Inharmonious World: China and the Global Financial Crisis

Leong H. Liew

February 2009

The Lowy Institute for International Policy is an independent international policy think tank based in Sydney, Australia. Its mandate ranges across all the dimensions of international policy debate in Australia — economic, political and strategic — and it is not limited to a particular geographic region. Its two core tasks are to:

- produce distinctive research and fresh policy options for Australia's international policy and to contribute to the wider international debate.
- promote discussion of Australia's role in the world by providing an accessible and high quality forum for discussion of Australian international relations through debates, seminars, lectures, dialogues and conferences.

Griffith University's Griffith Asia Institute produces innovative, interdisciplinary research on key developments in the politics, economics, societies and cultures of Asia and the South Pacific. By promoting knowledge of Australia's changing region and its importance to our future, the Griffith Asia Institute seeks to inform and foster academic scholarship, public awareness and considered and responsive policy making. The Institute's work builds on a 25-year Griffith University tradition of providing cutting-edge research on issues of contemporary significance in the region. Its research and associated activities aim to promote greater interest in and awareness of Australia's changing region and its importance to Australia among the public, universities, policy-makers and the media.

The Griffith – Lowy Institute Project was established with the firm belief that the future of Australia and the world will be significantly shaped by the future of China and that a deeper understanding of what is happening within China will be essential to many of the key policy decisions Australian governments and businesses will need to make in the first half of the 21st century. The project will produce a stream of practically-focused, policy-relevant research on the future of China and be designed for a general audience with the aim of helping to shape broad debate about these issues in Australia and internationally. The project will focus its resources on two particular issues, China's domestic reform challenges and the changing nature of China-Australia relations.

Dealing with the inharmonious world:
China and the global financial crisis

Leong H. Liew

The global financial crisis is posing Chinese economic and political leaders a nasty set of domestic challenges. There is a broad consensus among China's key economic policymakers over China's appropriate response to the crisis: social stability and China's 'harmonious society' must be maintained. With the number of protests in China mounting, it is clear that Chinese leaders will utilise whatever means at their disposal to try to maintain a sufficient level of economic growth to preserve social stability as they did in response to the Asian financial crisis a decade ago.

This may be difficult though, as the unfolding global crisis is working against four of China's major economic reform agendas central to its continued development and Hu Jintao's 'harmonious society' concept: reining in inflation and financial speculation, industrial upgrading, diversifying Chinese overseas investment, and redistributing wealth to the vast rural hinterland. The global financial crisis has hit China at a time when reforms in these areas were beginning to bite, aggravating the depth of the crisis for China and complicating its policy responses.

At the same time, China's three decades of 'opening up' have lessened the role of the state in the economy, an economy now more and more driven by the decisions of first-generation local consumers and investors exposed to the global economic gloom. This last factor is a new and growing force in the Chinese economy and one that policymakers seem not to have fully factored into their expectations about China's exposure to the global crisis or into their crisis responses. While much of the local and global focus has been on Chinese exports, now shrinking but much more slowly than their regional competitors, domestic demand and the outlook of local consumers and investors may well be as important.

The global crisis has derailed some of these reform efforts, creating the likely need to revisit them in the future in less favourable conditions. More broadly, this disjuncture has weighed heavily on China's fiscal and monetary policy responses to the crisis. Recent changes to the nature of Chinese economic policymaking have empowered local governments and weakened key central ministries. Consequently, shorter-term local political factors are being given more consideration in fashioning China's responses.

This shift in influence and policy focus may widen the gap between outside expectations on China and China's crisis responses, especially if the Chinese currency depreciates against the US dollar. In the first week of December, the Chinese yuan experienced its largest weekly drop against the US dollar since the end of the yuan's peg to the dollar in July 2005. China's massive foreign exchange reserves declined, largely through valuation changes, in early January for the first time in five years.[1]

The impact of the crisis

Most of the early attention on China and the global financial crisis has focused on what it means for China's external trade and GDP growth rates, with predictions on both fronts for this year continuing to worsen. The impact of the global financial crisis on China's economic growth is real but should not be exaggerated. According to official figures, China's economy grew only 6.8 per cent in the 12 months that ended in the fourth quarter of 2008. This translates into a growth rate of only 9 per cent for the year compared with 11.9 per cent in 2007. The full impact of the global crisis on growth will be felt this year. Growth should fall below the 8% level that many see as key to China's economic and social stability.[2] The bullish World Bank, for example, has revised downward its latest growth projections for China for 2009 from 9.2 to 7.5 per cent, while the more sober International Monetary Fund's most recent World Economic Outlook predicts 6.7 per cent growth. However, by themselves, the global crisis centred in the United States and the consequent sharp reduction in world trade will not necessarily lead to a dramatic slump in China's growth rate. China does not depend on foreign demand to the extent that many people think.

---

[1] China warns of risks from 'abnormal' cross-border capital flow. *Xinhua*, 6 January 2009.

[2] Christopher A. McNally, *China and the global financial crisis*. Asia Pacific Bulletin. Honolulu, East-West Center, 2008; Yiping Huang. *China: are Chinese policy-makers getting it right?* East Asia Forum 2009: http://www.eastasiaforum.org/2009/01/11/china-are-policymakers-getting-it-right/.

Table 1: Share and contribution of various final demands to GDP growth (%)

	Consumption	Gross Capital Formation	Net Exports Goods & Services	GDP Growth
2001(GDP share)	50.0	50.1	-0.1	
(share of growth)	4.1	4.2	0	8.3
2002	43.6	48.8	7.6	
	4.0	4.4	0.7	9.1
2003	35.3	63.7	1.0	
	3.5	6.4	0.1	10.0
2004	38.7	55.3	6.0	
	3.9	5.6	0.6	10.1
2005	38.2	37.7	24.1	
	4.0	3.9	2.5	10.4
2006	38.7	42.0	19.3	
	4.5	4.9	2.2	11.6
2007	39.4	40.9	19.7	
	4.7	4.9	2.3	11.9
1Q 2008				10.6
2Q 2008				10.1
3Q 2008				9.0
4Q 2008				6.8
2008				9.0

Source: National Bureau of Statistics

The importance of net exports to China's GDP growth peaked in 2005, when they contributed 2.5 per cent to a total growth rate of 10.4 per cent. In most years between 1991 and 2005 the absolute contribution of net exports to GDP growth rates of between 7–10 per cent was no higher than 1 per cent. These figures have been behind the now unfashionable belief that China is 'decoupling' from the developed world and becoming an autonomous engine of global growth. A major reason for the relatively low contribution of exports to China's economic growth is that many of the exports are processed manufactures, which require imported inputs. This is particularly true for more sophisticated manufacturing exports and those from foreign-invested firms. The latest available estimate of the domestic value-added proportion of China's exports is only about 50 per cent.[3] The fate of the Chinese economy is in the hands of Chinese, not foreign demand.

Cooling speculation

The global financial crisis has hit China at a particularly inopportune time as it is pushing China in an opposite policy direction to the country's continuing efforts to manage domestic demand and channel credit into productive areas of the economy and to diversify investments overseas. The crisis has caused a significant overshooting of China's policy aimed at cooling an overheated economy and dampening dangerously high levels of speculation in previously booming asset markets. Only a year ago, China's economy, driven by strong domestic and foreign demand, was at risk of overheating. An asset bubble, inflated through the formal and informal banking sectors, was forming which the authorities were trying to deflate before it burst (these domestic efforts also ran into external headwinds as global perceptions of an undervalued yuan induced significant speculative capital inflows). In response, the People's Bank of China (the central bank) increased banks' reserve requirement ratio[4] as well as interest rates to rein in bank credit and domestic demand.

Table 2: RMB Benchmark Deposit

	15-Sep-07	21-Dec-07	9-Oct-08		30-Oct-08	27-Nov-08	23-Dec-08
Household and corporate deposits							
Demand deposits	0.81	0.72	0.72		0.72	0.36	0.36
Time deposits							
3-month	2.88	3.33	3.15		2.88	1.98	1.71
6-month	3.42	3.78	3.51		3.24	2.25	1.98
1-year	3.87	4.14	3.87		3.60	2.52	2.25
2- year	4.50	4.68	4.41		4.14	3.06	2.79
3-year	5.22	5.40	5.13		4.77	3.60	3.33
5- year	5.76	5.85	5.58		5.13	3.87	3.60

Source: People's Bank of China

[3] Robert Koopman, Zhi Wang and Shang-jin Wei, *How much of Chinese exports is really made in China? Assessing domestic value-added when processing trade is pervasive*. NBER Working Paper, 2008.

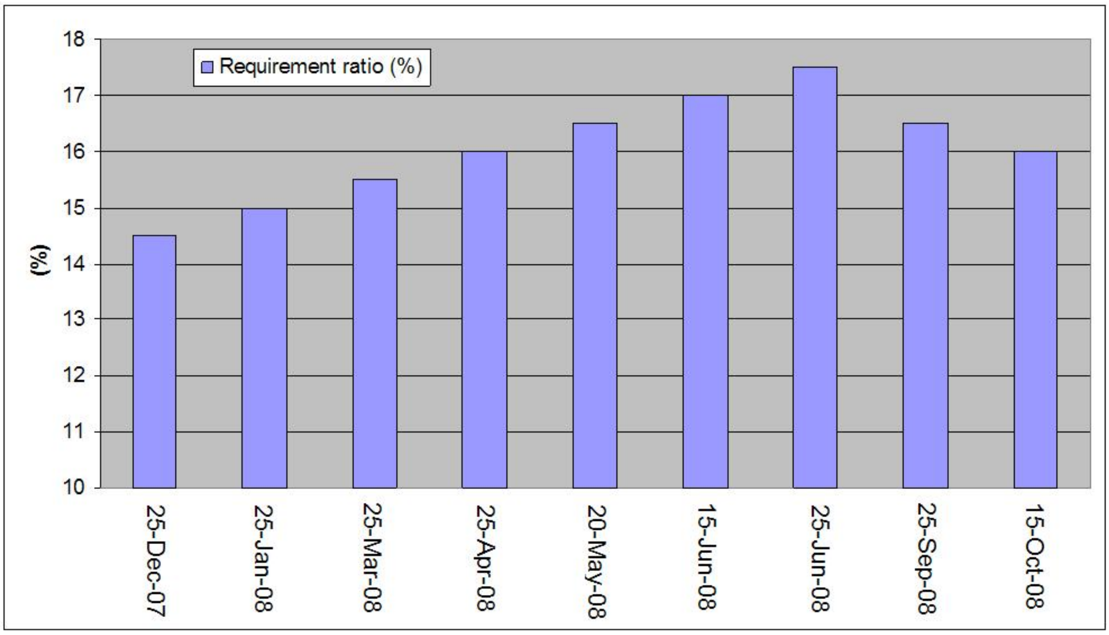
[4] The reserve requirement ratio (RRR) is the percentage of deposits banks are required to hold with the central bank. Raising this ratio reduces the amount of money banks can lend to customers leading to a tightening of the credit market.

Table 3: RMB Benchmark Lending Rates

	21-Dec-07	16-Sep-08	9-Oct-08	27-Oct-08	30-Oct-08	27-Nov-08	23-Dec-08
Loans							
6-month	6.57	6.21	6.12	6.12	6.03	5.04	4.86
1-year	7.47	7.20	6.93	6.93	6.66	5.58	5.31
1 to 3-year	7.56	7.29	7.02	7.02	6.75	5.67	5.40
3 to 5-year	7.74	7.56	7.29	7.29	7.02	5.94	5.75
Over 5-year	7.83	7.74	7.47	7.47	7.20	6.12	5.94
Individual housing provident fund loans							
Below 5-year (inclusive)	4.77	4.59	4.32	4.05	4.05	3.51	3.33
Above 5-year	5.22	5.13	4.86	4.59	4.59	4.05	3.87

Source: People's Bank of China

Figure 1: Reserve Requirement Ratio



Source: People's Bank of China

Beyond monetary policy, the central government raised the stamp duty on share transactions in May 2007 from 0.1 per cent to 0.3 per cent and reportedly even resorted to the use of satellite pictures to detect unapproved construction projects to rein in investment.

These contractionary policies are working, but, with global economic conditions souring, they are engineering a hard rather than a soft landing. Asset prices did not just stabilise, they plummeted.

Share prices peaked in October 2007 and then fell steadily. Share prices though are still about 50 per cent higher than they were at the beginning of 2006. Year-on-year urban housing prices also fell for the first time in 2008 (China only started releasing urban housing data publicly in 2005), with Shenzhen witnessing a massive 18.1 per cent drop.[5] Reversing course, policymakers restored the stamp duty on share transactions from 0.3 to 0.1 per cent in April 2008, less than a year after raising it, and made it easier for people to buy and sell houses.

Table 4: Share price indices

Index	31-Dec-05	30-Oct-07	2-Sep-08	14-Jan-09
HSCAC*	1935	7021	4098	3110
Shanghai A	1221	6191	2420	2025
Shanghai B	62	379	149	120
Shenzhen A	290	1496	665	625
Shenzhen B	196	791	378	284
Hang Seng	14876	31638	21042	13705

Note: *Hang Seng China-affiliated corporations (red-chip)

A-shares are traded in yuan. B-shares are traded in US$ (Shanghai) or HK$ (Shenzhen).

Sources[6]

While stock prices were a leading indicator of the pain to come, inflation was a lagging one. Hence, authorities did not loosen monetary policy until September 2008 as they remained concerned with inflation. Inflation, as measured by the rise in the consumer price index, peaked at 8.7 per cent in February 2008, before falling gradually to a still significant 4.6 per cent in September as bank credit tightened in response to monetary policy. However, producers' prices continued to rise at an accelerating rate even as consumer prices began to fall. The rate of growth in the producer price index rose to an historical high of 10.1 per cent in August 2008, before falling to a still significant 9.1 per cent in September. By November, this index had plunged to 2 per cent. In the same month, the purchasing managers' index bottomed out at 38.8, a drop of close to six points from October.[7] A rating below 50.0 indicates a contraction in output. China's index first fell below 50.0 in July 2008.

Industrial restructuring

While endeavouring to slow the economy in 2007, policymakers were also simultaneously pursuing longer-term structural change to make the Chinese economy less dependent on export demand and to

[5] Chinese housing prices decline for the first time since 2005. *Xinhua*, 10 January 2009.

[6] Data before 2009 are from Paul B. McGuiness, An overview of the A- and H- shares of Chinese SOE issuers. (2008). The 2009 data are from the websites of the Hong Kong Exchanges and Clearing Ltd, and the Shanghai and Shenzhen stock exchanges.

[7] The purchasing managers' index in December improved to 41.2 and again in January to 45.3.

shift production from low value-added, low-skilled manufacturing to higher value-added, high-skilled manufacturing. From 2003, policymakers reduced export rebates on low-value added exports like crude oil, textiles and garments and later allowed the yuan to appreciate. The yuan appreciated 21.4 per cent against the US$ from 8.28 yuan per US$ on 21 July 2005, when the yuan peg to the US$ ended, to 6.82 yuan per US$ on 16 September 2008, the day after the collapse of Lehman Brothers. Together with rapidly rising wages, this lowered the global competitiveness of many firms in the coastal export hubs of southern China.

Chinese firms also face additional cost pressure from a law enacted by the National People's Congress in 2007 that grants increased rights to workers. This law requires employers to provide written contracts to workers, gives more power to workers to bargain with employers, limits temporary employment and provides increased job security. If these pressures on employers are not challenging enough, some firms and industry sectors have been additionally confronted with a number of scandals over product quality.

With the sudden downturn in global demand, pressures on some of these firms have reached a critical point. In November, China's year-on-year exports shrank by 2.2 per cent and in December they fell by 2.8 per cent, the largest monthly drop in over a decade. The crisis has exacerbated the costs of the industrial restructuring policy that is designed to lower China's dependence on exports of low value-added and low-skilled labour-intensive manufacturing. More than 50 per cent of toy exporters in the Pearl River Delta reportedly fell into bankruptcy in the first seven months of 2008. Factory closures there have attracted much media attention but factories in the Yangtze River Delta, which tend to produce higher value-added exports, are not as badly affected and have not received as much media attention. In 2009, Guangdong province, the centre of the Pearl River Delta export boom, estimates zero growth in exports. Zhejiang province, the centre of the Yangtze River Delta export boom, estimates a healthy 9% increase.[8]

Facing such a sharp downturn in traditional, labour-absorbing exports, Chinese authorities have taken industrial restructuring off the immediate reform agenda. Again, the highest export rebates now go to textiles, clothing and toys, which have been severely hit by rising costs and falling export orders. This is good news for the Pearl River Delta, where many of these exporters are located. Exporters in general have also been assisted by the fact that appreciation of the yuan against the dollar has slowed, if not reversed.

[8] China provinces see zero 2009 export growth. *Reuters*, 7 January 2009.

Foreign investment

One of the most internationally and domestically debated policy reforms in China has been the recent growth and diversification in state-controlled foreign investment. With China's massive foreign exchange reserves in mind, many have interpreted the minor foreign investment forays by the $200 billion China Investment Corporation, China's sovereign wealth fund, as the first tentative steps towards a major expansion of Chinese foreign investment. In 2007, for example, the Corporation invested US$3 billion in the Blackstone Group and US$5 billion in Morgan Stanley. In line with this thinking, throughout 2008, many expected Chine to act as a 'white knight' bailing out global investment banks and boosting the coffers of the International Monetary Fund and World Bank.[9] However, there has been much criticism inside and outside the bureaucracy over the losses that China has incurred from its overseas investments, especially in financial institutions. The fallout from the September 15th collapse of Lehman Brothers has made the authorities much more cautious about placing Chinese funds overseas.

Likewise, China was lukewarm to suggestions from Prime Minister Gordon Brown that is should provide funds to help bail out countries hit by the crisis. It has declined to lend to its close ally Pakistan $5 billion without guarantees from Islamabad to undertake structural reform. China has expressed its willingness to increase its capital contribution to international financial institutions like the IMF to help countries hit by the crisis, but only if its higher contribution is matched with increased influence. This was made clear by Jin Liqun, the chairman of the Board of Supervisors in the China Investment Corporation, at a financial conference in Shanghai in late 2008.

There are two areas of overseas investment that remain politically safe, domestically, for China's policymakers: strategic investments to secure China's long-term supply of key commodities, and purchases of US government securities to influence downwards the value of the yuan. The yuan's appreciation against the currencies of many of China's trading competitors has contributed to the difficulties of manufacturing, and many local government officials in southern China blame this for the economic downturn in their localities.

Economic redistribution

The three decades of China's 'opening up' economic reforms have seen a sharp rise in inequality, and a rapid widening of the rural-urban split. China's Gini coefficient (a measurement of income inequality) rose from a low 0.29 in the 1980s to a very high 0.49 in the early part of this decade. In comparison, Australia's Gini coefficient in 2007, according to the Australian Bureau of Statistics, was 0.307. Reflecting this worrying trend for social stability, China's rural-urban split is greater today than

[9] Chin Hon Chua. Straits Times 2008: http://blogs.straitstimes.com/2008/10/28/why-china-may-not-save-the-world.

when the Communist Party took power in the late 1940s.[10] Income inequality is now roughly on par with Latin America and the Philippines. In response, the state under former Party leader Jiang Zemin channelled more resources into rural areas and moderated China's focus on rapid economic development.

Hu Jintao and Wen Jiabao have taken this further doctrinally and switched the Party's emphasis from Jiang's on economic growth to focus more on reducing income inequality and the rural-urban divide by promoting a 'harmonious society' and a 'new countryside'. This is clearly the most ambitious and politically central of the four policy reforms under challenge from the global financial crisis. The Third Plenum of the 17th Party Congress in October 2007 committed the Party to increase government spending massively on social welfare in rural areas and double the per capita income of rural residents by 2020. Yet, even China's impressive fiscal resources are not limitless. In the seven years prior to 2007, China ran fiscal deficits. The global crisis is cutting into state revenue growth at the same time that the demand for fiscal stimuli mounts. In 2008 and 2009, the growth rate of government expenditure will probably outstrip that of government revenue for the first time since 2000, constraining the ambitious goals of the 'harmonious society' concept.

Table 5: State Revenues and Expenditures

Year	Government Revenue	Government Expenditure	Fiscal Balance	Fiscal Balance	Annual Increase Rates (%)	
	100 million yuan	100 million yuan	100 million yuan	% GDP	Government Revenue	Government Expenditure
2000	13395.2	15886.5	-2491.3	-2.5	17.0	20.5
2001	16386.0	18902.6	-2516.5	-2.3	22.3	19.0
2002	18903.6	22053.2	-3149.5	-2.6	15.4	16.7
2003	21715.3	24650.0	-2934.7	-2.2	14.9	11.8
2004	26396.5	28486.9	-2090.4	-1.3	21.6	15.6
2005	31649.3	33930.3	-2281.0	-1.2	19.9	19.1
2006	38760.2	40422.7	-1662.5	-0.8	22.5	19.1
2007	51321.8	49781.4	1540.4	0.6	32.4	23.2
2008 (3 Qs)	48946.9	36428.1	12518.8		25.8	25.5

Source: Ministry of Finance and author's calculations.

[10] Jikun Huang, Qi Zhang and Scott Rozelle, *Determinant of rural poverty reduction and pro-poor economic growth in China*. (LGOPAD/IPRCC report, 2007).

The macroeconomic response

The speed and the depth of the crisis' impacts have taken many in China by surprise. Policymakers seem to have been unprepared for the global contagion of negative expectations hitting China so soon and so hard. China's economic growth is driven mainly by domestic demand and its financial markets (and currency) remain largely unintegrated with world markets and are highly regulated. Yet, China's policymakers have been unable to barricade China against the inflow of global pessimistic expectations and the deep fears these have triggered among Chinese consumers and investors. Policymakers now agree that the global financial crisis is a serious challenge to China, with the Chinese media warning of 'grim times' ahead and fears of greater social unrest.[11]

Chinese authorities have found it more difficult to find a consensus on the proper mix of fiscal and monetary responses. China's combination of fiscal and monetary expansion and the nature of each reflect the macro-economic concerns of the three main central ministries, the People's Bank of China, the Ministry of Finance, and the National Development and Reform Commission (NDRC), and recent shifts in the nature of Chinese macro-economic policymaking. These same factors are likely to be decisive in China's future responses to the domestic effects of the global crisis and in the longer-term policy measures taken once the crisis has moderated.

High-level economic policymaking and policy implementation in China is still under a unified Party and government command structure. The Central Leadership Small Group in Finance and Economics (CLGFE) chaired by Premier Wen Jiabao is a joint organ of the State Council and the Politburo of the Chinese Communist Party and is the key economic policymaking organ in China. Its members are senior Party leaders in charge of the economy and include the heads of the three key economic ministries. Decisions of the group are normally rubberstamped by the Politburo of the Central Committee of the Communist Party. Central ministries dominated the CLGFE under Premier Zhu Rongji, but Party elections in late 2007 shifted power from the central ministries to the provincial governments, leading to a more diffuse and activist response to the crisis, and one less sensitive to international expectations or pressure.

Except for Premier Wen, all the chosen Standing Committee members of the Politburo have served as provincial party chiefs and five of the new Politburo members were provincial-level party secretaries when elected. As for the key central ministries, not only did then NDRC minister Ma Kai, who is close to Wen, fail to gain a seat in the Politburo; Zhou Xiaochun, the central bank governor, also unexpectedly failed to get one. Xie Xuren, who replaced Jin Renqing as minister of finance and

[11] 'Grim times ahead' as China battles worsening crisis. *China Daily*, 7 January 2009.

became its representative in the CLGFE, only joined the Party Central Committee at the 17th Congress and is not considered a heavy-hitter in macroeconomic policymaking.

The rise of the provinces at the expense of central ministries is particularly reflected in loss of influence of the NDRC. After the 17th Party Congress, the NDRC lost a number of its functions and more than half of its senior officials. According to the central government circular that announced the change in the NDRC functions, 'Enterprises will play the leading role in business investment while local governments should have a say on whether projects ought to be approved'. Significantly, the NDRC lost its industry management responsibilities, but has been given the primary responsibility of ensuring balanced growth. The NDRC has lost influence over industrial restructuring (now in abeyance owing to the crisis); however it remains a major player in overseeing the Party's work in reducing poverty, especially in rural areas, a key focus of Hu's harmonious society concept.

Monetary response

In line with governments around the world, China has responded to the sharp drop in global growth and demand by loosening monetary policy with more cuts to official interest rates likely. China's monetary policy response though has been muted in comparison to the responses of developed economies around the world and India, despite China's comparatively greater scope for monetary expansion. This monetary rectitude stems directly from the sequencing problems China faces dealing with the effects of the global crisis, as we discussed with inflation earlier.

More importantly though, the People's Bank of China and the Ministry of Finance are wary of using monetary policy, due to its potentially counterproductive effects on efforts to strengthen financial markets and China's banking system, which is ill-equipped to allocate capital efficiently. Small and medium enterprises are often disadvantaged and many of them have to borrow in the informal money market, while large enterprises are often able to borrow for projects with scant regard for economic returns. Scarce capital is often diverted to purchase property and shares in boom times, fuelling speculation.

The People's Bank of China prefers fiscal policy to carry the major burden of stimulating the economy. Although the current state of the economy calls for a stimulus to the economy, the Bank is concerned that a massive monetary expansion would flow disproportionately to projects of relatively low or even negative returns and reignite speculation in property and shares, which it was trying very hard to dampen just a year ago. Moreover, undisciplined lending has the potential to sharply increase the number of non-performing loans and the consequent need for another government bail-out of the banking system.

The Ministry of Finance is also a major player in the financial sector as it controls the China Investment Corporation, which itself became more central in the transmission of monetary policy in November 2007 when it took over Central Huijin Investments from the central bank. Huijin Investments is the major shareholder for China's four main state-owned banks, banks that control roughly half of the country's total banking assets.[12] As with the People's Bank of China, the Ministry is wary of too much reliance on expansionary monetary policy, as the Ministry is worried about the additional cost to taxpayers of repairing the balance sheets of banks should non-performing loans reappear. In 2006, Guonan Ma, a senior economist at the Bank of International Settlements, estimated that the final cost to Chinese taxpayers of cleaning up banks' non-performing loans on the balance sheets of China's banks from previous bad lending practices might reach 30 per cent of 2005 GDP.[13] The Ministry of Finance is aware of the potential cost of non-performing loans and wants to avoid the responsibility for the collateral damage from a mismanaged monetary expansion and its potential impact on the main state banks.

On the most closely watched, globally, element of China's monetary response, the value of the yuan, there are powerful interests pushing for a stable or depreciating yuan. Both the People's Bank of China and the Ministry of Finance, as custodians of the under-pressure China Investment Corporation, are wary of the effects on the Corporation's foreign assets of an appreciating yuan. The significant dollar assets on the central bank's own balance sheet are also negatively affected by an appreciating yuan. The bank has invested heavily in US Treasury bonds and the securities issued by the US government mortgage companies, Freddie Mac and Fannie Mae. Newly empowered local governments, especially in the coastal export powerhouses of China, naturally share this interest in a stable or weakening yuan.

Burden shifting

The effects of institutional interests on the monetary policy response are brought out into even sharper relief in the mechanics of the muted monetary expansion. Reflecting the interests of the People's Bank of China, it is interesting to note that while official interest rates have fallen to levels below what they were in late 2007, the banks' reserve requirement ratio has fallen only to what it was in April 2008. Moreover, China's reserve requirement is comparatively very high. Required reserves deposited by banks with the People's Bank of China earn an interest rate that is well below the rates that banks can charge their customers. This implicit tax on commercial banks is levied so that the

[12] Conglu Cai, Banking structure and financial stability: a comparison of Chinese and German banking systems. *Frontiers of Economics in China* 3 2006.
[13] Guonan Ma, *Who pays China's bank restructuring bill?* CEPII Working Paper, 2006.

central bank's sterilisation of purchases of foreign exchange to manage the appreciation of the yuan can occur without requiring deposit rates to rise substantially. High deposit rates would significantly increase the cost of the central bank's considerable program of sterilisation, and these rates would attract additional foreign capital into the country and exert even more upward pressure on the value of the yuan.[14]

The relatively low deposit interest rates paid by banks to their depositors allow for a wide margin between lending and deposit rates, which partially compensates the commercial banks for the low interest paid to them for their large required reserves with the central bank. The central bank benefits from this arrangement but at a cost to households have parked most of their huge savings in these low-return bank deposits. The recent series of bank deposit interest rate cuts has further reduced the interest income of many households, while largely compensating banks for the minimal interest earned on their reserved deposits.

In line with the interests of the Ministry of Finance, Huijin Investments announced on 23 September 2008 that it had bought an additional 2 million shares in the Bank of China, China Construction Bank, and Industrial and Commercial Bank of China respectively on the Shanghai Stock Exchange, and would purchase more shares in these banks in the next 12 months. This is clearly a move to boost the share prices of these banks, contributing to increasing confidence in the stock market and banking system, which the Ministry would welcome as a key macroeconomic policymaker and controlling shareholder in these main banks.

Fiscal response

Beijing's fiscal response has been quicker and larger and more closely linked to the interests of the newly empowered provincial governments than its monetary policy actions. While the monetary response to the crisis has been closely associated with the ongoing reform of the financial system and fighting structural inflation, the fiscal response is mostly directed at social stability. The major stimulus package so far has been the 4 trillion yuan (roughly A$ 900 billion) one announced in November 2008 just before the first G-20 leaders' meeting. The Ministry of Finance, which controls the budget and is thus fiscally conservative, required a push from other policymakers to acquiesce to this package and the restraining hand of the Ministry in drawing up the package is clear. The package was designed to create a psychological as well as a fiscal impact and much of the proposed spending in the package is not necessarily new spending but spending brought forward because of the crisis. Arthur Kroeber of Dragonomics in Beijing estimates that only about 1.3 trillion yuan or a third of the

[14] Nicholas R. Lardy, *Financial repression in China*. Policy Brief PB08-8, Peterson Institute, 2008.

announced package is additional investment, but this, according to Kroeber, would still be about 2 per cent of GDP.[15]

The package supports the NDRC's leading role in fighting poverty and in building the new countryside as it provides significant funding for infrastructure and projects targeted at rural areas and poverty alleviation. There were many big-ticket items in these packages that the NDRC is normally keen on, including plans to increase investment in railway construction by 800 billion yuan under its current five-year plan. This will increase expenditure on railway construction to an annual average of 500 billion yuan over the next three years, compared with 250 billion yuan in 2007.

Local governments have had a great say in the nature of the fiscal response and are clear beneficiaries as it appears that they have been more or less granted carte blanche to boost local investment. This may lead to more wasteful projects, but the leading officials who are strong advocates for the provinces in the CLGFE are also champions of pro-poor policies, which are likely to have a more immediate impact on stimulating consumption and the economy compared to spending on major infrastructure. Notable initiatives in the fiscal packages favouring the poor are subsidies to poor urban and rural families and low-cost housing projects targeted at low-income earners. The latter is thought to be a pet project of Li Keqiang, a protégé of President Hu Jintao, who narrowly lost out to Xi Jinping as Hu's heir apparent but nevertheless became a standing member of the Politburo at the 17th Party Congress in 2007 and China's vice-premier and deputy chair of CLGFE in 2008. Both Li and Hui Liangyu, a Muslim Hui Politburo member who champions policies to alleviate rural poverty, entered the top Party leadership positions from the provinces and are strong supporters of the new economic direction of President Hu Jintao and Premier Wen Jiabao targeting poverty and income inequality.

Other elements of the fiscal response also clearly align with local government interests and their consuming and investing constituents. Commencing from 9 October 2008, individuals no longer have to pay income tax on interest savings and tax on interest income earned from stock account balances. And from 27 October, the minimum down payment for first-time home buyers was reduced to 20 per cent from 30 per cent of the declining purchase price. The central government suspended from 1 November the stamp duty on the purchase and sale of the family home as well as the value-added tax on land that such homes are built on. It also announced temporarily lowering the deed tax for first-time buyers on homes that are 90 square metres or smaller to 1 per cent. The property sector is among the hardest hit in China's current slowdown and these measures are certainly designed to boost consumer demand in real estate. But policymakers also have in mind the significant contribution the property sector makes to local government revenues.

---

[15] Doubts remain over stimulus plan's size. *China Economic Review* 11 November 2008.

What's next

China was able to generate sufficient domestic demand during the Asian financial crisis to compensate for the fall in exports and maintain GDP growth in 1998 at about 8 per cent. However, China faces a greater challenge in this financial crisis. The Chinese economy has become more integrated with the global economy since its entry into the WTO, but the greater international commodity and financial capital flows accompanying this greater integration are not the pressing challenge for Chinese economic policymakers. The state's control over the economy has shrunk further since the Asian financial crisis. Domestic private sector decisions of whether to consume or to invest have a greater influence on the economy than before and these are determined by the actors' expectations about the future, which are influenced by the global media and by the delayed effects of monetary policy.

The long-forgotten debate over whether the Chinese economy has decoupled from the US economy focused on commodity and capital flows. What was absent in the debate was consumer and investor confidence. In a world dominated by mass communication and culture, no media firewall in any country can prevent 'bad' global economic news from having an effect on its national economy. In this sense, Chinese investors and consumers are increasingly 'coupled' with the global counterparts The effectiveness of the various policies in stimulating the Chinese economy will therefore depend significantly on how successful the authorities are in restoring confidence among Chinese consumers and investors, independent of the sentiments elsewhere. Will optimism triumph over pessimism?

Producing a sufficient growth rate to prevent outbursts of social unrest may be easier for Chinese policymakers to achieve than to ensure quality economic growth. Pro-poor officials and ministries at the centre may be outwitted by profligate local governments. Fiscal spending could simply be wasted, creating 'white elephants' that contribute little to national welfare but provide ample opportunities for local official corruption. The lower the level of consumer and investor confidence that the current government's fiscal and monetary policies are able to generate in the private sector, the larger would be the need for additional fiscal and monetary stimuli in the near future and the greater the likelihood of waste.

We can be confident of additional economic stimuli – another large fiscal stimulus package cannot be ruled out – and more active management of the exchange rate, if the Chinese economy deteriorates any further. Officials are certain to err on the expansionary side to try to ensure at least 7 per cent GDP growth in 2009, concerned as they are that a significant jump in unemployment, including among university graduates, following lower economic growth would lead to nationwide social unrest. Officials are particularly sensitive to this grim scenario since many in China regard 2009 as a portentous year, the year being the 60th birthday of the People's Republic and 90th anniversary of the

May Fourth student demonstrations against the Treaty of Versailles, and the 20th anniversary of the Tiananmen Square protests.

But there is also the danger in officials' quest for short-term internal stability that the resulting massive fiscal and monetary stimuli could lead to extended delays in much-needed economic restructuring and closing of uneconomic plants, and undisciplined investments that will increase, not eliminate, industrial overcapacity. These actions could sow the seeds of a future domestic banking crisis, and its attendant potential for social unrest, as well as exacerbating China's trade tensions with its trading partners. Economic disharmony at home might only be postponed, not permanently controlled. However, short-term harmony at home might be achieved by trying to export more but only at the cost of causing disharmony abroad.

Chinese policymakers therefore face an enormous challenge to overcome the global crisis and yet produce long-term stable and sustainable growth without compromising their commitment to greater equity. China's fourth-generation leaders possess the necessary education and experience to surmount this challenge, but economics alone cannot guarantee their success. Their economic initiatives have to be framed within a bold political reform agenda that is consistent with the liberalisation and global integration of China's economy. China's authoritarian 'political superstructure' is increasingly at odds with its increasingly market-oriented, consumer-driven economic 'infrastructure'.

Leong H. Liew is a Professor at the Griffith Business School and the Head of the International Business and Asian Studies Department. Professor Liew is an expert on China's political economy and has published widely on China's economic reforms and its responses to globalisation.

LOWY INSTITUTE
FOR INTERNATIONAL POLICY

WWW.LOWYINSTITUTE.ORG