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## **Can China be the First to Recover from the Global Economic Downturn?**

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# Can China be the First to Recover from the Global Economic Downturn?

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# Can China be the First to Recover from the Global Economic Downturn?

Yang Mu\* and Lim Tin Seng\*\*

The current global financial crisis is unfolding to become a dreadful event. Indeed, the crisis has so far pushed almost all major western banks into the brink of bankruptcy and virtually choked the credit market. Without the crucial money supply, businesses are forced to close down and consumers have to cut back their spending. This is leading to a slowdown in global demand which in turn caused export-oriented economies to paint a gloomy economic outlook in the coming years. The numerous multi-billion bailout plans revealed by governments across the global to recapitalize credit-starved banks and to start-up infrastructure projects for job creation, however, revealed an interesting observation. It placed to the forefront the crucial role of the government and reinstalled the real economy as the main source of growth and a possible remedy to the global financial crisis.

China presents itself as an invaluable example to illustrate this argument. After experiencing years of double-digit growth, the global financial crisis had caused the red-hot Chinese economy to slow down significantly. However, Beijing had released a number of stimulus packages worth over US\$500 billion to induce growth. Most of the funds would be injected into sectors such as housing, infrastructure, manufacturing and education. A significant share of the amount would also be directed to boost consumption, capitalize the stock market and improve the social security system. How successful the response remains to be seen. But it is likely that it can cushion the Chinese economy from the full impact of the financial crisis. This paper explores the current challenges that China is facing before listing some of the monetary and fiscal measures that the central government has adopted to address the economic slowdown. In all, it

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illustrates the role of the government and how it can be viewed as the most effective mechanism to fight the recession.

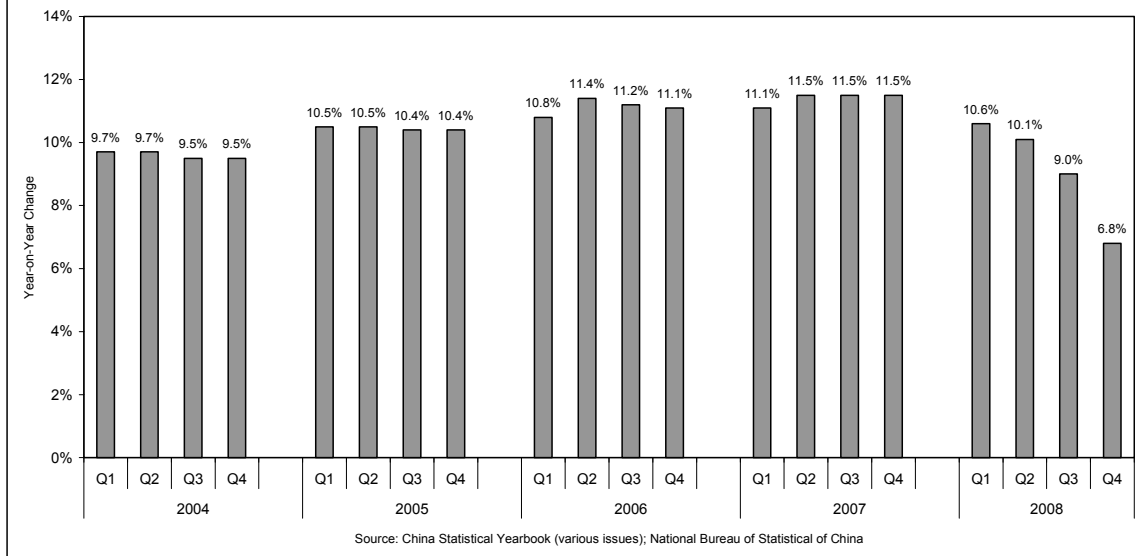
### **The Slowing of the Chinese Economy**

The financial meltdown in the United States and Europe is unfolding to become a potentially catastrophic global event. In only four months after the crisis took form following the collapse of Lehman Brothers in September 2008, its rippling effect has reversed the high economic growth displayed by most global economies for the past several years.

Indeed, by the end of January 2009, industrialized Western economies such as the United States, Germany, England and France as well as Asian economies such as Singapore, Hong Kong and Japan have all plunged into deep recession. Even China which has been trying in vain to slow down its red-hot economy prior to September 2008 seems to have scrambled to the financial crisis.

For the final quarter of 2008, the Chinese economy registered one of its slowest growths of 6.8 percent. This pulled down the economic growth for the whole of 2008 to 9 percent, ending China's four years of double-digit growth (Chart 1). As the year progress in 2009, there is still a high level of uncertainty in China on whether the economy will be able to register the crucial growth of 8 percent for 2009, a level commonly regarded as the minimum growth rate to generate sufficient employment.

**Chart 1 China's Quaterly GDP Growth, 2004 to 2008**



So far, the stake appears to be against China. In January 2009, China’s exports declined for the third consecutive month by falling 17.5 percent in value from a year ago as global demand for electronics, cell phones, steel products and other goods made or assembled in China plunged (Chart 2).<sup>1</sup> The fall in January 2009 is the largest since October 1998. But above all it indicated the troubles ahead for China’s all powerful industrial sector.

<sup>1</sup> “China’s January exports fall 17.5% from a year ago”, *Los Angeles Times*, 12 February 2009.



Indeed, official data shows that at least 67,000 small and medium size companies across China were forced to shut down in 2008.<sup>2</sup> For instance, China’s toy industry started the year 2008 with more than 8,600 factories producing and exporting 70 percent of all the world’s toys. But by the end of 2008, only about 4,400 remained.<sup>3</sup>

The closing down of Chinese factories has adverse effects on China and the global economy. In China, the rate of factories closing down is driving the country’s unemployment upwards at an alarming rate. In February 2009, the Central Rural Work Leading Group stated that more than 20 million migrant workers lost their jobs during the final months of 2008.<sup>4</sup> This is about 15 percent of the total migrant labour pool.

For the global economy, the slowing down of China’s industrial sector has led to a sharp decrease of Chinese demand for global supply of equipment and machines and commodities such as crude oil and metals. In January 2009, China’s imports slumped

<sup>2</sup> “Factories Shut, China Workers Are Suffering”, *New York Times*, 13 November 2008.

<sup>3</sup> “Half of China's toy factories close after exports slump”, *The Times*, 10 February 2009.

<sup>4</sup> “Chinese migrant job losses mount”, *BBC News*, 2 February 2009.

over 40 percent in value from a year ago. This has resulted in the swelling of China's trade surplus to a record of US\$39.1 billion, adding tension to the already delicate state of China's trade relations with industrialised economies such as the United States and the European Union.

Despite the bleak economic outlook, Beijing remains optimistic. During his "trip of confidence" to Europe in January 2009, Chinese Premier Wen Jiabao stated in his speech at the World Economic Forum that the Chinese economy can continue to grow amid the global downturn.<sup>5</sup> He explained that this is because the fundamental of the Chinese is sound. However, Premier Wen admitted the year ahead remains a challenge for the Chinese economy and recovery is still largely dependent on the recovery of global demand. Nevertheless, the Chinese Premier is confident that China is still likely to meet the crucial target of 8 percent growth in 2009.

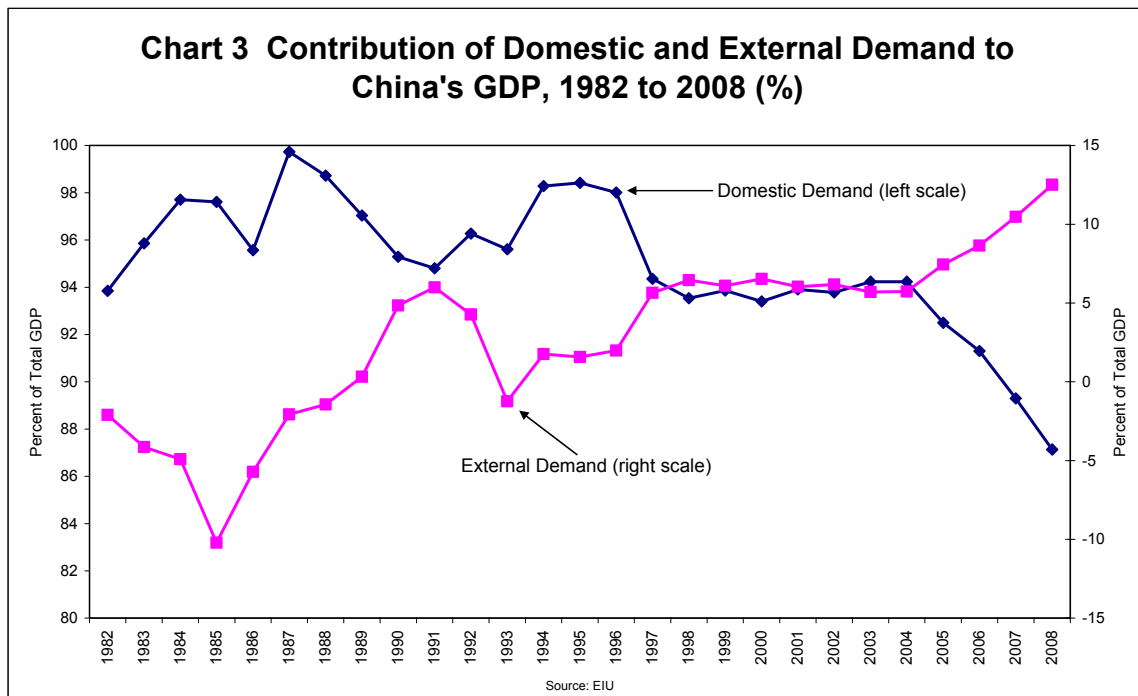
### **Domestic Demand as a Source of Growth**

Wen Jiabao's proclamation in the World Economic Forum that there is still a huge potential that the Chinese economy will continue to grow in 2009 is not dumbfounded. This is because China's economic growth is not solely driven by external demand (or exports net of import) like in Singapore or Hong Kong. Domestic demand, comprising personal and household consumption, domestic investment and government spending, is also a source of growth for China. This is not surprising as China is a huge continental economy with one-fifth of the world's population. Furthermore, China is still the process of industrialization and urbanization. In fact, China's urban population only amounts to about 43 percent of the country's total population. This means that there is still plenty of room for growth for China's domestic consumption through infrastructure and other urban expansion projects. However, China's domestic demand is often overlooked by many Western scholars and media as they often cite the decline in China's exports as the end of its economic growth.

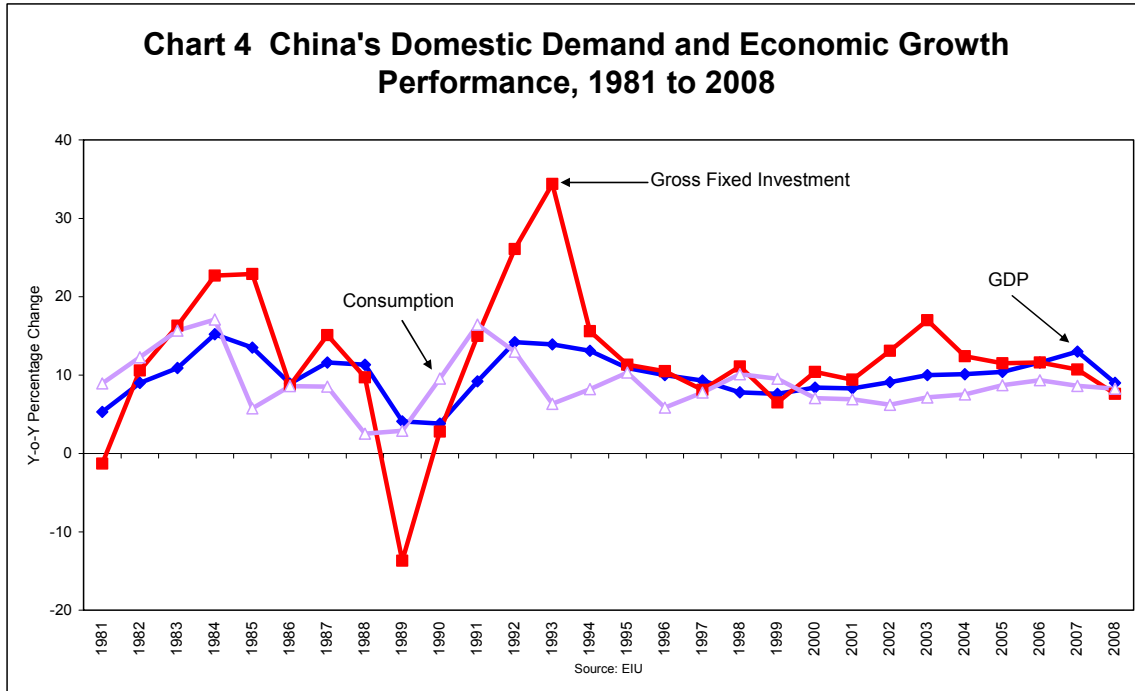
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<sup>5</sup> "Chinese premier upbeat about China growth, stresses confidence in addressing crisis", Xinhua, 29 January 2009.

As shown in Chart 3, domestic demand is the mainstay of the China's economic growth. From the 1980s through the 1990s, the share of domestic demand to China's GDP accounted an average of more than 90 percent. Even after a surge in China's external trade following its accession to the World Trade Organisation in 2002, the share of domestic demand in China's GDP remains well over 85 percent.



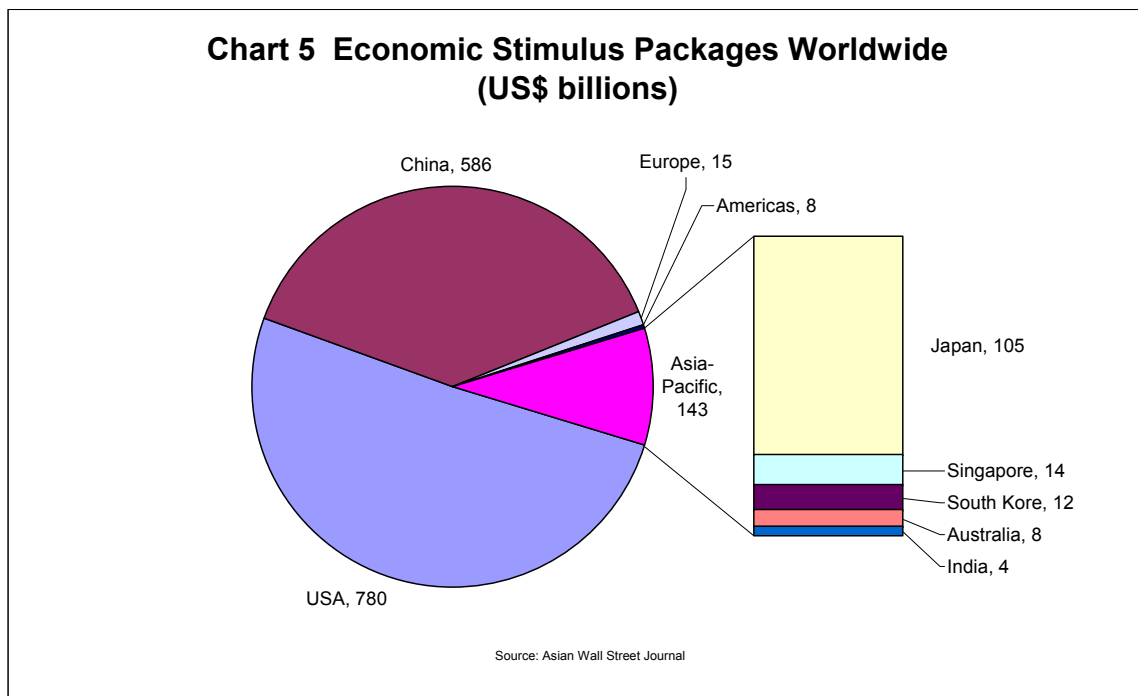
By studying the fluctuation of China's past economic growth with the components of domestic demand, fixed investment has always been the major source of China's growth. In fact, the numerous "business cycles" (or variation of economy growth) that China experienced over the past three decades tends to swing with the ups and downs of fixed investment (Chart 4). This relationship also indicates that the central government uses fixed investment as a fiscal instrument to expand the economy when domestic deflation sets in or to curb growth when the economy faces overheating.



Indeed, local governments' enthusiasm to develop their economies increased following Deng Xiaoping's *nanxun* in 1992 led to a surge in domestic investment which in turn resulted in a sharp rise in economic growth. This subsequently caused the economy to overheat. To address it, Premier Zhu Rongji cut fixed investment in the mid-1990s, allowing China's economy to achieve a "soft landing" in 1996. The of adjusting the level of fixed investment was repeated in the late 1990s to offset the effects of the Asian financial crisis and more recently to cool the economy in late 2007 and early 2008.

The stimulus package unveiled by Beijing in November 2008 is the continuation of the central government's practice to peg China's economic growth with the level of fixed investment. In fact, the package is meticulously prepared to boost domestic demand for economic growth. The main areas for government spending include: 1) public housing for low-income groups, 2) rural infrastructure such as water supply and conservation, rural roads and power grids, 3) transport infrastructure such as high-speed railways, mass transit systems, highways and airports, 4) healthcare and education, 5) ecological and environmental projects, 6) innovation and R&D, and industrial upgrading, and 7) Sichuan earthquake construction.

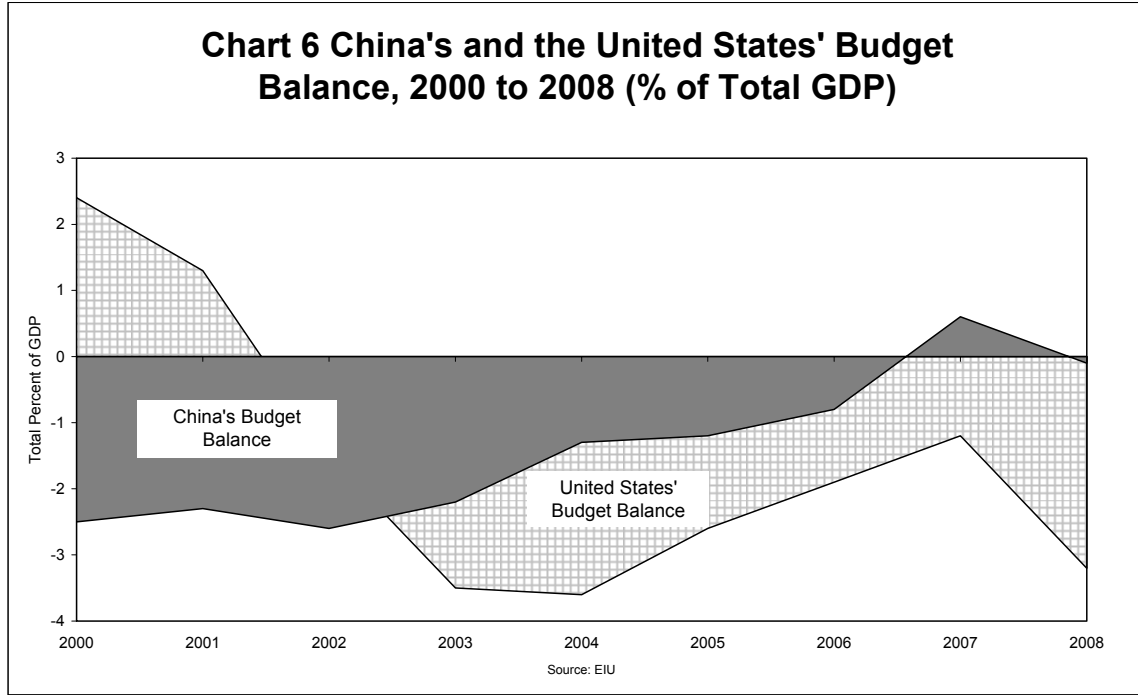
The estimated cost for the first two years of these projects is about US\$586 billion (4 trillion yuan) which is around 15 percent of China’s GDP in 2007. On a global scale, China’s stimulus package is the second largest in the world after the United States’ US\$780 billion “American Recovery and Reinvestment Plan” stimulus package which was passed in February 2009 (Chart 5). It is, however, the largest among the stimulus package unveiled by Asian and European economies.



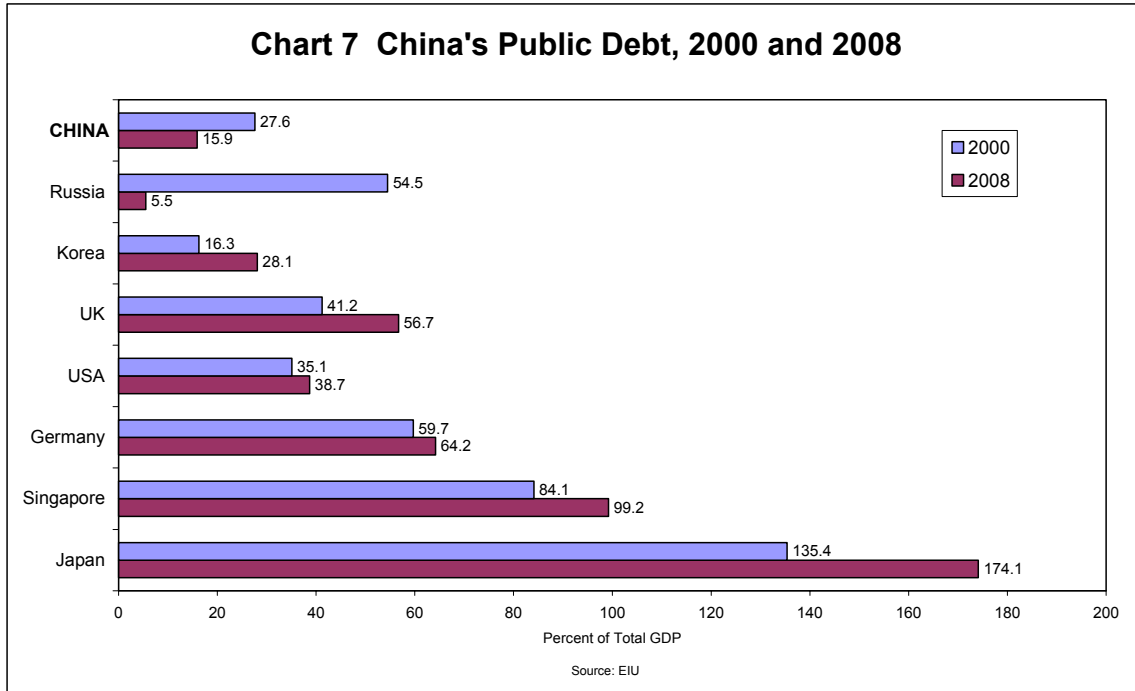
### China’s Strong Fiscal Position

By taking into account of China’s fiscal health, it is also possible to see why the Chinese economy can rebound from its current slump faster than regional and western economies. First, China’s budget deficit has been decreasing rapidly in recent years. From 2000 to the end of 2007, China fiscal balance increased from a deficit of nearly 3 percent of total GDP to a surplus of 0.7 percent of GDP. On the other hand, most developed economies, particularly the United States, have been experiencing growing budget deficit and rising public debt. For instance, the United States’ budget balance dropped from a surplus of

2.4 percent of total GDP in 2000 to a deficit of 3.2 percent of total GDP by the end of 2008 (Chart 7).



In addition, China's public debt is also declining. This allows Beijing to flex its fiscal muscle to fight the recession. From 2003 to 2007, China's public debt has decreased from nearly 30 percent of GDP to only about 18 percent of GDP. In comparison, the United States' public debt increased from 35 percent of total GDP to nearly 40 percent of the total GDP during the same period (Chart 8).



Besides, China's savings rate is also very high. On average, a Chinese household save about 26 percent of total disposable income which is considerable higher than the savings rate in western economies (e.g. United States' saving rates is less than 0.5 percent of total disposable income in 2007).<sup>6</sup> Although Zhou Xiaochuan, the governor of the People's Bank of China, has been trying to reduce domestic savings by adjusting exchange and interest rates and developing China's financial markets, savings continued to grow. By the end of 2007, China's accumulative domestic household savings amount to about 67 percent of the country's GDP.

Coupled with low level of loans, China's high domestic savings translate into well-capitalized banks. In fact, three out of the world's top ten cash-rich companies are Chinese banks (Table 1). Furthermore, the three Chinese banks in list, namely Bank of China, Industrial and Commercial Bank of China (ICBC) and China Construction Bank, have a total net cash of US\$272 billion which nearly 55 percent of the total net cash of all the top-ten companies.

<sup>6</sup> "Consumers Are Saving More and Spending Less", *The New York Times*, 2 February 2009.

**TABLE 1 Top Ten Cash-Rich Companies as End of 2008**

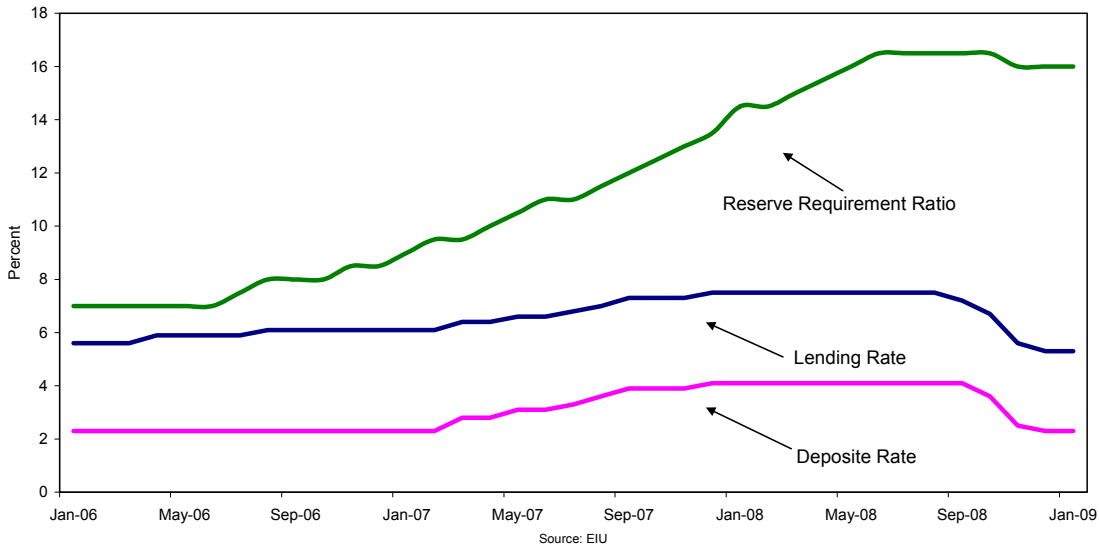
	<b>Companies</b>	<b>Net Cash (US\$ billion)</b>
1	Berkshire Hathaway	106
2	<b>Bank of China</b>	<b>101</b>
3	<b>ICBC</b>	<b>89</b>
4	<b>China Construction Bank</b>	<b>82</b>
5	ExxonMobil	28
6	China Mobile	26
7	Apple	25
8	Cisco Systems	20
9	Microsoft	19
10	Google	14
	<b>TOTAL NET CASH</b>	<b>540</b>

Source: Bloomberg

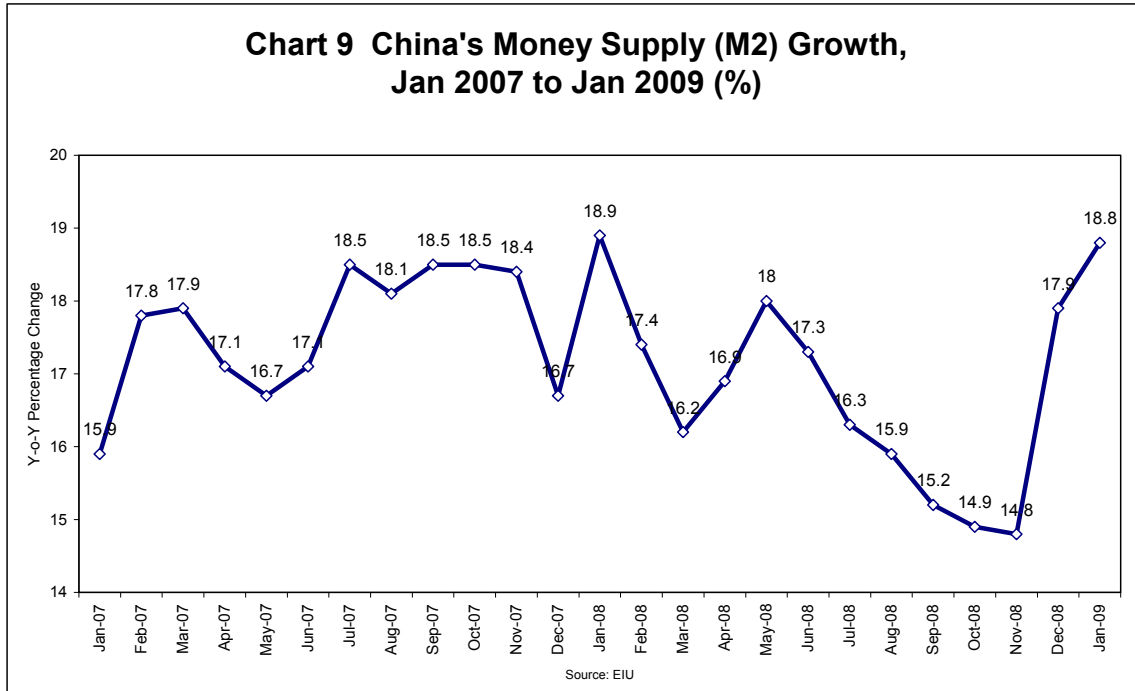
### **Loosening Monetary Policies**

To fight the recession, Beijing also made important adjustments to loosen its monetary conditions. Some of the measures the government adopted to improve lending include issuing interest rate cuts and lifting lending limits on commercial banks. As Chart 8 shows, China's central bank has adjusted lending rates quite significantly downwards in recent months from 7.2 percent to 5.6 percent from August 2008 to November 2008. Lending rate was further revised to 5.3 percent in December 2008. Similarly, the central bank also cut half a percentage point on the reserve requirement ratio for banks from an all-time high of 16.5 percent to 16 percent in December 2008.

**Chart 8 China's Lending Rate, Deposit Rate and Bank Reserve Requirement Ratio, Jan 2006 to Dec 2008**



As part of the blueprint to ease the country's monetary conditions, the central bank has also started to increase China's money supply. As shown in Chart 9, China's money supply in December 2008 and January 2009 registered its highest year-on-year percentage change since May 2008 of 17.9 percent and 18.8 percent respectively. According to the State Council, China will continue to maintain a high level of money supply growth of around 17 percent in 2009.

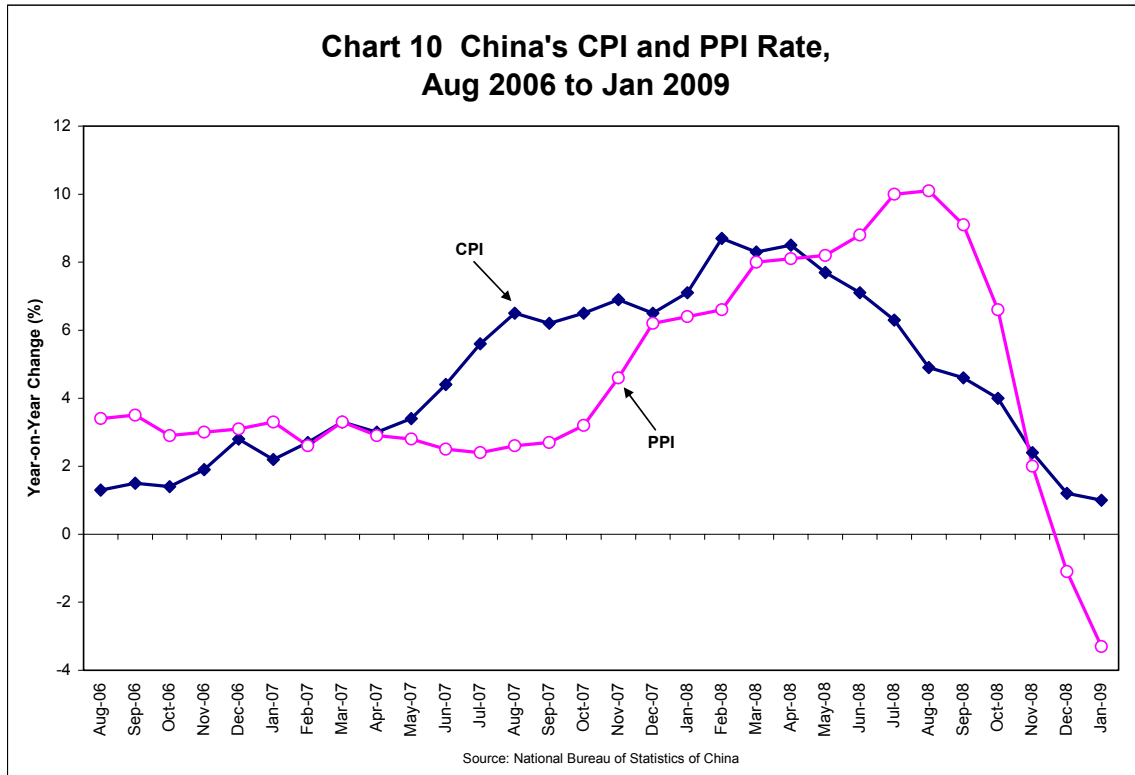


With the stabilisation of the country's China's runaway inflation in the second half of 2008, the central government should be able to continue relaxing the country's monetary conditions in 2009. Besides, the massive foreign reserves and favourable trade surplus also allow China to maintain the stability of its currency. Both of which are important monetary factors for China to maintain the competitiveness of its economy and its attractiveness to FDI inflow. This can in turn provides China's economy a stable support to maintain the crucial 8 percent growth.

### **China's Business Cycle**

Unlike the developed economies, particularly the United States, China's current economic slump does not originate from the meltdown of its financial sector. Instead, the slowing down started as part of the process of its economic fluctuation or "business cycle". In later part of 2007 and early 2008, the Chinese economy was in danger of being overheated. The country's economic growth was clocking double-digit growths and the investment and inflation growth have gone beyond the government's comfort zone. For

instance, China's CPI was averaging nearly 8 percent from the fourth quarter of 2007 through the second quarter of 2008 (Chart 10).



To fight inflation and to cool down the economy, Chinese policymakers introduce various tightening measures to slow down the economy. Since domestic demand plays an important role in inducing growth, one of the main strategies was to cut government spending. Indeed, government investment dropped quite significantly between 2006 and 2008 from 11.6 percent of total GDP to 10.7 percent of total GDP in 2007 and then 7.6 percent of total GDP respectively.

Besides, Chinese authorities also administer policies to tighten the monetary conditions. This includes raising interest rates and increasing the banks' reserve requirement ratio. In fact, from January 2006 through September 2008, China had readjusted the requirement ratio upwards about 15 times. Similarly, lending rates was also raised more than ten times during the same period.

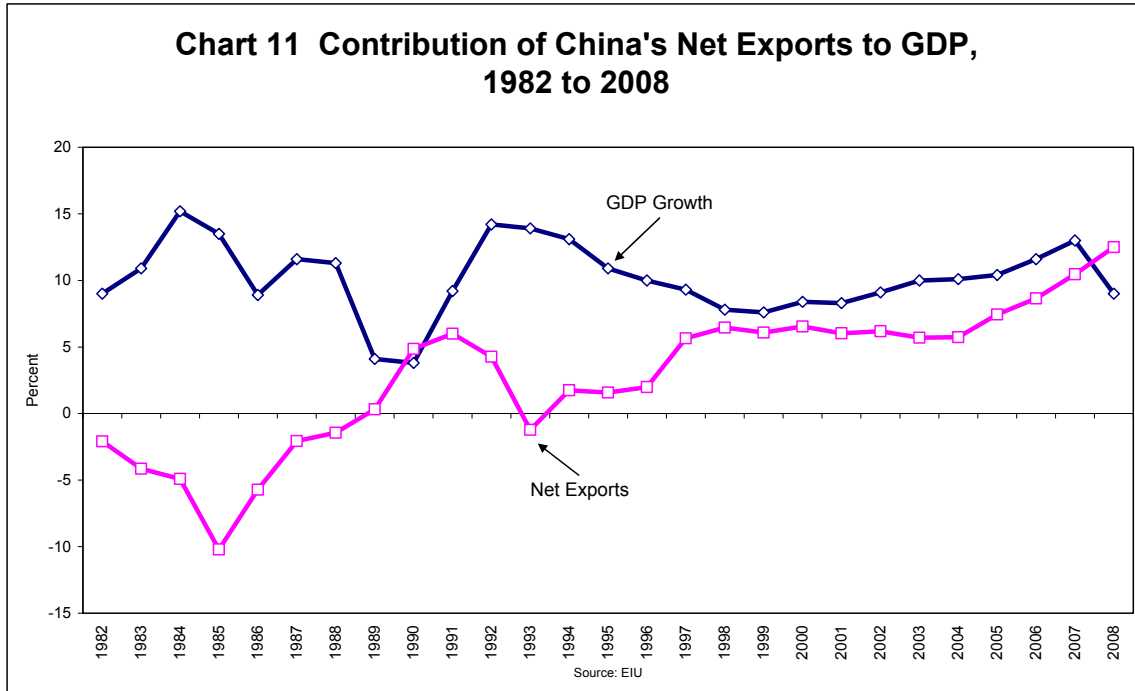
Furthermore, the central government also implemented a series of measures to slow the growth of industries and to curb overinvestment. This includes tightening land supply for industrial use and taking steps to restrict the inflow of FDI. Incentives were also removed from labour-intensive industries and environmental fees were charged on dirty industries. A new labour contract law was also introduced to raise the labour cost in industries.

To a certain extent, China's current economic slowdown also stems from also a whole string of events that disrupted production in the country. These ranges from the snowstorm in early 2008 to the Sichuan earthquake in mid 2008 and the Olympics in August 2008.

### **External Demand Still Important**

Although Beijing's response to the global downturn is to focus on boosting domestic demand, this does not mean that it is disregarding its external trade. In fact, Premier Wen has made it clear that Beijing is against taking on any protectionist measures. He also urged other economies to continue maintaining a liberalised trading environment. Furthermore, the Chinese Premier also admitted that China would not be able to fully recovery from the current global recession if global demand remains weak. In all, it shows that China still view external demand playing a key supporting role in inducing growth to the economy.

In addition, although China's external demand constitutes only a small share of its GDP growth, it has been rising in recent years especially after China's accession to the World Trade Organisation in 2002. As Chart 11 illustrates, the share of net exports to China's GDP growth has been growing for the past decade from about 6 percent in 1998 to over 11 percent by the end of 2008. This rising trend indicates that external demand is set to play a more important supporting role for China's economic growth in the future.



Above all, industries in Guangdong's Pearl River Delta which is the China's manufacturing and export hub and other coastal areas are highly dependent on external demand. Therefore it is crucial for the external situation to improve before these regions can recover from the effects of the global financial crisis. Mostly made up of foreign funded firms, these regions were badly hit by the crisis. In fact, Huang Yunlong, vice governor of Guangdong province, termed 2008 as "the most difficult year after the 1998 Asian financial crisis".

Huang's remark was not an understatement. According to the Guangdong Statistics Bureau, 100,600 companies were established in 2008 but by the end of the year, more than 62,400 had been eliminated. This alarming rate of closing down has also resulted in massive job loss. In fact, the Statistics Bureau reported than an estimated 600,000 migrants lost their jobs in 2008.<sup>7</sup>

<sup>7</sup> "600,000 migrant workers leave Guangdong amid financial crisis", *Xinhua*, 9 January 2009.

For this financial crisis, however, the Chinese leadership is more concerned on stimulating domestic demand rather than external demand. This is because they are aware that the weakening global demand is beyond the control of the Chinese government. Nonetheless, it is important to note that most of the measures taken to stimulate the domestic market such as the stimulus projects are also cater to create jobs.

### **Early Signs of Recovery?**

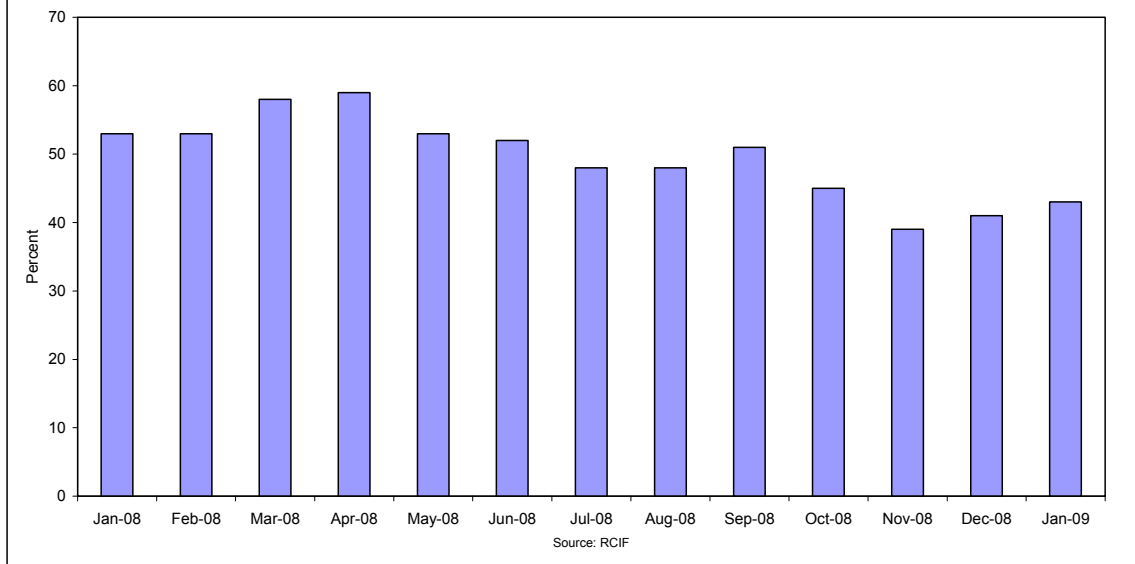
It is still too early to examine whether the policies undertaken by Beijing to boost the economy are effective. Not only the global economic situation remains difficult, it appears to be worsening. In fact, there are an increasing number of companies succumbing to mounting corporate debt and defaulting in the United States and other Western economies. By various estimates, it is likely that American companies will default on US\$450 billion to US\$500 billion of corporate bonds and bank loans over the next two years, the most corporate-debt defaults by dollar amount in the economic history of the United States.<sup>8</sup> This could suggest the widening effect of the meltdown of the financial sector which is likely to send jitters to global economies, including China.

But there are some encouraging signs stating that the steps taken by Beijing so far are yielding positive results for the economy. First, China's Purchasing Management Index (PMI) which measures new orders made by the manufacturing sector registered an increase of 41 percent in December 2008. This stops the slide of the country's PMI index for the first time since May 2008 (Chart 12). Although the PMI in December 2008 is still below 50 percent which indicated that the economy is still in decline, the index is creeping upwards. Indeed, in January 2009, the PMI index registered an increase of 43 percent.

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<sup>8</sup> "Defaults Mount in U.S.", *The Wall Street Journal*, 16 February 2009.

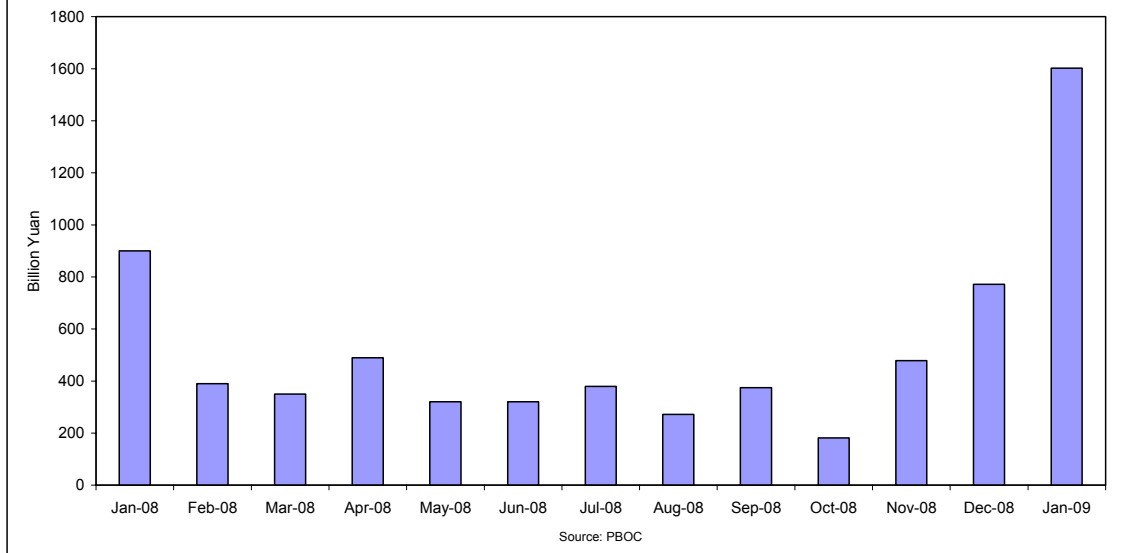
**Chart 12 China's Purchasing Management Index,  
Jan 2008 to Jan 2009**



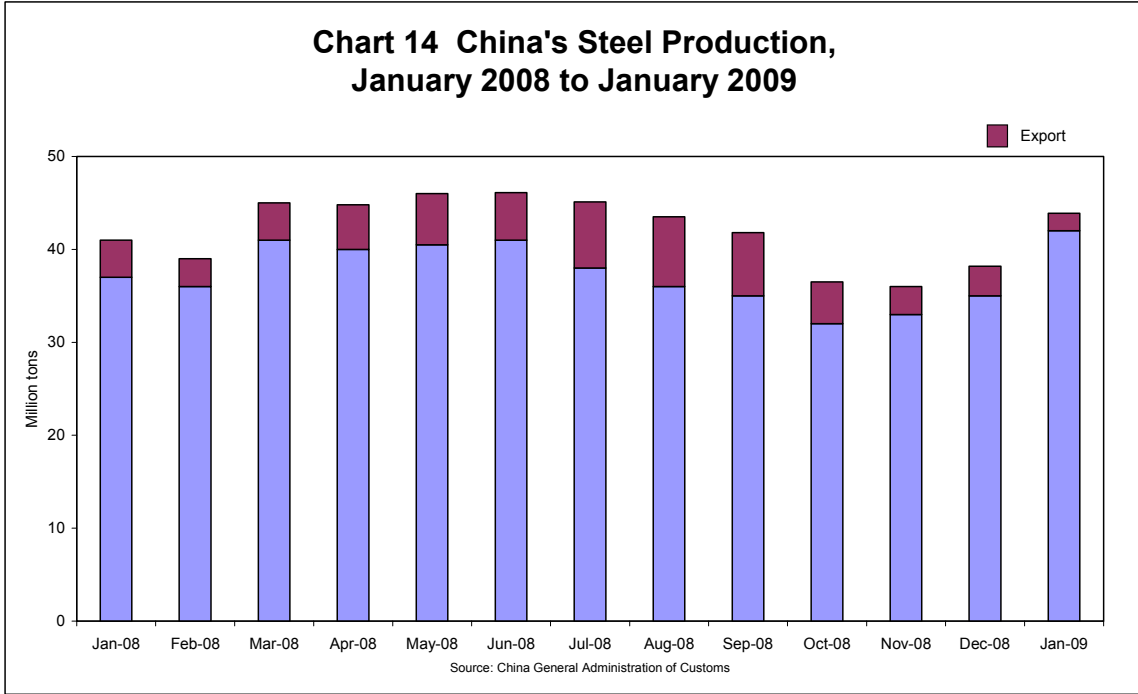
Second, China's credit problem seems to be easing. For instance, bank loans made in China in January amounted to 1.62 trillion yuan (US\$237 billion), a year-on-year increase of over 800 billion yuan or 104 percent (Chart 13). The massive growth in bank loans signals that banks are lining up to provide funds to developers for the stimulus-package projects. This could be a blessing for cash-strapped domestic enterprises trying to stay afloat amid shrinking overseas demand and waning consumer confidence.<sup>9</sup>

<sup>9</sup> "China's bank loans see striking rise in Jan", *China Daily*, 13 February 2009.

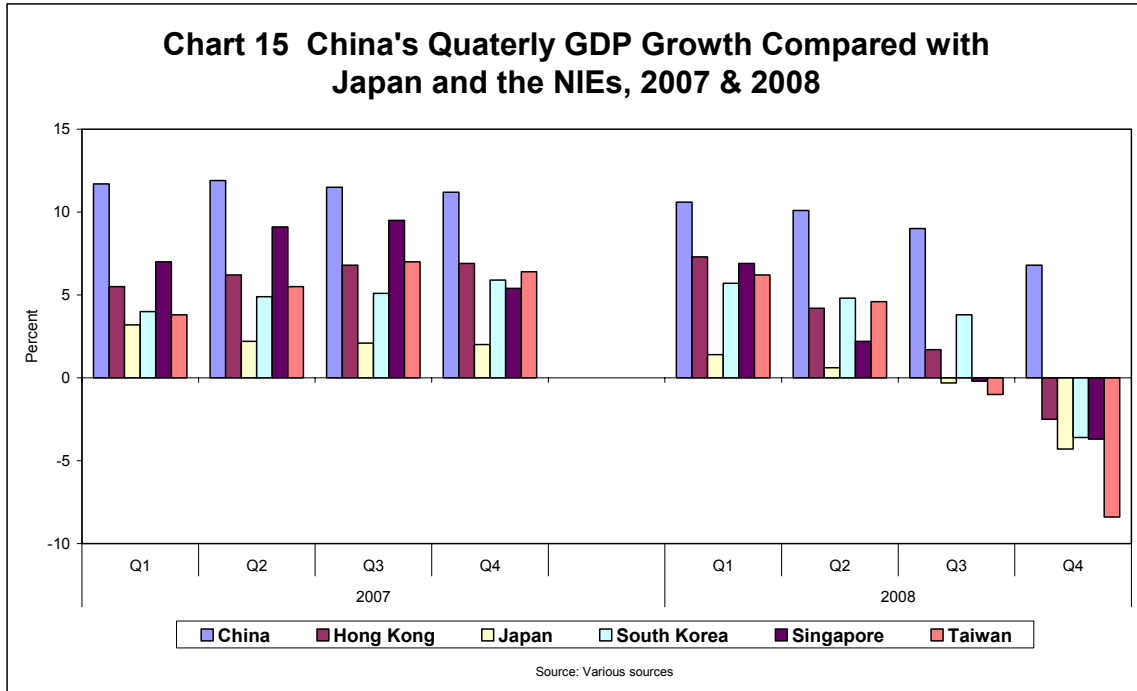
**Chart 13 Banks Loans Made In China,  
Jan 2008 to Feb 2008**



Third, China's crude steel output is also increasing. In January 2009, steel production rose for the second consecutive months to reach 42 million tons, a level that was not seen since July 2008 (Chart 14). This is in contrast to its neighbours as Japan's and South Korea's steel output continues to experience a sharp decline. For instance, Japanese production fell 38 percent to 6.4 million tons while South Korea and Taiwan fell 26 percent to 3.5 million and 28 percent to 1.4 million tons respectively. It is likely that the recovery in China's steel production is largely fuelled by the expected increase in demand for steel following the central government's announcement of numerous massive infrastructure projects in its stimulus package. Furthermore, the increase of production could also be attributed to Beijing's decision to scrap export tax on high value-added steels, such as cold-rolled products.



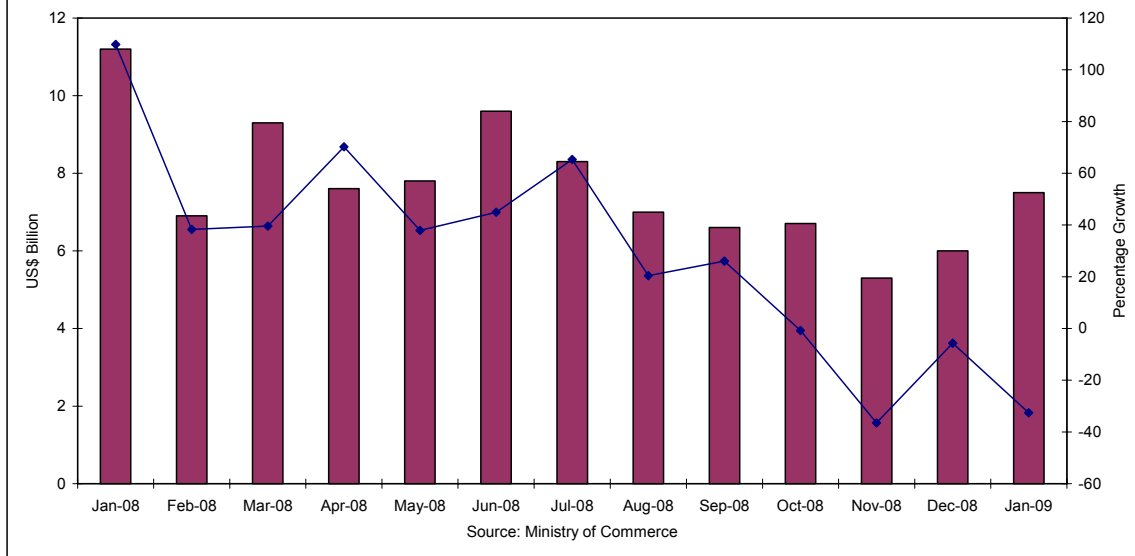
Fourth, China’s economy seems to be holding up despite being badly hit by the financial crisis. Although China’s GDP declined from 9 percent in the third quarter of 2008 to 6.8 percent in the fourth quarter of 2008, China’s overall economic performance is still much better when compared to Japan and the Newly Industrialized Economies (Chart 15). As a result, this should place China firmly in the pole position to recover from the current global downturn.



However, the economic situation remains difficult. As a result, it is too early to conclude that the positive momentum registered by the Chinese economy is sustainable. The continuing credit squeeze and the diminishing global demand may derail China's recovery plans entirely. For instance, the sharp decline in foreign direct investment (FDI) that China is currently experiencing appears to be worsening. Despite relaxing monetary conditions in China, FDI inflow continues to slide. In January 2009, China's FDI inflow dropped for the third consecutive month of 32 percent year-on-year to reach US\$7.5 billion (Chart 16). The number of new companies set up on overseas capital dropped, too, by 48.7 percent year-on-year to 1,496.<sup>10</sup>

<sup>10</sup> "FDI sees 4th monthly dive in row", *China Daily*, 17 February 2009.

**Chart 16 Growth of China's FDI,  
Jan 2008 to Jan 2009**



The sliding FDI inflow will definitely exacerbate the rate of factories closing down in the industrialised costal regions which will have a rippling effect on the unemployment situation in China. Therefore, the following months would be an interesting time to see how far China's stimulus package can work in reviving the economy.

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