China Analysis 67
January 2009
www.chinapolitik.de

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In 2008, as the international financial crisis spread from the developed countries to emerging economies and spilled over from the financial sector to the real economy, two widely shared assumptions about China have been shattered: that China could decouple from a recession in the West and that it could be immune from financial turmoil by its "closed" capital account and insulated banking sector primarily relying on deposits and not exposed to risky Western financial instruments.[1]

This article deals with some of the immediate consequences of the financial crisis for China so far, sketches the Chinese policy responses and presents two alternative scenarios for the longer-term future. It does not speculate about China's growth rate for 2009 on which estimations vary enormously (from zero growth to 8%) depending on how much China's export ratio is factored in the calculation of its GDP.[2] No matter which GDP growth rate for 2009 is assumed, the downturn from 13% in 2007 to e.g. 7% or even less in 2009 would mark the sharpest contraction of China's economy in 20 years.

The Short-term Impact on China

The international financial crisis has already left its mark on several aspects of China's economy although according to the official numbers the negative impact is not fully reflected in the year-on-year comparison (cf. table below). The most visible damage so far has been inflicted on China's *export-oriented light industry* in southern China. Thousands of companies have gone bust, tens of thousands of workers have been laid-off and even the official statistics reveal that 10 million migrant workers have returned to their home provinces.

In the *financial sector* the stock market crash that started in October 2007 has wiped out more than two thirds of market value although this dramatic collapse of the Chinese stock market has many home-made reasons. The Chinese banks for all their profitability have witnessed the sudden pull-out of many of their Western partners as these (Bank of America, UBS, RBS) had to sell their minority stakes in order to retrieve capital. In how far this trend will have negative consequences for Chinese banks remains to be seen. The international financial crisis has definitely dealt a massive blow to China's fledgling sovereign wealth fund (China Investment Corporation, CIC). With huge losses incurred by its engagement in Western companies the Chinese public has become very critical towards the CIC's investment strategy. As a result, the CIC's current attitude of "cash is king" has led Western analysts to call the Chinese sovereign wealth fund the "China Not-Investing Corporation".[3]

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[1] On these two assumptions see Albert Keidel: "The Global Financial Crisis: Lessons for the United States and China", *Carnegie Endowment Remarks*, October 26, 2008; "The Decoupling Debate"; in: *The Economist*, March 6, 2008.

[2] On this question see "Economic Focus: An Old Chinese Myth"; in: *The Economist*, January 5, 2008.

[3] Brad Setser: "The China Not-Investing Corporation" (January 5, 2009); in: http://blogs.cfr.org/setser/2009/01/05/the-china-not-investing-corporation/ (accessed January 25, 2009).

In China's *external economic relations* November and December 2008 saw the turning of the tides: For the first time since 2001 exports fell in November 2008 by 2,2% while imports in December declined by more than 21%. Since China is at the centre of Asian production networks and a big chunk of its imports from Asia is processed for exports, this decline of imports as well as the corresponding export slumps in Taiwan (-41% in December) and South Korea (-17%) do not bide well for the coming months. Positively at least, China is one of the major beneficiaries of the decline of commodity prizes (esp. crude oil) which has helped to ease inflationary pressures and for the time being muted international concerns about China's "ruthless petro diplomacy".

China's economy in 2007 and 2008

	2007	**2008**
GDP (billion CNY)	25731	30067
GDP growth rate (%)	+13,0	+9,0
Unemployment rate (%)	4,0	4,2
Inflation rate (%)	4,8	5,9
Fiscal balance (% of GDP)	2,1	2,0*
Trade (billion US$)	2174	2562
Exports (billion US$)	1218	1429
Imports (billion US$)	956	1133
Trade surplus (billion US$)	262	296
Current Account surplus (% of GDP)	11,3	9,7*
FDI received (billion US$)	82,7	92,4
Foreign exchange reserves at year end (billion US$)	1530	1950

*Sources: Statistical Bureau of the People's Republic of China, People's Bank of China, WTO, IMF. *OECD projection.*

Policy Responses

At home the Hu Jintao – Wen Jiabao leadership has concentrated on means to manage the economic downturn and minimize the social costs of the crisis. A central work conference in December set the goal of 8% growth for 2009. Already in November the government revealed a 4 trillion Yuan (586 billion US$) stimulus package that is to bring about an economic recovery in the third quarter of 2009. The fiscal measures include funding commitments for massive infrastructure investments as well as tax rebates for suffering industries and have been accompanied by anti-cyclical monetary policies (the central bank cut benchmark interest rates 5 times from September to December 2008).[4]

China's international response has been in line with its traditional attitude of cultivating its image as a responsible power while avoiding responsibilities that would surpass its capacities as the "biggest developing country of the world". Thus, Hu Jintao at the G20 summit meeting in November made it clear that China's main contribution to international financial stability would be ensuring "steady and relatively fast growth" of its own economy.[5]

[4] On the stimulus package see Barry Naughton: "The Scramble to Maintain Growth", *China Leadership Monitor* No. 27 (Winter 2009).

[5] "Hu Jintao Addresses the G 20 Summit on Financial Markets and the World Economy in Washington" (2008/11/16); in: http://www.fmprc.gov.cn/eng/wjdt/zyjh/t522600.htm (January 17, 2009)

The Longer-Term Consequences: Alternative Scenarios

Under an *optimistic scenario* the international financial crisis would be short, China would be able to recover starting from the middle of 2009 and in 2010 it would have reached its pre-crisis growth rate of about 10% thereby serving as an engine of growth for the world economy.

As a consequence of the financial crisis the traditional US model of capitalism with minimal state intervention could be discredited and China's reform path once again hailed as the triumph of the "Beijing Consensus" over the "Washington Consensus" (liberalization, privatization, deregulation). Thus, the international political and economic architecture would no longer be dominated by the US alone but would be determined by extensive Sino-American coordination (Group of 2, G2).[6]

There are a couple of reasons why this optimistic outlook might come true: During the 30 years period of reform and opening to the outside world (1978-2008) there has been no shortage of doomsayers who predicted a soon-to-come collapse of China because the Chinese reform path was supposed to be unsustainable. Now however, there is a growing body of experts who concede that the Chinese leadership has a proven record of "authoritarian resilience", flexible adaptation to changing circumstances and crisis management skills.[7] Even more remarkably, the Chinese Communist Party leaders used times of crises (1991, 1997/98, 2003) to push forward more ambitious reform agendas. In addition and in contrast to conventional wisdom, the success of the China model should neither simply be attributed to "export-led growth" or to economic factors in a strictly neoclassical sense (rapid rise of factors of production, productivity gains) alone. China can be considered as the prototype of a "learning authoritarian system", one that combines selective long-term planning with an unprecedented degree of broad-based policy experimentation.[8]

Furthermore, China is in a far better position to weather the current storm than most other emerging economies (Russia, in Eastern Europe, in Latin America): It has a sound ratio of external debt to GDP, a massive current account surplus and its fiscal position may allow it to spend its way out of the present calamities.

A *pessimistic scenario* implies a protracted crisis with a deep recession, an ongoing decrease in foreign demand for Chinese goods, a breakdown of production in the respective industries, thus rapidly rising unemployment and mounting social tensions. This would come at a time when China's social security system for its urban – let alone rural – population is still in its infancy.

The Chinese leadership would be confronted at home with calls to speed up its efforts of re-balancing growth away from export supporting policies towards propping up private con-

[6] Zbigniew Brzezinski: "The Group of Two that Could Change the World"; in: *Financial Times*, January 13, 2009.
[7] Andrew J. Nathan: "Authoritarian Resilience"; in: *Journal of Democracy*, Vol. 14, No. 3, January 2003, 6-17.
[8] On the interplay between planning and experimentation in China's economic governance, see two recent studies by Sebastian Heilmann: "Policy Experimentation in China's Economic Rise"; in: *Studies in Comparative International Development*, Vol. 43, No. 1, March 2008, 1-26; "Authoritarian Upgrading? The Innovative Potential of China's Economic Governance", paper presented to the conference "Three Decades of Reform and Opening: Where is China Headed?", Boston University, December 2008.

sumer demand. This would be accompanied in China's external relations by rising Western criticism to increase its imports substantially so as to reduce the global imbalances.

There are some reasons why this scenario might gain the upper hand: First of all, the Chinese statistics in many respects raise more questions than they provide answers. For example, how is the news of declining Chinese non-performing loans in the banking sector or the minimal increase in its unemployment rate in 2008[9] to be reconciled with the many company closures at least since the 4th quarter? A more psychological aspect should also not be underestimated: The Chinese public has got used to growing welfare and demands the continuous provision of better public goods (health care, education, public infrastructure, communications). These ongoing rising expectations are directed at a Chinese leadership that has never been going through a deep depression with no or even negative growth during the last 30 years. At worst it had to cope with a growth rate of 3,8% in 1990. The financial crisis of today thus might confront the Chinese leadership and its bureaucracy with challenges they have never faced in their political life.

With regard to China's external relations there is also reason to be worried: China has been criticized by the EU since 2006 as an "unfair trading partner". The standard EU repertoire calls for more "reciprocity" or a "level playing field" in EU-China economic relations (in EU speak this means more imports and less bureaucratic barriers for doing business in China). In the US Congress there has already been a lot of legislative action pending against China as a "currency manipulator".[10] If China chose to depreciate the Yuan against the US$ (as it did in August 2008 for the first time since July 2005) so as to boost its export industries this could set off new calls for retaliatory protectionist action. These problems together with other ongoing conflicts (e.g. intellectual property rights violations) could lay the groundwork for an extremely anti-China atmosphere in the West so that the bilateral relationship could easily spiral out of control.

Which of the two scenarios (or a mixture of elements from both) prevails will thus depend to a considerable extent on factors beyond the control of the Chinese leadership. The year 2009 with its many symbolic anniversaries (1919, 1949, 1979, 1989) may in the end turn out to be a watershed in the history of the People's Republic of China.

[9] "China Banks See Sharp Decline in NPL Ratio"; in: http://www.news.xinhuanet.com/english/2009-01/18/content_10678253.htm (January 19, 2009); "China's Urban Jobless Rate Rises to 4,2% at End-2008"; in: http://www.news.xinhuanet.com/english/2009-01/20/content_10688189.htm (January 20, 2009).

[10] For an overview of current Anti-China bills in the U.S. Congress see Wayne M. Morrison: "China-U.S.Trade Issues" (Updated October 7, 2008), Washington D.C., CRS Report For Congress RL33536, 28-31.