

The Quaid-i-Azam Lecture

China's Economic Growth, Global Economic Crisis and China's Policy Responses

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As a result of opening and reform, China has maintained an annual average growth rate of 9.8 percent for nearly three decades. China's growth is based on high savings and high investment. Its export promotion policy has also played a very important role in promoting economic growth. However, as a result of China's growth pattern characterised by investment-driven and export promotion, the Chinese economy also has been suffering from serious structural imbalances. Its high and ever-rising investment rate has created overheat and overcapacity in tandem. Its high dependency on external market makes its economy vulnerable to external shocks. The global financial crisis has hit the economy seriously and exposed the structural weakness of the economy. The dramatic fall of external demand led to dramatic slowdown of the economy. The Chinese government responded to the slowdown of the economy swiftly and forcefully. A four trillion Renmibi stimulus package and expansionary monetary policy have successfully stabilised the economy. However, the stimulate policy has worsened structural problems. China's structure problems include high external dependency, high investment rate, deterioration of environment, widening income gap between different social group and between rural and urban areas, insufficiency in the provision of social goods and so on. Due to its strong fiscal position, there should be no problem with China to achieve a growth rate of 8 percent. At the same time, the Chinese government should be able to tackle its structural problems successfully so as to ensure the sustainability of China's economic growth.

JEL classification: G01, E44, E65

Keywords: Growth, Global Financial Crisis, Stimulus Package, Structural Adjustment

INTRODUCTION

This paper is aimed at assessing China's economic performance in recent years and China's policy responses to the global financial crisis. The first section depicts China's economic performance since 1990s, especially after 2002. In this section, factors behind China's persistent high growth are identified within the framework of traditional growth accounting. At same time, short-run analysis on the demand side of the economy is also made. The main findings of the analysis are that the Chinese economy has been suffered from overcapacity chronically, and in the short-run, owing to China's growth pattern characterised by investment-driven and export-driven, the overcapacity was concealed and the economy was overheating due to strong investment demand and external demand. The second section analyses causes of the sudden loss of the speed of the Chinese economy. It is pointed out that the sudden disappearance of external demand and cooling down of investment fever turned an overheating economy into deflation. The third section introduces China's macroeconomic policy responses towards the global economic crisis. While government's policy direction is fully endorsed, some worries are

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expressed about the worsening of the structural problems. In the fourth section, a rather optimistic assessment is given on the short-run economic perspective. However, the possibility discussed is that in the longer run, due to the worsening structural problems, the Chinese economy may lose its growth momentum of the past three decades. The final section presents concluding remarks.

I. CHINA'S GROWTH SINCE 1990

Since the reform and opening up, China has created a truly economic miracle. Its average annual growth rate of GDP over the three decades since 1979 was 9.8 percent, though there are several ups and down in the past. In the period from 2002 to 2007, China's economic growth was even more impressive, which registered an average annual growth rate of 10.5 percent. Before the global financial crisis struck in the last quarter of 2008, China's economic growth was still very strong.

The Supply Side of the Chinese Economy

Why and how China was able to maintain a very high GDP growth rate for three decades is a very important as well as interesting question. No one should be so presumptuous as to say that the answer has been found. However, there are many tentative answers that can be found in the literature. Following the traditional approach, as a starting point, we use the most widely used growth account framework proposed by Solow to identify the driving forces of China's growth:

$$g_y = w_k g_k + w_l g_l + a$$

Where the " g_y , g_k , g_l " are the growth rates of GDP, the capital stock, and employed labour, the " w_k , w_l " are the shares of capital income and labour income in national income, and " a " is the residual that measures total factor productivity growth.¹

According to Solow's *growth accounting*, given the shares of capital income and labour income in national income the growth rate of Gross Domestic Product (GDP) can be treated as being determined by the growth rates of capital stock, employed labour and total factor productivity (TFP). There are numerous literatures on China's growth accounting.

The following is a summary of some main results of investigations on contributing factors to the GDP growth by both Chinese and foreign economists.

It is difficult to judge which results are more reliable. All underlining models for growth accounting are deficient one way or another, and statistics are hardly reliable. For example, most growth accounting models assume constant return to scale, which is a very doubtful assumption. How to use an appropriate deflator to calculate capital stock in constant price is very controversial in China. Based on the Table 1, we can draw tentative conclusions that capital accumulation is the single most important contributing factor to growth, the contribution of TFP is significant, and labour contribution is the least important among the three factors of production. These conclusions are consistent with most Chinese economists' experience and intuition.

¹Barro, Robert J. and Xavier Sala-i-Martin (1995) *Economic Growth*. New York, McGraw-Hill, Inc., pp. 346–352.

Table 1

The Contributions of Factors of Production to the GDP Growth

Authors	Period	Growth Rate	Capital	Labour	TFP
Maddison (1998)	1978-1995	7.5	49	21	30
Chow and Li (2000)	1978-1998	9.3	55	13	32
Wu (2002)	1980-2004	9.5	52	11	37
Hu and Khan (1997)	1979-1994	9.3	46	13	41
Swamy (2003)	1980-1997	10.0	39	16	45
World Bank (1997)	1978-1995	9.4	37	17	46
Bosworth and Collins (2003)	1980-1990	9.2	23	31	46
Bosworth and Collins (2003)	1990-2000	10.1	32	18	50
Zhang and Shi (2003)	1978-1989				28.9
Hu (2003)	1995-2001		57.6-86.3	4.39-2.93 ²	3.9-27.8
Xiang Ao, Fulginiti and Lilyan (2003)					38.7
Wang and Yao (2003)	1978-1999		47.7	15.9	25.4 ³
Sun and Ren (2005)	1981-2002				34.6
Rawski (2006)	1978-2004				29
Cai (2006)	Since reform		28	24	48
Kuijs (2006)	1978-1993		46	13	40
Kuijs (2006)	1993-2005		61	6	32
Hu (2007)					50

Source: WuYanrui: Can China's Economic Performance Be Sustained by Productivity Growth?, EAI Background Brief No. 265, December 2005. Wang Ling: A Research Note, 2007.

Note: In Cai's calculation, contribution of education (24 percent) and migration from farming to non-farming (21 percent) is included in TFP.

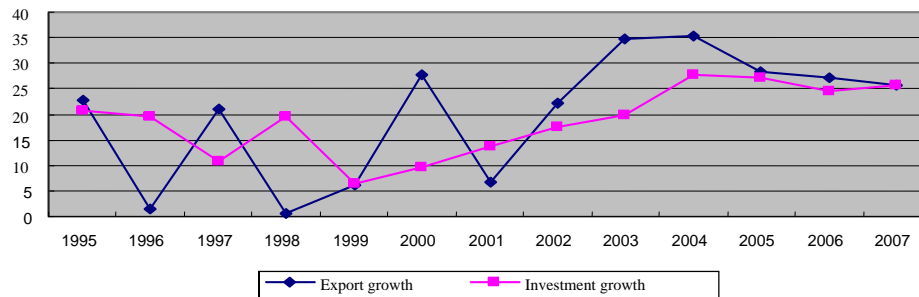
It is worth mentioning that the TFP contribution can be further disaggregated. Although it is statistically difficult to quantify, the constant reform of the economy has played important role in raising the TFP. As pointed out by Perkins that, "it was the jump in productivity that came first and lifted the rate of GDP growth and that higher rate of GDP growth in turn made it possible for a given rate of investment as a share of GDP to produce a much higher rate of growth of capital. From time to time new bursts of productivity in particular sectors (first agriculture, then TVEs, and then FDI) helped keep the high growth in both GDP and capital formation going." [Perkins (2006), p. 26]

The Demand Side of the Economy: Two Engines of Growth

Until the middle of 1990s, the growth pattern or the growth strategy of the Chinese economy was not very clear. Though there were plentiful twists and turns, China's growth pattern has more and more clearly discernable over the years since the reform and opening up in the late 1970s and early 1980s. Export promotion and attraction of FDI were two key elements of China's post-reform growth strategy. On top of some inherent features of the Chinese economy, such as high saving rate and so on, as a result of implementing this growth strategy, gradually, fixed asset investment (FAI) and exports have become the two most important engines of China's growth. During the period of 2002-2007 in China, the average annual growth rate of exports was 29 percent and the average annual growth rate of fixed assets investment was 24 percent. In 2007, the combined contribution of fixed assets investment and net exports to GDP growth was more than 60 percent (Figure 1).

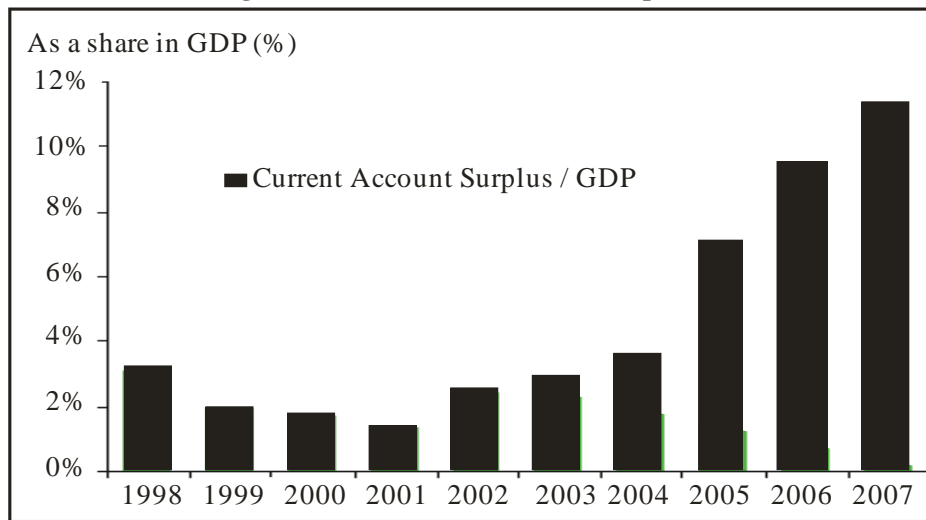
²Contribution by human capital is 6.83-10.24 percent.

³Contribution by human capital is 11 percent.

Fig. 1. Growth Rates of Exports and Investment

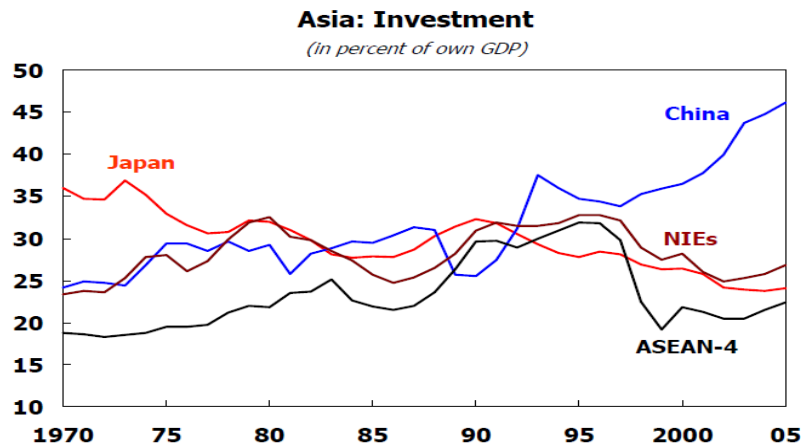
Sources: Statistical Year Book (various issues) Statistics Bureau of PRC.

Since the turn of the century, the Chinese economy has become more and more relied on external demand, and the share of current account surplus (mainly trade surplus) in GDP has been on rising rapidly. In 2007 the contribution of trade surplus to GDP growth was almost 10 percent of GDP (Figure 2).

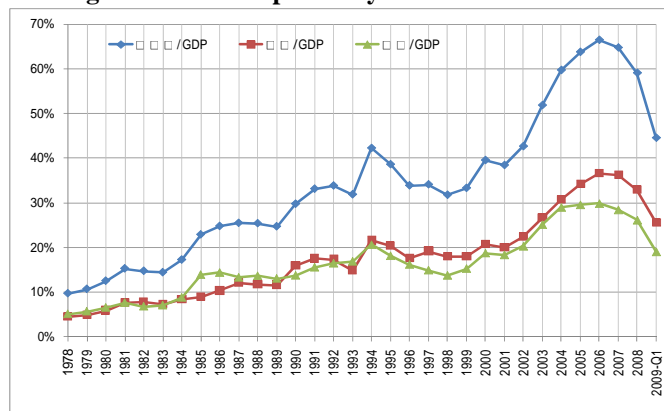
Fig. 2. Share of Current Account Surplus/GDP

Source: CEIC, UBS estimates.

As a result of the investment-driven and export-driven growth strategy over the past two decades, China's economic structure has changed correspondingly. China's investment rate has risen to more than 40 percent, significantly higher even than those of Japan when they were in the periods of high growth in 1957-1984 and 1978-2005, respectively (Figure 3). China's trade over GDP ratio is also much higher than all major open economies in the rest of the world. In contrast to America's less than 20 percent, in 2000s, China trade over GDP ratio has been above 60 percent and rising (Figure 4).

Fig. 3. Investment Rates, International Comparison

Source: imf.org/external/np/speeches/2006/pdf/012306.pdf

Fig. 4. China's Dependency on External Demand

Source: Wu Haiying, based on Statistical Year Book of China, (various issues).

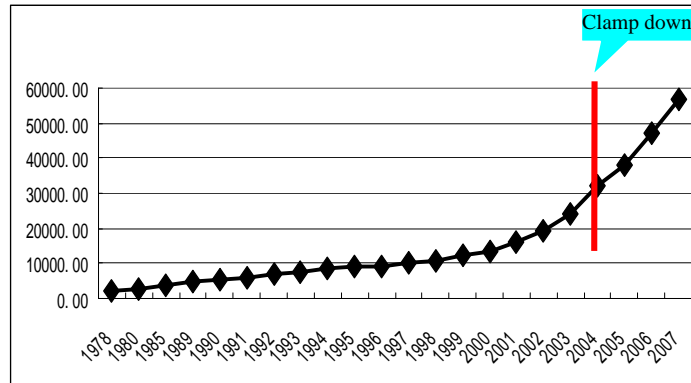
However, since 2006, as a result of the government's policy of rebalancing, China's dependency on external markets has started to fall.

Over Capacity

As a result of extremely high investment and other favourable conditions, China has been able to build up its production capacities. The expansion of China's steel industry is a case in point. In 2004 when China's steel production capacity was less than 400 million ton, because of the worry about overcapacity in the steel industry, the government started to clamp down on building new steel mills. In a very famous case, which was known as Tieben event, a manager of a steel mill, which was under construction, was arrested on charge of tax evasion, and his mill under construction was abandoned with great losses of investment and loans. However, new projects for steel mills were kept mushrooming exponentially after the clampdown, which in turn was caused by strong demand for steel products. China's steel production rose from

less than 400 million ton to nearly 700 million ton from 2004 to 2007 (Figure 5). The strong demand was based on investment fever and strong external demand, and hence was not sustainable. It is worth mentioning that over-capacity is not for a few industries. It is prevalent across all major industries.

Fig. 5. China's Steel Production Capacity (Unit: 10 Thousand Ton).



Source: Collective by Dr Zhang Bin.

Despite the fact that overcapacity in Chinese was serious, until the onset of the American Financial Crisis, the Chinese economy showed no prevalent sign of overcapacity. Rather it suffered from overheating. Since the middle of 2007 China's inflation was worsening rapidly. In the February of 2008, the growth rate of CPI surpassed 8 percent, the worst since 1996. The overcapacity in China was concealed due to two factors. One is the high growth rate of fixed asset investment, and another is the even higher growth rate of exports. For example, the excess capacity of steel production was to be absorbed by the construction of more steel plants. In the short-run, the overcapacity was concealed. However, demand neither can be self-sustained nor rely on external market for long. The investment rate cannot be raised persistently. Sooner or later, increase in investment demand will fail to catch up with increase in capacity. China's investment rate is more than 40 percent of GDP. It is difficult to envisage how the rate can be further increased. When the Chinese economy was relatively small, increasing exports could absorb excess capacity effectively. However, as a result of the expansion of the Chinese economy, it has become increasingly difficult to rely on exports to absorb the excess capacity. Again, the steel industry is a case in point. China has already become the world's number one steel producer. In 2007, 37 percent of global steel output was provided by China. It is easy to see that if external demand collapses, overheating will turn into over-production, and inflation into deflation immediately.

II. THE SUDDEN WORSENING OF THE ECONOMIC SITUATION IN THE THIRD QUARTER OF 2008

China's fast growth came to a sudden halt in the third quarter of 2008. In the third quarter, China's GDP growth dropped to 9 percent; growth rate of industrial production fell to 8.2 percent, about half of the rate in the same period of last year;

growth rates of many important products fell from double digits to negative; growth rate of exports fell from 20 percent in October to -2.2 percent in November; share price index fell by 70 percent; growth of real estate investment stagnant and house price started to fall in some major cities; and inflation pressure disappeared suddenly.

Statistics shows that the most important cause for the collapse of China's growth in the 3rd quarter of 2008 was attributable to the sudden collapse of the export market, which was in turn caused by the sudden worsening of the US financial crisis since the collapse of the Lehman Brothers. In all China's industries, the most dramatic fall in production happened in the steel industry. The analysis of the causes of the fall of steel production sheds lights on the causes of the fall of the Chinese economy in general in a crystal clear way (Table 2).

Table 2

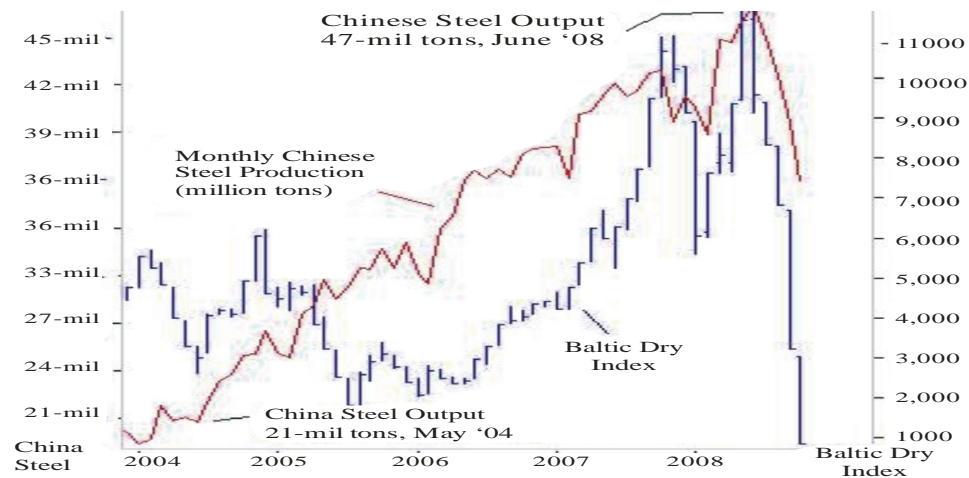
Direct Impacts of Fall in Foreign Demand on Steel Production

Types	Output, Aug.	Output, Sep.	Reduction in	
			Sep.	The fall
Exports	7.6769milT	6.67mil T	-1mil T	-13.12%
Total Output	47.8 mil T	45.9 mil T	-1.9 mil T	-3.93%
Exports/Total Output	16.06%	14.53%	53.58%	-

Source: Xue Qiyuan, based on various sources.

It can be seen that the drop in steel exports accounted for 54 percent of the total decrease in steel productions in September 2008. The fall of exports was a direct result of the fall of global economy (Figure 6).

Fig. 6. Market Signals of Sharp Downturn in Global Economy



Source: Seeking Alpha: Can Central Bankers Prevent a Great Depression? <http://seekingalpha.com/article/106770>, 2008 Nov 19 09:23 AM.

Besides direct impact, indirect impacts of fall in demand of steel-related exporting industries on steel production was also very grate. Just take two industries as example.

- **The Container Industry.** Orders for containers have fallen dramatically, especially in October 2008. Most shipping companies have stopped ordering new containers.
- **The Ship-building Industry.** From January to September 2008, global-wide order for tonnage of ships has fallen by 27 percent. In September 2008, the order fell by 66.1 percent. This is a global phenomenon, in October 2008, order for Japanese shipping companies fell by 82 percent. That direct and indirect reduction in external demand is the single most important cause for the fall in steel production.

In my view, in summary, the dramatic fall of export demand since the third quarter of 2008 is the single most important cause of China's slowdown. The slowdown in fixed asset investment was the second important contributing factor. Contributing factors to the fall of fixed asset investment on growth in turn can be attributed to the slowdown in real estate investment—as a result of monetary tightening over the past several years, the fall of export-related investment, the worsening of expectations, and financial losses made in speculations in financial markets by due to the burst of assets bubbles and the collapse of commodity prices. The third important cause for the slowdown of the economy is the large inventory adjustment. Until the middle of 2008, many Chinese enterprises were still expecting further rise in prices and engaged in large scale hoarding activities. The unwinding of the inventory worsened greatly the fall of China's growth. Anecdotal evidence also shows the wealth effect of the burst asset bubbles also played certain role in slowing growth of consumption.

It is worth mentioning that supply side factors have also played a certain role in the slowdown of Chinese economy. Since the middle of 2000s, labour costs have been on rising, due to tightening of standards of labour protection and shortage of labour supply in some areas and industries. The more stringent environmental standards also contributed to high production cost.

III. CHINA'S MAIN POLICY RESPONSES TO THE GLOBAL SLOWDOWN

Since the fourth quarter of 2008, as a result of the dramatic fall of economic growth, debate on the policies adopted by the government, especially by the People's Bank of China (PBOC, China's central bank) has gotten heated. The opinions are divided among economists. Some described the policy adopted since 2003, especially since 2005 when the Renminbi (China's currency) depegged from the US dollar and embarked on the road of appreciation, as "self-destruction". In my view, this accusation is totally wrong. Objectives of Chinese government's policy since 2003 were aimed at preventing overheating, containing asset bubbles, controlling inflation, and reducing current account imbalances. Faced with the situation, the government had no choice but to implement tight monetary policy. Contrary to the accusation of "self-destruction", the biggest shortcoming of the policy mix during this period was the failure by the government to adopt a more forceful demand switching policy, especially to allow the Renminbi to appreciate more quickly by reducing central bank's intervention in the foreign exchange market. With benefit of hindsight, a more expansionary fiscal policy could be used to offset the possible negative impact of a more forceful demand switching policy (e.g. Renminbi appreciation) on the economy. If the government had

succeeded in reducing Chinese economy's dependence on external demand by using exchange rate policy and other policies more forcefully, the Chinese economy would have fared much better when the global economy fell drastically. However, it is fair to say that the government and some economists (me included) underestimated the dramatic deflationary impact of the global slowdown on the Chinese economy. The persistent investment fever since 2002 has created serious excess capacity. However, the overcapacity was concealed by strong external demand as well as self-sustained investment demand. On the surface, the economy suffered from overheating rather than overcapacity. The government should have recognised that, because of the existence of overcapacity, the economy could shift from overheating to dramatic slowing down and from inflation to deflation in a dramatic fashion, and should be prepared for such a dramatic shift. In fact, such a shift happened, as soon as the external demand disappeared as a result of the global economic slowdown. Because it was impossible for the government to have a very clear idea about the trajectory of the American Subprime Crisis, I do not know whether there was a better policy combination than that was adopted by the government at the time. However, the government could at least have prepared the public better for such a shift psychologically.

When the global slowdown has become apparent, the government shifted its policy direction quickly and forcefully. Less than two months after the Lehman Bother fiasco, in November 2008, the government started to implement a very large stimulus package. At the same time the PBOC also ushered in expansionary monetary policy.

Expansionary Fiscal Policy

In November 2008, the government introduced a 4 trillion Yuan (\$580 billion) stimulus package for 2009 and 2010. To have a better idea about the scale of the package, it is worth mentioning the following statistics. In 2008, China's GDP was 29 trillion Yuan. The originally, the government expenditures in 2008 was budgeted about 5.7 trillion Yuan, which means that China's government expenditures/GDP ratio would be 19.6 percent. The package accounted for 14 percent of GDP in 2008. Besides the increase in government expenditures, the government also considered possible tax reductions, which included VAT reform, Business tax cut and raising the threshold of individual income taxes. Among the 4 trillion package, the new added expenditures are about 1 trillion. According to National Development and Reform Commission (NDRC), assuming that the fiscal multiplier in China is 2-3, the package can create about one percentage point increase in GDP in each year for 2009 and 2010. On top of the central government's stimulus package, each province was encouraged to raise money to launch its own complimentary stimulus package. Soon after the announcement of the stimulus package by the central government, local provincial governments announced their own complimentary packages. The total amount of planned stimulus packages announced by local governments totaled at 18 trillion Yuan.

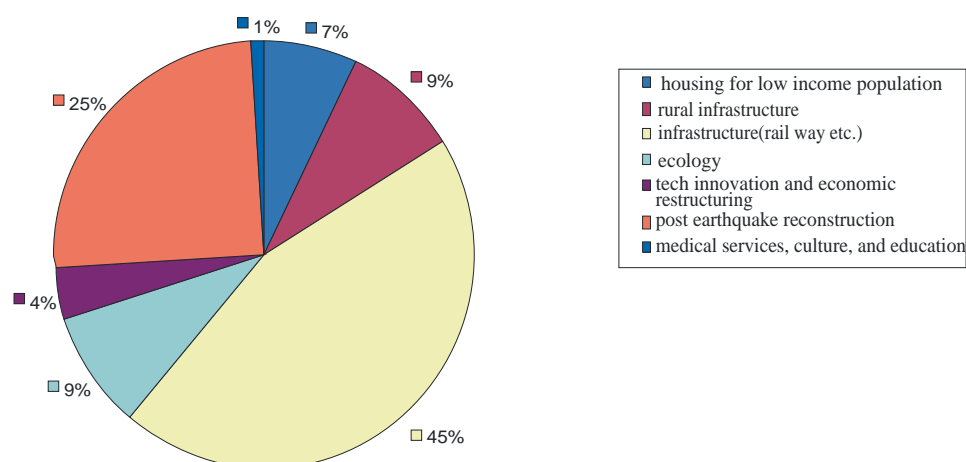
The structure of the 4 trillion stimulus package is summarised by the following table (Table 3 and Figure 7).

Table 3

The Breakdown of 4 Trillion Yuan Stimulus Package (Unit billion Yuan)⁴

Construction of houses for low income urban households	280
Increased spending on rural infrastructure and boosting rural incomes	370
Expenditures in transportation network construction	1800
Increased investment on medical service, culture and education	40
Increased spending on ecology protection	350
Technical innovation and economic restructuring	160
Sichuan post-earthquake reconstruction	1000
Total	4000

Source: NDRC.

Fig. 7. The Structure of China's Stimulus Package

It is easy to see that most of the money will be spent on building railway, highway and so on, followed by earthquake rebuilding. Sources of financing of the stimulus package were designed as follows:

- Central government financing one-quarter of the 4 trillion Yuan package, in forms of direct grants and interest rate subsidies. In the case of central government-sponsored project, NDRC-MoF may inject all of the registered capital.

⁴In March 2009, the package has undergone some adjustments. As a result, the expenditures on construction of houses for low income urban households increased to 400 billion Yuan, expenditures in transportation network construction reduced to 1500 billion Yuan; investment on medical service, culture and education increased 150 billion Yuan; spending on ecology protection reduced to 210 billion Yuan; expenditures on technical innovation and economic restructuring increased to 370 billion Yuan.

- Government bonds will be issued to cover the budget deficit.
- Central government will issue bonds on behalf of local governments to fill the short fall in financing local projects.
- Banks loans will be important sources of funds, especially for local governments.

In March of 2009, People's Congress approved the government's new budget for 2009. According to this budget, in 2009, the total government (central plus local) revenue would be 6.623 trillion Yuan, up 8.0 percent from 2008, among which, revenue of the central government should reach 3.586 trillion Yuan, an increase of 9.8 percent over 2008 (Table 4). Total government expenditure (central plus local) would be 7.635 trillion Yuan, up 22.1 percent, among which, expenditure of the central government would be 4.3865 trillion Yuan, an increase of 848.501 billion Yuan, up 24 percent (Table 5). In 2009, the total government deficit would be 950 billion Yuan (\$139 billion), the highest in six decades, compared with 111 billion Yuan in 2008. Central government's deficit will be at 750 billion Yuan, 570 billion Yuan more than last year. The state council will allow local governments to issue 200 billion Yuan worth of government bonds through the ministry of finance. The expected budget deficit/GDP ratio will be about 3 percent of GDP, compared with the budget deficit/GDP ratio of 0.4 percent in 2008.

Table 4

Revenue Targets for 2009 (Central Government Revenue only)

Item	Amount (Billion Yuan)	Change (%)
Domestic VAT	14563	7.9
Domestic Sales Taxes	443.4	72.7
Import Tariffs and other Taxes Related to Imports	989.5	8
Corporate Income Taxes	760.5	6
Individual Income Taxes	239	7
Stamp Tax	24.5	-74.2
Vehicle Purchase Tax	97	-2
Export Tax Rebates	670.8 (reducing revenue)	14.4

Source: Ministry of Finance, 2009.

Table 5

Expenditure Targets for 2009 (Central Government Spending only)

Item	Amount (billion Yuan)	Change (%)
Agriculture, Forestry and Water Conservancy	344.6	27.5
Education	198.1	23.9
Medical and Health Care	118.1	38.2
Social Security	335.1	22.1
Low-Income Housing	49.3	171
Cultural Programmes	28.0	10.7
Grain, Cooking Oil and Materials Reserves	178.0	61.1
Science and Technology	146.1	25.6
Environmental Protection	123.7	18.9
Public Security	116.1	32.6
Earthquake Reconstruction	108	
National Defense	472.9	15.3
Transport	188.7	17.9
General Public Services	131.4	8
Interest Payments on Bonds	137.2	7.3

Source: Ministry of Finance, 2009.

There is no detailed information available on how the budget for 2009 was amalgamated with the 4 trillion Yuan stimulus package. However, attention should be paid to some key figures provided by the Ministry of Finance in a related report on central government's 2009 budget:

- 908 billion Yuan in public spending, an increase of 487.5 billion Yuan, an increase of 54 percent over 2008.
- 123.08 billion Yuan for direct subsidies to agricultural production and trade, an increase of 19.4 percent over 2008.
- 220.833 billion Yuan for subsistence allowances for both urban and rural families.
- 103.341 billion Yuan for subsidising rural residents' purchase of home appliances and vehicles and increase reserves of important materials such as grain, petroleum, nonferrous metals and specialty steel products.
- 716.14 billion Yuan, an increase of 120.59 billion Yuan or 20.2 percent, to assist agriculture, rural areas and farmers.
- 728.463 billion Yuan for items directly related to the people's well-being such as education, medical and health care, the social safety net, and so on, an increase of 29.4 percent over 2008
- 146.103 billion Yuan for science and technology, an increase of 25.6 percent over 2008.⁵
- 500 billion Yuan reductions in Taxes and fees, which partially will be the result of VAT restructuring, increase in tax rebate, and exemptions. On the whole the government plans to withdraw or suspend 100 administrative charges by 2009.

As of May 31 2009, China allocated 562 billion Yuan (82.3 billion U.S. dollars) for public works projects, completing 61.9 percent of its central budget for 2009.

More than half of the allocated went toward rural development and prominent infrastructure construction, according to the MOF. A total of 138.1 billion Yuan was put into projects to enhance rural infrastructure and improve living standard in the countryside through the construction of irrigation facilities, power grids and paved roads.

Another 163.5 billion Yuan went toward infrastructure projects such as railway, highway, airports and harbour construction.

Other spending included 84.8 billion Yuan for reconstruction in areas hit by the May 12 earthquake last year, 42.7 billion Yuan for low-income housing project, 44.2 billion Yuan for education, medical care and cultural development, 41.2 billion Yuan for industrial upgrades, 27.8 billion Yuan for environmental protection and energy saving as well as 19.7 billion Yuan for public service facility buildings.⁶

It can be seen that the single most important element in China's stimulus plan is public work. This policy can work but it is also an antithesis to the structure readjustment. China's investment rate was already too high in all measurements. The extremely high investment growth rate, which hit an annual growth rate of 32.9 percent y/y in the first five months of 2009, will inevitable lead to the even higher investment rate, which on average already

⁵Source: Xinhua News Agency: Key figures from Chinese Finance Ministry's 2009 draft budget report, March 05, 2009.

⁶Xinhua News Agency, 2009-06-04 20:52:35.

surpassing 43 percent over the past several years. The excessively high investment rate in turn will lead either to more serious overcapacity or lower efficiency reflected in an even higher capital-output ratio, which was already very high in China. Another important feature of China's stimulus plan is the large amount of tax rebate. The amount of rebates was planned to be 670 billion Yuan, account for some 15 percent of the total central government expenditure. This policy is very problematic. As a result of the policy, some exporting enterprises can survive or linger on for a while. But the negative impact of the policy on resource allocation and rationalisation of the economic structure is equally obvious.

Another important issue is the sustainability of China's expansionary fiscal policy. It should be emphasised that China has a very comfortable fiscal position. Over the past decade, China's budget deficit over GDP ratio was very low. In 2007, China ran a budget surplus. As a result, China's debt balance over GDP ratio is just 18 percent. Even after having adopted the expansionary fiscal policy, by the end of 2009, China's debt balance over GDP ratio will still be lower than 20 percent. Therefore, there is plentiful policy room for the government to manoeuvre. However, complacency is dangerous. As a result of the stimulus package, the policy space can be used up quickly. One of the most worrying phenomenons is that wasteful investment has become ubiquitous now, which in turn will produce increasingly high pressure on the government budget. Nonperforming loan ratio definitely will be increasing in the future. The quality of the growth and sustainability of the growth can be compromised by the over-zealot investment drive (Table 6).

Table 6

Expansionary Monetary Policy

Billion Yuan, %	May	April	March	February	January
Growth of M1	18.7	17.5	17.0	10.9	6.7
Growth of M2	25.7	26.0	25.5	20.5	18.8
Credit	664.5	591.8	1890	1070	1620
Growth of Credits	30.6	29.7	29.8	24.2	21.3

Source: People's Bank of China.

Up to May the increase in bank credits was 5.77 trillion Yuan, higher than the official target of 5 trillion Yuan for the entire year. In contrast, the annual increases in bank credits in 2006 and 2007 were 3.18 and 3.63 trillion Yuan, respectively. The increase in bank credits in the first quarter was surprisingly high, and the same was true of the growth rate of broad money M2. The gap between the growth rate of M2 and nominal GDP has broken the record in history.

The most important cause of the rapid increase in credits and money supply is attributable to PBOC's expansionary monetary policy. Previously, corresponding to the rapid increase in liquidity caused by PBOC intervention in the exchange market, which was aimed at offsetting the appreciation pressure on the RMB created by persistent trade surplus (and capital account surplus), the PBOC sold large amount central bank bills to mop up the excess liquidity. Since the fourth quarter of 2008, the PBOC has reduced the strength of sterilisation operation. As a result, the liquidity has inundated the inter-bank money market and even once made the interest rates in the inter-bank market lower than interests on deposits with commercial banks with same terms of maturity. China's financial

condition is very different from those in America and Europe in the global financial crisis. China's financial system is not suffering from credit crunch. Its banking system is safe and sound in terms of bad loans, capital adequacy and so on. China's assets bubbles are not that serious or have been corrected. As a result, China's monetary multiplier has not fallen dramatically as in the United States. Therefore, the dramatic increase in liquidity in the inter-bank money market translates to rapid increase in bank credits and broad money. On top of less sterilisation, other measurements aimed at accommodating expansionary fiscal policy have also been introduced. These measurements include:

- Abolishment of credit rationing.
- Lowering reserve requirement.
- Lowering interest rates on banks' loans and deposits.
- Lowering the thresholds of down payments of mortgages.

In my view, China's monetary policy in the first quarter of 2009 was too loose. The rapid expansion of credits and money supply were, to a certain extent, the result of non-market interferences. These are not sound economic rationales, which can be used to support such a dramatic expansion. If commercial banks had been allowed to make decisions that were based purely on economic consideration, growth of credits and money supply would not have grown so fast. And there would have been fewer needs to worry the consequences on possibilities of rising nonperforming loan ratio, worsening of economic structure and resurging of assets bubbles. The huge gap between the growth rate of M2 and nominal GDP implies very large inflation pressure in the future. Taking into consideration the fact that China has highest M2/GDP ratio in the world, the possible grave consequences of a loose monetary policy is even more frightening.

IV. SHORT TERM AND MEDIUM TERM PROSPECTS OF THE CHINESE ECONOMY

I have not a shred of doubt about China's ability to achieve a growth rate of 8 percent in 2009. The confidence is based on the following facts:

- Strong fiscal position.
- Vast domestic market.
- Strong external position.

As a result, the scope for using stimulating package by the government is very great. China will be able to spend its way out economic slowdown. In fact, now in the Chinese economy "green shoots" can be seen everywhere. It is possible that the Chinese economy has bottomed out since the end of fourth quarter of 2008.

According the most recent government announcement, industrial production rose 8.9 percent in May from a year earlier, higher than April's 7.3 percent growth. Retail sales increased 15.2 percent after a 14.8 percent rise the previous month. The growth rate of fixed asset investment was 32 percent. The PMI index has been kept above 50 three months in a row. Housing prices have started to rise in many important cities and The Shanghai Composite index are approaching 2,700 from the low of 1,600 in late 2008. The bad news is that exports in May fell 26.4 percent from a year earlier, China's Customs agency said Thursday, accelerating from April's 22.6 percent decline, which shows that

despite trade promotion policies such as the increase in tax rebate, the recovery of exports is something which cannot be decided by exporting countries along.

Despite the strong showing of recovery, worries about sustainability in the recovery are still lingering. The Chinese government is facing with the dual tasks of crisis management and structural adjustment. While we can say that the crisis management has been successful, the same is difficult to say about structural adjustment. To achieve a sustainable growth and improve the welfare of the nation, growth should not be achieved at the expense of structural adjustment. China's structural problems include:

- High external dependency.
- High investment rate.
- Pollution.
- Energy efficiency.
- Income distribution gap between different social group and between rural and urban areas.
- Insufficiency in the provision of social goods (social safety net, medic-care, education, etc.).

If China fails to tackle these structural problems, growth is likely to have a W shape trajectory. In order to deal with structural problems, China should push further for more reforms. Actually, the current crisis also means good opportunity for the speeding up of reforms.

Some key areas of reforms include:

- Liberalise the restriction to the entry into Medic-care, sanitation, education, finance, communication and transportation. Rules of fair competition should be applied to these areas. Anti-monopoly laws should be formulated and enforced in natural monopoly industries;
- Liberalise price controls over energy, water, electricity and allow market demand and supply to determine the prices of these products;
- Further liberalise control on interest rates and establish a more flexible exchange rate regime, and capital controls can be further liberalised side by side with internationalisation of the Renminbi (China's currency); and
- Low efficient enterprises should be allowed to go bankrupt, while the government should take more responsibilities for providing safety net for the employees of the enterprises.

V. CONCLUDING REMARKS

Over past three decades, owing to the gradual reform and opening up to the outside, the Chinese economy has maintained an average annual growth rate of GDP as high as 9.8 percent. Now China has become the third largest economy, the second largest trading nation and the largest foreign exchange reserve holding country in the world. China's growth is truly a epoch making miracle.

Now as the global financial and economic crisis is still unfolding, the growth strategy and economic policy of the Chinese government are put under test. It seems that

the Chinese government has been very successful in responding to the global slowdown in a very swift and determined fashion. As a result, the Chinese economy has been bottoming out. However, the seriousness of the impact of the global crisis on the Chinese economy shows that China needs to speed up its structural reform and adjust its once very successful strategy and policies in managing the growth and maintaining the stability of the growth in a timely way. Otherwise, the Chinese economy may lose its growth momentum in the near future.

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Comments

Professor Yu's excellent presentation provides much food for thought. China achieved spectacular economic growth in the last two and a half decades that transformed China's economy making it the second largest in the world and China a middle income country. Between 2002 and 2007, China witnessed unprecedented growth. It grew at an average annual rate of 10.5 percent in contrast to the average annual rate of 9.7 percent since the last two and a half decades. Professor Yu identifies two main engines of China's spectacular growth between 2002 and 2007 namely (i) export growth—at an annual average of 29 percent over the five year period and (ii) growth of fixed assets investment—at an annual average of 24 percent over the same period.

As a result of the onset of the global financial crisis, during the third quarter of 2008, there was a sudden slowdown in China's growth, which dropped to 9 percent. The main causes of the fall in growth of the Chinese economy, as identified by Professor Yu, were a dramatic fall in export demand, slowdown in fixed asset investment, and inventory adjustment.

According to Professor Yu, the main objectives of China's macroeconomic policy since 2003 have been to contain overheating, asset bubbles, inflation as well as to reduce international imbalances. However the biggest shortcoming of Chinese macroeconomic policy has been failure to adopt a more forceful demand switching policy by effectively using fiscal policy to offset the tightening effect of monetary policy as well as its failure to use exchange rate policy to reduce dependence on external demand.

China's growth of the last decade or so not only transformed the Chinese economy, but it also impacted the world economy in a number of ways. Perhaps the most significant impact was the large expansion in world supply of industrial goods, which seems to have fooled the world's central bankers, policy-makers and economists into thinking that the world had changed, i.e., you could have high growth with low inflation despite huge expansions in world liquidity. The consequent inaction on their part resulted in the build up of a major asset price bubble, particularly in housing, which in many ways is at the root of the global financial crises.

The Global Financial Crisis is likely to have a two-fold impact. Firstly, the crises will impact the world economy in terms of a worldwide recession, possibly the worst since the great depression. According to IMF's latest projection (March 2009), world output will decline by between 0.5 and 1.5 percent in 2009, with only a very gradual recovery beginning in 2010. Likewise, the International Labour Office (ILO) says in its annual Global Employment Trends report that the global economic crisis is expected to lead to a dramatic increase in the number of people joining the ranks of the unemployed, working poor and those in vulnerable employment. Similarly the worldwide crisis is likely to set back progress on poverty reduction and social development.

Secondly, the global financial crisis is likely to impact economic thinking. With blind faith in markets shaken, there is a rehabilitation of Keynesian economics, with its greater reliance on public spending and stress on the need for better regulation particularly of the financial sector. Further, the domination of the financial sector over

real sectors will be questioned. Finally, the currently dominant paradigm in development economics will be subject to greater criticism. This paradigm largely stresses on getting prices right, privatisation, export oriented growth, and minimal role of the government – limited largely to maintaining macroeconomic stability. The success of East Asia and China is seen as proof of the superiority of this paradigm—though China and many East Asian countries followed their own version of this strategy. While this paradigm, particularly the Washington Consensus, was already under attack, a new dimension will be added to the critique in the aftermath of the global financial crises, i.e., are these policies appropriate for the post-crises world? And if not, how should they be modified? These are interesting questions, but I will restrict my comments to the impact of the Crisis on China and its plans to deal with it.

Trade has played a key role in China's outstanding growth performance—in fact by the time of the crisis it was evident that China had become too dependent on external demand. China's economic managers were aware of this, but according to Professor Yu the export industry had become so influential that it was able to prevent the government from adopting a forceful demand switching policy during the last five years when it had the opportunity. Therefore, the recession in developed countries and slowdown in world trade could have a massive impact on China's exports and thus growth in the economy.

China's main policy response to the global slowdown has been an expansionary fiscal policy. A four trillion Yuan (\$580 billion) stimulus package will be implemented over two years—out of which approximately forty five percent will be spent on infrastructure investment while twenty five percent on earthquake rehabilitation. In 2008, this package accounted for fourteen percent of GDP which stood at approximately twenty nine trillion Yuan. Expansionary fiscal policy also calls for tax reduction. More specifically it entails a VAT reform, a cut in business tax as well as an increase in threshold of individual income tax. The government also plans to undertake new expenditure worth one trillion Yuan in the economy. With the Chinese multiplier ranging between two and three, NDRC forecasts that this package can potentially create a one percentage point increase in GDP growth rate each for 2009 and 2010. To complement the expansionary fiscal stance, China is also following an accommodating monetary policy by abolishing credit rationing, lowering reserve requirement, interest rates on banks' loans and deposits, thresholds of down payments of mortgages as well as by exercising less sterilisation.

New budget for 2009 entails a budget deficit of 950 billion Yuan. Debt/GDP ratio is expected to be twenty percent while deficit to GDP ratio is expected to be about three percent. The budget involves fiscal expenditures on Science and Technology (146 billion), social security (293 billion), and rural development (716 billion). It also entails tax and fee reductions worth 500 billion Yuan. For 2009, the main objectives are to achieve a growth rate of eight percent and an inflation rate of four percent. According to Professor Yu, given China's strong fiscal position, vast domestic market, and strong external position, a growth rate of 8 percent seems achievable. In fact since mid-December the economy has begun to rebound.

China can afford to follow such a policy because of its large foreign exchange reserves and significant fiscal space, but I think that this will only work in the short run mainly due to a mismatch between demand and existing production capacity—excess

capacity will be prevalent in consumer based export industries while demand that is likely to be generated by a public spending based stimulus will be in investment industries. While the impact on investment has already taken effect, so far Chinese macroeconomic policy has not been successful in stimulating consumption. Moreover due to China's extremely high export dependency (in 2006 exports/GDP ratio was 40 percent) following an export driven growth agenda is no longer possible. China ultimately needs to generate domestic demand for its consumer industries which will require a reduction in high savings rate. However, high saving rates in China are tied to inadequate provision of existing public health system, pensions/old age support system, etc. Therefore unless these structural problems are addressed, it will be difficult to increase private consumption.

Professor Yu is fully aware of these difficulties. He argues that investment-driven and export driven growth is not sustainable. Self sustained growth of Fixed Asset Investment requires construction of more steel plants to absorb excess capacity of steel production. However demand cannot be sustained by an ever-increase in investment rate. Likewise external demand dependency is subject to uncertainty. When external demand collapses, overheating turns into over production, and inflation turns into deflation immediately. He also stresses that the most serious challenge is to strike a balance between growth and structural adjustment so that growth is not achieved at the expense of structural adjustment. Some of the structural problems highlighted include high external dependency, high investment rate, pollution, energy efficiency, income distribution across regions as well as across groups and inadequate provision of social safety nets.

He suggests speeding up reforms as the way out. Some key areas of reform identified by Professor Yu are: (i) improving access to Medicare, sanitation, education, finance, communication and transportation; (ii) implementing fair competition rules and liberalising price controls over energy, water, electricity and allowing market demand and supply to determine the prices of these products; (iii) adopting a flexible exchange rate regime and further liberalising interest rate controls; and (iv) allowing low efficient enterprises to go bankrupt.

In the end I would like to note that while China, because of its massive foreign exchange reserves and significant fiscal space, may be able to rely on public investment/spending as a means of stimulating growth, developing countries like Pakistan will not be able to do so. Pakistan, for example, will instead need to concentrate on promoting private investment, exports, and labour intensive sectors like agriculture, SMEs, and housing, as well as aim to achieve greater efficiency in public resource allocation. This is clearly a much more difficult task.

In conclusion I would like to congratulate Prof. Yu on his excellent paper, which helps us to understand the issues facing China at these critical times. Given the size and importance of China's economy it is some comfort to know that China will continue to grow at a reasonable pace and this will help to mitigate the impact of the global crisis on the world economy and hopefully make the recession shorter and less damaging. Thank you.

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