China's Policy Responses to the Global Financial Crisis: Efficacy and Risks[1]

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1. External Shocks from the Crisis

Owing to the relatively strict capital control, China's financial institutes have very limited financial losses in the US sub-prime crisis. However, the deep involvement of its real economy in the global production has made China deeply affected by the global financial crisis and the economic recession or downturn. The economic growth rate in China was 9% in 2008, much lower than the growth rate of 13% in 2007. In the first quarter of 2009, growth rate continued to shrink and hit the bottom by 6.1% on an annual base before getting rebound in the second quarter. Accordingly, the inflation pressure was quickly replaced by an increasing deflation pressure. The PPI and CPI have been continuously declined from the peaks (more than 8%) in the first half of 2008 to almost zero in the end of the year and began to be negative in the early 2009.

The external shocks at least came from two sources. *Firstly,* due to the free fall of the international demand, China's export sector was badly hurt. In the last two months of 2008, China's export dropped 2.2% and 2.8% y-o-y respectively, after continuously increasing for seven years since 2001. In the first half of 2009, the export sequentially decreased even by 21.8%. *Secondly,* due to the collapse of the commodity markets in August after madly surging in the first half of 2008, together with the quick fading of the inflation pressure, massive inventory de-stocking by manufactory firms heavily suppressed the investment demand from industrial sector. Based on a survey of 500 Chinese firms in 60 cities conducted in the end of 2008 and early 2009, 60% of the surveyed firms had cut their inventory to one or two months of usage or sales, which is much lower than the normal levels of three or four months (Sun, 2009). Because of the slowdown of export and investment (before the stimulus package was introduced),

One of the most interesting questions is which source, fall of export or massive de-stocking, is the more important interpretation for the economic slowdown? According to a study given by Sun Mingchun (2009), from March 2008 till February

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2009, the growth rate of China's industrial value add decreased by 14 percentage points, from 17.8% to 3.8%. For the decline, export drop can only account for 3.1 percentage points while the fall of domestic demand accounts for 10.9 percentage points. Moreover, since the retail sales and real fixed investment even got a slight increase during the period, the massive de-stocking might be the main reason for the decline of domestic demand and eventually the key source of the economic slowdown.

The economic growth in the first half of 2009 has strengthened our analysis on the source of the economic slowdown since the fourth quarter of 2008. Although the export continued to shrink dramatically with a negative growth rate of 21.8% in the first half of 2009, the end of massive de-stocking, together with the implementation of government stimulus package, has led the economy strongly rebound since April and gained a growth rate of 7.9% in the second quarter of this year.

2. Policy Response and its Effectiveness

For better dealing with the external shocks in the context of the global financial crisis and economic recession in developed countries, in November 2008, the Chinese government announced a mix of macroeconomic policies supplemented by some industrial policies.

The most important policy response is the stimulus package of 4 trillion Yuan for 2009-2010 announced in November 2008, for stimulating the domestic demand through enhancing the public expenditure. The spending structure proclaimed by the National Development and Reform Commission shows that most of the money will go to transportation network, earthquake reconstruction, rural infrastructure and other social works (see table 1). Besides the increase in expenditures, the government also considered possible tax reductions, including VAT reform, business tax cut, increase of export rebate rate, and raising the threshold of individual income taxes, etc. On March 5, 2009, during the annual National People's Congress (NPC) Meeting, Premier Wen Jiabao promised, if export performance severely deteriorates in the coming few months, more fiscal stimulus measures could be announced.

There are several forms of financing the stimulus package. (1) Central government will finance one-quarter of the 4 trillion Yuan package, in forms of direct grants, interest rate subsidies and direct injecting registered capital to the central government projects; (2) More budget deficit will be arranged through issuing government bonds (the ratio of budget deficit to GDP will reach about 3% in 2009, compared to 0.6% in 2008); (3) Central government will issue bonds on behalf local governments to fill the short fall in financing local projects; (4) Banks lending will be the main source for local governments.

Table 1: Spending Structure of 4 trillion Yuan Stimulus Package (Unit: billion Yuan)

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: China National Development and Reform Commission

While pursuing expansionary fiscal policy, China also exited from its moderately tight monetary policy that has been adopted since 2003 and switched to an expansionary monetary policy in November 2008. By cutting done the interest rates to a historical low level, lowering bank reserve requirement ratios, and removing quota control on lending by commercial banks (temporarily introduced in early 2008), China successfully made an injection of huge amount of liquidity to the banking system. In order to reduce credit crunch and encourage banks to increase lending, the authorities announced a series of measures to accelerate the development of credit guarantee services. Moreover, it also decided to loosen control on mortgage loan in some extent for stimulating resident to buy property. As a result, China's money supply and bank credits increased rapidly in the first half of 2009. The growth rate of M2 y-o-y in June reached a historical height since May 1996. The new bank lending in the first half of 2009 dramatically surged by 7.37 trillion Yuan, which roughly equals to 90% of the targeted scale for the whole year. In contrast, the annual increases in bank lending in 2006 and 2007 were 3.18 and 3.63 trillion Yuan, respectively.

Table 2: Money and Credit Increase (first half year of 2009)

(Unit: Billion Yuan, %)

	January	February	March	April	May	June
Growth of M1	6.7	10.9	17.0	17.5	18.7	24.8
Growth of M2	18.8	20.5	25.5	26.0	25.7	28.5
Credit	1620	1070	1890	591.8	664.5	1530
Growth of Credits	21.3	24.2	29.8	29.7	30.6	34.4

Source: People's Bank of China (2009)

Besides expansionary fiscal and monetary policies, for mitigating the external shocks more effectively, China has declared various industrial policies for promoting and recovering those key sectors, such as automobile, steel, textile, equipment machinery and other manufactory sectors. And also, the authorities decided to stop the Renminbi appreciation for mitigating the export decline.

Although it is too early to make a comprehensive evaluation on effectiveness of the policy response to the crisis, it should be reasonable to say that most of the policies have been working well in terms of boosting domestic demand. The strong rebound of the economic growth in the second quarter 2009 should be partly attributed to the end of de-stocking as we mentioned above, but the fiscal stimulus package and the expansionary monetary policy have undoubtedly played more important roles in this regards. After all, the large enhancement of the government expenditures and abundance of the bank lending are the main sources of the new fixed asset investment, particularly the enormous investment for those grand infrastructure projects. Besides, the government-oriented stimulus activities have made an important positive impact on strengthening the confidence for private investment and eventually caused more investment. By offsetting the significant drop in external demand and creating more effective domestic demand, it is believable that the stimulus package and other policies have built a very solid base for the targeted growth rate of 8% or even higher.

Besides, the stimulus package is expected to have a significantly positive impact on the long term economic structural adjustment. Making economic growth more relying on domestic demand rather than external demand, particularly more relying on the domestic consumption is one of the goals for economic structural adjustment in China. As the reported spending plan has shown, much of the government spending in the stimulus package have been used or will be used for strengthening transportation networks and infrastructure in rural areas. It is believable that a better investment environment in the rural areas, particularly in the inland areas, is very much crucial for encouraging firms to switch their investments from coastal areas to rural and inland areas and eventually improve people's income and consumption in these areas. More spending on the construction of houses for low income and the enhancement of medical and educational facilities will help people living in cities to reduce their precautious savings and eventually increase domestic consumption. It is noted that the shares of the spending on medical and educational facilities are actually not large enough compared to the enormous needs in this regards.

3. Risks and Policy Implications for the Future

For many years, China has been very much conservative in fiscal expansion. China's fiscal revenues as a share of GDP increased from 11 per cent in 1997 to 21 per cent 2007. In 2008, the ratio of fiscal deficit to GDP amounted to a mere 0.6%; the ratio of public debt to GDP was only about 20%. Therefore, China has a very strong fiscal position for implementing the stimulus package and even for enlarging its scale if necessary. Similarly, China's banking sector basically remains sound and healthy. The average ratios of non-performing loans (NPL) for all commercial banks and state-owned banks have been successfully reduced from 25% in 2002 to about 6% in 2008. The leverage ratio of the Chinese banks has been very low. The loan-to-deposit ratio in 2008 was only about 63%, lower than many emerging market economies. The sound banking sector will provide more room for the possible deterioration of a loan quality.

However, there are also some risks and problems. *Firstly,* much evidence indicates that some of the new bank loans have been infused into the stock markets and property markets. From November 2008 till July 2009, the Shanghai stock composite index (A share) increased by 110 %, reaching 3300 points from 1600 points. Since February 2009, the housing prices in some coastal cities have surged by 40% on average. Obviously, the asset bubble problem has once again become a big concern now. Since July, the authorities have decided to control the increase of bank credits, which eventually caused the new bank lending shrinking to 355.9 billion Yuan in July or a sharp fall by 77% from the latest peak amount in June. It is clear that the monetary policy is facing a dilemma. If the authorities continue to control the bank credits and even switches to moderately tight monetary policy, then many new projects may suffer from shortage of expected new funding injection and eventually become problem projects and the bank loans injected early may become non-performing. If it gives up the efforts to control the crazy surge of bank loans, the asset bubble may become very serious in the near future.

Secondly, the stimulus package might strengthen China's reliance on the investment-driven growth model if the money can not be used more correctly. Since the late of 1980s, owing to the rapid the industrialization and urbanization and the deep integration into the world production network after its access into WTO, China's economic growth has increasingly relied on the investment in industrial sectors. Under such a growth model, China's industrial sector has been much larger while the service sector is much smaller, compared to the average level in the world (even in developing world). By implementing the RMB 4 trillion fiscal stimulus packages, China should have a good chance to make a better balance between the two sectors, but it is also likely to make the structure more imbalanced in the future. As we mentioned above, the spending on education, medical care, social security and other modern service sectors are quite limited. It would be more helpful if the government could finally increase the weights of the investment in these areas.

Thirdly, keeping Renminbi exchange rate relatively stable and restoring export stimulating measures, such as increasing the tax rebate rates for some exports may slow down the process of reducing the economy's excessive reliance on external demand. These policy responses are somehow necessary for eliminating the negative external shocks. And keeping exchange rate stable is also helpful for improving the effectiveness of fiscal expansion (McKinnon and others, 2009). But if these export stimulating policies, as a short-term policy response, wrongly remain in the long run, China's structural adjustment may be delayed. Therefore, when the external shock dissipates, it is necessary for the government to allow the Renminbi to appreciate gradually in accord with the need of structural adjustment.

Finally but not least, it would be a big challenge for the central and local governments to avoid mistakes in selecting investment projects at microeconomic level. Accordingly, a rebound of nonperforming loan rate seems to be unavoidable. It is really important to keep it under control through comprehensive and effective financial regulation.

Reference

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