

# The Economic Crisis Poses Challenges to China's Wisdom on Economic Growth

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The financial storm in the wake of the American sub-prime crisis has turned into a global economic crisis. The impact and breadth of this disruption appear to be greater than all those in recent history. Unilaterally and collectively, governments around the world have enacted a series of countermeasures, but the crisis continues to spread on all levels.

## The origins of the crisis

Looking back, the crisis that originated in the US is the outcome of collective factors. As a result of the unchecked pursuit of profits and US government's indulgence, real estate financing companies, led by Freddie Mac and Fannie Mae, sowed the seeds of today's market crash by imprudently purchasing high-risk mortgage loans. The prevalent usage of financial derivatives and the securitisation of risks by investment banks have threatened numerous subscribing insurance companies, banks and venture capital institutions. Many financial institutions were engaged in these types of gambles; the total value of credit default swaps reached an astonishing USD 62 trillion. Financial and credit rating agencies exacerbated the situation by failing to ensure the soundness of their ratings. On the fiscal policy front, the US Federal Reserve maintained overly low interest rates over too long a period, giving rise to excessive liquidity and real estate bubbles. Further, the financial regulators adopted a laissez-faire attitude to the financial derivatives market, neglecting proper control over risks. In due course, when the American housing market bubble finally burst, the assets of Freddie Mac and Fannie Mae plummeted, the capital funding chain broke and the federal government was forced to buy out the two entities. All financial institutions owning assets in Freddie Mac and Fannie Mae were also dragged down. Meanwhile, a series of chain reactions forced the top five investment banks, including Lehman Brothers, to go bankrupt, merge or transform into commercial banks. Many other financial institutions were so direly affected that they had to ask the government for help. The financial crisis spread faster than predicted to other areas of the real economy. Given how intricately connected today's globalised world is, the financial crisis soon spread beyond US borders, and caused global financial disruption, subsequently leading to economic recession.

## The wind rises before the storm

By early December 2008, various economic indicators showed that the world's economy had sunk into a general recession, indicated by the sharp drop in housing

prices, the shrinking value of assets, stock market slides, corporate bankruptcies, massive layoffs, declining investment and consumption, and the general slump in primary commodity prices. The latest statistics indicate that in December 2008 alone, almost 530,000 people in the US lost their jobs, raising the unemployment rate to 7.2%. On 5 December 2008, President Bush formally announced that the American economy had entered into a period of recession, and more than 60,000 companies were expected to go bankrupt next year. Due to its close economic ties with the US, Europe has been particularly hard hit, with 200,000 companies expected to close down in 2009, affecting a wide range of economic sectors, including automobile, retail, real estate and textile. The struggling Japanese economy sank into recession, recording an additional drop of 0.5% to its third-quarter gross domestic product (GDP), on top of the decline in the previous quarter. Eastern European countries now face the difficulty of meeting their repayment obligations, but their heavy borrowing has made asking for help from the International Monetary Fund necessary. A global economic depression similar to or worse than the Great Depression of 1929 seems imminent.

In attempts to stabilise the market and save the economy, governments around the world have responded with a series of large-scale rescue plans. After the USD-700-billion bailout package, US Congress is contemplating a USD-800-billion fiscal stimulus plan, along with USD 14 billion in aid to the big three struggling US automakers, General Motors, Ford and Chrysler. The EU also announced an economic stimulus plan of 200 billion euros, representing 5% of the EU GDP. France plans a 26-billion-euro stimulus plan to save its auto and construction sectors. Poland announced a USD-31-billion economy stabilisation plan, while the UK has released its 20 billion pound economic stimulus plan. At the same time, the central banks have moved to lower interest rates to maintain the supply of credit. By mid-December 2008, the Bank of England had slashed its official interest rate to 2%, the lowest since its establishment in 1694. Similarly, the European Central Bank had cut the interest rate of the euro zone to 2.5%, the lowest since its founding nearly a decade ago. Internationally, many countries are making efforts to rebuild the international financial system to replace the current Washington Consensus.

According to World Bank forecasts, the growth rate of global GDP in 2008 will drop from 3.6% in 2007 to 2.5%, and fall more significantly to 0.9% in 2009. South Korea President Lee Myung-bak recently remarked that the Korean economy needs at least three years to recover from the crisis.

## Impact on China

China, as the world's fourth-largest economy, is not immune to this international economic predicament. The economic crisis first affected China through the export chain. In light of the increasing gravity of the overseas economic crisis, export orders dwindled, causing some Chinese factories to stop production, export enterprises to shut down and many to lose their jobs. Since China's export dependency ratio (total value of exports over the value of GDP) is as high as 40%, the problems encountered by foreign trade enterprises soon spread to other sectors, with severe adverse impact on China's national economy. Meanwhile, foreign investment in China dropped significantly following the plunge in overseas stock prices and shrinking of corporate assets. Various factors collectively contributed to China's drop in investments, reduction in consumption, dwindling of profits, corporate operational difficulties, rising unemployment and increasing downside pressures on the economy. In its Global Economic Prospects World Economic Outlook released on 8 December 2008, the World Bank adjusted China's GDP growth rates for 2008 and 2009 down to 9.4% and 7.5% respectively, a far cry from the 11.9% recorded in 2007.

The crisis has arrived in the midst of China's economic transformation. The internal stresses and external troubles pose serious challenges to China's future development.

Yet the problems facing China are fundamentally different from those of Western nations. Coming off long years of blunt force economic progress, China's growth relies heavily on two driving forces, export and investment. As a result of extensive economic growth, China has to deal with overcapacity, poor investment efficiency, low national income per capita, flagging domestic consumption, an expanding gap in personal income, high dependency on overseas markets and serious foreign trade frictions. Meanwhile, the development of heavily polluting and high-energy-consumption industries has resulted in environmental damage and natural resource depletion. To address these issues, the Report of the 17th CPC National Congress, adopted in October 2007, clearly outlines the need to apply a scientific development outlook, transform the model of economic growth, build a harmonious society and achieve sustainable economic development. Along with these guiding principles, a series of reform measures have been formulated, including boosting domestic

consumption, improving environmental protection, and encouraging energy savings and emissions reduction. The moves in macro-economic regulation since the end of 2007 are aimed at addressing these significant issues in China's economic development and promoting its economic transformation.

In response to the crisis, like other countries, the Chinese government has adopted a series of unprecedented policies, including ten measures (see next page) for promoting economic growth in the coming two years and a RMB-4,000-billion economic stimulus plan. The State Council Standing Committee meeting held on 3 December 2008 further demanded "the implementation of proactive fiscal policies and a liberalisation of monetary policies, and the introduction of stronger measures to increase domestic demand, to facilitate economic growth at a steady and relatively fast pace." The CPC Central Committee Economic Work Meeting held between 8 and 10 December 2008 further specified five key tasks (see next page) for economic work in 2009.

There are many valid goals in the responsive policies and measures introduced by the Chinese government.

They include:

- Improving China's economic structure;
- Expanding the scale of loan lending, broadening the channels of corporate financing;
- Reducing corporate and individual taxes;
- Increasing the income of urban and rural residents, and improving social security practices to better meet pension, medical and housing needs;
- Encouraging entrepreneurship and business growth, and accordingly, improving employment;
- More stringent regulation of industrial monopolies (natural monopolies such as petroleum, telecom, communications and transportations, medical and education); and
- Stronger mechanisms to control cost, among other things.

With the release of implementation rules and the commitment of policies to practice, these measures should help turn the economic slump around.

# Ten measures adopted in the State Council Standing Committee Meeting on 9 November 2008

- Measure One: Speed up the construction of affordable houses. Increase support to the building of low-rent houses; speed up the reconstruction of shantytown neighbourhoods; carry out the settlement projects for nomadic people; and expand the pilot-run coverage of reconstruction of decrepit rural houses.
- Measure Two: Speed up the basic infrastructure construction in rural areas. Increase input into the rural bio-gas projects, rural drinking water safety projects and rural road construction; improve power grid in rural areas; quicken the pace of major water conservation projects, including the South-to-North Water Diversion Projects, and quicken the pace in eradicating hidden perils and reinforcing run-down reservoirs; and increase efforts in the reconstruction of major water-saving facilities in irrigated areas. Intensify efforts in poverty alleviation through development.
- Measure Three: Speed up the construction of major infrastructure, including railway, roads and airports. Focus on the construction of a number of dedicated passenger railway lines, fast tracks for coal transportation and backbone railway lines in the western regions; improve the superhighway network; orchestrate the building of airports for major and branch air routes in the western regions; speed up the renovation of urban power grids.
- Measure Four: Speed up the development of health and medical, culture and education causes. Intensify efforts to build the health and medical service system at the root level; speed up the renovation of primary and middle schools in rural areas in the middle and western regions; advance the building of special education schools and village- and township-level integrated cultural centres in the middle and western regions.
- Measure Five: Promote eco-environment protection. Speed up the building of waste water and garbage processing facilities and the prevention and reduction of water pollution of major rivers; increase efforts in growing and preserving the shelter forests and advancing projects for the protection of natural forest resources; support key energy-saving and emission reduction projects.
- Measure Six: Speed up proprietary innovation and structural adjustments. Support the industrialisation and the advancement of technology and development of the service industry.
- Measure Seven: Speed up all lines of work in connection with the reconstruction of the earthquake-stricken areas.
- Measure Eight: Improve the income of urban and rural citizens. Raise the floor prices for grain purchase in 2009; raise the level of direct comprehensive subsidies on agricultural production materials, the subsidies on promoting the use of top-quality seeds and advanced farming techniques, and the subsidies on the purchase and use of agricultural machinery; increase the income of rural residents. Improve the benefits to low-income groups and others who depend on social securities; increase the level of urban and rural subsistence allowances; continue to increase the level of basic pensions to retired employees and the living allowances to beneficiaries of state pensions with preferential treatment.
- Measure Nine: Implement full value-added tax (VAT) transformation reform in all sectors and all regions across the country; encourage technological improvement in business enterprises; and reduce the burden of business enterprises by RMB 120 billion.
- Measure Ten: Increase the financial sector's support to the economic growth. Cancel the restrictions on the size of loans of commercial banks; reasonably increase the scale of loans; increase lending support to key projects, the state's initiatives on agriculture, rural areas and farmers, SMEs and technological reform, and M&As and restructuring exercises; direct efforts to nurture and reinforce growth potentials in consumer loans.

# The five key tasks for the economic work in 2009 set out in the CPC Central Committee Economic Work Meeting held between 8 and 10 December 2008

1. Increase and improve macro regulation, and implement proactive fiscal policies and moderately liberal monetary policies.
2. Reinforce and continue to better the favourable economic position in rural areas, ensure effective supply of agricultural products and help farmers to continually increase income.
3. Speed up the transformation of development model, and advance the strategic adjustment of the economic structure.
4. Deepen reform and opening-up, and put in place sound systems and mechanisms and continue to refine them to ensure scientific development.
5. Commit resources to address the hard and hot issues directly involving the interests of the people, and make solid efforts to safeguard social stability.

## A crisis to challenge the wisdom of Chinese leadership

The tremendous impact of global economic upheaval is being felt in China in many areas, including politics, economy and the society. Faith in the reform process and the opening up of China is beginning to falter. It is therefore important for the Chinese government to make its stand explicitly and clearly, stick to its long-term vision, be decisive in its action, and speed up economic transformation while stimulating economic growth in order to pave the way for sustainable development. While implementing these policies and measures, the Chinese government may need to consider focusing its efforts in the following areas.

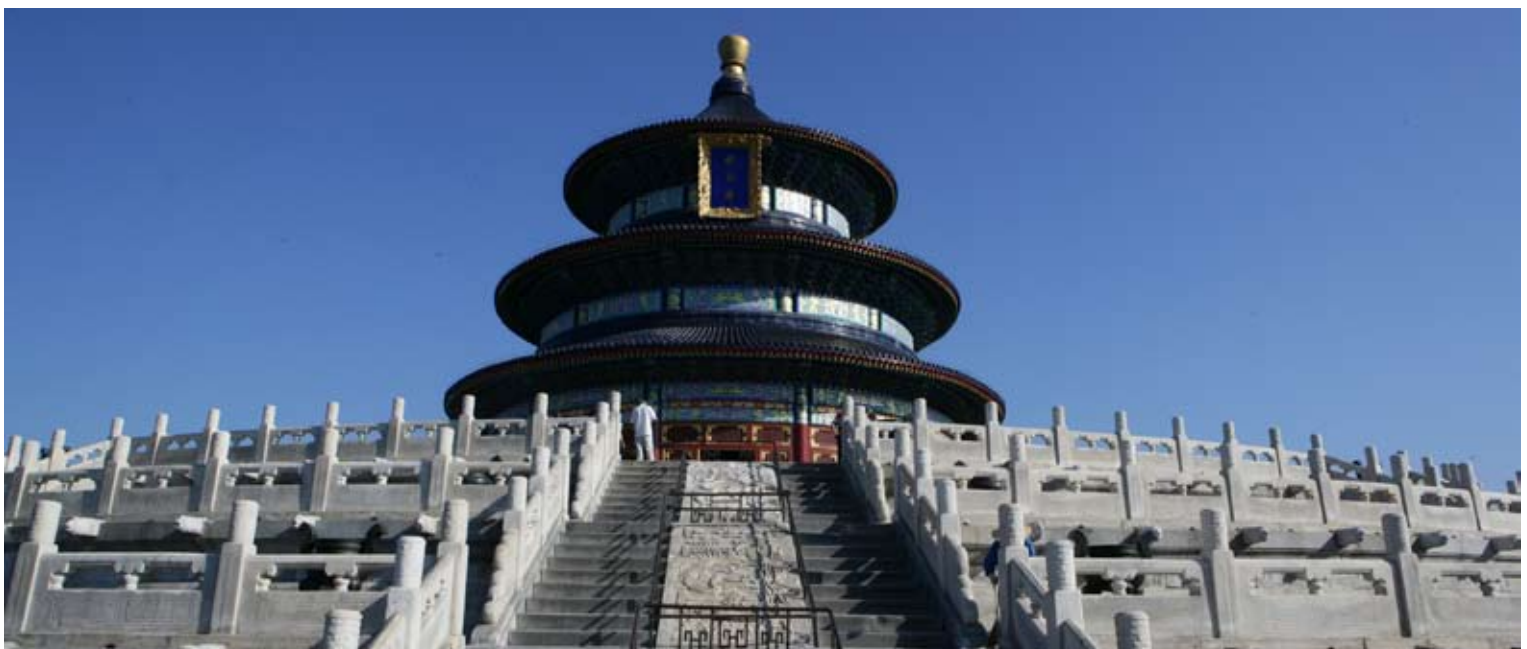
### **Commit to the course of a market economy**

In thirty years of market reform and lifting of trade barriers, the Chinese economy has witnessed tectonic changes. The nation has developed from a country that had suffered decades of poverty to that with the fourth-largest economy in the world today. History has proven that this is the right way of development for China. Due to the late arrival of China's financial market to the world scene and the relatively low level of international exposure, the impact of this financial crisis on the country has been relatively minor. However, this should not be a reason for China to shut its doors, and China cannot retract its pace, slipping back into the old pattern of tight regulation and a planned economy. The problems that China must tackle are the result of underdeveloped markets and immature reform policies. In this moment of crisis, China should brace itself and quicken its pace of reform, and demand market opportunities, economic efficiency and more employment opportunities as reform runs its course.

The government rescue packages of Western European nations and the United States are no indication that they have abandoned free market principles; they spring from practical considerations. If governments remain inactive and allow market confidence and credit to wither, the harm will be exacerbated, and most likely, the financial upheaval may turn into an economic depression that brings all nations into its fold. The core principles of government rescue plans are to stabilise markets, boost investor and consumer confidence, and prevent the crisis from spreading to the broader economy. Once the economy rebounds, governments will eventually take a step back. Since government and the market are co-existing symbiotically, it is important not to overstress the value of one over the other.

### **Speed up deregulation and better define the role of government**

Against the backdrop of the economic crisis, the Chinese government must, in line with the guiding principles set out by the 17th Session of the CPC National Congress, quicken the pace of its own structural reform from a "centrally planned government" to a "service-oriented government". This will allow private citizens and enterprises to become the major driving forces for social progress and economic development, while the government focuses on playing the role of a competent market regulator and guardian of law and order. Accordingly, the government needs to stay streamlined and ease taxation so as to allow its people to enjoy the fruits of progress and act as keepers of the state's wealth.



Relative to other major countries of the world, the various levels of Chinese bureaucracy continue to expend excessive administrative, economic and societal resources. The large amount of administrative reviews and approvals, regardless of importance or priority, not only needlessly increases the operating cost of doing business and for general society, but also stifles market dynamics and social creativity, creating more room for corruption. In addition, excessive regulation is detrimental to fostering the development of an open and tolerant atmosphere, and an “innovative society”. The government needs to streamline its review and approval processes and ease market regulation to allow for favourable external conditions for the survival and development of commerce.

As for promoting and stimulating economic growth, the government needs to consider leveraging the organic role of the market, providing as many incentives as needed to motivate non-governmental participation. It should fully credit societal creativity, and refrain from acting in a surrogate role, attending to every marketplace detail. Some practices of Western governments in managing economic stimulus plans can be taken as points of reference. For example, the US is attempting to stimulate its economy by lowering mortgage rates for low-income families while purchasing corporate bonds. The French government tried to stabilise its auto and real estate markets through direct investment and awarding small to medium-sized enterprises (SMEs) that recruited new employees. Meanwhile, the government needs to consider the establishment of a contingency fund in order to compensate for future uncertainties. Counter-cyclical taxes on initial loans and investment could be established to raise these funds. The tax percentages will depend on the performance of the economy in specific markets.

Deregulation does not denote a lack of government regulation, particularly where the financial industry is concerned, as bitter lessons from this crisis have so clearly demonstrated. In light of the central government’s recent lifting of restrictions on the credit scale of commercial banks, it is critical to note that in these times, it is imperative to strictly control credit risks in limiting the expansion of non-performance loans and preventing a situation wherein solving one problem leads to another. Under the supervision of China Banking Regulatory Commission (CBRC) and China Securities Regulatory Commission (CSRC), commercial banks need to strive for financial innovation, developing new products in accordance with the needs and characteristics of SMEs.

They must also increase their credit support and widen SME funding channels while maintaining rigorous and effective control over risk. It is crucial to enforce end-to-end monitoring of project implementation under the RMB-4,000-billion plan in order to ensure effective results.

The government needs to fully recognise the role and utilise the expertise and skills of intermediaries. It would be more effective and efficient to ensure the management and transparency of these projects if intermediaries could participate in the full cycle of these projects from creation, review and approval, that is, the ongoing management through to completion. Meanwhile, there is an urgent need to replace the current cash-based accounting system with an accrual-based system to bolster fund management and reduce the opportunity for manipulation.

### **Reforming natural monopolies by fostering the development of SMEs**

SMEs are the main body of the Chinese economy, representing 99% of all enterprises, providing more than 80% of jobs in urban areas, and contributing 60% of the GDP and 50% of state taxation proceeds. However, due to institutional constraints, SMEs have struggled to gain market entry, access to funds and policy support, among other things, which are strong hindrances to their growth. In the face of this increasingly serious economic disruption, the main priority for China should be to maintain employment levels. From this point of view, the success or failure of SMEs is tied directly to the stability of Chinese society and the outcome of China’s future economic transformation.

It is commendable that the ten measures introduced by the Chinese government make earnest effort to address SME problems, such as the difficulties in financing and limitations on business venues they face. However, apart from providing external support, the government may focus on how to resolve the SME market entry issues, through addressing the monopoly in non-strategic industries. Over the years, state monopolies in certain industries have not only subjected many consumers to losses in price value and quality of service, but more importantly, have restrained competition, stifled industry incentive for progress, and hampered improvements in societal welfare. By tackling these monopolies, the government can introduce competition, stir up enthusiasm and enterprise creativity, increase productivity, and improve employment outlook. There are many

successful precedents, including the UK's privatisation of the telecommunications industry, which led to a large increase in medium- and small-sized value-added service providers, a huge boom in telecom service content, and a quadrupling of telecom employees. This is a win-win situation for all parties. With the injection of fresh competition, the major service providers increased their competitiveness and reinforced their market positions, a large number of SMEs also gained entry into new markets, and the government achieved its objective of improving the market environment, expanding the tax base, creating more employment opportunities, and preserving stability and maintaining economic growth.

### **Reducing dependency on investment and boosting domestic consumption**

The RMB-4,000-billion investment plan does discuss raising standards of living, but it is relatively vague in terms of specifics, compared with the concrete directives given for infrastructure projects, including railway and road construction. Regional governments have in the past focused on earning political points by giving preference to large-scale infrastructure projects that produce quick and quantifiable results, such as heavy chemical industry and energy-related projects. They have shown less enthusiasm for addressing issues related to improving standards of living. The concern held by some that this government-sponsored investment plan may lead to a repeat of past mistakes, that production and investment may spiral out of control, and that low efficiency, overcapacity and corruption will emerge is justified. In addition, adhering to the call that the response should be swift and decisive and the delivery of solutions powerful and effective, some projects began prematurely, before proper review and deliberation, leaving many concerned about the quality and benefits of these projects. With a host of new issues surfacing, the government will need to think clearly, make careful and detailed study, and focus on how to turn consumption into its new pillar for economic growth to complement investment and export.

For years, China's growth in domestic consumption has lagged behind that of GDP, the result of a series of systemic issues. The root of the problem lies not in an unwillingness to spend, but in the lack of spending confidence. Apart from the limited increase in personal income over the years, the financial burden for housing,

education, medical and pension costs, and other forms of social security have been shouldered by China's citizens, who have had to save their income to prepare for future adversity, resulting in the consistently high savings rate in China. The government will need to address how to alleviate these spending fears by investing heavily into the promotion of the people's welfare. This will be a huge institutional project, one that will not produce quick results, unlike that of bridge or road construction, and will require dedication and persistence. The essential goal, to increase and maintain investor and consumer confidence for the future, is achievable only through tremendous reform in existing employment, education, household registration and domicile control, and social security practices, under the purview of a new series of policies and laws.

### **Balancing export growth and industry transformation**

The global economic recession will see a rise in trade protectionism and an increase in international trade friction. As the world's second-largest trading nation and a world manufacturing centre, China will find itself in all manner of conflicts. China's recent adjustment of its export tax refund policy and its foreign exchange adjustment may be used by some countries as excuses to attack China's trade policies. As the biggest beneficiary under the existing international trade regime, China may consider championing free trade and actively promoting the Doha Round of World Trade Organisation negotiations. Through its actions, China can support the stand on anti-trade protectionism adopted by the Group of Twenty (G20) Summit on Financial Markets and the World Economy, and the Asia-Pacific Economic Cooperation Economic Leaders' Meeting.

Trade in manufactured goods represents more than half of China's exports. Over the years, China's manufacturing export businesses have remained at the low end of the value chain. With no pricing power, and offering only temporary employment to some low-wage labourers in the short term, these businesses have made limited contributions to the overall economy. It is critical for China to decrease its overdependence on overseas markets, gradually reduce the proportion of primary manufacturing trade, improve its level of technology, strengthen the competitiveness of proprietary brands, enhance the quality of Chinese products, upgrade its industrial base and turn domestic demand into a driver for economic

growth. The shift from low-end manufacturing to design and innovation is also a task that must be addressed urgently, and requires original policies such as an innovative tax refund. As Premier Wen Jiabao pointed out in his Dongguan study tour, only by effectively addressing the existing problems facing commercial enterprises in the context of the transformation of China's economic growth model can another economic crisis be prevented in China.

### **Intensify mergers and acquisitions activity and business enterprise restructuring**

The Chinese market is still highly regarded notwithstanding the current global recession. China's strengths are highlighted by its huge foreign exchange reserves, high savings rate, the relatively low leverage in its businesses, the limited effects of the crisis on the Chinese economy, and the enormous growth potential of its domestic market. It is vital for Chinese enterprises to fully leverage these strengths and seize the opportunities offered by the current crisis by aggressively recruiting top-level professionals overseas in the financial, IT and engineering/construction sectors to build a reserve of talent for the next stage of economic development. Also, the time is ripe for the Chinese to acquire financial assets, technology, equipment and natural resources overseas. It is clear that the process of industrialisation and urbanisation in China will not stop for the economic crisis, and the demand will be as strong as ever for primary commodities that are in short supply at home, including petroleum, natural gas, copper, nickel, lead and zinc. It would be wise for the Chinese enterprises to take decisive action in making acquisitions abroad while international commodity prices are dropping. Naturally, it is prudent to prepare for all potential risks fully and engage in well-considered transactions to prevent losses in asset and reputation. On the whole, the government needs to also improve the leadership and coordination of its "going-abroad" strategy, look beyond its immediate future, look beyond temporary gains and

losses, and make judgments based on whether or not the matter concerned would enhance the overall strength and competitiveness of the state.

Domestically, the crisis has also offered the opportunity for industry reshuffling. The government may facilitate and encourage the merger and restructuring of uncompetitive business enterprises operating inconsistently with the state's industry and environmental protection policies. This is also a good time for domestic enterprises to work diligently in building up their fundamental strengths, improving internal and risk management, reinforcing and expanding key business lines, and divesting themselves of non-critical assets. They must also innovate, increase research and development capacity, pursue brand promotion diligently, take advantage of recent preferential government policies, and increase M&A activity and business restructuring to sharpen their competitive edge. Businesses can then reach a new level of development.

## Closing remarks

An ancient Chinese proverb says, “Thousands of vessels can sail past a shipwreck to reach their destinations peacefully, and a green forest can flourish around withered trees to brighten the spring.” As long as China has a clear grasp of the big picture, firmly holds its ground, sticks to the established path of development, gamely explores new and better solutions, promotes innovation earnestly, meets obstacles head on, and commits itself to ensuring all work is done properly, it will not only survive this period of hardship, but will emerge like a phoenix from the fire to set out on a new path of sustainable development.

This was best summarised in Premier Wen Jiabao’s speech on 25 October 2008 at the Seventh Asia-Europe Meeting, which stated that the biggest contribution a country with 1.3 billion people could make to the world was managing its own business right, and maintaining a steady and relatively fast pace of economic development.

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