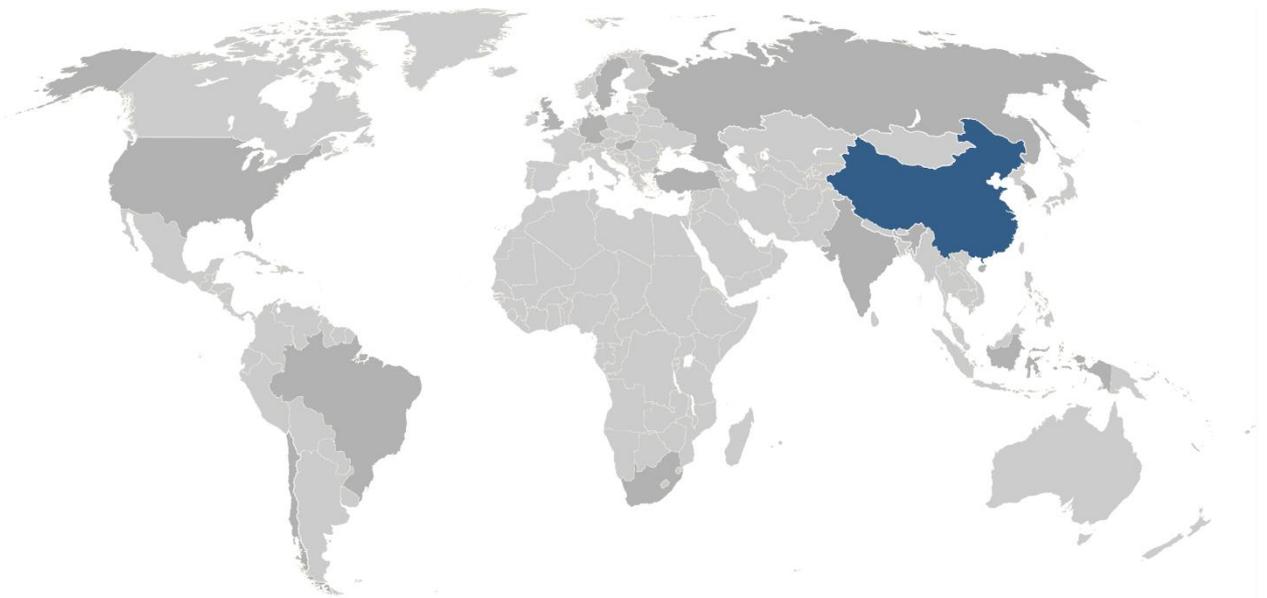


Managing the Crisis | China Country Report

Sebastian Heilmann and Dirk Schmidt



This report is part of the study *Managing the Crisis* which assesses 14 governments' response to the global economic and financial crisis between September 2008 and September 2009 on the basis of a standardized set of criteria.

Please cite as follows: Sebastian Heilmann and Dirk Schmidt, *China Country Report*. In: Bertelsmann Stiftung (ed.), *Managing the Crisis. A Comparative Assessment of Economic Governance in 14 Economies*. Gütersloh: Bertelsmann Stiftung, 2010.

For more information on the study, additional country reports and the comparative article, please visit www.bertelsmann-transformation-index.de/crisis

1. Risk Exposure at the Outset of the Crisis

- What was the structure of demand (e.g., share of private/state consumption, gross capital formation, exports and imports in GDP/GNI)?
- To what extent was the economy exposed to macroeconomic imbalances (e.g., foreign debt, trade or fiscal imbalances)?
- Was/is the financial system primarily bank- or market-based?

Economic structure and macroeconomy

Prior to the economic downturn, China's economy showed many remarkable and in some regards even unique features:¹

- In 2007, almost 43 percent of China's GDP was spent on gross capital formation. At 35 percent, private consumption was low even compared to other emerging economies;² public consumption amounted to 13 percent of GDP.
- In line with the previous years, China's 13 percent GDP growth was primarily driven by gross capital formation and net exports, which accounted for 41 percent and 20 percent of GDP growth respectively.
- With a trade dependency rate of 66 percent, China has a very open economy by international standards. In contrast to conventional wisdom, however, China is not overly dependent on foreign exports since net exports account for only nine percent of GDP.

Over the last couple of years, China has increasingly been at the center of global imbalances. In 2007, its current account surplus of \$372 billion accounted for 11 percent of GDP, which is much more than that for the other top export countries, Germany (7.5%) and Japan (4.8%). This account surplus contrasts starkly with the United States' \$731 billion current account deficit (-5.3% of GDP).³ As a major merchandise exporter, in 2007 China

¹ Unless other sources are cited, the statistics for 2007 mentioned here are taken from: National Bureau of Statistics of China, *China Statistical Yearbook 2008*; National Bureau of Statistics of China, *Statistical Communiqué of the People's Republic of China on the 2008 National Economic and Social Development*, Beijing February 26, 2009. For a broader background on the structural composition of China's economy see Eswar Prasad, "Is the Chinese Growth Miracle Built to Last?" in *China Economic Review* 20 (2009): 103-123.

² According to the World Bank, private consumption as a percentage of GDP in 2007 was, for the following countries, as follows: Russia (50%), Brazil (48%), India (55%), Mexico (71%). See World Bank, *World Development Report 2009*, Washington 2009.

³ For a description of China's contribution to global imbalances see: Karen H. Johnson, "Gross or Net International Financial Flows. Understanding the Financial Crisis." Council on Foreign Relations Center on Geoeconomic Studies Working Paper July 2009. http://www.cfr.org/content/publications/attachments/CGS_WorkingPaper_7_Financial_Flows.pdf (accessed August 20, 2009).

was the biggest net exporter of capital (21% of all exported capital in 2007).⁴ In addition, China has one of the highest gross national savings rates (50% of GDP in 2007), with corporate and private savings comprising almost half of it.⁵ China's financial system is primarily bank-based. Among external funding sources, bank lending represents by far the largest (85%), while bonds (10%) and stocks (4%) play minor roles.⁶

- What was the government's economic record (e.g., growth, unemployment rate, inflation and fiscal position) prior to the crisis?
- What was on the economic agenda prior to September 2008 (e.g., anti-inflation, efficiency-oriented, redistributive, supply vs. demand-side policies)?

Policy priorities
prior to crisis

From 2005 to 2008, the government's two main concerns were fighting inflation and preventing economic overheating, as inflation stood at 4.8 percent in 2008 and—to some extent even more worrisome—foodstuff prices increased by more than 12 percent in the same year. Macroeconomic policy therefore addressed two problems and its monetary policy was contractive. During the summer of 2008, as the global economic crisis mounted, the official policy line shifted to “safeguarding growth and containing inflation.”

Since taking over, the Hu Jintao-Wen Jiabao leadership has energetically pushed forward the concepts of a “harmonious society” and the “scientific development path,” recognizing that a more balanced economy was needed in the medium and long term.⁷ They initiated a number of measures aimed at improving the income situation of rural households (e.g., abolishing the land tax), reforming the social security system and boosting the hitherto neglected central and western provinces by means of infrastructure investments. The 11th five-year plan (2006–2010) clearly reflects these broader goals.

The government's economic record in the years before the crisis is impressive: the growth rate in the years between 2000 and 2008 averaged 9.8 percent. The official unemployment rate (registered urban unemployment only) was around four percent. Against the backdrop of its capital-intensive development path, however, the economic boom did not translate into aggre-

⁴ cf. International Monetary Fund, *IMF Financial Stability Report 2008*, 169.

<http://www.imf.org/external/pubs/ft/gfsr/2008/02/index.htm> (accessed February 25, 2010).

⁵ For more information on China's savings rate, see: Shikwa Jha, Eswar Prasad and Akiko Tereda-Hagiwara “Saving in Asia and Issues for Rebalancing Growth,” *Asian Development Bank Economic Working Paper Series* No. 162, May 2009.

⁶ Syetam Hansakul, Steffen Dyck and Steffen Kern, “China's Financial Markets. A Future Global Force?” *Deutsche Bank Research*, March 16, 2009: 4.

⁷ For a review of China's economic policy priorities prior to the crisis see: Shujie Yao and Minjia Chen, “Chinese Economy in 2008: A Turbulent Year Amid the World Financial Crisis,” *Nottingham University China Policy Institute Briefing Series* No. 47, February 2009.

gate employment growth.⁸ According to a widely shared rule of thumb, a growth rate of seven to eight percent is needed just to absorb laid-off workers and graduates entering the labor force. Government expenditures for health and education represent only 18 percent of all expenditures, which is less than in peer countries.

At the beginning of 2008, southern China was hit by the severest snowstorm in a century. Later in the same year, Sichuan and its adjacent provinces suffered from a disastrous earthquake that caused 80,000 deaths and \$124 billion in direct economic losses.

- How stable was the executive branch in the years/months prior to September 2008 (e.g., credibility/legitimacy of leaders/parties in government, cabinet stability/reshuffles, parliamentary/electoral support)?
- How much room did fiscal conditions provide for a major stimulus (e.g., budget surpluses/deficits, conditions for issuing additional treasury bonds)?
- How much room was there for monetary policy initiatives (e.g., pre-crisis level of interest rates, required reserve ratios, flexibility of foreign exchange rate regime)?

Executive, fiscal & monetary capacities to respond to downturn

Politically and institutionally stable, the central government of the People's Republic of China (PRC) has in recent years become more effective in implementing its national economic policy priorities. Open political opposition and protest typically emerge from dissatisfaction with local government behavior manifest in cases of corruption, illegal land seizures, pollution and ethnic discrimination. Although social protests have increased in frequency (official PRC sources speak of 80,000 to 100,000 "mass incidents" per year) they are usually limited to single-issue protests and have not coalesced into a cross-regional movement. As far as the limited polls reveal, the population is most concerned with better public goods being provided (i.e., education, social security) and affordable housing.

As a result of China's contractionary fiscal policy from 2001 to 2007, the Chinese government is in a very good fiscal position to act: the fiscal balance as percentage of GDP in 2007 was 0.7 percent; its debt-to-GDP ratio was only 20 percent. China's net external position is better than that of most other emerging market economies. In addition, China holds the world's biggest forex reserves with \$1531 billion at the end of 2007.⁹

⁸ According to Eswar Prasad, China's impressive growth rate from 2000 to 2008 of almost 10% p.a. only induced a yearly growth in employment of barely 1%, by far the lowest compared to the rest of Asia. See Eswar S. Prasad, "Rebalancing Growth in Asia," *Institute for the Study of Labor, Discussion Paper Series IZA DP No. 4298* July 2009: Table 2, 38.

⁹ World Bank, *China Quarterly Update* June 2009: 9; International Monetary Fund, *IMF Financial Stability Report 2008*: 46.

China's monetary policy prior to the crisis mirrored its contractive fiscal policy. In China, as in most neighboring Asian countries, there was far more policy space to switch to expansionary orthodox monetary measures than in Western economies.¹⁰ Because of China's currency policy and its political system, however, the country's monetary policy displays some extraordinary features.

Against the backdrop of China's quasi-fixed exchange rate, economists debate about whether one can speak of an independent Chinese monetary policy at all.¹¹ Of central importance to the understanding of China's monetary policy are credit quotas set by the People's Bank of China (PBoC) vis-à-vis China's commercial (i.e., mainly state-owned) banks so as to control the country's loan growth. The Chinese press refers to the government's ongoing imposition and lifting of credit quotas as a "back door" policy instrument that stands in contrast to conventional and more transparent market tools or standard central bank instruments such as open market operations, changing policy rates or reserve requirements. In contrast to Western central banks, the PBoC's role consists less in directly providing or absorbing liquidity to and from the money market and more in being a transmission belt between the government and the commercial banks so as to influence investment growth and the inflation rate.¹²

¹⁰ Cf. Asian Development Bank, *Asia Economic Monitor* July 2009: 12.

¹¹ For a concise discussion of this problem, see: Morris Goldstein and Nicholas E. Lardy, "China's Exchange Rate Policy: An Overview of Some Key Issues," in *Debating China's Exchange Rate Policy*, edited by Morris Goldstein and Nicholas E. Lardy, 4-9. Washington D.C.: Peterson Institute For International Economics, 2008. As Morrison and Lardy stress, there is no definitive measure to resolve this controversy, as it all comes down to a judgment of whether China's capital controls are efficient and its sterilization policy can continue.

¹² For an assessment of the role of the PBoC see: James Riedel, Jing Jin and Jian Gao, *How China Grows. Investment, Finance, and Reform* (Princeton: Princeton University Press, 2007): chapter 8. For the Chinese differentiation between "market tools" and "back window" policy see: "Three Stages in the Adjustment of Our Future Monetary Policy," *Economic Observer Online*, August 17, 2009 <http://www.eeo.com.cn/eeo/jjgcb/2009/08/17/147976.shtml> (accessed August 20, 2009); "Keen Eyes Fixed on China's Monetary Policy," *Caijing Online*, July 29, 2009 <http://www.english.caijing.com.cn/2009-07-29/110215562.html> (accessed August 20, 2009)

- To what extent has the country been exposed to global financial market risks, particularly contagious/toxic financial instruments (e.g., open capital account, floating or pegged/fixed currency)?
- How important was/is the financial sector for the national economy? What was/is the extent of interdependence between the financial sector and real economy?
- To what extent was the economy integrated into regional/global trade flows? How dependent was the economy on foreign demand for manufactures and commodities?
- Did property, equity or other markets display excessive growth and a bubble-like situation prior to September 2008?
- In what condition was the banking sector (e.g., size/structure of banking sector, non-performing loans, capital adequacy ratios of major banks, if available)?

Exposure to specific market and trade risks

As mentioned above, China has an unusually high degree of trade openness, which has made it vulnerable to a sharp contraction in global trade. In 2007 and 2008, China was the world's second biggest exporter and third biggest importer. To make matters worse, China is part of Asian transnational production networks in which raw materials or semi-finished goods are shipped to China where they are processed for the world market. Thus, China's export-oriented economy is vulnerable to any downturn of imports from Asia and a fall in Western demand.

China's financial system is often characterized as underdeveloped, "repressed" or "deep, but not broad."¹³ This means that China's broad money (M2) supply, at 160 percent of GDP and household deposits at 70 percent of GDP, is much higher than that of other East Asian countries. Most investment derives from savings, not loans. The financial system provides cheap capital in the form of low real interest rates to large companies, whereas private SMEs often have difficulty accessing the needed resources. The financial system also discriminates against households, which often face negative interest rates on their deposits.

Since 2000, bank lending has grown considerably, showing an average year-on-year increase of 15 percent. By 2008, the volume of outstanding loans had increased by more than 200 percent. China's stock market peaked in October 2007 and for the first time, market capitalization was higher than GDP.

Prior to the 2008 global economic crisis, China had a clear comparative advantage because the central government had been very cautious in liberalizing the derivatives market. Indeed, China's financial system is not well integrated into the global financial market and has had only minimum

¹³ Barry Naughton, *The Chinese Economy. Transitions and Growth*. (Cambridge/Mass.: MIT Press, 2007): 449. For more information on financial repression, see: Svenja Schlichting, *Internationalising China's Financial Markets*. (New York: Palgrave Macmillan, 2008); Riedel, Jin, Gao, *How China Grows*, ch. 4.

exposure to the most risky financial products (e.g., derivatives). Much of what was characterized as a bane (i.e., a limited share of foreign bank assets, a segmented stock market, regulated portfolio investments, restricted licensing for “Qualified Foreign Institutional Investors”) has turned out to be a boon. In addition, starting in 2000, the central government has taken aggressive steps to recapitalize major banks, improve their corporate governance and strengthen banking supervision. Thus, despite some ongoing problems (e.g., profitability, insufficient risk management) the Chinese banking sector—according to a Deutsche Bank Research study—is in a far better position than most East European banking sectors, though it does rank lower than some other Asian counterparts like Hong Kong and Singapore.¹⁴

Given the position of China’s financial sector, it is not surprising that most Chinese policy advisors in 2007–2008 were not much worried about a U.S.-style crisis spreading from the financial sector to the real economy. Quite on the contrary, their utmost concern was the defense of China’s real economy, in other words, stabilizing output and employment.¹⁵

- Did policymakers/executive agencies have any experience in handling financial crises? Did this experience play a role in the 2008-09 policy response?
- Were there independent regulatory institutions or prevention/response schemes in place to contain financial risks?
- Were there internal veto players (e.g., federalist powers, courts) or international obligations that thwarted swift action on the part of the government?
- Have executive powers been extended in times of crisis? Has this been based on formal or informal mechanisms?

Structural or policy advantages and disadvantages

Although China was not directly involved in the Asian financial crisis of 1997–1998, it nevertheless drew some of the same lessons as those affected most: reduce or limit the inflow of portfolio investment, hoard foreign exchange reserves, and encourage a high savings rate. Infrastructure investment was an important aspect of China’s attempt to stimulate its economy after the Asian financial crisis. Under former Prime Minister Zhu Rongji, China’s government passed a 200 billion yuan stimulus package for ailing state-owned enterprises in 1998. This was followed by a one trillion yuan infrastructure investment in western China from 2000 to 2003.¹⁶

¹⁴ See Maria Laura Lanzeni and Veronica Vallés, “Antikrisenmaßnahmen der Schwellenländer. Die Spreu vom Weizen trennen,” *DB Research Aktuelle Themen* 455, August 13, 2009.

¹⁵ Zhang Zhichao, Li Wei and Shi Nan, “Handling the Global Crisis. Chinese Strategy and Policy Response.” *Social Science Research Network Working Paper Series*, April 15, 2009 <http://ssrn.com/abstract=1377049> (accessed August 5, 2009)

¹⁶ For more information on the post-Asian Financial Crisis Chinese stimulus see: Zheng Yongnian and Chen Minjia, “How Effective Will China’s Four Trillion Yuan Stimulus Plan Be?” University of Nottingham China Policy Institute Briefing Series Issue 49, March 2009; Victor Shi “China Takes the Brakes Off,” *Wall Street Journal* July 22, 2009.

China has some advantages in battling the economic crisis which are rooted in some hallmarks of its political system: China has a distinctive crisis mode which is characterized by the (re)centralization and personalization of policy-making. The Communist Party of China (CPC) still plays the leading role in all government and nongovernmental economic and financial institutions (i.e., central bank, regulatory institutions) and big state-owned enterprises. The CPC can therefore be used as a distinctive hierarchical channel to communicate, implement and monitor decisions made by the central government. All government agencies as well as regional and local political actors are accustomed to planning procedures that date back to Maoist times. As soon as the need arose to set an additional investment plan on track, policymakers and bureaucrats could revert to the entrenched administrative mechanisms stemming from the command economy era.

- How strongly has the national economy been hit during the period under review? Where has it been hit most severely thus far (e.g., growth rate, production, trade, employment)?

Initial impact of economic downturn

Given China's risk exposure as the center of Asian production networks, it is hardly surprising that China was hit fast and hard as the crisis unfolded.¹⁷ Its GDP growth rate shrank from 10.6 percent in the first quarter of 2008 down to 6.8 percent in the fourth quarter. The yearly growth rate was 9.0 percent. Even the big state-owned companies under the supervision of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), which had not reported losses since 2002, suffered from declining profits of about 30 percent in 2008 and the first half of 2009.¹⁸

From January to October 2008, China still registered double digit growth rates in both exports and imports, but these declined dramatically shortly thereafter. In the first half of 2009, exports sank 21.8 percent and imports declined 25.4 percent. Among the export sectors, China's technology and capital-intensive exports were hit harder than labor-intensive ones (e.g., textiles, shoes, toys). Foreign companies in the business of manufacturing machinery and telecommunications equipment, especially from Taiwan and South Korea, simply closed down their factories in southeast and northeast

¹⁷ For the economic data see: Wayne M. Morrison, "China's Economic Conditions," Congressional Research Service, *CRS Report for Congress*, March 5, 2009; National Bureau of Statistics of China, "China's Economy Stabilized with a Better Performance Trend while its Upturn yet to Consolidate," July 16, 2009; China Daily, July 15, 2009 "FDI in China Falls 6.8%," www.chinadaily.com.cn/bizchina/2009-07/15/content_8432292.html (accessed July 20, 2009); "China's Imports, Exports Continue Falling, But Rate Eases," Xinhua July 10, 2009 <http://english.mofcom.gov.cn/article/counselorsreport/americaandocanreport/200907/20090706396639.html> (accessed July 20, 2009)

¹⁸ "State Firms' Profit Decline Slowing," http://www.chinadaily.com.cn/2009-07/22/content_8457073.html China Daily (Online) July 22, 2009 (accessed July 22, 2009)

China. The speed and scope of this development came as a shock for Chinese policymakers.¹⁹

The trade surplus at the end of the first half of 2009 stood at \$97 billion. China's net export, which in 2007 contributed 2.6 percentage points to GDP growth, now reduced the GDP growth rate by almost 3 percentage points. Similarly, starting in October 2008 and continuing through the first half of 2009, there was a sharp downturn in incoming FDI (e.g., \$43 billion, down 18 percent from 2008). As a result of collapsing commodity prices since the middle of 2008, China's main inflation indicator (consumer price index) was down 1.1 percent in the year to June and producers' prices fell by 5.9 percent.

According to official statistics, China's unemployment rate barely budged from 4.2 percent to 4.3 percent (from 8.86 million registered urban unemployed to 9.06 million). However, these figures misrepresent reality. For example, the city of Dongguan—one of China's export-oriented centers—alone reported job losses of 630,000.²⁰ In the spring of 2009, even China's Ministry of Agriculture let it be known that 20 million recently laid-off migrant workers had returned to the countryside. By the end of 2008, there were numerous reports of Chinese officials being concerned about unemployment-related mass protests.²¹

As was to be expected, China's banking sector was spared any heavy hits from the financial crisis. China's stock market collapsed by two-thirds from the third quarter of 2007 to the third quarter of 2008 but showed a turnaround in November.

¹⁹ "Macroview: Crisis Tests Strength of China's Export Muscle," *Caijing* (Online) August 19, 2009 <http://www.english.caijing.com.cn/2009-08-19/110227250.html> (accessed August 20, 2009)

²⁰ "China's Powerhouse Suffers Jobs Blow," *Financial Times*, July 29, 2009

²¹ cf. Elizabeth C. Economy/Adam Segal, In China, Stimulus and Questions about Global Financial Governance", Council on Foreign Relations Expert Brief November 18, 2008.

2. Agenda-Setting and Policy Formulation

- When did state organs (e.g., government, central bank) begin setting a crisis response agenda? How long did it take to adopt the first crisis measures?
- Who were the driving forces (e.g., government, central bank, foreign actors, media, trade unions, employers' associations) in getting stabilization/stimulus policies started?
- Were these measures launched as executive orders or parliamentary laws? How closely did constitutional bodies (e.g., executive, legislative, central bank) cooperate?
- What kind of role did sectoral or regional lobbies play in policy formulation?

Agility and credibility

China's reaction to the unfolding economic crisis was one of the fastest in the world.²² The first policy discussions began as early as June 2008 just before the Beijing Olympics. Obviously, the Chinese leadership was already in a state of alert before Lehman Brothers collapsed. Full-fledged stimulus efforts were initiated on November 5, 2008, with a meeting of China's State Council, which announced a four trillion yuan stimulus plan (details of the contents are described under "policy contents"). The headline number of \$586 billion was immediately picked up by the international press, although in the words of Barry Naughton, "The Chinese government had simply announced a very big, vague number, which had not been fleshed out with concrete programs and projects."²³ Only some time later in an emergency meeting did the National Development and Reform Commission (NDRC) discuss the allocation of the stimulus plan. Parallel to the government conference on November 5, 2008, the CPC held a meeting and issued a central document stipulating that 100 billion yuan would be distributed in six designated areas. The importance of this party document lies less in its rather murky contents and more in the sense of urgency it conveyed. The document, which was channeled through the party hierarchy, announced that formal obstacles should not slow the timely implementation of the government's aggressive measures. Local governments throughout China held emergency meetings as soon as the central document reached them. This was followed by a structured bargaining process between the center and local governments that mirrored the usual mechanisms for setting up five-year and annual plans. The center signaled the preferred types of projects and the amount of money that the local governments could expect. Local government projects proposed to Beijing were then checked by the NDRC to

²² For a good chronology of events see Zhang/Li/Shi 2009, 39-44 and Barry Naughton (2009a), *Understanding the Chinese Stimulus Package*, *China Leadership Monitor* 28, Spring 2009, 2-3.

²³ Naughton (2009a), 2.

determine whether they fit into the slated categories of the investment plan, and how fast they could be implemented. In the end, by mid-December 2008, the first round of the bargaining process had already been finalized.

The most obvious common aim of both the central and the local governments is to curb unemployment and thereby ensure social stability. Beyond this, the central government's interests often collide with local interests when it comes to the stimulus. The central government is more concerned with addressing longer-term structural problems and boosting private consumption. On the other hand, local and regional governments and party organizations are more concerned with the stabilization of their income revenues by protecting the local industries, even if these industries rely on energy insufficient, polluting production (e.g., steel factories). When the center addressed the local governments with the request to come up with project proposals, the local governments tried to exploit the situation in order to get their favored projects on the stimulus plan. It is hardly surprising that the provinces immediately came up with "ready-made" proposals far exceeding the total budget (with 80% of the annual GDP). Thus, the central government was forced to give the local governments a lot of leeway in devising the investment projects so as to ensure a swift launch of the stimulus program.²⁴

- Did policymakers actively consult domestic and/or foreign experts outside of government?
- Did the government actively seek collaboration with other governments or international organizations?
- Did the government participate in multilaterally coordinated rescue efforts?
- Was the government curtailed in its response through IMF support programs?

Consultation with external experts and openness to international collaboration

Against the backdrop of China's often opaque decision-making process, it is difficult to assess the amount of outside expertise that actually made its way into the government's decisions. Judging by past experiences, however, government think tanks and other research institutes have probably contributed considerable intellectual input. These organizations closely monitor the crisis reaction packages in other countries and provide the government with up-to-date assessments on foreign expertise. A close look at Chinese scholars' published research in 2008 suggests that a sense of acute threat to China's economic well-being was underway that called for a decisive government response.²⁵

The Chinese government has actively participated in international conferences that dealt with the financial crisis (especially in the G20 setting).

²⁴ On the divergence of interests between the centre and the regions see: Zheng/Chen 2009, 6-9.

²⁵ See Zhi/Li/Shi 2009, 6-12.

However, the Chinese position during the conferences has dovetailed with its traditional foreign policy stance, which identifies the root causes of the financial crisis in inadequate regulation, Wall Street greed, the West's unchecked financial innovations, and architectural flaws in international finance (e.g., the dominance of an undisciplined U.S. dollar, open capital accounts). All in all, China has shied away from shouldering more and new responsibilities that are not in line with its status as "the biggest developing country in the world."²⁶

According to the Chinese government, China's best contribution to fighting the crisis lies in a successful turnaround of its own economy. As there is no one blueprint for all countries, every rescue package should start from and rely on the specific conditions given in each country. Clearly from the Chinese position, a new international financial architecture with the IMF playing a larger role is needed, and it should take into account the needs and interests of developing countries.

3. Policy Content

There is currently very little in-depth research on the details of China's program.²⁷ Media reports concentrate on Chinese banks' lending surge and the economic effects of the stimulus package so far.

- How large is the stimulus package as expressed as a percentage of GDP (including compensations to those hit particularly hard by the crisis through social/labor policies)?
- The stimulus is spread over a period of how many years?

Scope of stabilization and stimulus policies

China's stimulus package of four trillion yuan (\$586 billion) amounts to 15.5 percent of the country's 2007 GDP or 13.3 percent of its 2008 GDP. It is unclear how much money is really "new" and has not in some form or the other already been appropriated before (e.g., money for earthquake reconstruction or funds slated in the 11th five-year plan). The government plans to spread the allocation of this massive stimulus over nine quarters (from Q4/2008 to Q4/2010).

²⁶ For examples of China's multilateral crisis response attitudes see *ibid.*

²⁷ The most noteworthy examples are Naughton (2009a) and Zhao/Li/Shi 2009

- How is stimulus spending distributed across sectors? How and to what extent is the financial sector supported (e.g., through loans, guarantees, capital injections)?
- Which industrial and structural policies (e.g. corporate tax cuts, subsidies, company bail-outs) can be observed?
- What kinds of measures target the expansion of public spending on infrastructure? Which ones are designed to sustain business and consumer spending?
- Are policies in support of businesses adequately targeted and delineated (e.g., at creating employment, supporting competitive firms)?

Targeting and coverage of policy tools

The Chinese stimulus package contains, in addition to monetary policies, several fiscal elements which the central government has called its “investment plan to counter the global financial crisis” (duiying guoji jinrong jingji weiji de yilanzi jihua). (For more on this, see “monetary and currency policies”). It should be noted that the choice of the word “plan” is deliberate here. Made public first in November 2008, the composition of China’s investment plan were changed by March 2009 at the National People’s Congress. The following table illustrates the distribution of the 4000 billion yuan.²⁸

Table 1: Allocation of stimulus package

Category	Plan as of March 2009 yuan (bn) -- % of total	Plan as of November 2008 yuan (bn) -- % of total
Sichuan earthquake reconstruction	1000 – 25%	1000 – 25%
Public infrastructure	1500 – 38%	1800 – 45%
Housing for low-income households	400 – 10%	280 – 7%
Rural development	370 – 9%	370 – 9%
Technological innovation and structural adjustments	370 – 9%	160 – 4%
Sustainable development (energy, environment)	210 – 5%	350 – 9%
Health care, education, culture, family planning	150 – 4%	40 – 1%

The Sichuan earthquake reconstruction efforts are the only elements in the plan for which no additional information is available. As Table 1 clearly illustrates, it is wrong simply to reduce the plan to its public infrastructure components (e.g., the construction of roads, railways, airports, irrigation, electricity grid). Social policy programs (see “social protection”) as well as industrial policies (see “targeting and coverage of policy tools”) also play a

²⁸ The table is based on: Economic Observer Online March 2009, 3 “China’s Stimulus Package: A Breakdown of Spending” in:

http://www.eeo.com.cn/ens/finance_investment/2009/03/07/131626.shtml (accessed August 5, 2009); Caijing (Online) March 3, 2009 “4 Wanyi touzi jiegou da qiaozheng” (Major facelift for 4 trillion Yuan Investment Structure); Fazhan Gaige Weiyuanhui : “4 Wanyi touzi goucheng ji Zhongyang touzi xiangmu zuixin jinzhan qingkuang” (The Structure of the 4 trn. Yuan investment plan and the current situation of the central government’s investment projects) in: http://www.ndrc.gov.cn/xwzx/xwtt/t20090521_280383.htm (accessed August 5, 2009)

substantial role. They were even upgraded in their importance when the plan was revised in March 2009. These adjustments, together with the actual implementation of the plan (see “modes and time frame of implementation”), reflect the central government’s desire to concentrate on measures with an immediate impact on people’s livelihood.²⁹

Unlike western countries, China has not been forced to buttress its financial system through direct support in the form of capital injections, loans, guarantees or asset purchases.

- Are stimulus measures influenced/limited by pre-crisis development strategies (e.g., industrial policies) or have novel/additional (e.g., environmental) policy objectives been inserted?
- Is the response to the crisis grounded in a broader developmental perspective (i.e., crisis as development opportunity) or predominantly short-term political constituency logic?
- Do stimulus policies address prevailing structural deficits and future growth potential?

Development as an objective of stimulus policies

China’s response to the crisis contains a broader concern for development issues. The central government is aware of the Chinese economy’s structural deficits and has therefore slated nine percent of the investment plan for “technological advancement and restructuring.” The usage of these funds is embedded in the so-called “long range plan for adjustment and rejuvenation” as put forward by the NDRC, which identifies 10 industries to be supported from 2009 to 2011. The targeted industries include, among others, the electronics (e.g., next generation Internet, digital television and third generation mobile telecom) and automobile industries.

Even local politicians have made clear on several occasions that they consider the crisis to be an opportunity to push forward structural changes so as to upgrade their industries.³⁰ These promises should not be regarded as mere lip service. China has proven in the last decade that it can use economic crisis as an opportunity to push forward with ambitious reform agendas (especially in 1999–2001 when it used the economic downturn to override internal skepticism about the WTO entry).

²⁹ This aspect is also highlighted in Naughton 2009a, 7.

³⁰ This is for example expressed by Guangdong’s Party Secretary Wang Yang in an interview with the Financial Times. See Financial Times (Online) August 2, 2009 “China’s Arnie Takes Advantage of Crisis.”

- Has the stimulus included “buy national” clauses? Have import-restricting mechanisms been newly established or re-established?
- Has the country’s executive/central bank manipulated the exchange rate or intervened in the foreign exchange market (if so, in which direction)?
- Have there been measures to prop up export industries (e.g., tax rebates, direct export subsidies)?

National bias and protectionism

Since the crisis, China has re-introduced some well-known protectionist measures. During the summer of 2009, China made several rounds of hikes in VAT rebates for export industries. These are hard to track in detail because they cover different product groups with differing levels of rebates.³¹ More often than not, they represent successful lobbying by local constituencies and do not necessarily follow a commercial logic.

At the end of May 2009, the central government issued bidding rules (“Buy Chinese Clause”) that discriminate against foreign suppliers. This means, for example, Western companies have no chance of winning contracts in wind power constructions.³² The American economist Nicholas Lardy, however, warned against overdramatizing this step. In an interview with the Peterson Institute for International Economics, he pointed out that China, as a non-signatory state to the WTO’s “Government Procurement Act,” was legally in a position to move in this direction. In addition, by issuing these bidding rules, China had only reiterated policies that have been in effect for years, making it difficult to deem this move as a sign of “new protectionism.”³³

- Which labor market policies have been enacted (e.g., unemployment benefits, rise in public-sector employment)?
- Which social policies have been included (e.g., expansion of support, additional investment in health and education system)?
- Which measures have been taken to support purchasing power (e.g., consumer checks, tax cuts, cash transfers)?

Social protection

No new official labor market policies can be observed. However, there are numerous reports of party organs at every level having urged state-owned companies under their jurisdiction to refrain from laying off their staff, which is fully in line with China’s flexible response to problems.³⁴

³¹ For an example of such adjustment in export VAT rebates for bags, toys and furniture starting from June 1, 2009 see Circular 88/2009 issued by Ministry of Finance and State Administration of Taxation (*Caishui 2009 nian 88 hao*), http://szs.mof.gov.cn/shuizhengsi/zhengwuxinxi/zhengcefabu/200906/20090608_164478.html (accessed August 20, 2009).

³² Financial Times (Online) May 2008, 2009 “Protectionist Fears Over China Stimulus.”

³³ Peterson Institute for International Economics, Interview with Nicholas Lardy on Current Topics “Is China’s Stimulus Program Protectionist ?” June 25, 2009.

³⁴ Financial Times (Online) June 13, 2009 „China’s Stimulus Is Working But Social Unrest Fears Persist“.

As discussed under “targeting and coverage of policy tools,” the adjustments to the stimulus plan in March 2009 specifically aimed at beefing up the amount of money allocated for improvements in people’s livelihood. This is especially true for health care policies. The overhaul of China’s health care system is a very complex process, as reform measures and pilot projects differ from one province to another. Given this state of affairs, it is quite remarkable that the government decided in late 2008 to move forward with a system that would be more heavily dominated by direct central government provision. According to Naughton, this move cannot be understood without the stimulus package. Clearly, the government has recognized that the stimulus presents a window of opportunity to dramatically expand outlays for health care.³⁵

In addition to the above initiatives, the government started two other initiatives targeting the consumption in rural households: “household appliances going to the countryside” (jiadian xia xiang) and “exchanging old for new” (yi xiu huan xin). Under these two schemes, which are set to run for four years, households, especially in the countryside, are eligible for subsidized electronic household items.³⁶ The government thus kills two birds with one stone, as it boosts rural consumption and assists struggling Chinese companies.

³⁵ Naughton 2009a, 8.

³⁶ On some details of these two schemes see: Caizheng Bu “Caizhengbu dengqi buwei yinfa ‘jiadian yi xiu huan xin shishi banfa’” (The Finance Ministry and 7 other Ministries, Commissions issue Implementation Rules for “exchange old for new household appliances”) July 2, 2009 http://www.mof.gov.cn/mof/zhengwuxinxi/caizhengxinwen/200907/t20090702_175325.html (July 23, 2009); Fagai Wei “Guowuyuan changwuhui shenyi tonguo guli qiche jiadian yi xiu huan xin shishi fangan” (NDRC: The Standing Committee of the State Council investigates into the implementation program of promoting car sales and exchange old for new household appliances), in: http://xwzx.ndrc.gov.cn/xwfb/t20090522_280982.htm (accessed August 5, 2009).

4. Implementation

- Does the government actively communicate and justify the rationale/goals of its stimulus policies to the public?
- Over time, how has the public responded to the government's management of the crisis (e.g., consumption/investment trends, public opinion polls)?

Political
communication

In communicating its anti-crisis measures, the Chinese leadership has been clear about the extraordinary challenges ahead and the need for decisive countermeasures from the start. Initially, the government was very careful not to let criticism of the package emerge. This has changed considerably, as the reporting atmosphere among the official Chinese press has become much more relaxed (see “policy feedback and adaptation”).

During the first quarter of 2009, when the impact of the stimulus was not yet clearly discernible, reports in the Chinese press hinted at additional fiscal initiatives. More often than not, CPC politburo members or top policy advisers were quoted as saying that additional measures could be taken if needed.³⁷ NDRC head Zhang Ping has said on several occasions that the composition of the investment plan could change.³⁸

Even as the crisis eased and the recovery began, President Wen Jiabao and Premier Hu Jintao continued to speak of China as having reached a critical moment (*guanjian shiqing*) and of a grim financial situation. They, as well as other top members of China's cabinet (e.g., Finance Minister Xu Xieren) continue to support the dual course of a “proactive fiscal policy” and “relatively loose monetary policy.”³⁹ This stands in obvious contrast to statements emerging from the People's Bank of China, the China Banking Regulatory Committee or the critical Chinese financial press, who admonish the banks to maintain stricter lending rules and even tentatively use the word

³⁷ For such reports see Bloomberg News April 13, 2009 “China Mulls New Stimulus to Boost Consumption, Bolster Recovery”; Bloomberg News March 22, 2009 “China's Stimulus Spending to Help Growth Reach Target”.

³⁸ Zhang Ping cited in *Caijing* (online) March 6, 2009 “Facelift for China's Economic Stimulus Plan”, in: <http://www.english.caijing.com.cn/2009-03-06/110114405.html> (August 6, 2009).

³⁹ For statements such as these cf: People's Daily July 23, 2009 “Chinese Premier Urges Firm Implementation of Proactive Fiscal Policy” <http://english.people.com.cn/90001/90778/90857/90859/6708487.html> (accessed August 4, 2009); People's Daily July 23, 2009 “Chinese President Urges Adherence to Macroeconomic Policies in Second Half” <http://english.people.com.cn/90001/90778/90857/90862/6708530.html> (accessed August 4, 2009); Xinhua June 21, 2009 “Wen Jiabao: woguo jingji zheng chuzai qi-wen huisheng de guanjian shiqing” (Wen Jiabao: China's Economy is currently at a critical moment for an early recovery) http://news.xinhuanet.com/politics/2009-06/21/content_11575848_1.htm (accessed July 22, 2009).

“exit” with regard to monetary policy.⁴⁰ The basic policy line as expressed in official documents continues to be dominated by references to the scientific development approach and the central government economic guidelines for defending stable and relatively fast economic growth (sometimes only referred to as “defending 8%”), expanding consumption at home (*kuoda neixu*), and improving the structure of the economy.⁴¹

Since no free venues exist for the public to express their voice on the subject, public acceptance of the government’s program is difficult to judge. However, glimpses at the Chinese blogosphere—which includes numerous discussion forums that are highly critical of China’s economic administration and policies—provide some insights. Most commentators seem to share the government’s view that the financial crisis was of “American doing” and hit an undeserving China. In addition, many Chinese seem to give their government credit for strengthening the economy, and there is a palpable pride in the fact that some Western media are pointing to China as the potential leader in pulling the world out of recession. On the other hand, commentators in both the blogosphere and the official media frequently raise concerns about waste and embezzlement (including speculation in stock and real estate markets with diverted stimulus funds) in connection with the implementation of the stimulus plan.

- How large has the time lag been between adoption and implementation of selected major stimulus components?
- What are the reasons for delay in implementation (e.g., legal barriers, insufficient capacities, corruption)?
- Have sectoral or regional interest groups influenced the workings of policy implementation in any way?

Modes and time frame of implementation

It is for several reasons enormously difficult to measure and assess the speed and effectiveness with which the government has implemented its stimulus plan. First, since the central government is heavily reliant on local governments for funding and implementation, the status of implementation varies widely from province to province, city to city, and township to township. In addition, the official press in some cases gives seemingly exact numbers for

⁴⁰ For examples of these reports see Financial Times (Online) July 28, 2009 “Rise in Loans Prompts China Scrutiny”; People’s Daily July 28, 2009 “Banking Regulator: Ensure Loans Enter Real Economy”, in: <http://english.people.com.cn/90001/90778/90857/90862/6712365.html> (accessed August 4, 2009), Caijing (Online) July 23, 2009 Hu Shuli “Editorial: Reality Check for China’s Monetary Policy”.

⁴¹ Li Xiaochao (Spokesman, National Bureau of Statistics) “China’s Economy Stabilized with a Better Performance Trend While Its Upturn Yet to Consolidate”, July 16, 2009. Xinhua “*Xinwen fenxi: Xiaofei zengchang xi ren – xia bannian caizheng zhengce ruhe fali*” (New Analysis: The rise in consumption makes people happy – How fiscal policy in the second half of the year can deliver strength) July 16, 2009 in: http://www.gov.cn/jrzq/2009-07/16/content_1367469.htm (accessed July 16, 2009)

some projects (“273 pieces of grain-drying equipment”) and in others makes only superficial statements (“speeding up the work on the South-North water transfer project”).⁴² Wall Street journalist John Making has drawn attention to a peculiarity of China’s statistics: as soon as project funds are disbursed, they are counted as having been spent—even if the project might not have started yet. There are similar issues with the way in which retail sales are measured: shipments to retailers are counted as actual sales to the final consumer. Clearly, such practices distort the overall picture. Also, it has been reported that in order to boost up the numbers and show success, local government agencies have virtually handed out household equipment for free or electronic home appliances (such as washing machines) even in areas with no access to electricity.⁴³

The central government’s 1.18 trillion yuan investment plan is to be disbursed over a three-year period as follows: 104 billion yuan in 2008, 487.5 billion in 2009 and 588.5 billion in 2010. At the time of this writing, the plan seems to be on track. At the end of June 2009, the Ministry of Finance announced that the government had dispersed 591.5 billion yuan thus far. If the roughly 200 billion yuan for earthquake reconstruction is omitted, the allocation of the remaining 390 billion yuan is as follows:

Table 2: Allocations

Category	Yuan (bn)	%
Rural village infrastructure	125	32
Affordable housing	52	13
Public infrastructure	59	15
Health care, education, culture	70	18
Sustainable development	26	7
Technological innovation and structural adjustments	58	15

Source: data based on authors’ calculations and Chinese Ministry of Finance

These figures are generally in line with Naughton’s research, which looked at the first two tranches for the fourth quarter of 2008 and the first quarter of 2009.⁴⁴ It seems safe to say that the projects funded by the central govern-

⁴² Sky Canaves, “Spending the Stimulus: Where China’s Money Is Going,” Wall Street Journal, May 22, 2009; <http://blogs.wsj.com/chinarealtime/2009/05/22/spending-the-stimulus-where-chinas-money-is-going/tab/article/> (accessed February 25, 2010).

⁴³ John Making “China: Bogus Boom?” American Enterprise Institute for Public Policy Research Economic Outlook August 2009.

⁴⁴ Naughton 2009a, 7.

ment have received considerably higher amounts than scheduled in the November 2008 and March 2009 disbursements of the investment plan. Since these funds have to be matched by local money, the total outlays for the improvement of peoples' livelihood (affordable housing, health care, education, rural infrastructure) are considerably higher than is widely assumed in the West.

Despite this success, certain drags on effectiveness remain. Without doubt, a massive misuse of funds has directed resources away from designated aims and into assets (e.g., the stock property markets in hopes of winning higher and faster returns on investments). Since land sales and taxes from property transactions constitute a considerable part of local government revenue, there is a strong appeal to invest money there. Symbiotic collusion of CPC cadres in different functions leads to distortions and waste. Economist Andy Xie tells stories of "land kings" at local land auctions who bid up prices with money lent from local banks so that in the end the money circulates from one government pocket to the other.⁴⁵

Other problems, such as insufficient supervision capacities, corruption and fraud, are typical of emerging, less-developed economies. However, the political leadership relies again on classic Maoist strategies—such as inspection tours conducted by individual top CPC cadres—to address these shortcomings.

- Beyond emergency stand-by programs with the IMF, has the government collaborated with other governments or international organizations in implementing its response to the crisis?

International or regional cooperation

As discussed under "consultation of external policy expertise," China has thus far been wary to take on greater international responsibility beyond its capacities. Nonetheless, parallel to its own rescue efforts, it has displayed some efforts to step up its image as a responsible stakeholder in international financial management. As such, China has offered support to other countries especially in Asia, by signing currency swap agreements (e.g., with South Korea and Malaysia). China obviously wants to boost Asian financial cooperation, in which it already occupies a central position.⁴⁶

⁴⁵ Xie Guozhong (Andy Xie), "You fengkuangle" (Crazy Again), xieguozhong.blog.sohu.com/128798351.html (accessed August 4, 2009).

⁴⁶ For an in depth analysis of China's efforts in this context see Zhang/Li/Shi 2009.

5. Funding, Tax and Monetary Policies

- Has the government initiated tax reductions/incentive schemes?
- Have these been aimed at the private and/or the corporate, domestic or the foreign sectors?

Tax policies in support of stimulus/stabilization

The Chinese tax system, even after several rounds of reforms aimed at unifying the national tax code, is still characterized by a considerable degree of regional variation and informal practices (e.g., local administration granting tax exemptions for preferred industries and ad hoc levies imposed on citizens). Apart from the export VAT rebates mentioned above, the stimulus program relies on tax reductions in order to boost private consumption, especially in rural areas. The most important elements of the stimulus are tax reductions for light vehicles, light trucks and an automobile scrapping scheme that provides for a 50 percent sales tax reduction for low emission cars with no more than 1.6 liter engines.⁴⁷

- What kind of policies did the central bank contribute to the national crisis response? Which unconventional measures were used to fight the crisis?
- If an independent national monetary policy is not feasible, were there substituting measures in the country's exchange rate policy?

Monetary and currency policies in support of stimulus/stabilization

When the government announced its fiscal stimulus program in November 2008, it shifted from a “moderately tight” to “moderately loose” monetary policy. As a part of this shift, the central bank incrementally cut its policy rate from 7.47 percent to 5.31 percent (where it has stayed since then) and lowered the required reserve requirements from 17.5 percent to 14 percent.⁴⁸

In October 2008, the PBoC began lifting credit quotas. This measure, arguably the PBoC's most effective measure since the crisis began, set off a huge lending surge of 7.37 trillion yuan by Chinese commercial banks in the first half of 2009 (see “structural distortions”). Indeed, this amount is considerably more than the 275 billion yuan released by the PBoC itself in regular open market operations during the same period.⁴⁹

⁴⁷ For the details see Naughton 2009a, 9 and Barry Naughton (2009 b), China's Emergence from the Economic Crisis, China Leadership Monitor N. 29, Summer 2009, 7.

⁴⁸ On China's monetary policy see World Bank, China Quarterly Update December 2008, March 2009 and June 2009 and Asian Development Bank, Asia Economic Monitor July 2009.

⁴⁹ See Caijing (online) July 29, 2009 “Keen Eyes Fixed on China's Monetary's Policy” in: http://www.english.caijing.com.cn/2009-07-29/110215562_1.html (accessed August 20, 2009).

In China, the initiation of a more contractive monetary policy relies on remnant “command economy” methods that are not employed in other major economies. Instead of using market mechanisms to absorb liquidity, the PBoC as well as the Chinese Banking Regulatory Commission, directly addressed commercial banks in June 2009 and ordered them to cap or even stop lending (as was the case with the Bank of China).⁵⁰ As a result, in July 2009, new bank loans dramatically dropped by more than 75 percent to 356 billion yuan compared with 1,530 billion yuan in June 2009.⁵¹ In general, monetary measures derive from decisions made by a very small group of top-ranking economic policymakers who define current priorities and initiate policy shifts.

China’s currency policy, especially what is assumed to be an undervaluation of the Chinese yuan against the U.S. dollar, has for years been a bone of contention between Chinese and U.S. policymakers as well as among China scholars. From June 2005 to the outbreak of the crisis in 2008—a period in which China ended its decade-long fixed exchange rate vis-à-vis the U.S. dollar and introduced a more flexible management vis-à-vis a basket of currencies—the yuan appreciated against the U.S. dollar on a nominal basis from 8.277 yuan per dollar (June 2005) to 6.818 yuan per dollar (September 2008).

Since September 2008, the yuan has gradually depreciated, reaching a low in December 2008 of 6.87. As this has taken place within the context of China’s exports downturn, Chinese policymakers have attempted to support China’s export industries without raising Washington’s concerns about unfair Chinese trade measures.⁵² It should be noted that the actual level of depreciation is expected to be larger if one takes into account exchange rate substitutes like rebates on export taxes or special loan programs for export industries.

⁵⁰ This is not to say that market mechanisms were not used. Indeed, the PBoC did raise repo rates or issued notes that commercial banks had to buy. The steps taken, however, pale in comparison with the non-market tools used.

⁵¹ Financial Times (Online) August 11, 2009 “China’s Economy Cools as Lending Slows.”

⁵² For an in-depth analysis of China’s exchange rate policy see Morris Goldstein and Nicholas Lardy, “The Future of China’s Exchange Rate Policy,” Washington: Peterson Institute for International Economics, Policy Analysis in International Economics No. 87, July 2009.

- Relative to conditions at the outset of the crisis, does stimulus funding have a solid foundation in monetary policy or in bond/credit markets?
- Is the program part of the normal budget/integrated into the budgetary cycle, or is it financed primarily from sources outside of the formal budget?
- Is there cross-level burden-sharing between center and regions (e.g., debt issuance, fund transfers)?
- Is financial aid given to banks/companies/households in a discretionary way or based on well-defined formulas (e.g., conditionalities)?
- Did the government make credible commitments to terminate its expansionary fiscal and monetary policies under (what kind of) post-crisis conditions?

Credibility of
funding
mechanisms

Delineating how China is funding its stimulus plan is extremely complex in part because the stimulus plan overlaps with monetary policy.⁵³ China's stimulus funding differs significantly from that found in other countries. In China, the central government contributes only a small proportion, about one-fourth, of all funds (1.18 trillion yuan out of the overall sum of four trillion). The government intends to raise this 1.18 trillion by issuing bonds over a two-year period from 2008 to 2010. The remainder of the four trillion is to be provided by local governments, state-controlled enterprises and "the market" (i.e., government-linked financial institutions and non-public firms under government guidance).

Technically speaking, local governments must not incur debt by borrowing from local banks or by issuing bonds. The central government has therefore introduced new means of circumventing this restriction, including permitting the Ministry of Finance to issue bonds on behalf of local governments and allowing private companies to issue corporate bonds for projects with promising future yields. For local governments, the most common means of raising money is for them to make use of "city investment companies," which borrow from banks on their behalf. In reality, this means that the lion's share of stimulus funding is made available through the banking system. This is a very efficient way to tap money since the local banks do not hesitate to lend for government-guaranteed projects. Moreover, there has obviously been competition among some local and regional party leaders over who would provide the most funds for projects supported by the central government.⁵⁴ It should also be noted that Chinese banks have a history of inflated loan-writing because asset and market share are major criteria for assessing their performance.

⁵³ For an overview and details see Naughton, 2009a, 3-6.

⁵⁴ The Financial Times cites a Chinese economist who was taken aback when learning from a provincial governor that he considered the surge in bank lending as his greatest political success in 2009. See Financial Times (Online) July 8, 2009 "China's Banks Lend with Communist Zeal."

A closer look at the composition of bank-lending sources shows the Bank of China to be the single biggest lender, providing more than one trillion yuan. Considerable sums have also been lent by China's three other major state owned-banks, namely the Agricultural Bank of China (859 bn), China Construction Bank (709 bn) and ICBC (865 bn), bringing the sum lent by these four banks to 3.433 trillion yuan (46.5% of the total). As *Caijing* magazine reports, the medium-sized joint stock commercial banks, policy banks and city commercial banks have been the driving force for lending growth as the central government has grown increasingly vigilant about lending since May 2009.⁵⁵ Loans that had hitherto been restricted to provincial capitals now also flow to second or third-tier cities.

It is unknown how much local governments have borrowed through their city investment companies. Some Chinese media report that lending by Chinese local governments has reached 10 trillion yuan.⁵⁶ For many local governments, paying back the loans is based on continuing revenues from land sales and corporate taxes, which are of course contingent on the overall economic situation. The National Audit Office of China has reported that the financial conditions of some localities, which have not been able to come up with their "matching funds" on time, have already slowed down the implementation of some projects.⁵⁷

6. Feedback and Lesson-Drawing

- Have there been revisions or additions to the original policy packages or a sequence of distinct stimulus policies in response to unexpected new developments?

Policy feedback and adaptation

As indicated under "policy contents," the government revised in March 2009 the original stimulus plan of November 2008. There have also been some minor changes made to social policy regulations. Policy learning has taken place in areas that did not directly translate into changes being made to contents of the stimulus plan. As discussed under "public communication," however, the government has shifted in its handling of the stimulus to adjust to new conditions. Indeed, as the economy gained momentum, the Chinese leadership felt increasingly confident and thus permitted criticism of certain elements of the stimulus. As a result, official reporting on the stimulus pack-

⁵⁵ *Caijing* (online) June 30, 2009 "Where Did That 7 Trillion Come From?"

<http://english.caijing.com.cn/2009-07-30/110218623.html> (accessed August 4, 2009)

⁵⁶ *Financial Times* (Online) July 15, 2009 "Beijing Keeps Foot on Accelerator"

⁵⁷ *Economic Observer* Online June 1, 2009 "Mitigating Debt Bomb for Chinese Local Governments", in: http://www.eeon.com.cn/ens/finance_investment/2009/06/01/138892shtml (accessed July 23, 2009)

age is now more transparent and consistent. Agencies such as the National Audit Office have bent over backwards to make clear to the public that concerns about fraud and corruption are taken seriously. By far the most spectacular case involved criticism voiced by Yan Yiming, a Shanghai lawyer calling for transparency in the appropriation of government funds. As thousands of Chinese “netizens” joined in support of his efforts, the NDRC was forced to publish the exact distribution of the funds for the respective projects on its homepage.⁵⁸

- Has major institutional reorganization/capacity-building been undertaken in financial supervision?
- Do we find new institutions that were not in place prior to the crisis (e.g., bad banks)?

Institutional restructuring

To date, the Chinese government has not undertaken any major institutional restructuring that would be comparable, for example, to establishing bad banks or overhauling financial market regulation. Chinese economic and financial bureaucracies have been undergoing constant institutional reshuffling for many years. The regulatory authority of new supervisory bodies in the financial sector is still shaky.

The 2008–2009 stimulus program has already exerted a discernible influence on the distribution of powers and funds among China’s major economic bureaucracies. Those administrative bodies that are in charge of planning and implementing the stimulus have clearly benefited from the program. This is especially true for the National Development and Reform Commission (i.e., the former State Planning Commission, which has been comprehensively reorganized), the Ministry of Finance, the Ministry of Railways (which commands the most centralized and nationally integrated administrative apparatus among all government ministries) and the Ministry of Industry and Information Technology (which is in charge of a plethora of newly launched industrial policies).⁵⁹ The increasing powers of these “big spending” economic bureaucracies have come at the expense of “non-spending” regulatory and supervisory bodies and, most conspicuously, the Ministry of Environmental Protection, which not only saw its funds reduced in the March 2009 revision of the original stimulus plan but also has been sidelined in its role as a watchdog for investment projects.⁶⁰

⁵⁸ For more on the case of Yan Yiming, see New York Times January 7, 2009 “Lawyer Demands that Chinese Government Open Its Book.”

⁵⁹ On the role of the Ministry of Industry and Information Technology see Naughton 2009b, 5-7.

⁶⁰ The Chinese Economic Weekly, “Economic Observer,” which is based on official Chinese numbers, reports that out of more than 200,000 investment projects now under way only one out of 590 projects has the formal approval of the Ministry of Environmental Protection; Economic

7. Tentative Economic Impact

Keeping in mind that the official Chinese data are to be treated with caution, the stimulus fulfilled its main short-term aims, that is, to defend the real economy so as to sustain eight percent growth, to buy time for the export-oriented economy, and to hedge the rise in unemployment so as to guarantee social stability.⁶¹ These measures, however, have fallen far short of addressing the medium- and long-term structural deficits of China's economy. On the contrary, it has even reinforced some of its most salient imbalances.

- What do major economic performance indicators tell us about the short-term effectiveness of the crisis response (e.g., growth rate, unemployment rate, industrial output, private consumption, consumer/producer confidence, inflation, exports, bank balance sheets, credit squeezes)?
- How has the political logic of crisis management (i.e., crisis as an opportunity to broaden political support) worked out for the major decision-makers so far? How has the reputation of major government leaders at the center of the crisis response evolved (e.g., based on polls, election results, backing within their political party)?

Economic and political effectiveness of the crisis response

The stimulus has so far been effective in upholding China's GDP growth in the range of eight percent, the government's official target figure. In the first half of 2009, China's industrial output rose by 10 percent and the country's GDP registered a growth rate of 7.1 percent (Q1/2009 6.1%, Q2/2009 7.9%). On a quarterly basis (data are not published on a quarter-to-quarter basis in China), the second quarter even saw a hefty 16.5 percent growth in industrial output compared to the previous one.⁶² This is no small feat, especially given that several analysts had, at the beginning of 2009, deemed a negative growth rate possible. In the meantime, most international organizations and financial institutions have revised their growth projections to figures near or even above China's official eight percent target.⁶³ That the Chinese economy

Observer Online July 10, 2009 "From Stimulus to Restructuring"

<http://www.com.cn/ens/faecture/2009/07/10/143395.shtml> (accessed August 19, 2009).

⁶¹ At least the following facts warrant a cautious handling of the Chinese numbers: As has been so often the case in the past, the added GDP numbers as reported by the provinces exceed the numbers as reported by the National Bureau of Statistics. See Financial Times (online) August 4, 2009 "China's Growth Figures Fail to Add Up." Derek Scissors has calculated that the figures at the expenditure side of the GDP (fixed investment+retail sales+net exports) equal 112% of GDP. See: Derek Scissors "China Refuses to Adjust Its Economy" Heritage Foundation Web Memo Number 2546, July 16, 2009.

⁶² This is a calculation by Goldman Sachs as cited in: Economist July 16th, 2009 "A Fine Rebalancing Act"

⁶³ For international organizations the growth rates are 7.2% (World Bank China Quarterly Update June 2009), IMF (World Economic Outlook Update July 2009), ADB 7.0% (ADB Development Outlook 2009), OECD 7.7% (Economic Outlook June 2009) Investment Banks

might have bottomed out is also mirrored in China's business climate index and enterprise confidence index, both of which have climbed into positive territory. These data come at a time when inflation seems distant, as China's consumer price index (-1.1% year-on-year in the first half of 2009) and producer prices (-5.9%) show.

- Is there early evidence that the structure of the economy will change (e.g., greater role of the state, changes in sectoral shares in GDP)?
- Could old structural imbalances be aggravated? Can we already identify new structural imbalances? Have previously existing imbalances been tackled?

Structural distortions

China's economic rebound comes at the cost of several continuing structural imbalances that the stimulus package also sought to address. The Chinese economy is now even more dependent on investment in fixed assets, which grew 33.5 percent on a year-on-year basis. Retail sales as a proxy for private consumption also picked up, though at a rate of 15 percent only. Nevertheless, this rate is about twice as much as it was in previous years. If we deconstruct China's 7.1 percent growth rate for the first half of 2009, we see that investment accounted for 6.2 percentage points and consumption only for 3.8 percentage points of growth (net exports for -2.9 percentage points).⁶⁴

To discuss in depth whether the boom in fixed asset investment is based on commodities speculation and leads to damaging excess capacity goes beyond the scope of this paper.⁶⁵ However, some preliminary thoughts may suffice: most of the investment is targeted not at specific industries (e.g., steel, chemicals) but at infrastructure, which rose by 58 percent in the first half of 2009. Even though considerable efforts have been made in the last ten years to resolve China's infrastructure bottlenecks, there is still much to do, especially in improving railway transportation, which has lagged considerably behind highway construction. The officially reported increase in railway investments (up 126%) over road transportation (up 55%) should be greeted positively.

like Goldman Sachs (8.3%) or JP Morgan Chase (8.4%) even have higher forecasts. See Bloomberg News June 18, 2009 "World Bank Raises China Growth Forecast, Says Stimulus Is Adequate."

⁶⁴ China Daily (Online) July 16, 2009 "China's GDP Grows 7.9% in Q2" http://www.china.org.cn/business/news/2009-07/16/content_18147032.htm (accessed August 20, 2009)

⁶⁵ For a critical assessment see: Andy Xie "Fear the Dark Side of China's Lending Surge" *Caijing* (Online) June 19, 2009; for positive judgements stressing that China's infrastructure situation is still very much underdeveloped see: Min Ye "China's massive Stimulus and US Steel Companies," *Morningstar* (online) July, 30, 2009; Qing Wang "Railways vs. US Government Bonds: Putting China's "Overinvestment" in Context," *Morgan Stanley Global Economic Forum* July 29, 2009.

As a result of the Chinese banks' lending spree, broad money (M2) grew 28.6 percent in the first quarter of 2009, a 10 percent increase over the end of 2008. New loans grew a staggering 34.5 percent in the year to June; on average, Chinese banks lent a monthly average of 1.23 trillion yuan. Total lending by the end of 2009 could reach more than 10 trillion yuan, a figure well above the official target of eight trillion.⁶⁶ This trend suggests that a new, dangerous rise in non-performing loans may be underway. Some local governments could become so over-indebted that the central government would be forced to pick up the bill. By the summer of 2009, warnings of a ticking financial time-bomb had become common in the Chinese press, with commentators pointing to the obvious need to find other means of financing local governments.⁶⁷

Lending itself still goes primarily to the big state-owned enterprises. Cash-strapped private SMEs, however, continue to face poor borrowing conditions, leaving them with little choice other than to turn to the informal financial market.

Chinese share prices have soared 80 percent from their lows in November 2008 and the housing market—at least in some of China's big cities—also shows signs of a bubble inflating. There is the widespread belief that the government will do whatever it takes to prop up the markets ahead of the 60th anniversary of the founding of the PRC.

From the Chinese perspective, the stimulus has not explicitly been aimed at reducing the country's trade dependency or at helping it bring down global imbalances. Nevertheless, as a side effect of this year's shrinking trade, China's current account surplus will considerably decrease thereby possibly limiting criticism about "China's mercantilist trade policy."⁶⁸ The Chinese government has basically left untouched its exchange rate policy, despite all its recent criticism of the U.S. dollar as the world reserve currency and its accompanying rhetoric about the Chinese yuan taking on a more prominent future role. While the composition of China's U.S. dollar holdings has changed, its trend of buying dollars in order to drive its foreign exchange reserves still higher (to \$2.13 billion at the end of June 2009) has remained consistent.

⁶⁶ People's Daily August 4, 2009 "Loans Dip Likely in July, Analysts Say," in <http://english.people.com.cn/90001/90778/90857/90859/6717683.html> (accessed August 4, 2009).

⁶⁷ See for example: Economic Observer Online July 30, 2009 "We need to Find a Better Way of Financing Local Governments," <http://www.eeon.com.cn/ens/Observer/editorial/2009/07/30/146151.shtml>. (August 5, 2009); Economic Observer Online June 1, 2009 "Mitigating Debt Bomb for Chinese Local Governments", in: http://www.eeon.com.cn/ens/finance_investment/2009/06/01/138892.shtml (accessed July 23, 2009).

⁶⁸ According to Paul Cavey the current account surplus will fall to 6% in 2009 and 4% in 2010. Cited in The Economist July 30, 2009 "The Spend Is Nigh."

8. Concluding Remarks

As the dynamics of the current economic crisis are not yet fully understood and still unfolding, one has to be extremely cautious in asserting the success or failure of the government-sponsored stimulus and stabilization programs, or assessing the causal mechanisms, medium-term consequences and international and regional repercussions attached to these programs.

Indeed, there is considerable debate over whether the Chinese stimulus has been successful or not. To some it is “the gold standard” of all stimulus packages (Nicholas Lardy). Others simply dismiss it as “old and comparatively small” (Derek Scissors) or as a “missed opportunity” for China.⁶⁹

The Chinese government has thus far succeeded in achieving its short-term objectives--ensuring an eight percent growth rate and battling unemployment so as to buy time while simultaneously accepting the negative structural consequences. In its overall political logic, the Chinese stimulus does not differ very much from the approach of Western countries. Many elements, however, set China’s case apart:

- At the outset of the crisis, China, because of its closed financial account, was far less exposed to the international financial contagion. In China, the crisis did not originate in the financial sector but in parts of its export-oriented economy.
- Even before the collapse of Lehman Brothers, the Chinese authorities were already in a state of alert and had prepared for the worst.
- The Chinese government was able to jump-start its stimulus swiftly by relying on the hierarchical channels of Communist Party rule and by reactivating investment planning procedures that stem from command economy times.
- The bulk of financing does not come from central government funds but from the local authorities, which turn to the local branches of state banks to get the cash they need.

⁶⁹ For a positive assessment see: Naughton 2009a; Nicholas Lardy „China’s Role in the Origins of and Response to the Global Recession”, Peterson Institute for International Economics, Transcript of testimony at the hearing before the US-China Economic and Security Review Commission, February 17, 2009; for a rather sceptical look on the stimulus package see Derek Scissors “China’s Stimulus: More of the Same , And Not That Much More”, Heritage Foundation April 20, 2009; DB Research “Responding to the Crisis: Did Brazil and China Miss an Opportunity?” DB Research Talking Point Series, August 17, 2009.

- If fiscal stimulus policies mean a comeback of big government, this is especially true in the Chinese case. By swiftly lifting the credit quotas in the banking system, the government enabled state-owned banks to lend freely to local governments, which in turn handed over the investment contracts for the projects to state-owned companies.

It is extremely difficult at this point to determine the causal mechanisms for China's economic rebound and, more specifically, to gauge the role of the stimulus plan in this rebound. Based on growth accounting, the infrastructure investment boom has predominantly driven growth so far, with private consumption buoyant yet still lagging behind and net exports even shaving growth off. In 2009, the stimulus itself only accounts up for about two trillion yuan out of a total of 13 trillion in fixed investment.⁷⁰

The Chinese stimulus program might be best understood as a means of political signaling, expressing the leadership's strong commitment to reverse its course in the autumn of 2008. In other words, it signals a commitment to stopping the contractionary fiscal and monetary policies that had been designed to prevent overheating in the economy and instead to mobilize all available resources to jumpstart growth again. Indeed, the stimulus relied heavily on an investment-led growth pattern that had yielded impressive results in the past.

Nevertheless, the Chinese stimulus should not be reduced to its public infrastructure components. Long-term development goals as well as improvements in people's livelihood rank high on its agenda. The focus on investment is not a result of flawed design but a consequence of the central government's decision to give local administrations considerable leeway so as to ensure a prompt economic turnaround, even at the cost of postponing the necessary adjustments. With China's economy on its way to reach the eight percent annual growth target in 2009, the government is facing criticism by a growing number of outspoken economists, policy advisors and business journalists demanding that it turn its attention to unresolved structural imbalances in the economy.⁷¹

The relationship between China's stimulus and the international and regional economic environment and other countries' stimulus measures are also far from clear. In many accounts, China is seen as the driver behind the upturn

⁷⁰ Naughton 2009b, 4.

⁷¹ See for example: Caijing (Online) August 18, 2009 "Careful Steps Toward a Stimulus Exit Door" <http://english.caijing.com.cn/2009-08-18/110226471.html> (accessed August 19, 2008); See interview of the Economic Observer with the former PBoC Vice Governor Wu Xiaoling, now Vice Director of the Financial and Economic Affairs Committee of the Chinese Parliament: Jingji Guanchawang June 29, 2009 "Jiegou tiaozheng ying you shichang zhu dao" (Economic Restructuring Should Take the Market as the Guiding Principle), in: <http://www.eeo.com.cn/eeo/jjgcb/2009/06/29/141681.shtml> (accessed August 20, 2009)

in East Asia.⁷² This, however, should not be interpreted as China pulling the rest of Asia out of the recession by virtue of its increased demand for foreign goods. A surge in Chinese demand can mainly be observed for certain commodities (e.g., oil and iron ore) whose imports registered new records in July 2009 but which China does not buy from its East Asian neighbors. Quite on the contrary, China's merchandise trade with its Asian neighbors suffered more during the downturn than its trade with the United States and the European Union. China may be winning market shares in many countries, but its imports from Asia are still declining with double digit percentage rates even if they have begun to bottom out (imports from Asia fell by 18% in June 2009 compared to 28% in May 2009 or 47% in January 2009).⁷³ China's contribution to the Asian rebound may—at least at the time of this writing—have less to do with hard economic facts than with psychology. As early as November 2008, China signaled to the outside world its unwavering commitment to fight the economic crisis, thereby causing a sudden burst of optimism that drove up commodity prices and stock markets. For their recoveries, emerging economies in Asia mainly relied on investment and consumer spending at home as part of their own aggressive fiscal and monetary stimulus packages.⁷⁴

⁷² See for example Financial Times (Online) June 11, 2009 “Decoupling Gains New Group of Cheerleaders.”

⁷³ According to the official numbers from the Chinese Ministry of Commerce trade with Asia declined by 25.3% in the first half of 2009 whereas trade with the US and the EU sank by 16.6% and 20.9% respectively. China's imports (i.e. Asia's exports to China) during that period: Japan: -25.1%, ASEAN countries -27.8%, South Korea -22.9%, Hong Kong -41.4%, Taiwan -36.7%. On these numbers see Zhonghua Renmin Gongheguo Shangwubu (Ministry of Commerce) “2009 nian 1-6 yue wo dui Yazhou guojia (diqu) maoyi tongji” (Statistics of China's Trade with Asian Countries (the Asian Region) from January to June 2009) in: <http://yzs.mofcom.gov.cn/aarticle/g/date/1/200907/20090706418881.html> (accessed August 21, 2009)

⁷⁴ See The Economist August 15, 2009 „On the Rebound“.

Study Context

The Bertelsmann Stiftung has a long tradition of assessing the quality of governance and devising evidence-based policy strategies for decision makers.

The **Transformation Index (BTI)** monitors political management, democratic quality and economic development around the world. The BTI encompasses all 128 developing nations and countries in transition that have a population of more than two million inhabitants, and have not yet attained fully consolidated democracy and a developed market economy.

The **Sustainable Governance Indicators (SGI)** offer a complementary focus on the OECD member states. The SGI evaluate the sustainability of political action in 15 different policy fields (from economy, labor, and education to environment, research and development), the quality of democracy and questions of strategic management capability in each of the 31 OECD countries.

The study *Managing the Crisis* is a joint initiative of the two projects.

BTI Contact

Sabine Donner, Hauke Hartmann
Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
33311 Gütersloh
www.bertelsmann-transformation-index.de/en

SGI Contact

Thorsten Hellmann, Andrea Kuhn,
Daniel Schraad-Tischler
Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
33311 Gütersloh
www.sgi-network.de