



**Australian Government**  
**Productivity Commission**

# China's Policy Responses to the Global Financial Crisis

Yu Yongding

Richard Snape Lecture  
25 November 2009  
Melbourne

© COMMONWEALTH OF AUSTRALIA 2009

ISBN 978-1-74037-295-4

This work is subject to copyright. Apart from any use as permitted under the Copyright Act 1968, the work may be reproduced in whole or in part for study or training purposes, subject to the inclusion of an acknowledgment of the source. Reproduction for commercial use or sale requires prior written permission from the Attorney-General's Department. Requests and inquiries concerning reproduction and rights should be addressed to the Commonwealth Copyright Administration, Attorney-General's Department, Robert Garran Offices, National Circuit, Canberra ACT 2600.

*This publication is available in hard copy or PDF format from the Productivity Commission website at [www.pc.gov.au](http://www.pc.gov.au). If you require part or all of this publication in a different format, please contact Media and Publications (see below).*

**Publications Inquiries:**

Media and Publications  
Productivity Commission  
Locked Bag 2 Collins Street East  
Melbourne VIC 8003

Tel: (03) 9653 2244  
Fax: (03) 9653 2303  
Email: [maps@pc.gov.au](mailto:maps@pc.gov.au)

**General Inquiries:**

Tel: (03) 9653 2100 or (02) 6240 3200

**An appropriate citation for this paper is:**

Yu, Y. 2009, *China's Policy Responses to the Global Financial Crisis*, Richard Snape Lecture, 25 November, Productivity Commission, Melbourne.

JEL codes: E52 E62 G01

***The Productivity Commission***

The Productivity Commission, is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by consideration for the wellbeing of the community as a whole.

Information on the Productivity Commission, its publications and its current work program can be found on the World Wide Web at [www.pc.gov.au](http://www.pc.gov.au) or by contacting Media and Publications on (03) 9653 2244

---

# Contents

<b>Foreword</b>	<b>V</b>
<b>China's policy responses to the global financial crisis</b>	<b>1</b>
1 The features of China's growth pattern	2
2 China's policy responses to the global economic crisis	10
3 The long-term impact of the stimulus package and expansionary monetary policy	11
4 The rebalancing of the Chinese economy and the safety of China's foreign exchange reserves	13
5 Concluding remarks	14

---

## Productivity Commission

### Richard Snape Lecture series

- 2009     *China's Policy Responses to the Global Financial Crisis*  
Professor Yu Yongding  
Chinese Academy of Social Sciences
- 2008     *Latin America in the Global Economy: Challenges and Opportunities*  
Vittorio Corbo  
Governor of the Central Bank of Chile 2003–2007
- 2007     *Economic and Regulatory Reforms in Europe: Past Experience and Future Challenges*  
Patrick Messerlin  
Director, Groupe d'Economie Mondiale  
Institute d'Etudes Politiques de Paris
- 2006     *The World Economy in the New Millennium: A New Golden Age?*  
Deepak K. Lal  
James Coleman Professor of Development Studies  
University of California Los Angeles
- 2005     *Will Asian Mercantilism Meet its Waterloo?*  
Martin Wolf  
Associate Editor and Chief Economics Commentator, *Financial Times*
- 2004     *Spreading Prosperity and Resisting Economic Divergence:  
The Significance of Richard Snape's Academic Legacy*  
Anne O. Krueger  
First Deputy Managing Director, International Monetary Fund
- 2003     *40 Million Aussies? The Immigration Debate Revisited*  
Professor Max W. Corden  
Emeritus Professor of International Economics  
Johns Hopkins University

---

# Foreword

Richard Snape capped a long and distinguished career as Professor of Economics at Monash University with a new and accomplished career at the Industry Commission, and then as Deputy Chairman of the Productivity Commission. In the eight years that he spent at the Commission before his untimely death in October 2002, he played a pivotal role in overseeing our research program, as well as participating in major public inquiries.

This is the seventh in a series of lectures in memory of Richard Snape. With Richard's own interests and high standards in mind, the lecture series elicits contributions on important public policy issues from internationally recognised figures, in a form that is accessible to a wide audience.

We are fortunate to have Professor Yu Yongding as this year's lecturer. Professor Yu's distinguished career includes appointments as Director-General of the Institute of World Economics and Politics at the Chinese Academy of Social Sciences, member of the Monetary Policy Committee of the People's Bank of China, and member of the National Advisory Committee of the 11<sup>th</sup> Five Year Plan for National Economic and Social Development of the People's Republic of China. The theme of Professor Yu's presentation — China's policy responses to the global financial crisis — provides timely insight into what is perhaps the most significant economic challenge of the post-war era.

I am grateful to Professor Yu Yongding for agreeing to come to Australia to present the Richard Snape Lecture for 2009.

Gary Banks AO  
Chairman

November 2009

---

## **RICHARD SNAPE 1936 – 2002**

Richard Hal Snape was Deputy Chairman of the Productivity Commission and Emeritus Professor of Monash University. He was a Board Member of the Australian Research Council, Fellow of the Academy of the Social Sciences in Australia and a Distinguished Fellow of the Economic Society of Australia.

## **YU YONGDING**

Yu Yongding was until recently Director-General of the Institute of World Economics and Politics at the Chinese Academy of Social Sciences in Beijing, where he is a Professor at the Post-Graduate School. He is President of the China Society of World Economics, Editor of *China & World Economy*, and Associate Editor of *Asian Economic Policy Review*.

Professor Yu was formerly a member of the Monetary Policy Committee of the People's Bank of China, and a member of the National Advisory Committee of the 11th Five Year Plan for National Economic and Social Development of the People's Republic of China. He has authored, co-authored and edited a dozen books, and published numerous papers and articles. His main research interests are in macroeconomics and the world economy.

---

# China's policy responses to the global financial crisis

**Yu Yongding**

Since reforming and opening up its economy, China has created an economic miracle. Its average annual rate of GDP growth over the past three decades was 9.8 per cent. This unprecedented growth vastly improved the living standards of the Chinese people. In the period 2002–2007, China registered an average annual growth rate of 10.5 per cent, while the inflation rate was kept under 2 per cent. This period can be said to be the best period over the past three decades as far as macroeconomic performance is concerned.

In 2007, China's GDP growth rate was 13 per cent. In 2008 China's GDP growth fell gradually at first, and then after the Lehman Brothers fiasco, fell in a dramatic fashion. In the first half of 2008 China was still able to manage an annual growth rate of 10.4 per cent. In the third and fourth quarters, the rate fell to 9 per cent and 6.8 per cent respectively. In the first quarter of 2009, the growth rate fell further to 6.1 per cent.

With hindsight, the turning point of China's growth happened in September 2008, after the Lehman Brothers' bankruptcy. The monthly growth rate of industrial products better reflects the changing fortunes of the Chinese economy. In August and September 2008, the growth rate of industrial products was 14.7 per cent and 11.4 per cent respectively. It dropped to 8.2 per cent and 5.4 per cent in October and November 2008. In February 2008, China's CPI hit 8.7 per cent, the highest in more than a decade. But the CPI index fell to 2 per cent in November and has remained negative since then, though sequential CPI growth has turned positive recently. The fall of the Producer Price Index since August 2008 was even more dramatic.

There is no doubt whatsoever that the single most important impact of the global financial crisis on the Chinese economy came from the fall in global demand which reflected China's extremely high export dependency. Indeed, China's export dependency is the highest among the major world economies. China's export to GDP ratio in 2007 was 35 per cent. In November 2008 exports shrank by 2.2 per cent over the year, compared with a positive growth rate of 25 per cent in September. The fall of exports may have cut GDP growth 3 by percentage points. If

---

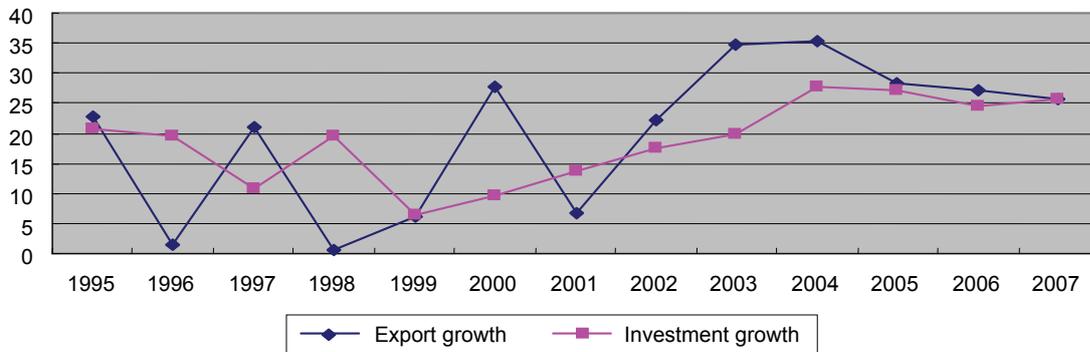
its indirect impact is included, it may have shaved more than 5 percentage points off China's 2008 growth rate.

## 1 The features of China's growth pattern

China's high export dependency is a result of China's export promotion policy, which has been in place for decades. However, from the macroeconomic point of view, China's high export dependency is, to a certain extent, attributable to China's overcapacity caused by over investment.<sup>1</sup> This is especially true over the past five years or so.

Fixed asset investment (FAI) and exports were the two most important engines of China's growth during the period 2002–2007. In this period, the average annual growth rate of exports and FAI were 29 per cent and 24 per cent respectively (figure 1). In 2007, the combined contribution of FAI and net exports to GDP growth was more than 60 per cent. Both China's investment rate and export to GDP ratio are strikingly high. These are the two most important characteristics of China's growth pattern.

Figure 1 **Growth rates of exports and investment (current prices)**



*Data source:* Statistical Year Book, various issues, Statistics Bureau of PRC.

FAI has long been the single most important factor contributing to China's economic growth, because of its high growth rate as well as its sizable share in

---

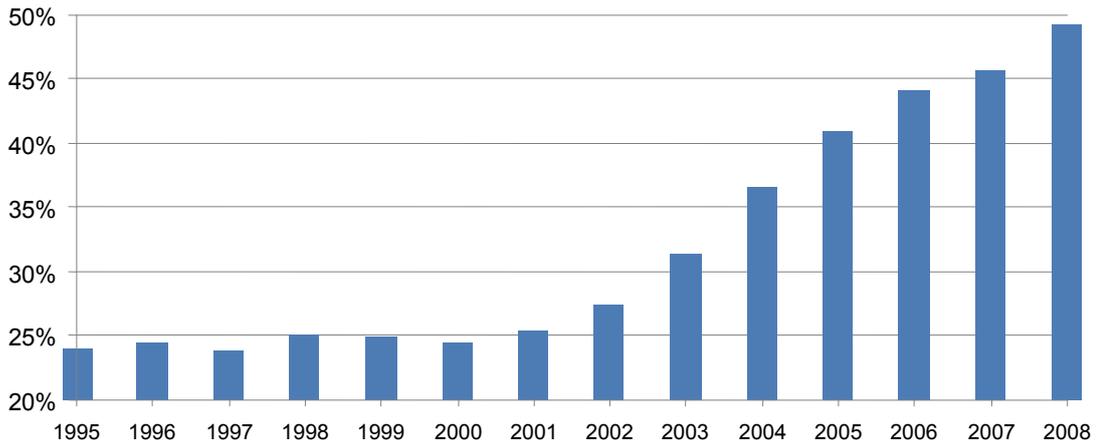
<sup>1</sup> The reason why China has been running current account and capital account surpluses is discussed in detail in Yu, Y. 2007, 'Global imbalances and China', *Australian Economic Review*, vol. 40, no. 1, March, pp. 1–21. The paper is based on the David Finch Memorial Lecture presented by Yu Yongding at the University of Melbourne on 17 October 2006.

---

GDP.<sup>2</sup> A noteworthy phenomenon in the past decade or so is that the growth rate of FAI has been consistently higher than that of GDP and, hence, the investment rate has been increasing persistently since 2001 (figure 2).

Figure 2 **China's investment rates**

---



---

Data source: Zhongjing Net data bank (中经网数据库).

The persistent rise in the investment rate means that growth of the Chinese economy is in a non-steady state. By definition, a steady state means that (1) aggregate demand is equal to aggregate supply (and so are their growth rates); (2) the growth rates of all components of aggregate demand are equal; (3) the shares of all components of aggregate demand are constant; (4) a growth process in a steady state is sustainable. Our question here is that, in a non-steady state, characterized by a constant rising investment rate, how is China's growth drama being played out? Let me set out a framework of analysis first.

1. If the initial steady state is disturbed by an external shock in the form of a sudden acceleration in the growth rate of FAI, the investment rate of the economy increases.
2. Starting from the initial steady state and equilibrium, an increase in the growth rate of FAI means aggregate demand is greater than that of supply and hence overheating occurs.

---

<sup>2</sup> There have been controversies about the FAI real growth rate statistics. However, despite the inaccuracy, it is difficult to deny the fact that the growth rate of FAI in real terms has been consistently higher than that of real GDP.

- 
3. Provided that there is no change in the capital-output ratio, a higher investment rate means a higher potential growth rate of the economy in the future.
  4. However, in the periods immediately following, if growth rates of the other components of aggregate demand remain unchanged, the excess demand caused by the initial rise of the growth rate of FAI, which disturbed the initial equilibrium, will persist until the gap of excess demand narrows gradually to zero. However, the new equilibrium is temporary. Because the growth rate of FAI is higher than that of other components of aggregate demand, the investment rate and hence the potential growth rate will continue to rise. As a result, excess demand (overheating) will shift to overcapacity. Equilibrium is just a transitional stage between the overheating and overcapacity. The specific point in time of the turning point from overheating to overcapacity depends on initial conditions.<sup>3</sup>
  5. It should be emphasized that equilibrium between aggregate demand and supply does not imply a steady state, because growth rates of different components of aggregate supply are different. In other words, the growth is imbalanced. Here, the growth rate of FAI is higher than those of other components of aggregate demand.
  6. If the growth rate of components of aggregate demand other than FAI as a whole fail to rise<sup>4</sup>, overcapacity can only be absorbed by a further rise in the growth rate of FAI. As a result, the investment rate will rise further and so will the potential growth rate.
  7. With both a higher investment rate and a higher potential growth rate, the growth rate of FAI must be increased further and further in subsequent periods so as to absorb overcapacity. Correspondingly, the investment rate will rise further and further and so will the potential growth rate. This implies that although a steady increase in the growth rate of FAI can help the economy achieve equilibrium (aggregate demand = aggregate supply) temporarily, it will worsen the balance of growth of different components of aggregate demand, with investment occupying an increasingly higher share of GDP, and ever widening overcapacity.

---

<sup>3</sup> For example, if the growth of FAI is maintained at the given higher rate after the one-off disturbance, the growth rate of potential GDP will rise gradually in the subsequent periods. At a certain point in time, when the growth of potential GDP has reached a certain rate, which is higher than rates of the rest of the components of aggregate demand but lower than that of FAI, the macroeconomic situation will shift from excess demand to overcapacity.

<sup>4</sup> We assume that there is no endogenous mechanism to ensure that the growth rates of these components of aggregate demand increase so as to catch up with FAI growth.

- 
8. Obviously, the growth rate of FAI cannot accelerate forever. Sooner or later the growth rate of FAI will hit a ceiling imposed by social, environmental, natural resources, ecological or other constraints.
  9. Even if the growth rates of all components of aggregate demand, including FAI, become constant, owing to the fact that the growth rate of FAI is higher than those of the other components of aggregate demand, the investment rate will continue to rise and so will overcapacity. This is an unsustainable process. Under the pressure of overcapacity, eventually, deflation will set in and the growth process of the economy will break down.
  10. To prevent the breakdown of the growth process, either the growth rate of FAI can be lowered, or the growth rates of the other components of aggregate demand can be raised, so that balanced growth of all components of aggregate demand is restored.
  11. If the growth rate of FAI is lowered, the immediate result will be worsening of the overcapacity. However, as a result of the fall of the growth rate of FAI, the investment rate will fall and so will the growth rate of potential GDP. If the growth rate of FAI continues to fall, balance can be restored when the growth rate of FAI is equal to that of the other components of aggregate demand as well as that of GDP.
  12. If the growth rate of other components of aggregate demand is raised, not only will overcapacity be reduced, but growth of all components of aggregate demand will become more balanced. The feasibility of this policy of adjustment depends on external constraints on the potential growth rate.
  13. The balance of growth of all components of aggregate demand, or more precisely, the equality of the growth rate of FAI and that of other components of aggregate demand, is a necessary and sufficient condition for staying at a steady state and maintaining sustainable growth. Government policy should be aimed at pulling the economy back to the steady state following one deviation after another, while recognizing that the steady state itself can be variable, owing to changes in exogenous conditions.

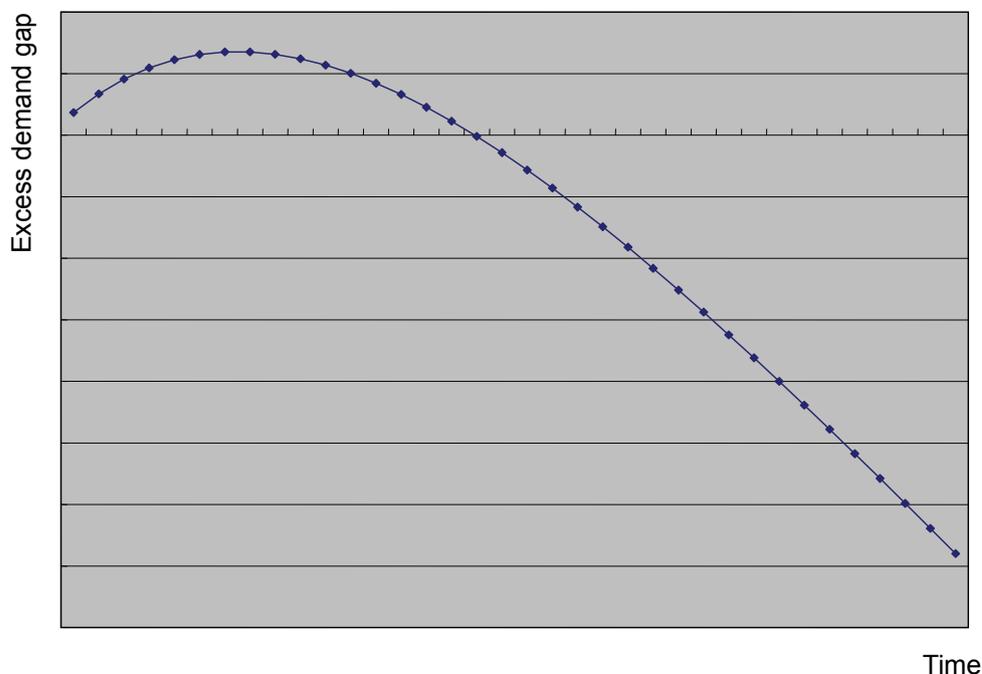
These dynamics can be simulated by numerical examples (figure 3).

The vertical axis and horizontal axis represent the excess demand gap and periods of time, respectively. The positive figures represent a positive excess demand gap to GDP ratio, and the negative figures represent overcapacity (negative excess demand gap to GDP ratio). The shape of the excess demand gap to GDP ratio is determined by various assumptions such as the initial shares of each component of aggregate demand, the initial growth rate, the growth rate of FAI after the initial shock, the

---

Figure 3      **Overheating and overcapacity in tandem (a numerical simulation)**

---



---

*Data source:* Drawn by Dr. Xu Qiyuan.

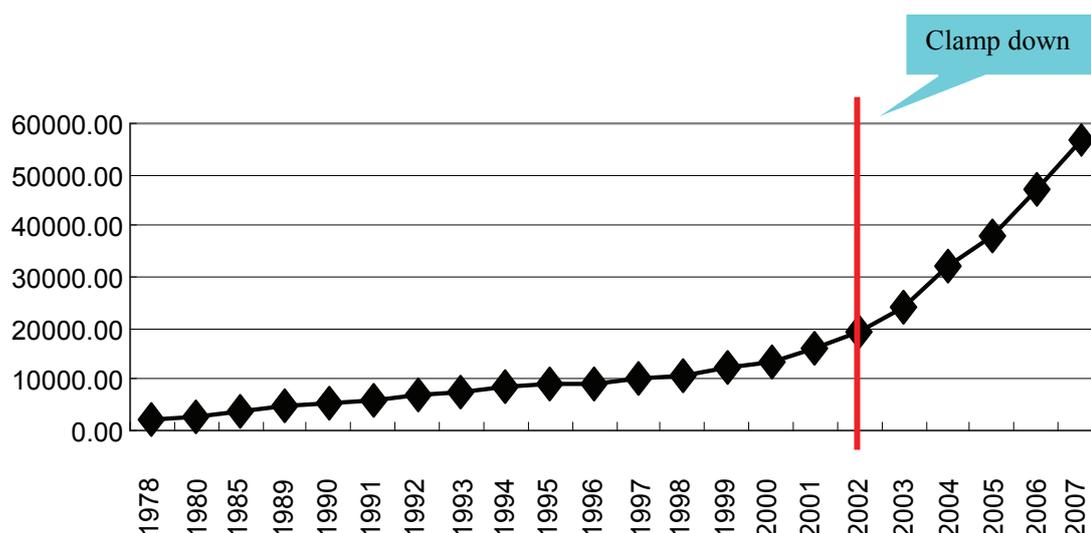
government's reaction to overcapacity, enterprises' responses to the existence of the excess demand gap and so on. In figure 3, it is assumed that, initially, all components of GDP grow at a rate of 8 per cent, and the shares of FAI and consumption in GDP are 40 per cent and 60 per cent respectively — hence, there are only two components of aggregate demand. The capital–output ratio is assumed to be 5. Provided that, as a result of an external shock, the growth rate of FAI jumps to 10 per cent, then in the next period, despite the increase in supply as a result of the higher investment rate in the preceding period, the increase in aggregate demand as a result of the increase in FAI more than offsets the increase in aggregate supply, and the excess demand gap appears. Assuming in the following periods, the growth rates of FAI and consumption remain unchanged at 10 per cent and 8 per cent respectively, the excess demand gap will increase until the 7th period and then the gap will decrease. After the 17th period, overcapacity will appear. If overcapacity is absorbed by increases in FAI in the current period, the overcapacity gap will increase further in the next period.<sup>5</sup> Obviously, this process is not sustainable.

---

<sup>5</sup> In this analysis, the question of how prices will react to changes in the excess demand gap to GDP ratio has not been discussed.

Over the past three decades, overheating and overcapacity occurred in tandem in China. During this process, the fluctuation of the growth rate of FAI has played a pivotal role. Since the turn of the century, the growth rate of FAI has begun to accelerate and surpassed that of GDP, owing to the expansionary fiscal and monetary policies implemented since the Asian financial crisis. As a result, the investment rate has risen since 2001 (figure 2) and overheating (excess demand) has surfaced gradually since 2002. As we have mentioned, a sudden acceleration of the growth rate of FAI will create excess demand immediately afterwards for a period of time, and then after the investment rate reaches a certain level, the economy will shift from overheating to overcapacity. The turning point seems to be 2004, when signs of overcapacity began to surface. The Government tried to clamp down on the launch of new investment projects. The Chinese Government's clamp down on investment in the steel industry was a case in point. In 2004, China's steel production capacity was about 400 million tons. Worrying about overcapacity, the Government started to clamp down on building new steel mills. The Government used administrative methods to ban unapproved construction of steel mills. Perpetrators even got jail terms. However, due to strong demand for steel, attributable to the real estate development fever and strong export demand, new steel mills were mushrooming exponentially. China's steel production rose to more than 600 million tons in 2007 (figure 4).

Figure 4 **China's steel production capacity**  
(unit: 10 thousand tons)



Data source: Collected by Dr Zhang Bin.

---

Despite the fact that China's investment rate was increasing steadily, which implies that overcapacity pressure was building up, until the onset of the US financial crisis, the surfacing of overcapacity was postponed by a further rise in the growth rate of FAI and the accelerating growth rate of exports. Growth was sustained at the expense of a widening imbalance between growth of investment and exports and that of consumption. Due to the investment fever and strong external demand from the middle of 2007, China's inflation rate worsened rapidly.

Since the turn of the century, the Chinese economy has become more and more reliant on external demand, and the share of the current account surplus (mainly the trade surplus) in GDP has been rising rapidly. In 2007 the contribution of the trade surplus to GDP growth was almost 10 per cent of GDP (figure 5). The strong external demand delayed the surfacing of overcapacity for many years.

The trouble is that export demand is highly unstable. More importantly, when the Chinese economy was relatively small, increasing exports to absorb excess capacity was not a big deal. However, as a result of the expansion of the Chinese economy, it has become increasingly difficult for the global market to absorb China's excess capacity. Again, the steel industry is a case in point. China has already become the world's number one steel producer. In 2007, 37 per cent of global crude steel was provided by China. It is easy to see that if external demand collapses, overheating caused by strong investment demand and strong export demand will turn into overcapacity, and inflation into deflation, immediately. In the second half of 2008, export demand collapsed due to the global financial crisis. Long-postponed overcapacity surfaced suddenly.<sup>6</sup> The rapidity of the shift from overheating to a sudden loss of speed, and from inflation to deflation, in September to October 2008 was truly stunning.

China's investment-driven and export-led growth pattern is not sustainable. The investment rate cannot increase forever. The growth rate of China's exports cannot remain persistently higher than that of the global economy. With or without the global financial crisis, overcapacity will surface and correction is inevitable. The global economic crisis exposed the vulnerability of China's growth pattern in a dramatic fashion.

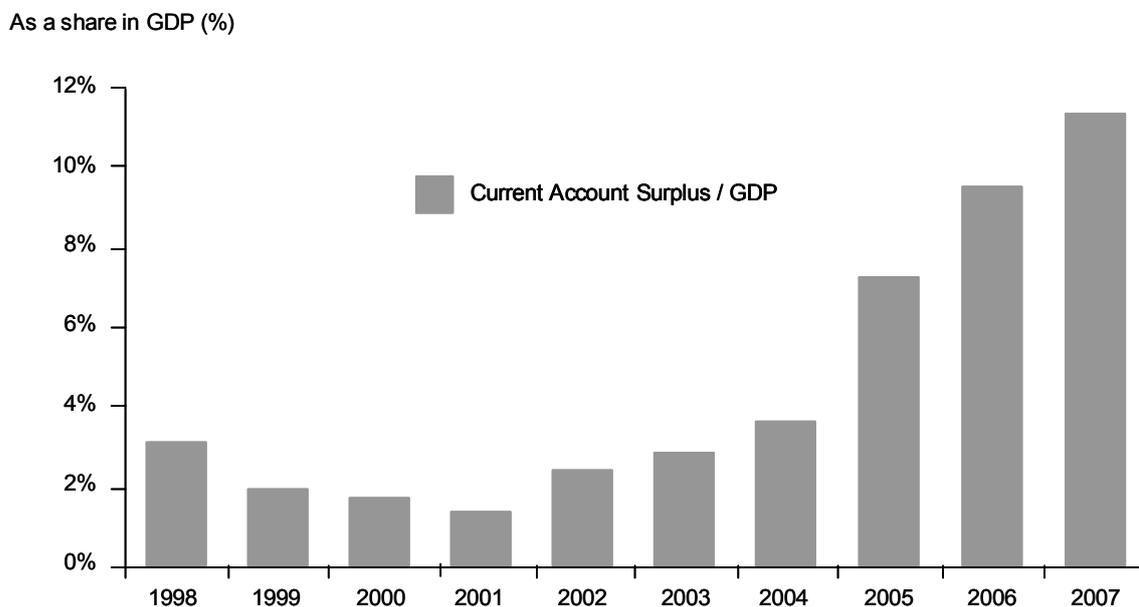
---

<sup>6</sup> Contractionary monetary policy aimed at containing investment fever and asset bubbles began to take effect in 2008, which also contributed to the slowdown of FAI growth.

---

Figure 5 **Share of the current account surplus in GDP**

---



---

Data sources: CEIC, UBS estimates.

## **2 China's policy responses to the global economic crisis**

### **The stimulus package**

Faced with the dramatic fall of GDP growth, the Chinese Government took action swiftly. In November 2008, the Government introduced a Rmb4 trillion stimulus package for 2009 and 2010. The prescribed dosage of the stimulus is very large, at 14 per cent of GDP in 2008. In March 2009, the People's Congress approved the Government's new budget for 2009. According to this budget, in 2009, total government expenditure (central plus local) would be 7.635 trillion Yuan, up 22.1 per cent over the previous year. In 2009, the total government deficit would be 950 billion Yuan (US\$139 billion), the highest in six decades, compared with 111 billion Yuan in 2008. The Central Government deficit will be 750 billion Yuan, 570 billion Yuan more than last year. The State Council will allow local governments to issue 200 billion Yuan worth of government bonds through the Ministry of Finance. The expected budget deficit will be about 3 per cent of GDP in 2009. The expansionary fiscal policy has been a great success, and it played a pivotal role in

---

stabilizing and reviving the economy. However, the success of China's stimulus package is not surprising at all. I have been very confident all along that China will be able to achieve a growth rate as high as 8 per cent. The reason is very simple — China has a very good fiscal position. As long as the Government so wishes, China can spend its way out of the slowdown, as long as it is affordable for the country.

China can afford such an expansionary fiscal policy. Over the past decade, China's budget deficit was very low, and in 2007 and 2008, it ran a small budget surplus and a small budget deficit of 0.4 per cent of GDP respectively. As a result, China's debt should only be about 20 per cent of GDP even after the stimulus. It is easy to see that there is plenty of room for the Chinese Government to use expansionary fiscal policy to supplement the lack of demand caused by the fall in export demand and, to a lesser degree, the fall in non-governmental investment demand.

The Central Government finances one-quarter of the 4 trillion RMB package, in the form of direct grants and interest rate subsidies. In the case of a Central Government-sponsored project, with the approval of the National Development and Reform Commission (NDRC), the Ministry of Finance provides all the funding for the registered capital. Bank credit is the second most important source of finance for the stimulus package. Local governments proposed their own stimulus packages of 18 trillion Yuan. The Central Government will issue 200 billion Yuan in government bonds on behalf of local governments. Commercial bank credit is expected to be the most important source of finance for the local-government-proposed projects.

## **Monetary expansion**

Since 2009, the People's Bank of China (PBOC) has adopted a very expansionary monetary policy to support the expansionary fiscal policy. In the first half of 2009, bank credit increased by 7.3 trillion RMB, which was above the official target for the full year. Credit growth was surprisingly high, and the same was true of the broad money supply, M2, which grew at a record rate relative to GDP. As a result, the inter-bank money market has been inundated with liquidity. In contrast, the annual increases in bank credit in 2006 and 2007 were 3.18 trillion Yuan and 3.63 trillion Yuan respectively. Previously, corresponding to the rapid increase in liquidity caused by the PBOC's intervention in the exchange market, which was aimed at offsetting the appreciation pressure on the RMB created by the persistent trade surplus (and capital account surplus), the PBOC sold a large amount of central bank bills to mop up the excess liquidity. Since the fourth quarter of 2008, the PBOC has almost stopped selling more bills. As a result, liquidity has inundated the inter-bank money market, and once even made the interest rates in the inter-bank

---

market lower than interest on deposits with commercial banks with the same terms of maturity. This phenomenon was described in China's banking circles as 'flour being more expensive than bread'.

China's financial conditions have been very different from those in the United States and Europe during the global financial crisis. China had just completed overhauls of its banking system by writing off non-performing loans and injecting a large amount of capital. Its banking system was relatively safe and sound when the Western banking system was on the edge. As a result, there was no liquidity shortage, no credit crunch, and the monetary multiplier in China has not fallen as dramatically as in the United States. Therefore, the dramatic increase in liquidity in the inter-bank money market has been duly translated into a rapid increase in bank credit and broad money.

### **3 The long-term impact of the stimulus package and expansionary monetary policy**

The very expansionary fiscal and monetary policies have succeeded in arresting a fall in growth. However, the medium and long-term impacts of the expansionary policies are worrying.

First, the most important feature of China's growth pattern is investment overdrive. China's investment rate has been increasing steadily since 2001. The rate has increased from 25 per cent in 2001 to 50 per cent as a result of the stimulus package that is centered on FAI. This means that China's overcapacity will become more serious in the future.

Second, China's investment efficiency has been falling as a result of the stimulus package. The Government knows very well that the Chinese economy has been suffering from overcapacity. Therefore, government-financed investment in the stimulus package is concentrated in infrastructure, rather than new factories. However, there are still problems with an infrastructure-centered stimulus package. With an investment rate of 50 per cent and a GDP growth rate of 8 per cent, the incremental capital-output ratio will be as high or more than six. In comparison, Japan's incremental capital-output ratio was about three. From 1991-2003, China's incremental capital-output ratio was 4.1. The fall of investment efficiency will have an important negative bearing on China's long-term growth.

Third, infrastructure investment is long-term investment and will take a long time to create revenue streams. Furthermore, despite the fact that investment in infrastructure has the virtue of avoiding overcapacity, investment in infrastructure

---

without accompanying investment in manufacturing capacity means investment in infrastructure will not bring returns. Where will tolls come from, if there is no traffic in an eight-lane highway? To make things worse, due to the hasty and under-supervised implementation, waste in infrastructure construction is ubiquitous. All this means not only low efficiency but possibly also a significant increase in nonperforming loans in the future.

Fourth, the over-enthusiasm of local governments for local investment may worsen China's fiscal position in the future in an unexpected and dramatic way. On top of the Central Government's stimulus package, provincial governments were encouraged to raise money to launch their own complementary stimulus packages. The total amount of planned stimulus packages announced by local governments was 18 trillion Yuan. The bulk of the local stimulus packages will be financed by commercial loans guaranteed by local governments. A small portion of the finance is raised by selling bonds issued by the Central Government on behalf of local governments. As a result of the particular institutional arrangements in China, local governments have an insatiable appetite for grandiose investment projects. Investment led by local governments is likely to lead to a sub-optimal allocation of resources. More importantly, the Central Government's contingent liabilities may shoot up in the future.

Finally, as already mentioned, China's monetary policy is too loose. There is no need for China to drop the benchmark interest rate to such a low level. Interest rates are an important screening device in developing countries. The rapid expansion of credit and money supply was, to a certain extent, the result of non-market interferences. There are no sound economic rationales for supporting such a dramatic expansion. If commercial banks had been allowed to make decisions based purely on economic considerations, growth of credit and money supply would not have been so fast. And there would have been less need to worry about the possibilities of a rising nonperforming loan ratio, a worsening economic structure and resurgent asset bubbles. Actually, anecdotal evidence shows that a large chunk of excess liquidity has entered stock markets and real estate markets. Asset bubbles are returning with a vengeance. The huge gap between the growth rate of M2 and nominal GDP implies very large inflation pressure in the future. With near zero interest rates, small and middle-sized private and innovative enterprises will be discriminated against *vis-à-vis* state-owned monopolistic enterprises. The progress made in enterprise reform may suffer retreat.

---

## **4 The rebalancing of the Chinese economy and the safety of China's foreign exchange reserves**

Before the global financial crisis, the critics of China's imbalances in the form of running twin surpluses mainly concentrated on the double-misallocation of resources. As a developing country, China should use its resources for domestic investment and improving people's living standards. As an FDI-recipient country, China should translate capital inflows into the current account deficit. After the global financial crisis, more and more attention has shifted to the safety of China's foreign exchange reserves. When Fannie Mae and Freddie Mac were on the brink of bankruptcy, the issue of the safety of China's foreign exchange reserves was brought to the fore.

China is resigned to the fact that in essence it is borrowing with high costs and lending the money back to the United States for low or zero return. More troubling is that now, even the safety of China's foreign exchange reserves is under threat. And capital losses — let alone obtaining decent returns — seem inevitable. As warned by Paul Krugman, China has fallen into a 'dollar trap'. In terms of capital losses, China is facing a triple whammy.

First, the devaluation of the dollar is inevitable, which will lead to capital losses in China's foreign exchange reserves. The bulk of China's 2.3 trillion dollar foreign reserve holdings are not held for the purpose of self-protection, rather they are savings in the form of US Treasuries. China needs to preserve the value of its savings. There is no question whatsoever that the US dollar will go south, which started in April 2002 and, after a short interval, restarted in March 2009. Unless the US economy is rebalanced, the dollar will fall. And unless the dollar falls, the US rebalance will not be achieved. As a result, capital losses of China's foreign exchange reserves are inevitable.

Second, though inflation may not be an immediate threat, the US inflation rate should be around 4 per cent according to US Federal Reserve officials. This would mean that each year China's purchasing power devalues by 4 per cent. Furthermore, due to an extremely expansive monetary policy, the dollar has been debased. Unless the Fed implements the exit strategy successfully, which is doubtful, the real value of China's foreign exchange reserves will be eroded. Finally, as a result of dropping money from the sky by Helicopter Ben, serious inflation in the future cannot be ruled out.

Third, due to the huge budget deficit and supply of bonds by the United States, there is no guarantee that there will be enough demand for the US securities. As a result,

---

the price of US government securities will drop, and China's US security holding will suffer losses.

First of all, China should reduce its current and capital account surpluses. If it cannot reduce the twin surpluses, it has to translate the surpluses into assets other than US Treasuries, which include increasing outbound FDI, investing in strategic resources, engaging in mergers and acquisitions and portfolio investment abroad, lending to international organizations, selling panda bonds, engaging in currency swaps, and providing aid to developing countries.

With regard to stocks, the US Government should offer more Treasury Inflation-Protected Securities — like financial instruments. This would allow China to convert some of its holdings of US government securities into similar but safer assets. China should be allowed to convert part of its foreign exchange reserves into special drawing rights (SDR) — denominated assets. China should not rule out the possibility of adjusting the composition of its foreign exchange reserves to mimic the composition of SDR. If the US Government cannot safeguard the value of China's holdings of US government securities, the US Government should compensate China in one way or another.

## **5 Concluding remarks**

All in all, the negative impact of the measures taken as part of the efforts of crisis management by the Chinese Government on China's long-run growth can be serious, if the Government fails to tackle structural problems head on. However, it is also worth noting that the Chinese Government is well aware of the problems and it has begun to take measures to put structural adjustment back high on the agenda. Hopefully, the Chinese Government will not only succeed in reviving the economy, but also in reversing the worsening of the structural problem, and lay a solid foundation for China's future economic growth.