



## China and the Global Financial Crisis: Assessing the Impacts and Policy Responses

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### Abstract

*The present paper explores the role of China in the creation of the current global financial crisis and the impacts of the crisis on its economy. It argues against the view that the “saving glut” in China (along with other Asian emerging economies) played a significant causal role in the crisis. The global financial crisis did not engender much damage in China’s financial structure, thanks to the relatively closed, bank-centered financial system. However, the impacts on the “real” side of the Chinese economy were hard felt. Growth and employment have fallen, largely due to the decline in exports and foreign direct investment. The crisis reveals the vulnerability of the export-dependent growth pattern. Policy responses of the Chinese Government, including monetary, fiscal and social policies, have helped to stem the downfall of the economy in the immediate term, but some of the policies have not addressed the structural problems of the Chinese economy and might well aggravate such problems over time. The present paper proposes a tentative reform blueprint to rebalance the economy and to sustain long-term growth.*

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**Key words:** export dependency, financial crisis, saving glut, structural imbalances

**JEL codes:** F40, O11, O53

### I. Introduction

China remains a bright spot amid the worst global economic downturn since the 1930s (Liu, 2009; Sun, 2009). Although its growth slowed down and unemployment rose during the peak of the crisis, China’s annual growth resumed at an estimated 8 percent in 2009. The crisis, however, poses many questions regarding whether China has contributed to the

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crisis and how the crisis has affected its growth pattern. Tracing the origin of the crisis, some authors argue that global imbalances caused the crisis. US Federal Reserve Chairman Ben Bernanke has put forward the theory of a “global saving glut” to explain the US current account deficit, the decline in long-term real interest rates and the bloated housing market (Bernanke, 2005, 2006, 2007). The “saving glut” argument, which partially blames China for generating the crisis, is widely received in policy-making circles and by academia. However, this view stands on shaky theoretical and empirical grounds.

This paper argues that China’s “oversaving” did not play any significant causal role in the crisis, but that China’s reliance on exports did render it vulnerable to external shocks. China’s financial system has been left largely untouched by the crisis, but its real economy has suffered. The global finance crisis has not produced economic hardship, but has aggravated China’s long-standing structural problems. In response to the crisis, the Chinese Government swiftly implemented a series of monetary easing, fiscal expansion and social policy reforms. Although these policies successfully stemmed the downfall of the economy, they may be insufficient to address structural problems in the Chinese economy. In fact, some of the structural pitfalls, such as the overreliance on investment and exports and the deficiency of consumption, might well be exacerbated by the government’s policies. Without amending these deficiencies, it is doubtful that China’s growth can sustain in the long run.

In what follows, we will analyze three questions in detail. First, what was the role of China in the origin of the crisis? Second, how has the global financial crisis affected the Chinese economy. Finally, to what extent are the Chinese Government’s policy responses effective in boosting recovery and long-term growth.

## **II. Global Imbalances, “Saving Glut” and China’s Role in the Financial Crisis**

The direct cause of the current global financial crisis is the bursting of the US housing bubble, which invoked a cascade of effects, including a money market freeze, the securities market fallout, financial institution failures and, eventually, the sinking of the whole US economy. However, it is argued that there is a deeper root cause of the financial crisis; that is, the so-called “global imbalances” (Bernanke 2005, 2006, 2007). Such imbalances are most notable in the overconsumption in the USA and the oversaving in China (or, on the flip side, in the persistent current account deficits in the USA and surpluses in China). The argument proceeds as follows: China, along with other Asian developing countries, has embarked on export-led growth ever since the Asian financial crisis. China’s national saving in excess of investment has allowed China to net export and accumulate foreign exchange

reserves, which are in turn invested in dollar assets, in particular, in safe US treasury bills.<sup>1</sup> The injection of foreign savings has pushed down the US long-term real interest rates and fueled asset prices, to the extent that US households were tempted to pile on debt to purchase everything ranging from houses to Chinese tires. As Bernanke puts the key asset-price effects of the global saving glut appear to have occurred in the market for residential investment, as low mortgage rates have supported record levels of home construction and strong gains in housing prices.<sup>2</sup>

The “global saving glut” argument, however, can be attacked from both theoretical and empirical fronts.<sup>3</sup> Bernanke’s global saving glut argument errs empirically in several aspects: first, the US net export to GDP ratio decreased ostensibly from 2001, right after the USA lowered the fed funds rate and increased government deficit spending to stimulate the economy. In contrast, China’s net exports did not register a significant increase until 2003 (see Figure 1). If Bernanke were right, one should have seen a much earlier surge in China’s current account surplus. However, what appears to have occurred is that US imports surged due to expansionary fiscal and monetary policies, which subsequently provided opportunities for China to increase its exports (to the USA). Second, as Bernanke also observed, the reduction in the long-term real interest rates was not restricted to the USA but occurred in many other OECD countries. Indeed, as shown in Figure 2, the 10-year benchmark government bond yield in the euro area has also trended down, even though the euro area has maintained positive net exports. That is, their long-term rates went down in the *absence* of net injections of foreign savings.

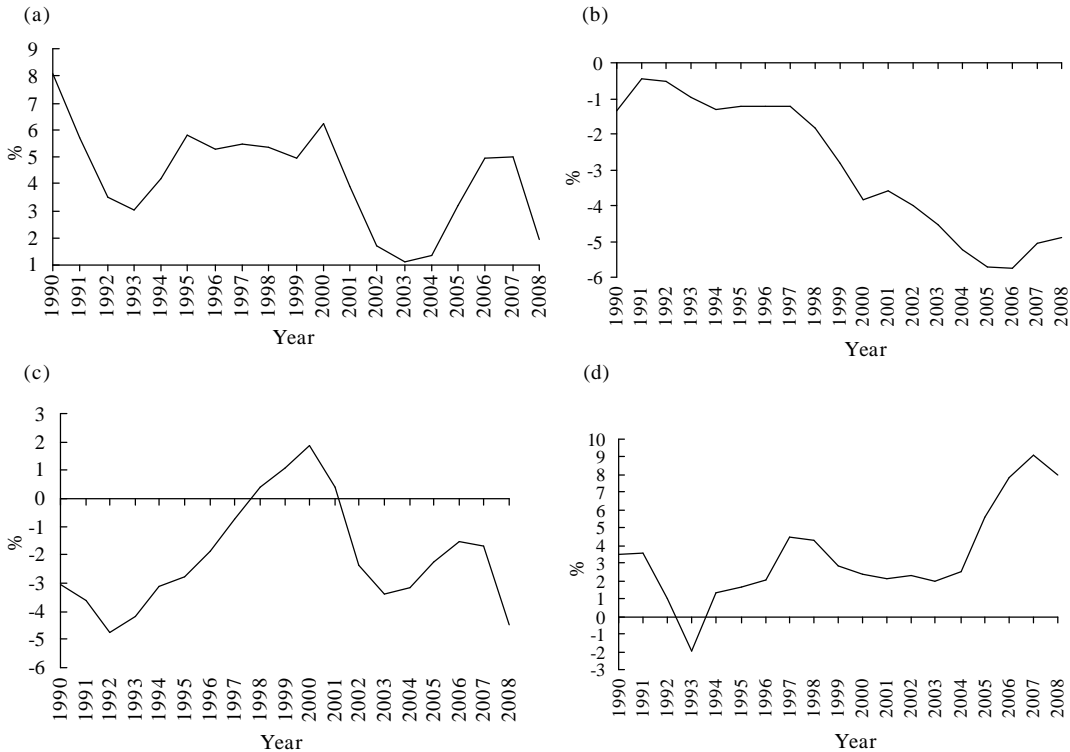
Third, it is clear that in an open economy, the following identity holds:  $(S - I) + (T - G) = (X - Z)$ ; namely, net savings in the private and government sectors must be equal to net exports. When Bernanke argues that the increase in the Chinese surplus can be attributed primarily to an increase in the saving rate between 2004 and 2006. The increase in China’s saving rate could, in part, be a consequence of the rapid pace of growth in the country. He

<sup>1</sup> It is held that foreign exchange reserve accumulation serves both precautionary and mercantilist purposes. In other words, large foreign exchange reserves help to protect China from currency crisis on the one hand and to keep the exchange rate artificially low on the other.

<sup>2</sup> Bernanke’s argument finds no shortage of supporters. Ferguson (2008) contends that “Chimerica [China and America] ... was the underlying reason why the US mortgage market was so awash with cash in 2006 that you could get a 100 percent mortgage with no income, no job and no assets.” Prasad (2009) argues that “the inflows resulted in a prolonged period of low interest rates in the United States, creating incentives for aggressive search for yields by U.S. financial institutions and blocking self-correcting mechanisms such as rising interest rates that would normally have resulted from higher government borrowing and a low private saving rate.”

<sup>3</sup> Space limitation prevents a full theoretical critique. The interested reader is referred to Bibow (2001) and Wray (2006) for a critique of the loanable funds theory, which underpins Bernanke’s arguments.

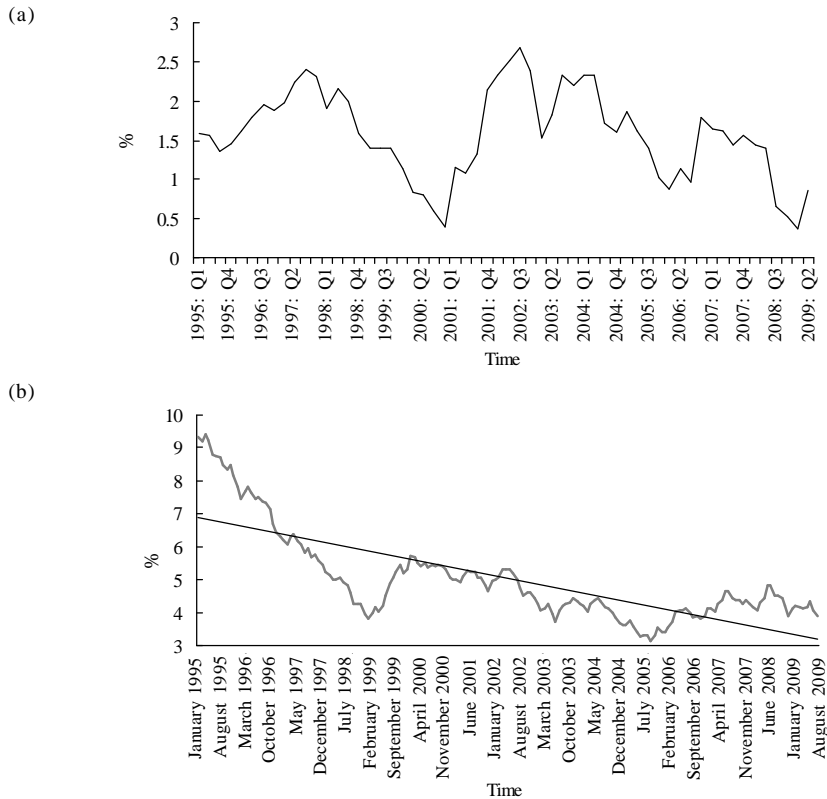
**Figure 1. Net Exports to GDP Ratios and US Policy Changes:  
 (a) US Effective Fed Funds Rate; (b) US Net Exports to  
 GDP Ratio; (c) US Federal Government Deficit to GDP  
 Ratio; and (d) China Net Exports to GDP Ratio**



Sources: FRB and BEA (2009).

seems to suggest that the causation runs from excess savings to net exports. This is clearly problematic. It is true that the level of savings is largely determined by the level of income, as Bernanke acknowledges. However, income is in turn generated by some forms of exogenous demand, be it government spending, investment or net exports. Given that government spending has not changed much in China in the past decade, it must be the growth of investment and/or net exports that drives income growth. If Bernanke were correct in stating that the saving rate (i.e. the share of saving to national income) exceeds the investment rate (the share of investment to national income) (as a corollary, if the demand gap due to desired saving is not filled by planned investment), then income can continue to grow *only if* net exports rise to fill the void. Therefore, it is the net exports that allow China to over save, but not the other way around. This is significant because it means that China is not pulling the strings: only when the USA decides to net import can

**Figure 2. Long-term Interest Rate and Net Export-to-GDP Ratio in Euro Area: (a) Euro Area 10-year Government Benchmark Bond Yield; and (b) Euro Area Net Export to GDP Ratio**



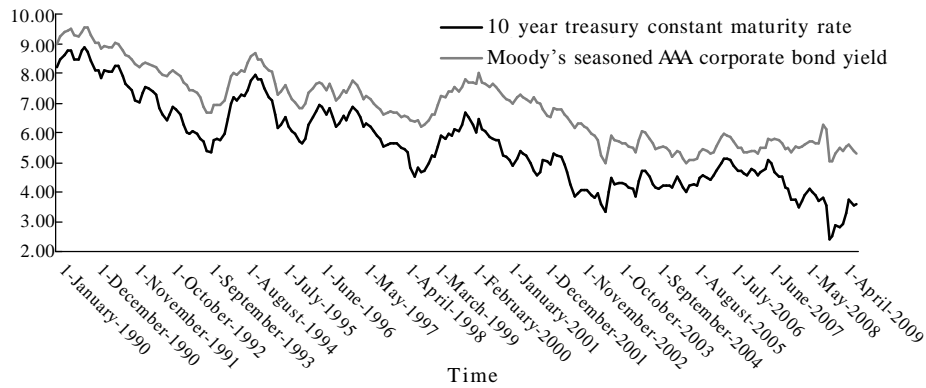
Source: ECB (2009).

China run a current account surplus, allowing its income and savings to grow.

Fourth, if China's excess saving causes the US long-term real interest rate to fall, this must be reflected mostly in the yield of government securities, because the Chinese Government invests its foreign exchange reserves mainly in US treasury bills. This would then mean that one should see the widening spread between the yield on government securities and that on other fixed income assets. However, the spread between the 10-year Treasury bond yield and the Aaa corporate bond yield has narrowed since 2000 and did not widen until mid-2007, when the US economy was swirling into recession (Figure 3). This suggests that the "global saving" could not sufficiently explain the across-the-board declining interest rates.

Fifth and finally, the amount of foreign capital inflows was largely dwarfed by the amount of liquidity slouching in the US equity and bond markets. For example, when the outstanding amount of mortgage securities and asset-backed securities peaked in the

Figure 3. Spread on US Bond Yields



Source: FRB (2009).

second quarter of 2008, the total outstanding value of the US bond markets reached US\$33.36tn (SIFMA, 2009), whereas the total capital inflows were only US\$2bn (excluding financial derivatives). Although some observers would argue that the US\$2bn inflows can amplify the generation of liquidity, an explanation is required as to why the amplifier effect is so large. Put differently, the effect of financial innovations and the ensuing tremendous leverage by financial institutions might be far more important than foreign capital inflows in accounting for the vast liquidity creation.

In closing, Bernanke's global saving glut argument is not backed by robust empirical evidence. Even Bernanke admits that "reserve accumulation abroad is not the only, or even the dominant, explanation for their (US yields) recent behavior." Separate research is necessary to probe into the genuine causes of the flattened yield curve despite the incipient monetary tightening in 2004; but suffice it to state here that the "global saving glut" should not be the focus of such research.

### III. Financial Impacts of Global Economic Crisis on China's Economy

Although China is not to be blamed for the crisis, it has been negatively affected by the crisis. As far as financial impacts are concerned, Chinese banks had rather insignificant losses due to their limited exposure to toxic assets issued by US financial institutions. According to Ma Delun, Vice President of the People's Bank of China (PBOC), Chinese banks' international exposure is relatively insignificant and their holdings of subprime mortgage loans should not exceed US\$10bn (Cai and Chen, 2008). This suggests that the losses from holding troubled assets would be miniscule. For example, total losses on holding

subprime mortgage securities of the three largest Chinese banks (Bank of China, Industrial and Commercial Bank of China, and China Construction Bank) have been estimated as reaching US\$2.8bn, which equates to only 1.08 percent of their total capital and 0.05 percent of their total assets combined (Kawai *et al.*, 2008). Indeed, despite the large provisions banks reserved to cover potential losses, the return to capital registered 17.1 percent in 2008, and the net profit after tax exceeded US\$83 billion, or a 30.6 percent increase from the previous year, according to Liu Mingkang, Chairman of the China Banking Regulatory Commission (Liu, 2009).

Even if the direct loss is mild, small external shocks might generate large ruptures if the banking system is weak and vulnerable. However, the Chinese banking system is reasonably healthy. The Chinese Government has recapitalized and restructured the state-owned commercial banks since the late 1990s and has attempted to reduce the immense non-performing loans (NPLs). The NPL ratio has fallen from over 30 percent at the end of 2001 to only 1.77 percent as of June 2009 (CBRC, 2009). As a result, the capital adequacy ratio of 192 commercial banks had exceeded 8 percent by the third quarter of 2008, up from 8 banks in 2003. The combined capital of these banks accounts for 85 percent of the total capital of all banks. Return on assets of banks in China increased from 0.1 percent in 1999 to 1.0 percent in 2007/2008, compared to 0.3 percent in Japan and 0.6 percent in the USA (IMF, 2004, 2008).

There are also concerns that the drying up of liquidity in the global financial markets might raise Chinese banks' costs of financing and funding. However, this concern should not be overstated. The availability of international liquidity did reduce substantially from RMB95bn in early 2007 to a little more than RMB75bn at the end of 2009. However, international financial institutions have provided only a small proportion of the total funds of Chinese financial institutions; the share of Chinese financial institutions' liabilities to foreign financial institutions to the total liabilities declined from 0.25 percent at the end of 2007 to below 0.15 percent at the end of 2008. This suggests that although cross-border interbank markets shrank, the fact that the cross-border interbank markets shrank would not have significantly raised the cost of funding of Chinese banks.

Furthermore, foreign banks have not been an important source of credit in China. From 1998 to 2001, only 15 new foreign banking organizations established offices in China. Only after China joined the WTO did foreign banks increasingly enter China. The number of foreign banks rose from 190 to 312 in the 5 years after China's WTO accession. However, currently, foreign institutions can only own up to 20 percent of the equity of a Chinese bank, and the total ownership of foreign equity investors is restricted to 25 percent. The assets of foreign-funded banks accounted for only 2.44 percent of the total bank assets in China. This implies that even if foreign banks tightened up lending due to financial difficulties of their parent companies, it would not have substantially reduced credit flows in China.

Unlike the liquidity crunch experienced by the USA, interbank lending and private domestic credit expansion seemed to function normally in China.<sup>4</sup> Indeed, as some observers point out, the exceedingly loose credit policy adopted by the PBOC has caused a surge in bank lending. Based on this view, the problem China faces is not the paucity of liquidity but the excessive supply and inefficient uses of credit, which might inundate the banks with NPLs in the near future. We will return to this point later.

#### IV. Impacts of Global Financial Crisis on the Real Sector

The above analysis resonates with McNally's argument (2009, p. 1) that: "China's financial institutions have largely escaped the global credit contagion because of capital account controls and limited exposure to global financial markets." However, he continues, "China's high export dependency and status as the world's premier manufacturing platform create vulnerabilities as Americans and Europeans drastically reduce consumption." At the current juncture, it seems that the impacts of global crisis fell mainly onto the "real" side of the Chinese economy through FDI and trade linkages.

Figure 4 shows inward FDI flows to China. It appears that inward FDI has been quite volatile, declining from US\$11.2bn in January 2008 to only US\$5.3bn in November 2008 before rebounding to US\$7.2bn as of November 2009. Similar to FDI, China's exports have declined on a year-on-year basis since November 2008 for 12 consecutive months (Figure 5). Thanks to the large decline in imports (partly due to the fact that much of China's exports are of the processing-and-assembly type, so a decline in exports is accompanied by the reductions in imports), China's trade balance has remained positive. However, the decline in exports directly reduces aggregate demand and depresses foreign and domestic investment in the industrial sector.

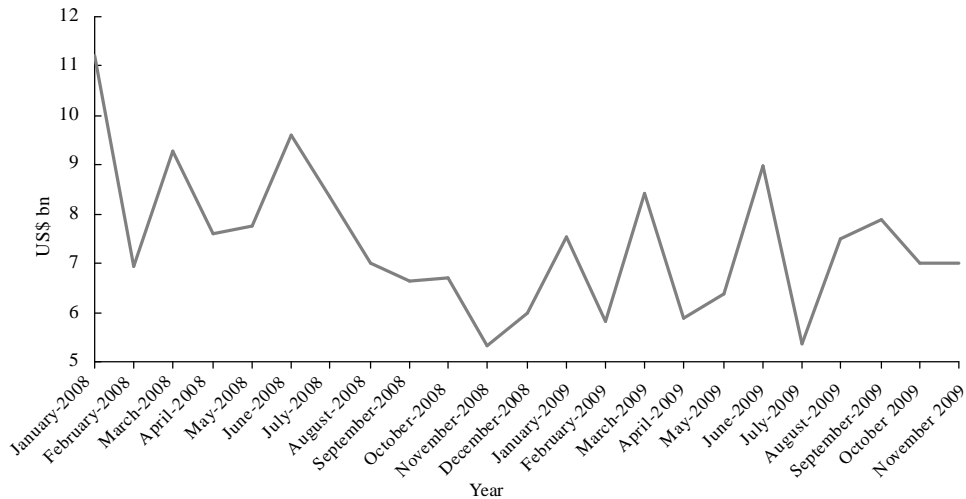
China has been dependent on exports for its economic growth. The share of net exports in GDP increased from less than 0 in the 1980s to 2 percent in the 1990s, and further to an astounding 8 percent in 2008. Even though the most significant driving force in China has been private investment, the share of which in GDP increased from 35 to over 40 percent from the 1980s to the present, the growth of net exports plays a key role in sustaining the

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<sup>4</sup> However, a recent *Financial Times* article cites Coface, one of the world's largest credit insurers, who have stated that banks restricted lending to export producers, who turned to their domestic suppliers for credit. Almost 90 percent of Chinese suppliers extended credit to their domestic customers on over half of their sales, up from 70 percent a year ago (Kwong, 2009). This seems to suggest that bank lending might be biased against certain industries and enterprises.

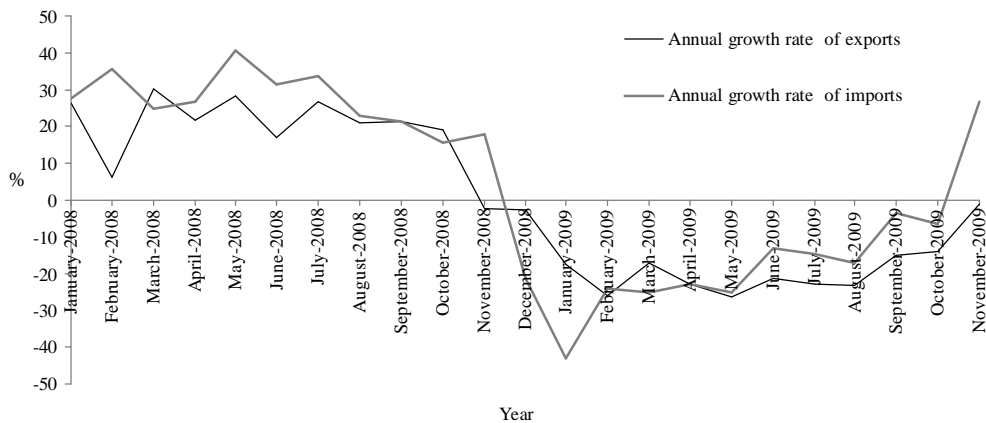


Figure 4. Total FDI Inflows, January 2008–November 2009



Source: China Customs (2009).

Figure 5. Annual Growth Rate of Exports and Imports, January 2008–November 2009



Source: China Customs (2009).

investment growth.<sup>5</sup> This is because investment and, hence, the expanded production capacity need to be absorbed or utilized by other forms of final demand; namely,

<sup>5</sup> It is controversial whether or not China relies heavily on exports. Some commentators argue that given the low domestic value-added of China's exports and that net exports still account for less than 10 percent of GDP, the contribution of exports to growth should not be overstated. However, this view fails to take into account the indirect, investment-promoting effects of exports. According to Cui *et al.* (2009), the largest impact of declining exports was on corporate investment, as weakening demand compelled businesses to contract.

consumption, government spending or net exports. However, the share of consumption to GDP declined from more than 50 percent in the 1980s to less than 36 percent in 2008; and the share of government spending remained at around 14 percent during the same period. Therefore, net exports have been the demand-of-last-resort that validates the growth of investment. As Liu (2009) demonstrates, China's investment growth has become highly correlated with the export growth since 2001.

With falling exports, the decline in manufacturing accelerated after September 2008. The Purchasing Managers Index (PMI) fell from a peak of 63.1 in March 2008 to 38.8 in November 2008 before it rose sharply and returned to an above-the-benchmark level in March 2009. It seems that despite the continuous export decline, manufacturing production has been stabilized. However, there are some concerns that the recovery of the manufacturing production is due largely to the extraordinarily expansionary policies, which will eventually level off. Without export expansion, manufacturing growth will slow down or even come to a halt. Some observers also point out that aggregate profits of large Chinese enterprises declined by 37.3 percent in the first 2 months of 2009, as compared to the same period of 2008 (Anderlini and Dye, 2009). By June 2009, the decline of profits had slowed down but still remained at 21 percent. Declining profits would make further investment unattractive. Finally, given that FDI accounts for roughly 57 percent of industrial output, a decline in FDI would undermine industrial production. It is reported that some Asian manufacturers have been faced with tight credit and have been obliged to cut down on their investments. Therefore, even if the PMI has passed the boom-bust benchmark for 8 consecutive months, it is still too early to claim a full recovery of manufacturing production.

In light of the falling exports, FDI and manufacturing production in early 2009, the IMF revised downward China's projected GDP growth rate in 2009 to 6.5 percent and the World Bank reset its projection to 7.5 percent. It turned out that in the first quarter of 2009, the growth rate was only 6.1 percent, a 4.5 percentage point reduction from the first quarter of 2008. However, by April, a number of financial institutions had revised upward their projections of China's growth. Despite the signs of recovery, the lack of good news on employment is concerning. A CLSA (CLSA Asia-Pacific Markets, an Asia's leading, independent brokerage and investment group) survey showed that manufacturers shed jobs in January 2009 at the fastest rate since the survey began in 2004. By February 2009, job losses had deteriorated to the extent that 20 million rural migrant workers were sent home (Anderlini and Dye, 2009). According to the Federation of Hong Kong Industries, only half or one-third of the previous layoffs were re-employed in the export-oriented plants during the recent recovery in export manufacturing. It is also reported that 147 million migrant workers had moved to urban areas for jobs by June 2009, but over 4 million had not been employed, along with 3 million college graduates who had yet to find a job. Data

paucity prevents a timely study of China's employment situation; however, it seems that the fast recovering sectors have been the ones that have received large government support and these sectors tend to be capital-intensive. Therefore, unemployment still poses an immense challenge to the Chinese policy-makers.

In short, the negative impacts of the global financial crisis on China's economy are channeled mainly through trade and FDI. China's reliance on exports to generate demand and provide jobs exposes the economy to external shocks; this growth model is also unsustainable, especially now that the US buying spree has been weakened. Indeed, a recent study (Aizenman and Jinjarek, 2009) projects a substantial decline in the Chinese current account to GDP ratio to 6 percent by 2013, which is markedly lower than the IMF's forecast of nearly 10 percent. This means that it is urgent that China rebalance its economy and boost domestic demand. Clearly, the Chinese Government must play a lead role in the rebalancing. We will now turn to examining the government's policies.

## **V. Examination of China's Policy Responses**

The Chinese Government was praised by the world for its swift and effective reactions to the crisis. At the beginning of 2008, the Chinese Government raised bank lending rates, reserve requirement ratios and stamp duties on stock transactions to cope with inflationary pressure, stock market fever and real estate speculation. As the global economic outlook turned sour, policy-makers quickly undertook a series of stimulative monetary, fiscal and social policies.

With regard to monetary policy, the PBOC has been cutting interest rates and funneling loans to government-backed infrastructure projects. On 16 September 2008, the PBOC announced a reduction in the benchmark interest rate for 1-year RMB-denominated loans by 0.27 percentage points, the first cut since October 2004. The PBOC continued cutting rates in the last 4 months of 2008, pushing the benchmark 1-year loan rate down from 7.47 percent in September to 5.31 percent in December, with the 1-year deposit rate down from 4.14 to 2.25 percent. In addition, the reserve requirement ratio was reduced by 1 percentage point in September 2008, the first cut since 2003. After three further cuts, as of December 2008, the reserve requirement ratio finally reached 14 percent for large deposit-taking financial institutions. These cuts helped to lower the cost of bank lending and, to some extent, to boost credit flows.

However, more importantly, answering the call of policy-makers, Chinese banks lavishly gave out loans, which registered, on average, RMB1.1tn every month in the first half of 2009. Most of the loans were invested in government-backed infrastructure (Anderlini,

2009). The surge in bank loans unquestionably contributed to the rapid recovery in investment, but it also caused some anxiety regarding whether the money was being used for speculation and wasteful projects. For example, Michael Pettis of Peking University asserts that somewhere between a fifth and a third of total new lending may have ended up in such things as stock market speculation, real estate speculation and even a measurable amount may be showing up in the casinos in Macau. In contrast, Tao Wang, a UBS economist, reckons that the new money that flows into the stock market and the purchases of imported metals amounted to only RMB660bn in the first half of 2009, which is less than 10 percent of the total new lending (and only a fraction of the RMB660bn can be financed by borrowing). Although a large share of lending, approximately 12 percent, went into property, it seemed that this was due to the purchases by first-time home buyers rather than speculators (CNN, July 24, 2009). In any case, the second half of 2009 saw much more moderate bank lending: total lending dropped from RMB1.53tn in June to RMB356bn in July and further down to RMB200bn in August 2009. This might be due to the government's credit tightening or simply because lending usually slows down in the second half of a year.

Concerning fiscal policy, the government has moved towards handing out stimulus packages, despite some skepticism regarding whether or not big stimulus is needed. A number of initiatives were announced by the government in October 2008, including: an expansion of construction projects; new export tax rebates;<sup>6</sup> tax and interest rate cuts on real estate transactions; increased agriculture subsidies and new loans for small and medium-sized enterprises; and elimination of taxes on interest income and dividend. Finally, the government instituted a stimulus package, pledging to spend estimated US\$586bn (2 percent of the GDP) by 2010 on a wide array of national infrastructure and social welfare projects, including constructing new railways, subways, airports and rebuilding communities devastated by an earthquake in Southwest China in May 2008 (Barboza, 2008).

Predicting weak domestic consumption, the Chinese Government strove to stimulate consumption. It announced RMB2bn in subsidies for trade-in cars in major cities. Small car taxes were also reduced from 10 to 5 percent. As a result, car sales in August increased by 82 percent on a yearly basis. The government also handed out RMB5bn subsidies for home appliances (to replace old models). Rural residents received extra subsidies up to RMB5000. One last important piece of the policy is the government's pledge to spend RMB850bn (\$123 bn) on health-care reform to provide basic universal health coverage to an additional

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<sup>6</sup> In November 2008, the government raised the rate of value-added tax rebates for 3770 export items. For example, the tax rebate rate on tires was increased from 5 to 9 percent, glassware 5 to 11 percent, various labor-intensive products from 11 to 13 percent, and textile and garments from 14 to 15 percent.

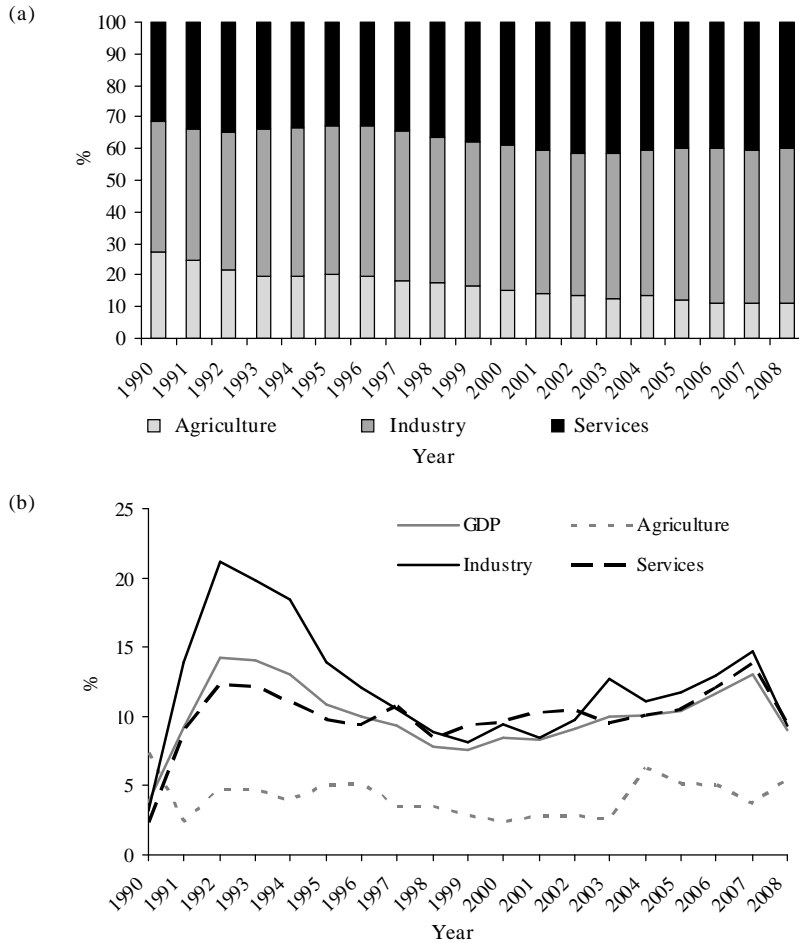
4 million Chinese by 2010. This is deemed an important policy to reduce precautionary savings by Chinese households.

These policies seemed to efficiently pull the economy out of recession, as suggested by the envious growth rates of 7.9 and 8.9 percent in the second and third quarter of 2009, respectively. It is important to note that much of the policy efforts were made in order to boost investment, which seems to be an expedient way of pulling the economy out of recession. However, investment growth cannot sustain, as mentioned above, unless it is validated by other forms of final demand. Moreover, investment growth might aggravate excess capacity, which would again force China to find ways to export its excess capacity and, hence, make rebalancing more difficult. Realizing these problems, many commentators have voiced the need to boost consumption in lieu of investment and export. The difficulty, however, is that consumption is very much dependent on income, income growth depends mainly on employment growth (assuming that wage growth measures up to productivity growth) and employment growth in turn largely depends on private production expansion and investment. In short, consumption growth requires income growth but income growth in turn necessitates consumption growth. It seems that, to escape the conundrum, government's direct job creation is needed. The Chinese Government's emphasis on investment and export and opponents' focus on consumption both miss the point: the point is to generate sufficient well-paid, stable jobs in order to sustain income and, hence, consumption growth.

Job creation in the services sector is particularly important. The services sector has been slow to grow and still accounts for only a small share of the economy ( Figure 6). Services are highly demanded in China but undersupplied, partly because of the government's biased policies toward industry to the neglect of services. Some commentators advocate government provision of health care, education and elderly care services as a way to reduce precautionary savings and to increase consumption, but the provision of these services is itself an important driver of the economy. Enhancing government's investment and job creation in the services sector not only helps to boost the economy (service jobs provide incomes and the development of the services sector enables more consumption of services), but improves peoples' standard of living and reduces the pressure on the natural resources and the environment (as compared to raising consumption of goods). From this point of view, the argument for reducing (government-led or government-supported) investment is misplaced; the point is that investment should be reduced in the industrial sector but elevated in the services sector.

In addition to rebalancing investment and consumption as well as industry and services, it is important to rebalance urban and rural development. The Chinese Government has been biased toward urban development, which has led to underdevelopment in rural areas.

**Figure 6. Structure of the Chinese Economy by Sector (a) and Sectoral Growth Rates (b), 1990–2008**



Source: ADB (2009).

Between 1999 and 2005, the proportion of rural population receiving an income of US\$0.50 a day increased from 1.9 to 2.8 percent. The ratio of per capita disposable income in the urban areas to that in the rural areas increased from 2.47 in 1997 to 3.28 in 2006, much higher than the average in other developing countries (UNDP, 2008). Impoverished rural residents results in low consumption at the aggregate level, given that rural residents still account for more than 60 percent of the total population. In October 2009, the government announced a landmark policy that allows farmers to lease their contracted farmland or transfer their land-use rights to “boost the scale of operation for farm production and provide funds for them to start new businesses” (Chinese Government’s Official Web Portal, 19 October

2008). It is believed that the measure will enhance income and consumption levels in the vast rural areas, and, therefore, create more domestic demand and jobs. This policy is a step in the right direction to rebalance the economy and to enhance domestic demand, but more needs to be done. The government not only needs to implement effective policies to reduce the tax burden on peasants and provide them with more subsidies, but invest more in rural industries.

Finally, rising inequality would also mean relatively low consumption simply because the consumption propensity is lower for the rich than the poor. The Gini coefficient jumped from 0.16 before China's market reform to 0.447 in the early 2000s and further to 0.469 in 2007 (UNDP, 2008). Therefore, income, tax and financial policies are required to reduce inequality, which would not only improve social stability but go a long way to boost consumption.

## VI. Conclusion

China has been increasingly relying on an export-led growth model, enabled by the US credit-driven consumption boom. This has allowed China to grow rapidly without generating sufficient domestic demand. China's reliance on exports did not cause the US consumption binge but, rather, the US consumption binge allowed China to continue falling back on export-led growth. However, as the global financial crisis unveils, China's real economy is vulnerable to external shocks because of its export dependency. As the US consumption growth decelerates, China has no choice but to abandon the old growth model and consider a new one. Although the government's monetary and fiscal stimulus has effectively orchestrated a fast recovery, some of the policies focusing on investment in industrial and export production will only aggravate excess capacity and create more problems in the longer term. What the Chinese Government really needs to undertake is a series of rebalancing. China needs to reduce its dependency on external demand and nurture its own domestic demand. The key is not to reduce investment, but to shift investment from the industrial sector to the services sector. Moreover, the government needs to play a more active role in direct job creation, in rebalancing urban and rural development, and in improving income equality. Crisis breeds opportunities. It is time for China to embark on a balanced and sustainable growth path.

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