Global Financial Crisis and China's Countermeasures

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The year 2008 will go down in history as a "once-in-a-century" financial tsunami. This year, as the crisis spreads globally, the impact has been felt everywhere on the real economy. The market environment of 2009 is characterized by the continued de-leveraging of financial institutions and households, which is depressing confidence across the globe and pushing the world economy is into recession.

This financial crisis and global recession offers us the best textbook. We all paid for it, but only those who are willing and able to think deeply can learn the lessons, get inspiration from it, and become wiser and more rational.

Global Financial Crisis: Causes, Nature and Impact

I argue that the financial crisis this time is structural in nature rather than a normal cyclical one. As economic phenomena, both cyclical volatility and structural crisis can be a process of "Equilibrium – Disequilibrium – Equilibrium". However, typical cyclical volatility tends to be caused by the imbalance between supply and demand, which results from the time lag between resource allocation and price signals. Price signals are released in a continuous and gradual way, which can be simplified by a function because of its two basic properties: continuity and convergence. People can therefore build up econometrics models by adopting marginal and equilibrium methods, and observe and forecast the business cycle so that corresponding measures can be taken. Determining the inflexion point – cyclical peak or bottom – however, is not easy.

A structural crisis, on the other hand, is usually characterized as a sudden failure or catastrophe of the whole system, for example, the abrupt collapse of asset prices and unexpected shrinkage of liquidity. It comes fiercely and becomes

contagious, leading to irrational public panic. In this case, the continuity is broken, the correlations are lost, and any functions or econometrics models are incapable of explaining or predicting the occurrence and development of the structural crisis.

Yes, the crisis we are facing is a typical structural one. It started with the sub-prime mortgage crisis in the United States. But the roots are in the US's over-consumption and under-saving growth model. To support consumption, financial institutions overused leverage and developed various high-risk asset backed securities and derivatives, with policy promoting financial innovation. These products spread world-wide like the plague without proper regulation and supervision, which finally led to the outbreak of the crisis.

On the other side of the story, globalization of the past decades has fostered the rise of China and other emerging economies, whose growth model is basically over-saving and under-consumption, contrasting sharply with the US over-consumption and under-saving model. These countries' trade surpluses constitute the main part of the US trade deficit, and they offer US consumers cheap products and low-cost capital by being the primary owners of US Treasury bonds. The huge US market has supported the industrialization and urbanization process of emerging economies like China. The coupling of these two growth models, which complement each other, has formed a global "unstable equilibrium", which meantime magnifies each other's imbalance. The accumulation of huge deficits and surpluses in the respective economies has affected the real economy. In that sense, this "unstable equilibrium" is not at all sustainable.

This story tells us:

Firstly, although globalization breaks the boundaries between economies, so that an equilibrium of a larger scope might be achievable, it will take a long time.

Before that, it is still important that various economies, especially large ones, maintain their own balance of international payments.

Secondly, although the direct impact of the crisis on China's financial system may be limited, China's real economy may be hit hard in the global economy recession. This is because China relies too much on exports (40% of its GDP), and its industrial structure mainly consists of mid- and low-end manufacturing, which is harder to adjust and transform compared with high-end service industries. Besides, as China undergoes an urbanization process, it has to face not only cyclical but also structural employment pressures.

Thirdly, a major difference between a cyclical and structural crisis is that the former tends to end up at the pre-crisis equilibrium, whereas the latter tends to find a new one. A new equilibrium means both the US and China must adjust to minimize the imbalances of their own economy. Specifically, China has to reduce its dependence on exports and increase domestic consumption. Consequently, its targeted GDP, CPI, unemployment rate, urbanization, and industrial structure will have to be modified accordingly. Reaching a new equilibrium under the above constraints will present a new challenge and involve a painful transition.

How Much Can This Crisis Change the World?

This financial crisis is seen as "once-in-a-century". It will have great impact on the global economic architecture and new world economic order. It will lead to debates on the roles of governments and international economic organizations, as well as on economic theory and policies. But how big will the impact be? Will it be fundamental? There are a number of popular viewpoints. We should keep an open mind and rational and independent thinking.

Firstly, globalization has contributed to the world economic boom in the past decade. It has also brought the economic imbalance which led to the outbreak of the financial crisis. As a result, some have called for protectionism,

de-globalization, and dollar-decoupling. However, it is my deep belief that globalization, as a historic trend, would not and should not stop. But we should cautiously review existing problems in the globalization process, get the global economy back on track, and restore growth.

Secondly, the crisis originated from the US and has shaken its economy severely. The long-term position of the dollar as the world's global reserve currency has come under threat. My view is that while the dollar’s position might be weakened in a foreseeable future, no other currency could possibly replace it as the global reserve currency. The dollar will remain strong in the short-term and will come under depreciation pressure in the mid- to long- term. Its fluctuation would be more cyclical, rather than structural. The emergence of a multi-polar economic system and a multi-currency system will still take time.

Moreover, during this crisis, each government has taken active measures by bailing out, injecting capital into, and taking over failing financial institutions, and by stimulating demand through interest rate cuts and fiscal expenditure increases. Does this mean a government-dominant or Keynesian economy will become the mainstream? I still believe in the private sector as the main body of resource allocation and the basis of the market mechanism. The boundaries between government and market should not be changed drastically. Government intervention and fiscal policy should be treated as special and short-term policy tools under rare circumstances. We must be cautious of using the visible hand and avoid the unlimited expansion of government power, while inspecting the flaws of laissez-faire policy.

Lastly, the crisis has exposed weaknesses in the functioning of the international financial system. While capital and financial products have been spread around the world, money supply, interest policy, and financial regulation are relatively individual decisions for each economy. The proportion of US-dollar money supply far exceeds the country’s share of the world GDP. Hence, the whole world

shoulders the US's economic problem. In other words, the US collects seigniorage from the world. The lack of global financial regulation, regarded as a key deficiency in the international financial system, has drawn attention from various economies. Establishing a new system, however, is not just an economic but a political challenge among large nations. We are not yet able to predict a clear future.

China Would be the First to Recover, but Reform and Adjustment Challenges Remain

China's real economy has been hit hard during this crisis, but I do believe China would be the first to recover from the recession. There are three reasons:

Firstly, compared with the major economies in the world, the balance sheet of the Chinese government, financial institutions, corporations, and households are among the healthiest. In fact, we are a lot better off than we were in 1997.

Secondly, 20 million migrant workers returning home, though a great social problem, also provides a cushion for urban unemployment pressures. That will give the government and businesses time and opportunity to adjust and respond.

Last but not least, the central government's 4 trillion yuan stimulus plan allows local governments to invest in projects which had been held back for a long time under macro-tightening policies. The monetary policy has created a "moderately easing" credit environment, allowing new loans to grow rapidly.

Based upon the above three reasons, I would say the goal of 8% of GDP growth is possible.

However, what I am most worried about is whether this government fiscal stimulus plan would be able to motivate private sector investment and encourage spending of end consumers. If not, the future recovery would probably be a "W"-shaped one as some economists predicted, with the first upturn purely fueled

by government fiscal investment, followed by a downturn due to the lack of support from private sector investment and consumption. The real recovery eventually relies upon market forces.

The next worry I have is whether or not 8% GDP growth is the bottom line to keep unemployment low. I do not think there is any scientific proof. I believe that the job creation issue has a lot to do with the industrial structure. An aggressive fiscal policy has its risks, which might include not only the unknown direct impact on the economy but also inflation risks in the long run. Hence, we must not over-rely on it. What is more, managing unemployment and maintaining social stability depends on an improved social security system. How to allocate the 4 trillion between investment and transfer payments should be thought through. Transfer payments include social security, lower-income insurance, health care, education, and housing, etc.

The third problem I am concerned about is excessive production capacity. A recession can be a disaster but an opportunity for reform as well. The current detailed stimulus plans are aimed at bailing out and helping troubled industries, but lack measures for adjustment or reform. We might be able to achieve the targeted 8% growth rate. But excessive capacities and lagging industries will survive; distorted pricing mechanisms will be maintained; inappropriate government interventions will be enhanced; and public goods will be lacking.

Lastly, the crisis poses challenges to China's model of economic growth.. It has proved that China's growth model, which relies heavily on exports and investment, is unsustainable. How to balance the relationship between investment and consumption, between exports and domestic demand, and between growth and employment are still important topics to be addressed. However, they do not seem to have gained the necessary attention, given that the mainstream viewpoint still considers this crisis to be cyclical rather than structural.