China and the Global Financial Crisis

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The impacts of the global financial crisis are now rippling across the globe, diminishing the demand for a broad range of goods and services and therefore raising the prospect of hard landings in emerging economies dependent on exports. The case of China is illustrative of how the broader economic downturn created by the global financial crisis is reverberating in Asia.

China’s financial institutions have largely escaped the global credit contagion because of capital account controls and limited exposure to global financial markets. But China’s high export dependency and status as the world’s premier manufacturing platform create vulnerabilities as Americans and Europeans drastically reduce consumption. The net effect is a plummeting demand for Chinese exports. Indeed, one of the biggest worries for 2009 is that tight credit markets and gyrating currency markets will cause disorder and a possible contraction in world trade—a situation that will have negative implications for China.

China’s outlook is also complicated by trends underway and decisions undertaken before the start of the financial crisis. China’s economy already started to decelerate at the beginning of 2008 due to a variety of measures taken to dampen inflationary pressures and a run-up in domestic real estate prices. The effects of these earlier measures combined with the present global economic down-turn are producing a fundamental deceleration of economic activity. Recent figures reflect this: power generation declined four percent in October from a year earlier; real estate transactions are plummeting in cities along China’s prosperous seaboard; and in November 2008, China’s exports fell for the first time in seven years.

As a result, predictions for China’s fourth quarter 2008 GDP growth are down to between five and seven percent—respectable by global standards, but a stunning drop from double digit growth rates just a few months earlier. To counteract this economic deceleration, the Chinese government has launched a 180 degree about-face in economic policy: interest rates are being slashed, bank lending quotas lifted, taxes reduced, government funds injected into the stock market, and, most visible of all, the announcement of a $586 billion stimulus package. This stimulus package is an important step and will put a floor under economic deceleration.

However, if past efforts at Keynesian stimulus spending by China and Japan are any guide, efforts aimed at funding infrastructure projects will have limited immediate results other than providing some employment opportunities. Measures aimed at increasing private consumption will probably disappoint as well since Chinese households are accustomed to saving rather than spending due to uncertainties in their livelihoods. Although comprehensive social security and medical care reforms could address these uncertainties, such reforms cannot be implemented overnight.
As a result of these perceived shortcomings, the Chinese public and commentators are expecting a further stimulus package to be announced soon. Certainly, the Chinese government has the fiscal wherewithal to do so, and a new package could include more direct stimulus for consumers and the poor.

Perhaps the biggest problem is that China is being hit by a double whammy. Just as efforts to restrain inflation and real estate speculation began to bear fruit, the global economic picture changed dramatically. A drop in external demand is now exacerbating a popped real estate bubble as well as impacting consumption demand and local government revenues. Industries such as steel, cement, and glass are already feeling the slowdown, while China’s banking sector could face problems due to its exposure to real estate developers and heavy industry. The brunt of these dynamics is probably large enough to counteract the potential upside stemming from government stimulus.

China’s economy therefore faces real trouble. Excess capacity of the boom years could lead to deflationary pressures and a new generation of bad loans. This could affect both China’s internal political developments and external relations.

Externally, China has become the largest creditor to the United States. China’s industrial development has been driven by U.S. consumer demand while U.S. consumption, in turn, relied on Chinese lending that kept domestic U.S. interest rates low. However, the rapid slow-down of economic activity in both the U.S. and China is causing this symbiosis to fall apart. For the time being, Chinese demand for U.S. debt continues to be high, in part because China’s trade surplus remains strong. Moreover, the Chinese government is unlikely to move out of U.S. debt instruments deliberately and on a large scale, as this would destabilize the global financial system and hurt China.

A less noted fact is that over the eighteen months from early 2007 until the middle of 2008 about $386 billion in “hot money” flowed into China to take advantage of an appreciating Chinese yuan. Recent indications are that these flows are reversing, though so far in a gradual manner. Should gradual unwinding become outright capital flight, the Chinese government would have to intervene on a large scale to keep the yuan’s exchange rate from falling too much too fast. China’s balance of payments surplus could provide sufficient dollars to halt such a slide. Nonetheless, a rapid reversal of speculative inflows could destabilize Chinese foreign exchange markets and diminish China’s ability to funnel dollar funds into the U.S. debt markets.

Both the United States and China thus must be extremely vigilant and foster continuous contact among economic policy makers, especially during the transition to a new administration in Washington D.C. The international financial system has become extremely fragile, and events in one country can rapidly trigger effects in another. The good news is that the Chinese government is in a good fiscal position, both domestically and externally. It has plenty of room to borrow to increase domestic consumption. While such efforts will take time and might not prevent a deeper economic downturn in China, concerted and wisely targeted efforts to keep China’s economy vibrant will aid global stability.