SECTION 2: CHINA'S ROLE IN THE ORIGINS OF THE GLOBAL FINANCIAL CRISIS AND CHINA'S RESPONSE

> "The Commission shall investigate and report exclusively on—
> . . .
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> "ECONOMIC TRANSFERS—The qualitative and quantitative nature of the transfer of United States production activities to the People's Republic of China, including the relocation of high technology, manufacturing, and research and development facilities, the impact of such transfers on United States national security, the adequacy of United States export control laws, and the effect of such transfers on United States economic security and employment.
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> "UNITED STATES CAPITAL MARKETS—The extent of access to and use of United States capital markets by the People's Republic of China, including whether or not existing disclosure and transparency rules are adequate to identify People's Republic of China companies engaged in harmful activities. . . ."

Introduction

The global financial crisis of 2008 that affected the economies of rich and poor nations alike has been blamed on a confluence of factors, including, but not limited to, the collapse of real estate values; lax regulation of financial services; historically low interest rates managed by central banks; and speculation in commodities and fixed assets. While informed opinions differ on the relative weight of the many contributing factors, much attention has also focused on the role of the unbalanced trade relationship between the United States and China. While this relationship does not tell the whole story, it does provide a guide to understanding how the many economic threads of the crisis converge in these two global powers.

Both nations have responded to the global economic crisis with large-scale spending programs, tailored to address each nation's individual problems. The United States in late 2008 addressed the crisis in the financial services industries by recapitalizing companies whose failure would create a systemic risk to the overall economy. Most of the government's initial response focused on the financial services sector, which included mortgage giants Fannie Mae and Freddie Mac. Later, in early 2009, Congress passed a $786 billion economic stimulus program designed to boost government and consumer spending.

China's response to the global recession emphasized quick spending on infrastructure projects such as highways, railroads, and ports, rather than on the financial services industry. Chinese banks had avoided many of the risky investments in financial derivatives that threatened American banks, money market funds, securities firms, and mortgage lenders. China was first, in November 2008, to announce its economic stimulus package—$586 billion over two years—chiefly intended to realize China's goal of an 8 percent annual growth rate. This is supplemented by bank lending, export promotion policies, and some consumption-boosting measures. As the details of China's recovery plan have emerged, problems have also surfaced. Beijing claims its yearly growth rate is on track to reach 8 percent yet admits that unemployment has skyrocketed and that disaffected workers have been migrating back to the rural areas. China's labor minister, Yin Weimin, said in September that although there has been a modest increase in the number of jobs in the second quarter of 2009, the unemployment situation remained "grave." [115]

In addition to the stimulus package, the Chinese government has directed its state-owned banks to drastically loosen credit—some 8.7 trillion RMB ($1.3 trillion) has been lent out in the first nine months of 2009. This lending risks creating unwanted financial imbalances and strains on bank balance sheets.[116] Much of the stimulus lending has also apparently wound up in the hands of inefficient state-owned and state-controlled enterprises rather than in the private economy or in the hands of consumers.[117] Some of the bank lending has fuelled stock speculation, which drove up the Shanghai stock index by 70 percent in the first half of 2009, making it the best-performing market in the world.[118] Realizing this, regulatory authorities in China urged the state-owned banks to rein in lending to large, state-owned companies that might have been investing the funds in the stock market.[119] The market quickly sold off 20 percent, and volatility has remained high.

Governments in both countries have claimed some success for their responses to the 2008 financial downturn. In the United States, the housing industry shows signs of stabilizing, and the equity market has begun to revive, but unemployment remains perilously high. In China, officials point to gross domestic product (GDP) growth that has returned to historic norms and to rising asset values. The International Monetary Fund (IMF) predicted in October that China's real GDP will grow at an annual rate of 8.5 percent for 2009, compared to a GDP decline of 2.7 percent in the United States.

But underlying problems in the economic relationship between the two countries remain. The stimulus plans of neither country have managed to address the bilateral imbalance that many economists identify as one of the principal factors for the precarious position of the global economy. China produces far more than its consumers buy, and the United States consumes far in excess of its production. (Personal savings in the United States is showing some improvement, however. The personal savings rate as a percentage of disposable personal income, which dipped below zero during the housing boom, was 4.2 percent in July 2009).[120] Even with the increase in private savings, U.S. government debt is expected to rise from 41 percent of GDP in fiscal 2009 to 60 percent of GDP by the end of fiscal 2010.[121]

Rather than address these fundamental problems, Washington's economic stimulus program still depends on federal deficit spending and high levels of consumption by American households to eventually float the U.S. economy off the rocks. Beijing still depends on an export and investment-led growth model to keep its factories humming and its workers employed. China's central government continues to serve as America's largest creditor. While the overall American trade deficit has declined from its record levels of 2008 ($216.9 billion in the first half of 2009 versus $406.2 over the same period in 2008), the goods trade deficit with China remains abnormally high ($143.7 billion in the first eight months of 2009 versus $169.2 billion during the same period in 2008) and represents an increasing percentage of the U.S.'s global trade imbalance.[122] By continuing to consume more than is produced, the United States must continue to borrow. Meanwhile, China continues to add manufacturing capacity, producing more than it can consume domestically.

Global Financial and Trade Imbalances

The February 2009 hearing before the Commission on the origins of the financial crisis and the response of the United States and China mirrored the disagreements among a larger group of analysts and economists in both capitals seeking to apportion blame for the crisis to each country's economic policies. Experts also differ in assessing the likely success of China's and America's responses to the crisis. The debate over which government policies created which problems and which remedies will ultimately prove effective will take years to resolve. But while history takes its own time to reach a conclusion, the Commission has considered much evidence and identified some common theories that have emerged from the discussion. The Commission's February hearing on "China's Role in the Origins of and Response to the Global Recession" provides a useful framework for the debate.

In his testimony at the February hearing, Michael Pettis, a finance professor at Peking University and a former Wall Street trader, connected several of the disparate economic elements to fashion a unified theory of how China contributed to the imbalances and how those imbalances helped to sink the world's economy. The key, said Mr. Pettis, is to follow the money.

As America's largest supplier of imported goods, China has accumulated an enormous amount of dollars. China has run record-setting trade surpluses during the past decade with the United States by exporting five to six times as much in dollar terms as it takes in imports from the United States. In addition, U.S.-based corporations have invested large sums in China. The Chinese government then gathers up the accumulated dollars and buys U.S. Treasury bonds, which pay interest to China's central bank, the People's Bank of China. The government might have chosen to allow those dollars to remain in the hands of the Chinese people and companies that earned them, but in order to control the value of the renminbi (RMB) relative to the dollar, China chooses to keep dollars out of the private economy by requiring Chinese citizens to exchange them at the state-owned banks.

This "recycling process" put the dollars back into the hands of the U.S. government and, indirectly, into the hands of U.S. consumers, who were thus able to purchase even more Chinese goods at very low interest rates. The process, said Mr. Pettis, became "self-reinforcing": Americans went on a buying spree.

> *In the [United States], the torrent of inward-bound liquidity boosted real estate and stock market prices. As they surged, substantially raising the wealth of U.S. households, these [households] became increasingly willing to divert a rising share of their income to consumption. At the same time, rising liquidity always forces financial institutions to adjust their balance sheets to accommodate money growth, and the most common way is to increase outstanding loans. With banks eager to lend, and households eager to monetize their assets in order to fund consumption, it was only a question of time before household borrowing ballooned.*
>
> *Meanwhile, in China, as foreign currency poured into the country via its trade surplus, the [People's Bank of China] had to create local money with which to purchase the inflow [of dollars]. In China, most new money creation ends up in banks, and banks primarily fund investment (consumer lending is a negligible part of bank lending). With investment surging, industrial production grew faster than consumption. A country's trade surplus is the gap between its production and its consumption, and as this gap grew, so did China's trade surplus, which resulted in even more foreign currency pouring into the country, thus reinforcing the cycle.*[123]

Mr. Pettis's analysis supports a generally accepted explanation for the dramatic decline in the overall U.S. savings rate: Consumers watching their stock holdings and home values soar felt wealthy enough to stop saving entirely, a phenomenon known as "the wealth effect." Meanwhile, voters gave up demanding that the federal government stop deficit spending. While economic theory holds that government borrowing crowds out private investment and makes interest rates rise, this did not occur. The economy continued to grow as American consumers emptied their savings accounts and even borrowed from the equity in their homes. Meanwhile, interest rates fell rather than rose, thanks to Beijing's willingness to buy U.S. government bonds, thereby driving down interest rates even as government borrowing increased. The ultimate result: an asset bubble driven by overspending in personal and commercial real estate and the stock market, aided by increasingly risky loans offered by commercial banks and investments in derivatives made by investment banks.

Other witnesses at the Commission's hearing agreed that China's trade surpluses were part of the problem, but they placed more of the blame on the U.S. government and American consumers for the ensuing economic troubles. Nicholas Lardy, a senior fellow at the Peterson Institute for International Economics, insisted that American consumers borrowed too much, and U.S. regulators lacked the foresight to recognize the dangers of the new financial instruments, such as securitized subprime mortgages, that facilitated the borrowing and the overspending. In contrast, home equity loans, which allowed Americans to withdraw equity from their homes and use it for consumer purchases, do not even exist in China, Dr. Lardy noted.[124] Chinese regulators did not approve of investments in collateralized debt obligations—the practice of bundling thousands of mortgages together and marketing the result as a bond secured by the underlying mortgages. In addition, Dr. Lardy said, China's "regulators have not allowed the introduction of complex derivative products of any kind, and the result is the central government has not had to inject capital into any financial institution, bank or otherwise, as a result of the crisis, nor have they had to guarantee the liabilities of any bank or other kind of financial institution."

Dr. Lardy praised China's efforts to rescue its own economy as "the gold standard" when compared to stimulus programs in Japan, Europe, and the United States. China was first among nations, in September 2008, to ease lending standards at its state-owned banks and to slash interest rates. China's government followed this action in November 2008 with the announcement of plans for a massive public works spending plan and in December announced plans for greatly expanded government-provided health care, with a goal of attaining universal coverage by 2011.[125]

Stephen Roach, chairman of Morgan Stanley's Asia branch, was no less critical of the role that U.S. indebtedness has played in setting up the world economy for a fall. "No one forced the American consumers to lever all their assets up to their eyeballs and squander the appreciation of those assets on current consumption," Dr. Roach told the Commission. However, he also believed that China has adopted policies that have led to massive trade imbalances and in turn have contributed to the destabilization of global finances. For example, China adopted a successful, export-dependent growth strategy that resulted in China's exports as a share of GDP to almost double in just seven years, from 20 percent in 2001 to 37 percent in 2008. Meanwhile, China's GDP grew at an average 10.4 percent rate in the seven years ending in 2007.[126]

Dr. Roach chastised America for its "reliance on China's funding of its external deficit—a reliance that can only grow in an era of open-ended, trillion-dollar budget deficits." But Dr. Roach was also critical of China's policy of undervaluing its currency to make its exports cheaper in the United States and its selective subsidies to boost exports. China, he said, should not "be tempted to use the currency lever or other subsidies to boost its export sector" but rather "shift its growth model from one that has been overly reliant on exports to one that draws increased support from private consumption."[127]

Nevertheless, Dr. Roach warned against any effort to "portray American consumers as innocent victims of Asia or Chinese mercantilist policies." Rather, Dr. Roach said, "We made dumb mistakes that were reinforced by, I think, poor policies and poor behavior across our economy, from politicians to central banks to regulators to Wall Street to Main Street, and I think it is really incorrect to even think that the Chinese are responsible for those poor decisions."[128] One of the most detrimental consequences of runaway consumption in the United States was the drastic fall in its domestic savings rate. Between 2002 and 2007, the U.S. net national savings rate—the sum of household, business, and government saving after adjustment for depreciation—plunged to a record low of 1.8 percent of national income, and then actually turned negative in 2008.[129]

Robert B. Cassidy, an international trade and services professional at Kelley Drye & Warren LLP, had a different view from Drs. Lardy and Roach and was more critical of China's policies as a cause for the financial crisis. Mr. Cassidy conducted the final negotiations with China over the terms of its 2001 entry into the World Trade Organization, a highly detailed process that stretched out over 13 years. The deal overseen by Mr. Cassidy required China to make many promises to empty its policy toolbox of central planning and state ownership and to adopt western free-market mechanisms. The problem, according to Mr. Cassidy, is that China has purposefully nullified one of the most powerful forces in any free market—the price factor. By artificially pegging the value of its currency at a rate that most economists agree is significantly undervalued, China is effectively "subsidiz[ing] its exports, subsidiz[ing] foreign direct investment, and [taxing] China's imports."[130]

At the same time, China has attracted the world's largest manufacturers by offering discounted land, energy, and taxes to relocate in China and to use China as a global export platform. More than half of China's exports originate from foreign-invested manufacturing enterprises located in China.* "The main driver of exports out of China has been foreign-invested enterprises," both wholly foreign owned and joint ventures with Chinese companies, which together account for roughly 55 percent ($790 billion) of the total exports in 2008, Terence P. Stewart, a Washington attorney and trade expert, told the Commission.[131] (For further information on the role of foreign invested enterprises in China's industrial policy, see chap. 1, sec. 3.)

The undervalued currency, which also attracts foreign investors by discounting land and manufacturing inputs, is the cornerstone of China's export-led growth strategy, said Mr. Cassidy. In effect, China simply "exports its savings to the United States rather than using those funds for domestic investment" or consumption, said Mr. Cassidy. "If China is unprepared to [allow its currency to appreciate in value as the market dictates], then the United States and other countries should consider initiating, in a progressive manner, strong actions against China's beggar-thy-neighbor policies," he suggested.[132]

Eswar S. Prasad, a professor of trade policy at Cornell University and former chief economist of the China division at the International Monetary Fund, offered a warning to the Commission that

*In China, foreign equity capital inflows are classified as foreign direct investment only if they lead to a foreign equity stake at or above 25 percent, and most foreign direct investment inflows into China finance foreign equity stakes in joint ventures, usually with only two investors in a joint venture. This is different from countries in the Organization for Economic Cooperation and Development (OECD), including the United States, where a 10 percent threshold is a common definition for foreign direct investment, and shareholding of a publicly traded company is diffuse. For more information, see Yasheng Huang, *Selling China: Foreign Direct Investment during the Reform Era* (New York: Cambridge University Press: 2003), pp. 4–6.

China's currency peg to the dollar will likely do even more harm to the world's economy by limiting the ability of the People's Bank of China to manage the fast-growing economy and to even out the business cycles by controlling inflation. "Flexibility of the currency is an essential prerequisite . . . rather than an objective in itself," he said. "Giving the Chinese central bank room to raise or lower interest rates by freeing it from having to target a particular exchange rate would help rein in credit growth and deter reckless investment, reducing the risk of boom-bust cycles; an important point here is that an independent monetary policy requires a flexible exchange rate," he said.

The Global Savings Glut

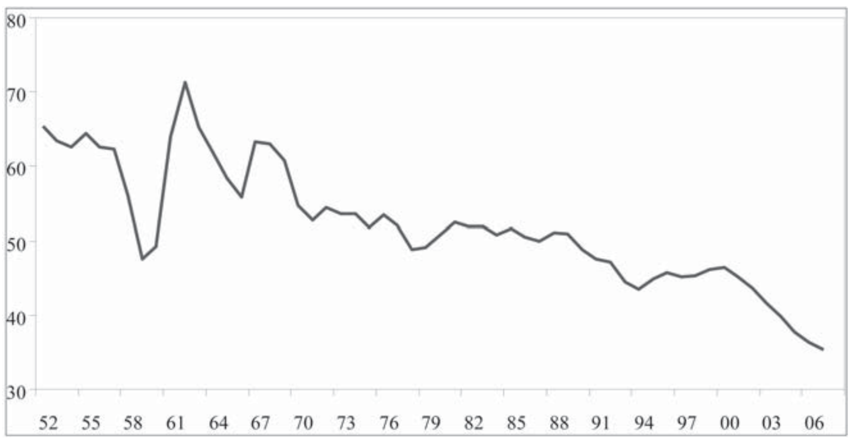
The speed and ferocity of the 2008 global financial crisis may have taken investors by surprise, but at the beginning of the millennium there were warnings that the world economy had entered a new and potentially destabilizing phase. Those warnings specifically focused on the financial and trade relationship between China and the United States and more broadly between the developed world and the emerging nations of Asia. Witnesses at the Commission's February 17 hearing referred to these early warnings, which went unheeded during the early and mid-2000s.

For example, Federal Reserve Board Chairman Ben Bernanke, while an economics professor at Princeton, helped originate the idea that a "global savings glut" had reversed the historic financial relationship between rich and poor nations. Ordinarily, poor nations borrow from rich nations. Poor nations put these loans to work by improving the low productivity of their labor force—through education, better health care, and especially through the automation of manufacturing processes and the application of more efficient energy sources. Poor nations historically ran trade deficits with rich nations as the poor nations borrowed to automate assembly lines and add electrical generating capacity.

Dr. Bernanke recognized in 2005 that "a combination of diverse forces has created a significant increase in the global supply of saving—a global saving glut—which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today." [133] Asian countries, led by China, had responded to the 1997 Asian financial crisis by adopting industrial and trade policies aimed at encouraging production and exports while suppressing domestic consumption. Rather than spend their income, Chinese citizens reacted to a variety of government actions or inactions by saving it in low-interest-bearing bank accounts. These savings became available to the government through its state-owned banks to build enormous manufacturing capacity, much of it also state owned, in effect providing low-cost capital.

In particular, the Chinese government chose not to rebuild a safety net to replace the "iron rice bowl" that was dismantled when Deng Xiaoping instituted market reforms and started selling off the government-owned industries that had been providing health care, education, and housing to the workers and their families. This situation forced Chinese citizens to save much of their income to meet medical, educational, and retirement needs and inhibited the development of a consumer culture. State-owned banks did their part by limiting consumer lending, refusing to issue credit cards, and requiring large downpayments for mortgages. Chinese citizens were prohibited from investing abroad for higher returns and could only expect low returns at home. As a result, the consumption share of Chinese GDP fell to a record low of 36 percent in 2007 (see figure 1), "underscoring the dark side of China's macro imbalances that is now so problematic in this global crisis," according to Dr. Roach.[134]

Figure 1: Chinese Personal Consumption as a Percent of GDP, 1952–2007



Sources: China National Bureau of Statistics and Morgan Stanley Research.[135]

The resulting sharp rise in savings created a financial counterweight that made it easy for trading partners, such as the United States and Europe, to run deficits. China's high national savings rate and its policy of tightly managing the value of the RMB "abetted U.S. profligacy by providing cheap goods and cheap financing for those goods," setting the stage for a crisis, said Dr. Prasad.[136]

The political economist Robert Skidelsky explained how China's loans to the U.S. government wound up in the checking accounts of Americans:

> *With Chinese savings available, the U.S. government could run a deficit without crowding out private spending. This allowed the Fed to establish a much lower funds rate—the rate at which banks borrow from the Fed and one another—than it would otherwise have been able to do, helped in this by the downward pressure on prices exerted by the import of cheap Chinese goods produced by cheap Chinese labor. Cheap money in turn enabled banks to expand their deposits and their loans to customers more than they could otherwise have done. In short, it was via their impact on the financing of the federal deficit that Chinese savings made it possible for the U.S. consumers to go on a spending spree.*[137]

Dr. Skidelsky also noted that this

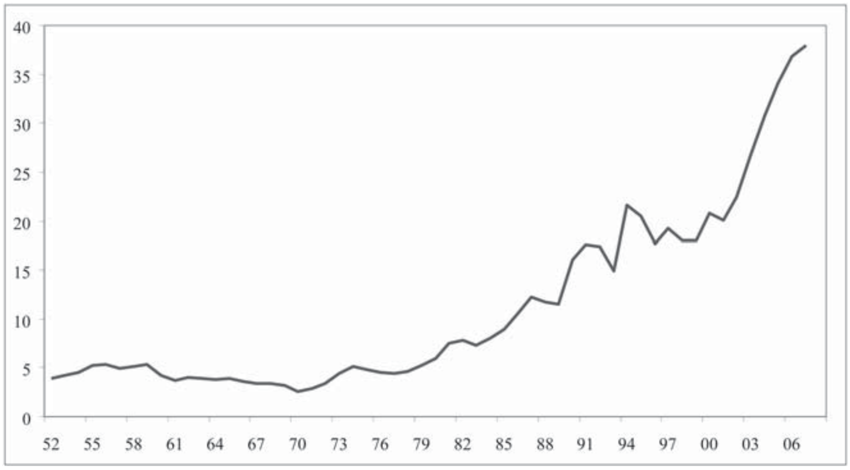
> *has left much too large a part of our own economic activity dependent on foreign loans. It is one thing to borrow from abroad for investment, a different matter to borrow for consumption, since this does not create assets which can service the debt. The global imbalances helped pump up the inverted debt pyramid that brought the system crashing down.*[138]

Speaking at a conference on Asia and the financial crisis in October 2009, Dr. Bernanke returned to the theme of unsustainable imbalances in trade in capital flows, saying that the United States "must increase its national savings rate," while most Asian economies "must act to narrow the gap between saving and investment and to raise domestic demand." He also cautioned against "trade surpluses achieved through policies that artificially enhance incentives for domestic saving and the production of export goods," because they "distort the mix of domestic industries and the allocation of resources."[139] However, as Dr. Bernanke pointed out, following the 1997 Asian financial crisis Asian economies' "commitment to export-led growth" only strengthened.

Before the 1997 Asian crisis, the normal range of the U.S. trade deficit was 1 percent of GDP; afterward, it soared to 7 percent of GDP.[140] It is clear that the currency is under pressure from China's rising trade surplus which, in a market economy, would cause the RMB to increase in value. As Derek Scissors, an economist at The Heritage Foundation and a witness at the Commission's February hearing, pointed out, from the end of 2004 to the end of 2008 the RMB appreciated at most by 21 percent against the dollar. At the same time, China's aggregate trade surplus with the world increased by 800 percent.[141] Since June 2008, the RMB has been held by Beijing at around 6.8 RMB to the dollar in order to help support exports during the global recession.[142]

China's government and its export industries benefited greatly from these imbalances when the times were good. Between 2001 and 2007, the export share of Chinese GDP nearly doubled, from 20 percent to 36 percent (see figure 2).[143] China was exporting its products and providing U.S. consumers with the wherewithal to buy them.[144]

Figure 2: China's Exports as a Percent of GDP, 1952–2007



Sources: China National Bureau of Statistics and Morgan Stanley Research.[145]

China's tightly managed exchange rate regime, rising overall trade surplus, and rapid accumulation of foreign exchange reserves have relied on the manipulation of the value of its currency to aid its exporters. In addition, other, more subtle practices remain pervasive. Through its business-oriented but consumer-unfriendly financial system, which is dominated by state-owned banks, China provides cheap capital to many of its enterprises. Land and energy subsidies have also held down the effective cost of production.[146] (See chap. 1, sec. 3, for a detailed discussion of China's industrial policy.) While personal consumption in China moved the opposite way, from 45 percent of GDP in the 1990s to 35 percent of GDP currently, excessive consumption in the United States inevitably led to trade deficits.[147]

China Denies Responsibility

The Chinese leadership has rejected the notion that Beijing shares responsibility for the financial crisis. Chinese policymakers believe that only U.S. overconsumption is to blame for the creation of the global imbalances and "are aghast at any mention of China's contributory role . . . consider[ing] Chinese overproduction to be nothing more than a response to U.S. demand," noted Mr. Pettis.[148] Premier Wen Jiabao told leaders at the World Economic Forum in Davos in January 2009 that the global economic collapse was caused by U.S. policies that included "an excessive expansion of financial institutions in blind pursuit of profit" and an "unsustainable model of development characterized by prolonged low savings and high consumption" as well as lax regulation of the financial sector.[149] In a February 2009 interview with the *Financial Times* in London, Premier Wen expanded on his theory that the meltdown was caused by U.S. borrowing rather than Chinese saving. "It is completely confusing right and wrong when some countries that have been overspending then blame those that lend them money for their spending." Premier Wen insisted that the written statement by Treasury Secretary Tim Geithner to the Senate Finance Committee during his confirmation hearings that China is manipulating its currency to gain a trade advantage was "completely unfounded."[150] White House Press Secretary Robert Gibbs later clarified that Mr. Geithner's statement "was restating what [President Obama] had said during the [election] campaign" rather than presenting a determination by the administration.[151] In its October 2009 semiannual report to Congress, the U.S. Department of the Treasury said that while it "remains of the view that the [RMB] is undervalued," and that "the recent lack of flexibility of the [RMB] exchange rate and China's renewed accumulation of foreign exchange reserves risk unwinding some of the progress made in reducing" global imbalances, no country "met the standards" for illegal currency manipulation.[152]

But few economists outside China think the global meltdown can be blamed on just one party. Wynne Godley, Dimitri Papadimitriou, and Genaaro Zezza, economists at The Levy Economics Institute of Bard College, wrote:

> *Some economists have gone so far as to suggest that the growing imbalance problem was entirely the consequence of the saving glut in Asian and other surplus countries. In our view, there was an interdependent process in which all parties played an active role. The United States could not have maintained growth unless it had been happy to sponsor, or at least permit, private sector [particularly personal sector] borrowing on such an unprecedented scale.*[153]

China's Response to the Crisis

Two years ago, Premier Wen Jiabao warned that the Chinese economy was "unstable, unbalanced, uncoordinated, and unsustainable." The 11th Five-Year Plan, currently in effect, essentially acknowledges this statement and stresses China's need to embark on a major structural transformation from export- to consumer-led growth.[154] However, that reform, welcomed at the time by China's major trading partners, including the United States, has been put on the back burner by Beijing policymakers in favor of stimulating the economy and maintaining a growth rate of around 8 percent.

The stimulus program, detailed below, is not channeling the stimulus money to household consumers and service industries, whose rising demand could absorb a greater share of Chinese production.[155] Instead, the fiscal stimulus is still based on raising production and investment in the manufacturing sector, especially the large, state-owned enterprises that dominate the economy, because exports are still considered a key source of job growth. China's overall trade surplus has continued to grow from just under $17 billion in the first half of 2008 to nearly $33 billion in the second half. In 2009, the increase in China's global surplus continued, despite a decline in exports: for example, the monthly trade surplus grew from $8.25 billion in June to $10.6 billion in July to 15.7 billion in August 2009.[156] Moreover, Chinese household savings are likely to increase due to the economic uncertainty, putting further constraints on consumption. Thus, the fiscal stimulus could end up actually worsening the global imbalances by boosting investment and exports rather than private consumption.[157]

The major risk to the United States and to China's other trading partners comes from several unique aspects of China's stimulus plan. China's plan has increased manufacturing capacity in areas that are already producing excess goods, which has resulted in more export sales at even lower prices. A series of tax rebates and cuts aimed at export industries has been performing the same function, leading to greater trade imbalances. Implementation of plans to create a better health care system and to extend free public education to rural areas has been long overdue, while too little attention has been given to consumer banking reform or an easing of strict capital controls that might encourage Chinese consumers to spend more on imported goods.

China's reliance on U.S. Treasury bonds to park its accumulation of foreign exchange reserves is also unlikely to diminish. First, Beijing continues to effectively peg the RMB to the dollar as a matter of national policy, so China will need to continue to employ capital controls and buy dollars. Second, given the turmoil in world financial markets and the dearth of safe and liquid financial instruments, U.S. Treasuries remain one of the most secure assets for investing China's foreign currency reserves.[158] Between September 2008 and July 2009, Chinese purchases of U.S. Treasury bills amounted to more than $182.3 billion, further consolidating China's position as the biggest holder of U.S. Treasuries.[159]

China's Economic Stimulus Package

In response to the economic crisis, on November 9, 2008, China's State Council announced a plan to increase domestic demand and stimulate economic growth by investing 4 trillion RMB ($586 billion) by the end of 2010 in 10 major areas. By most accounts, the stimulus has reversed China's economic slide, boosting GDP and setting off a domestic construction spree. But the plans also stoked speculation in the Shanghai and Hong Kong stock exchanges and produced warnings that the runaway inflation of the 1990s could return. A heavy reliance on bank lending (some $1.3 trillion in loans in the first nine months of 2009) has also caused the government to instruct banks to reimpose some lending restraint.

China's stimulus has been criticized on a number of grounds. The stimulus includes existing programs, such as earthquake reconstruction, that had already been announced. It requires the provinces and local governments to come up with one-third to nearly three-quarters of the funding—raising doubts as to whether these funds will actually be forthcoming. In addition, the plan will further stimulate export industries at the expense of domestic consumption, contrary to Beijing's stated goal of switching to a more homegrown expansion.[160] Dr. Scissors of The Heritage Foundation wrote that China's stimulus package is "largely a repackaging of previous measures designed to immediately bolster domestic confidence"[161] and that the stimulus is "not intended as a permanent solution, but instead as a mechanism to buy time until foreign demand recovers."[162]

The business and investment-friendly policies announced last November would also cut the value added tax (VAT) on purchases of fixed assets such as machinery, which would lower business costs by 120 billion RMB ($17.6 billion). Additionally, commercial banks' credit ceilings were abolished to channel more lending to priority projects, rural areas, smaller enterprises, and "industrial rationalization through mergers and acquisitions." [163] The government said it would give priority to "maintaining steady and relatively fast growth" in 2009, with "positive" fiscal and "moderately relaxed" monetary policies, translating to support for the export sectors. Meanwhile, easier credit terms reversed a 2007 policy of cutting back lending to fight economic overheating and inflation.[164]

In November 2008, Premier Wen Jiabao announced 10 areas that will receive investment: (1) low-income housing; (2) rural infrastructure; (3) major infrastructure, including railways, highways, and airports; (4) health, culture, and education; (5) ecological environment; (6) science and technology innovation and industrial structure adjustment; (7) post-earthquake rebuilding; (8) income increases for urban and rural residents; (9) value-added tax reform and other methods to reduce the burden on enterprises by 120 billion RMB (about $17.6 billion); and (10) improvement of financial systems in support of economic growth.[165]

Details revealed later that the central government will pay only a third of the total 4 trillion RMB ($586 billion). Government-owned banks, state-owned enterprises, and local governments are expected to provide the remaining 2.28 trillion RMB ($413.3 billion).

Typically, stimulus projects get fast approval and a partial financial contribution from the central government, while local authorities are left to come up with the majority of the funds. But local authorities do not have much money, as China's tax system channels most revenue to Beijing.[166] According to a recent report by China's National Audit Office, many infrastructure projects are being delayed because local governments cannot match the funds provided by the central government, coming up with only 48 percent of their matching funds.[167] Some local governments were so strapped for cash that they used stimulus money from Beijing to retire some of their older debts, the auditor said.[168]

Much of the stimulus spending is long term, designed not only to create jobs quickly but also to strengthen competitiveness in key areas. The loosening of monetary policy, easing of regulations on lending, and extension of tax breaks for exporters will provide quick relief. Some affected social groups, such as the urban poor, farmers, and migrant workers, will receive direct transfer payments, but otherwise the stimulus contains major infrastructure projects that will take years to produce tangible economic effects. And since it is relying on new government bonds and bank lending, the plan is debt driven. China, it appears, is using the global recession to launch long-anticipated reforms in underdeveloped regions, as well as a broad strategic development plan.[169] National Development and Reform Commission Deputy Secretary Ma Liqiang said that many of the projects "were previously on our agenda," but the crisis accelerated implementation plans, with some long-term projects moved up.[170]

China has experienced intense growth in the past decade by relying on manufactured exports. The central government plans to stimulate export-promoting programs by increasing the export tax rebates for a variety of industries including textile, steel, and machinery; upgrading petrochemical refineries; encouraging manufacturing of domestic goods; and eliminating export tariffs.[171]

Rebates of the VAT on goods produced for export were raised seven times between August 2008 and June 2009, in amounts ranging from 5 percent to 17 percent on products including textiles, ethanol, toys, and sewing machines.[172] The government also has extended more than 6 trillion RMB ($878 billion) in loans in the first half of 2009 to help small- and medium-sized companies expand into the international markets and establish distribution channels in emerging markets.[173] Credit lending programs favoring farmers and low-income groups have also been introduced, but urban consumers are not expected to get the income tax rebates that could spur consumption.[174] The government is also launching specific campaigns aimed at boosting exports. For example, in June 2009, China's Ministry of Commerce initiated a "421 project," the goal of which is to secure $42.1 billion of machinery and electronics orders within three months by mobilizing the resources of the state, including China's powerful, state-owned banks.[175]

Shifting to consumption-driven growth is a complex process that cannot happen overnight, but Beijing has shown reluctance to move away from export-oriented growth, despite warnings from economists not to rely on exports to fuel China's recovery and instead to initiate structural economic reforms. Li Yining, a noted economist and deputy director of the Chinese People's Political Consultative Committee's economic committee, argued that China "must not delay economic reform," cautioning that there will be "no true economic recovery without economic transformation."[176]

Later announcements, however, focused on boosting internal consumption. For example, the government announced a three-year, $850 billion RMB ($124.5 billion) plan to improve health care and a 13 percent rebate for rural dwellers on purchases of appliances such as refrigerators and washing machines.[177] The government cut consumption taxes on small cars. Interest rates have been cut five times since September 2008, and controls on bank lending have been eased. In addition, banks have been ordered to reduce required downpayments for mortgages from 40 percent to 20 percent.[178] In June 2009, China also approved a pilot pension program that aims to cover 10 percent of rural counties this year.[179] The Chinese government hopes the program will encourage farmers to spend more and help narrow the wealth gap between cities and the countryside.

For a government long focused on what it termed "social stability," a shortfall in GDP growth is a worrisome development, and a rough official calculation estimates that 1 percentage point of Chinese GDP growth creates about one million jobs.[180] In fact, the Chinese government maintains that a growth rate of at least 8 percent is necessary to avoid massive unemployment. The toll on Chinese employment has already been serious.* Researchers at the

* China's National Bureau of Statistics reported that in 2007 (the latest figures available), the total number of employed persons was 769.9 million. Chinese employment statistics, however, are notoriously unreliable, with the government consistently understating the rate of unemployment; it is also unclear how the migrant worker population is estimated and whether they are made part of the total employment statistics. These data should be viewed with caution. "Table

Continued

Chinese Academy of Social Sciences said that 41 million Chinese workers have lost their jobs as a result of the crisis and that about 23 million of those still remained out of work.[181] The government also acknowledged that by the start of the Chinese New Year festival on January 25, 2009, 20 million, or 15.3 percent, of China's 130 million migrant workers had lost their jobs and had left coastal manufacturing centers to return home.[182]

"Buy American" and "Buy Chinese" in the Economic Stimulus Packages

China is not a signatory of the World Trade Organization's (WTO) Government Procurement Agreement, which leaves it free to favor domestic suppliers in government procurement and allows the United States to exclude Chinese companies from U.S. government procurement programs. Although China criticized a proposed "Buy American" clause in the U.S. economic stimulus package (requiring that construction funds approved by the act be spent only on iron, steel, and manufactured goods produced by companies in countries that are signatories of the WTO's Government Procurement Agreement),[183] that did not stop China from implementing its own policy to keep stimulus money at home. On June 4, 2009, the Chinese central government introduced a comprehensive "Buy Chinese" policy, saying that government procurement with money from the stimulus program must use only Chinese products or services instead of foreign counterparts, unless a domestic equivalent was not commercially or legally available.[184] The edict—issued jointly by the legislative office of the State Council; the National Development and Reform Commission; and the ministries of Industry and Information, Supervision, Housing, Transport, Railways, Water Resources, and Commerce—also accused local governments of favoring foreign suppliers. Foreign companies with a presence in China responded that they have never had much access to government procurement.

Lending Surge by Chinese Banks

Chinese banks are currently under pressure to provide financing for the stimulus. Because the central government will supply only about one quarter to one third of the stimulus, and the local governments that need to finance the remaining three quarters are perpetually strapped for cash, banks will have to finance much of the remainder of the package. They have no option to refuse, because most senior bankers are appointed by the Communist Party.[185] With so much money to push out, there is concern that transparent risk management will take a back seat and nonperforming loans will rise.

The flood of bank credit also raises the specter of inflation and the crucial question of whether borrowers will be able to cover interest costs. Chinese bank lending increased to 8.7 trillion RMB

4–1 Employment," *China Statistical Yearbook 2008* (Beijing: National Bureau of Statistics of China, September 2008). *http://www.stats.gov.cn/tjsj/ndsj/2008/indexeh.htm*.

($1.3 trillion) between January and September 2009—a 149 percent increase over the credit level reported during the same period last year.[186] The central bank reported that new bank lending in June alone has surged by 1.53 trillion RMB ($224 billion).[187] *Caijing*, China's well-respected independent economic magazine, estimated that this year's total is on track to exceed all loans issued over the previous two years combined.[188]

Wei Jianing, deputy director at the macroeconomics department of the Development and Research Center under China's State Council, worries about stimulus lending being wasted on stock and real estate speculation. Wei Jianing, citing *China Business News*, a Shanghai-based newspaper, reported that an estimated 1.16 trillion RMB ($170 billion) was invested in the stock market in the first five months of this year—that is 20 percent of the 5.8 trillion RMB ($849 billion) loans that banks extended in the period.[189]

The Chinese leadership appears to be aware of the concerns over potential bubbles in stock markets, real estate, and commodities, as well as nonperforming bank loans, as a result of the nation's lending spree. New lending in July 2009 fell to 355.9 billion RMB ($52 billion), from 1.53 trillion RMB ($224 billion) in June.[190] Chinese banks habitually "frontload" lending in the first half of each year, but a drop of more than 75 percent is extreme. The *Financial Times* reported that China's central bank had told the heads of the largest state-owned banks to slow the pace of lending, although bank loans again picked up—410.4 billion RMB ($60 billion) in August 2009 and 517 billion RMB ($76 billion) in September 2009.[191] The plunge in lending is unlikely, however, to signal that the Chinese government will start winding down the stimulus measures. In a speech at the World Economic Forum in Dalian on September 10, 2009, China's Premier Wen Jiabao said that China "cannot and will not" pull back from its expansionary policies.[192] Liu Yuhui, an economist at the Chinese Academy of Social Science, said that Chinese policymakers are aware of the harm expansionary policies can do, "but they are unwilling to sacrifice short-term growth and wean the economy from addiction to the stimulus policies," especially with the 60th anniversary of the founding of the People's Republic of China on October 1, 2009.[193]

Most large credit flows are going to state-owned enterprises. In its report on monetary policy, the People's Bank of China said that of the 7.4 trillion RMB ($1.1 trillion) loaned out for the first six months of 2009, 6.3 trillion RMB ($993 billion) went to "non-financial companies and other sectors"—the large state-owned enterprises and infrastructure projects that the government has lined up as part of its stimulus.[194] Data from China's National Association of Industry and Commerce indicate that between December 2008 and January 2009, short-term lending extended to private firms dropped by 700 million RMB ($102.5 million), to 421 billion RMB ($61.7 billion), despite the surge in total lending.[195] The biggest borrower in the first quarter of 2009 was China Aviation Industry Corp, or AVIC, a Chinese aerospace state-owned enterprise, which reportedly received around 336 billion RMB ($49.2 billion) in credit lines.[196] In fact, AVIC received excessive amounts of money and is looking for places to allocate borrowing to increase returns, ranging from resorts and watch manufacturers to makers of airplanes, cars, and electronics.[197] "There are a lot of companies that borrowed not for the need of business expansion, but rather were talked into borrowing by banks," said Ma Jun, chief China economist at Deutsche Bank AG in Hong Kong.[198] Some of those companies in turn lend proceeds to firms that do not qualify for financing from banks, increasing the risk of defaults spreading through the economy, Mr. Ma said. In other cases, corporate loans are being used to cover operating expenses rather than investments.[199] As the banking sector is still dominated by state-owned enterprises, a big rise in nonperforming loans would probably require a further state bailout of the banks.[200]

The government also is trying to extend lending to a broader range of sectors. The China Banking Regulatory Commission, for example, has required banks to open up lending departments to target small- and medium-sized enterprises. However, such steps have had limited effect, because banks are reluctant to shift lending toward firms that are not effectively backed by the government and also because of weaker demand for borrowing amid the economic downturn.[201]

One Chinese economist pointed out that the loose lending encouraged by the stimulus comes with an implicit government guarantee against any losses, which poses a dangerous scenario. He Fan, an assistant director and professor at the Chinese Academy of Social Sciences who frequently advises top leaders, said that as much as two-thirds of Beijing's 4 trillion RMB stimulus program will be spent by local governments, financed mainly by state-owned banks: "Some local governments will virtually go bankrupt. . . . Previously, local governments got all their money from selling land. This is not sustainable. Some areas have already sold quotas from the next 30 years." This risk is exacerbated by a slump in real estate sales. Professor He is also concerned that easy money has poured into asset markets as well as into questionable projects that the National Development and Reform Commission previously rejected. "Banks have strong incentives to lend to National Development and Reform Commission-approved projects, because if they end up as a fiasco, there is no political risk," professor He said. "They can say 'it is not my fault, the [National Development and Reform Commission] told us to lend.'"[202]

Chinese banks are lending at a pace so rapid it will almost certainly lead to a future increase in nonperforming loans, and they are channeling the money into the manufacturing and infrastructure sector. The employment effect of this lending will "naturally contribute to global demand if it takes workers off the unemployment line."[203] However, the consequent increase in production may raise overcapacity, so that China will try to continue to export into a world struggling with collapsing demand.[204]

Conclusions

- The current economic crisis, which started in the United States but has now shifted to encompass the entire world, has its roots in the massive global economic imbalances. The responsibility for these imbalances can be placed partially on the United States as the world's biggest spender and borrower and partially on China as the world's biggest saver and lender.

- China pursues policies that have the effect of increasing Chinese savings, restraining consumption, and keeping the RMB undervalued. These actions boost investment in manufacturing capacity and help to promote Chinese exports. Combined with other export incentives and subsidies, the boom in China's exports helped China accumulate the world's largest foreign exchange reserves, valued at more than $2.27 trillion by the end of September 2009, most of which is invested in U.S. Treasury bonds and other dollar-denominated assets.
- The policies that China adopted generated a huge flow of liquidity—or money that can be easily lent to borrowers—into U.S. markets. This excess liquidity created perverse incentives in the United States that encouraged banks to make risky loans to U.S. households, which in turn grew ever more indebted. High U.S. demand for imports allowed China to save even more, creating a vicious cycle and laying the foundation for the current crisis.
- In response to the crisis, China introduced a fiscal stimulus package, raised rebates to exporters, and introduced other measures supporting the manufacturers in the export sector. This will only exacerbate overcapacity, aggravating the overall problem. China has also taken some steps to increase domestic consumption, but they are far outweighed by measures supporting exports.