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The Impact of the Global Financial Crisis on the Chinese Economy and China's Policy Responses

YU YONGDING

Financial Crisis and Asian Developing Countries

TWN
Third World Network

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NOTE

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Chapter 1

INTRODUCTION

THE United States subprime crisis and the consequent dramatic global slowdown after the Lehman Brothers fiasco hit the Chinese economy very badly. Following the freefall of the global economy, growth of the Chinese economy fell to 6.8 percent in the fourth quarter of 2008 from 13 percent in 2007. At the same time, inflationary pressure disappeared suddenly and was replaced by the threat of deflation.

The Chinese government responded swiftly to the impacts of the global economic crisis. In November 2008, a 4 trillion yuan stimulus package was introduced. Acting in tandem, the central bank, the People's Bank of China (PBOC), cut interest rates deeply, and the growth rate of credit and of broad money shot up. It seems that the economy started bottoming out as early as in the first quarter of 2009, owing to the stimulus package and the extremely accommodating monetary policy. However, it is still too early to judge whether the recovery is temporary or sustainable. To a certain extent, the recovery of growth is achieved at the expense of the worsening of structural problems. It is still too early to answer the question of whether the Chinese economy will be able to come out of the crisis with a more rational structure and embark on a more sustainable growth path.

This paper aims at reconstructing the unfolding of China's growth trajectory before and during the global financial crisis. It examines how the Chinese economy was negatively impacted by the crisis, and the effectiveness of the Chinese government's policy responses to the crisis. Since September 2008 the Chinese government has been faced with three major tasks: crisis management, structural adjustment and protecting the value of its foreign

exchange reserves. Chapter 2 identifies the channels through which economic shocks from the global crisis were transmitted to China. Chapter 3 introduces the Chinese government's policy responses and examines the effectiveness and consequences of these responses. Chapter 4 discusses China's structural problems. Chapters 5 and 6 look at the policy alternatives available to China to minimize the possible capital losses on its foreign exchange reserves and to participate in reform of the international monetary system.

Chapter 2

TRANSMISSION CHANNELS OF ECONOMIC SHOCKS FROM THE GLOBAL CRISIS

THERE are four major channels via which the global financial crisis impacted on the Chinese economy:

- Direct losses in the American capital market
- Changes in cross-border capital flows
- Reduction in growth of exports
- Safety of foreign exchange reserves.

Direct Losses in the American Capital Market

Before the subprime crisis, China's commercial banks had bought a moderate amount of mortgage-backed securities (MBS) and collateralized debt obligations (CDOs). According to the available data, the total direct loss suffered by China's four most important commercial banks on these securities amounted to $20 billion. It seems that the underdevelopment of China's overseas indirect investment spared China from bigger losses.

However, in August 2008, China was on the edge when Fannie Mae and Freddie Mac were on the brink of collapse. If these two US mortgage companies had collapsed, China would have lost some $400 billion in its official foreign exchange reserves. The decision by the US government to place Fannie Mae and Freddie Mac into conservatorship not only saved the two companies but also spared China a very big disaster. Since then China's State Administration of Foreign Exchange (SAFE) has started to gradually change its holdings of government agency bonds into government securities,

and from longer-term US government bonds to shorter-term Treasury bills. However, there is no official data on the change of composition in China's official holdings.

As of June 2008, Chinese commercial banks' holdings of Fannie Mae and Freddie Mac bonds and mortgage-backed bonds guaranteed by Fannie Mae and Freddie Mac amounted to $25.3 billion (Table 1).

There is no comprehensive data available either on the losses on the mortgage-related bonds held by China's commercial banks. According to what data is available, the direct losses seem limited. As of August 2008, Bank of China, which was the most exposed to the subprime crisis among all Chinese commercial banks, had written off $2 billion of subprime-loan-related assets. It was reported that, by the end of 2007, Bank of China's total holdings of subprime loans were $4.9 billion. According to a study by Henseng Bank, as of the end of November 2007, Chinese commercial banks' total holdings of subprime-loan-related bonds came to $18.2 billion. As of January 2008, the total holdings had been reduced to $15.9 billion. In line with Bank of China's write-off rate (40 percent), roughly speaking, Chinese commercial banks should have written off some $7.28 billion in losses. Take into consideration the fact that since early 2008, more and more MBS and CDOs were turning bad, and Chinese commercial banks' losses can be significantly larger. But on the whole and relatively speaking, China's direct losses on MBS and CDOs should be limited. This is mainly because China, as a latecomer, failed to jump on the bandwagon in time to purchase more MBS and CDOs.

On top of the abovementioned losses, seven Chinese commercial banks brought $0.76 billion in Lehman Brothers bonds. Of course, all these investments have had to be written off.

China's total foreign exchange reserves amounted to $2.1 trillion as of the end of the first quarter of 2009. Of these, some $1 trillion was in the form of US government securities, and the bulk of the securities were short-term US Treasury bills. At this moment, the book losses on China's foreign exchange reserve holdings are moderate. According to some sources, China has even earned some money from the holdings, because of the appreciation of the US dollar and fall in US government bond yields since the worsening

Table 1. China's Purchases of Fannie Mae and Freddie Mac Bonds ($ billion)

	Industrial and Commercial Bank of China	Construction Bank of China	Bank of China	Merchant Bank of China	China Investment Trust Bank	Minsheng Bank	Total
Fannie Mae and Freddie Mac related bonds	2.716	3.25	17.286	0.255	1.584	0.227	25.318
Other agency bonds	0.465	2.555	10.637	0.18	0.43	NA	14.24

Sources: Bloomberg and China International Investment Corporation (CIIC)

of the crisis. Obviously, the gain on the books is temporary. In any event, the safety of the value of China's foreign exchange reserves is one of the biggest worries of the Chinese authorities. This issue will be discussed later in more detail.

In summary, compared with the developed economies and economies in Eastern Europe, China's direct losses in its financial assets as a result of the US subprime crisis were limited, as was the impact of these losses on the Chinese economy.

Fluctuations in Cross-Border Capital Flows

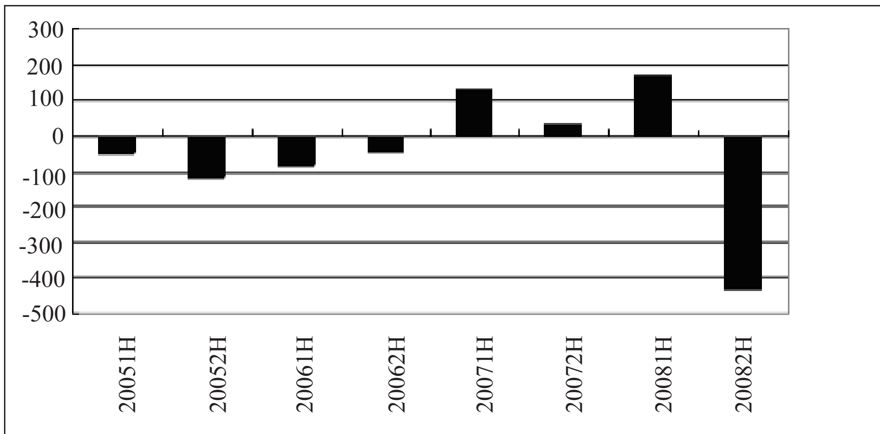
Because China only partially liberalized its capital account, theoretically speaking, cross-border capital can only flow into and out of China via the channels of foreign direct investment (FDI), officially approved foreign borrowing, and portfolio investment by qualified foreign institutional investors and qualified domestic institutional investors, respectively. However, there are many loopholes in the controls over cross-border capital flows. Among them are transactions through underground exchange houses (*dixia qianzhuang*), and under-invoicing of exports and over-invoicing of imports or vice versa (Yu 2008c). As a result, despite capital controls, pro-cyclical cross-border capital flows are still a serious threat to China's financial and economic stability.

Soon after the outbreak of the US subprime crisis, Chinese economists began debating the question of whether international capital would flow into or out of China. Some argued that because of China's relatively strong economic performance, international capital would flow into China to seek safe haven and China should be prepared for a new wave of hot money inflows. Others argued that because of the liquidity shortage, need for capital injection and deleveraging, unwinding of carry trades, and the flight to safety (i.e., US government securities), international investors would liquidate their holdings in emerging markets, and hence international capital would flow out of China and return to the US and other financial centres of developed countries. As it turned out, since early 2008, capital seemed to have been

flowing out of China. For example, China's FDI inflow declined to some $20 billion in 2008 from $50 billion in the previous year.

Traditionally, there are two ways to measure the magnitude of cross-border speculative capital flows (hot money): one is to check the volume of the "errors and omissions" item in the balance of payments; the other is to calculate the so-called unexplained capital inflows (or outflows), which is equal to the change in foreign exchange reserves minus FDI and trade surplus. Of course, these two methods can only provide very rough measures of the magnitude of hot money, but they can still give a sense of direction.

Figure 1. Errors and Omissions in China's Balance of Payments ($ hundred million)



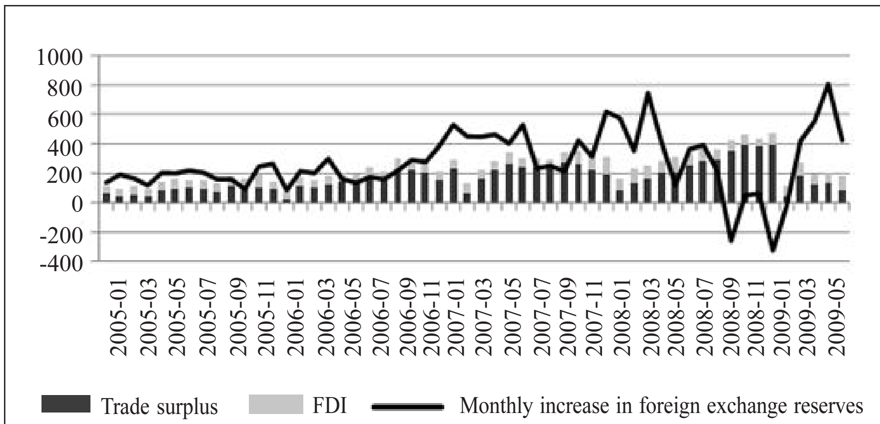
Note: Made by Dr Zhang Ming
Source: State Administration of Foreign Exchange

The statistics on errors and omissions in the balance of payments showed a negative figure of some $40 billion in the second half of 2008, compared with a positive figure of nearly $20 billion in the first half (Figure 1).

According to the second measurement, in 2007 and the first half of 2008, there were hot money inflows, and in the second half of 2008, there were hot money outflows (Figure 2). [In fact, in 2007 and the first half of

2008 hot money greatly complicated the Chinese monetary authorities' efforts to contain asset bubbles and stabilize the yuan exchange rate (Yu 2008c).] However, because of the strong recovery of the Chinese economy and perhaps also due to the improved risk appetite of international investors in general, hot money started to flow back into China since early 2009, increasing strongly since March of that year. In recent months, China's stock prices have rebounded with a vengeance and housing prices have broken the historic record set in 2007 when the asset bubble peaked. In August, hot money seems to have begun flowing out of China again, which may have impacted on the stock exchange crash in the same month. However, due to the lack of statistics, the direction of causality is difficult to judge. Most Chinese economists believe that the alternating between boom and bust in China's stock markets so far is mainly a domestic matter. They also believe that hot money will continue to flow into China but the scale and variation are difficult to estimate. The Chinese government is keeping a close eye on the cross-border capital flows and is ready to take action to maintain the stability of China's capital market.

Figure 2. Short-Term Cross-Border Capital Flows as the Difference Between Increase in Foreign Exchange Reserves and Trade Surplus and FDI ($ hundred million)



Note: Made by Dr Zhang Ming

Sources: Ministry of Commerce and State Administration of Foreign Exchange

As mentioned, therefore, China, like other developing countries, has been impacted by pro-cyclical cross-border capital flows. But, because of China's capital controls and its huge foreign exchange reserves, the PBOC is able to intervene in the foreign exchange market and the yuan exchange rate has been under the effective control of the PBOC. China did not suffer from roller-coaster changes in the yuan exchange rate. However, China's relative success in avoiding the shocks caused by the sudden surge or sudden stop of international capital flows should be mainly attributed to its insistence on maintaining controls over cross-border capital flows rather than to its huge foreign exchange reserves. For most developing countries, self-protection may be their most important motivation for accumulating foreign exchange reserves. For China, this is definitely not the main reason.[1] Finally, it is worth mentioning that despite the fact that capital controls in China are leaky, the controls do increase the transaction cost of the movement of speculative capital flows and hence have significantly reduced the adverse impacts of the global financial crisis on the macroeconomic stability of the Chinese economy.

It seems that the most serious impact of the crisis on the financial front in China was the difficulty in obtaining trade finance, the adverse effect of which was most acutely felt in the processing trade industry.

The Impact of the Global Financial Crisis via the Trade Channel

Compared with other areas, the far more serious impact of the global financial crisis on the Chinese economy has been on trade.

China's fast growth came to a sudden halt in the third quarter of 2008. In the third quarter, China's annualized GDP growth dropped to 9 percent (6.8 percent in the fourth quarter) from 13 percent in 2007; the growth rate of industrial production fell to 8.2 percent, about half the rate in the same period of the previous year; and the growth rates of many important product sectors fell from the double digits into negative territory. The export growth

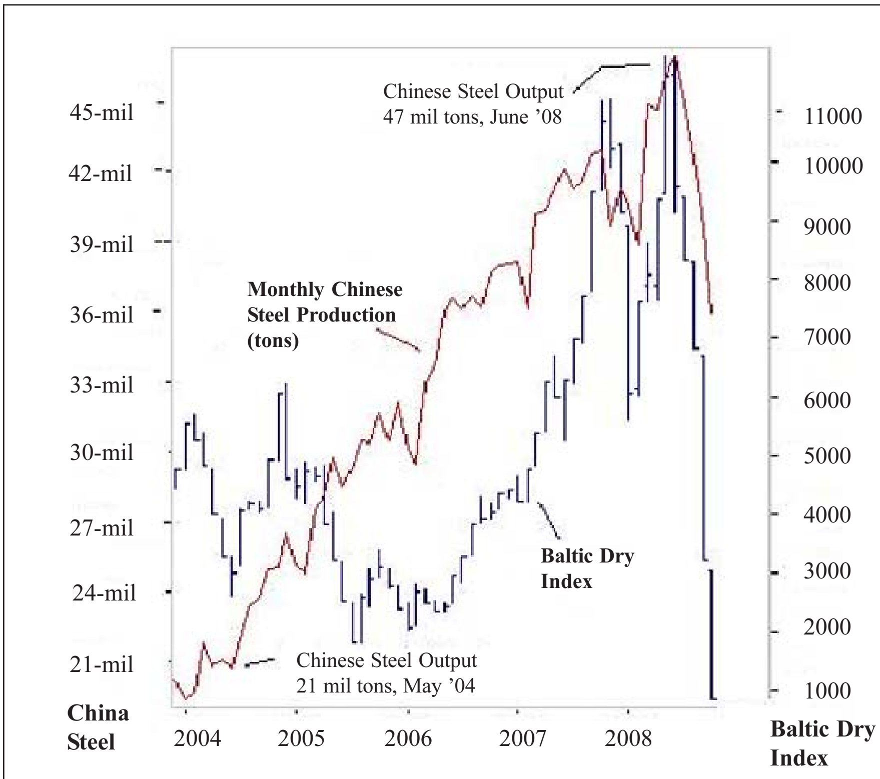
[1] A detailed discussion can be found in Yu (2006).

Table 2. Direct Impacts of the Fall in Foreign Demand on Steel Production

	Quantity, Aug 2008	Quantity, Sep 2008	Reduction in Sep 2008	Percentage reduction
Exports	7.6769 mil t	6.67 mil t	-1 mil t	-13.12%
Total output	47.8 mil t	45.9 mil t	-1.9 mil t	-3.93%
Exports/total output	16.06%	14.53%	53.58%	

Source: Xue Qiyuan, based on various sources

Figure 3. Market Signals of Sharp Downturn in Global Economy



Source: "Can Central Bankers Prevent a Great Depression?", http://seekingalpha.com/article/106770, 19 November 2008

rate fell from 20 percent in October 2008 to -2.2 percent the following month.

Statistics show that the most important cause behind the fall in China's growth in the third quarter of 2008 was the sudden collapse of the export market, which was in turn caused by the sudden worsening of the US financial crisis after the Lehman Brothers collapse. Among Chinese industries, the most dramatic fall in production happened in the steel industry. Indeed, an analysis of the causes of the decline in steel production would shed light on the factors behind the slowdown in the Chinese economy in general (Table 2).

It can be seen that the drop in steel exports directly accounted for 54 percent of the total decrease in steel production in September 2008, and the fall in exports in turn was a direct result of the global economic downturn (Figure 3).

Besides the direct impact, the indirect impact on steel production of the fall in demand experienced by steel-related exporting industries was also very great. On the whole, the decline in external demand can explain more than 60 percent of the fall in steel production.

In summary, the dramatic fall in export demand since the third quarter of 2008 is the single most important cause of China's slowdown. The slowdown in fixed asset investment was the second important contributing factor. The fall in fixed asset investment can in turn be attributed to the slowdown in real estate investment as a result of monetary tightening over the past several years, the fall in export-related investment, the worsening of expectations, and losses incurred in financial market speculation by big state-owned enterprises due to the bursting of asset bubbles and the collapse of commodity prices. Anecdotal evidence shows that the speculative losses of those enterprises were huge, but difficult to substantiate. The third important cause for the slowdown of the economy is the large inventory adjustment. Until the middle of 2008, many Chinese enterprises were still expecting a further rise in prices and engaging in large-scale hoarding. The unwinding of the inventory greatly worsened China's growth downturn. Lastly, the wealth effect of the bursting of the asset bubbles also played a role in slowing growth of consumption.

Chapter 3

CHINA'S MAIN POLICY RESPONSES TO THE GLOBAL SLOWDOWN

WHEN the global slowdown became apparent, the Chinese government shifted its policy direction quickly and forcefully. In November 2008, the government started to implement a very large stimulus package. At the same time the PBOC also ushered in an expansionary monetary policy.

Expansionary Fiscal Policy

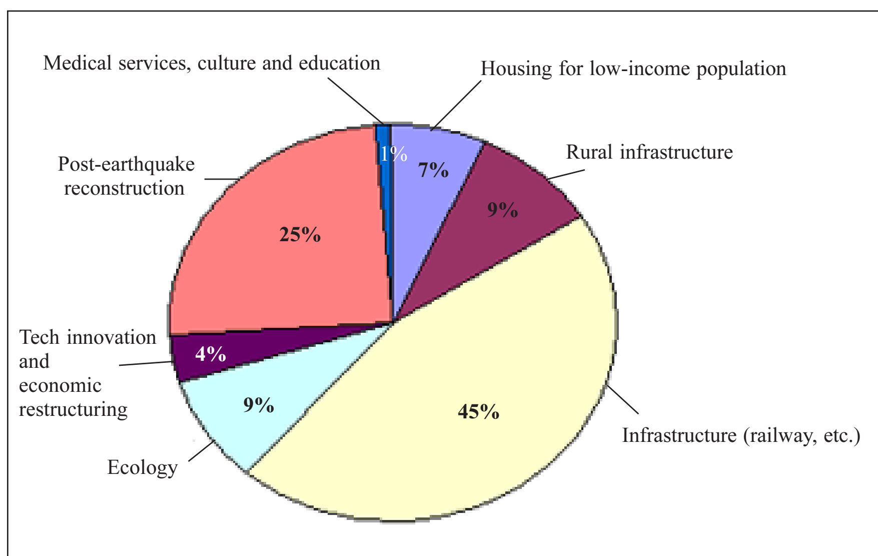
In November 2008, the government introduced a 4 trillion yuan ($580 billion) stimulus package for 2009 and 2010. In 2008, China's GDP was 29 trillion yuan. The package thus amounted to 14 percent of GDP. Besides the increase in expenditures, the government also considered possible tax reductions, which included value-added tax (VAT) reform, purchase tax cut and raising the threshold of individual income taxes. According to the National Development and Reform Commission (NDRC), assuming that the fiscal multiplier in China is 2-3, the package can induce an increase in GDP of about one percentage point in both 2009 and 2010. On top of the central government's stimulus package, provincial governments were encouraged to raise money to launch their own complementary stimulus packages. The total amount of planned stimulus packages announced by local governments stood at 18 trillion yuan.

Table 3. Breakdown of the 4 Trillion Yuan Stimulus Package (billion yuan)

Construction of houses for low-income urban households	280
Increased spending on rural infrastructure and boosting rural incomes	370
Expenditures in transportation network construction	1800
Increased investment in medical services, culture and education	40
Increased spending on ecological protection	350
Technical innovation and economic restructuring	160
Sichuan post-earthquake reconstruction	1000
Total	4000

Source: NDRC

Figure 4. The Structure of China's Stimulus Package



Note: Based on Table 3
Source: NDRC

The structure of the 4 trillion yuan stimulus package is summarized in Table 3 and Figure 4. It is easy to see that most of the money has been and will be spent on infrastructure such as railways, highways and so on, followed by post-earthquake rebuilding.

The sources of financing of the stimulus package were designed as follows:

- The central government will finance one-quarter of the 4 trillion yuan package in the form of direct grants and interest rate subsidies. In the case of central government-sponsored projects, the NDRC and Ministry of Finance may inject all of the registered capital.
- Government bonds will be issued to cover the budget deficit.
- The central government will issue bonds on behalf of local governments to fill the shortfall in financing local projects.
- Bank loans will be an important source of funds, especially for local governments.

In March 2009, the National People's Congress approved the government's new budget for 2009. According to this budget, in 2009, the total government (central plus local) revenue would be 6.674 trillion yuan, up 8.0 percent from 2008. Of this, the revenue of the central government should reach 3.586 trillion yuan, an increase of 9.8 percent over 2008. Total government expenditure (central plus local) would be 7.624 trillion yuan, up 22.1 percent; the expenditure of the central government would be 4.3865 trillion yuan, an increase of 848.501 billion yuan or 24 percent. [2] In 2009, the total government deficit would be 950 billion yuan ($139 billion), the highest in six decades, compared with 111 billion yuan in 2008. The central government's deficit will be at 800 billion yuan, 570 billion yuan more than the previous year. The State Council will allow local governments to issue 200 billion yuan worth of government bonds through the Ministry of Finance.

[2] "The decline of fiscal revenue will not deter the government from increasing expenditures to stimulate the domestic demand", china.com.cn, 21 April 2009.

The expected budget deficit/GDP ratio is estimated to be about 3 percent, compared with a ratio of 0.4 percent in 2008.

There is no detailed information available on how the budget for 2009 was amalgamated with the 4 trillion yuan stimulus package. However, attention should be paid to some key figures provided by the Ministry of Finance in a related report on the central government's 2009 budget:

- 908 billion yuan in public spending, an increase of 487.5 billion yuan, or 54 percent, over 2008.
- 123.08 billion yuan for direct subsidies to agricultural production and trade, an increase of 19.4 percent over 2008.
- 220.833 billion yuan for subsistence allowances for both urban and rural families.
- 103.341 billion yuan for subsidizing rural residents' purchase of home appliances and vehicles and increased reserves of important materials such as grain, petroleum, non-ferrous metals and specialty steel products.
- 716.14 billion yuan, an increase of 120.59 billion yuan or 20.2 percent, to assist agriculture, rural areas and farmers.
- 728.463 billion yuan for items directly related to the people's wellbeing such as education, medical and healthcare, the social safety net and so on, an increase of 29.4 percent over 2008.
- 146.103 billion yuan for science and technology, an increase of 25.6 percent over 2008.[3]
- 500 billion yuan in tax and fee reductions, which partially will be the result of VAT restructuring, increase in tax rebates and exemptions. On the whole the government plans to withdraw or suspend 100 administrative charges by 2009.

According to the Ministry of Finance, as of 31 May 2009, China had allocated 562 billion yuan ($82.3 billion) for public works projects,

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[3] Xinhua News Agency, "Key figures from Chinese Finance Ministry's 2009 draft budget report", 5 March 2009.

completing 61.9 percent of its central budget for 2009. More than half of the allocated funds went to rural development and prominent infrastructure construction:

- 163.5 billion yuan went towards infrastructure projects such as railways, highways, airports and harbour construction.
- 138.1 billion yuan was spent on projects to enhance rural infrastructure and improve living standards in the countryside through the construction of irrigation facilities, power grids and paved roads.

Other spending included:

- 84.8 billion yuan for reconstruction in areas hit by the 12 May 2008 earthquake
- 44.2 billion yuan for education, medical care and cultural development
- 42.7 billion yuan for low-income housing projects
- 41.2 billion yuan for industrial upgrades
- 27.8 billion yuan for environmental protection and energy saving
- 19.7 billion yuan for public service facility buildings.[4]

It can be seen that the most important component in the stimulus package is investment in infrastructure. Fixed asset investment has long been the most important driving force behind China's economic growth, and has been growing faster than GDP since the turn of the century. Due to the dual role of fixed asset investment in creating demand in the short run and supply in the long run, an increasing investment rate will create immediate excess demand for a while, then the economy will shift from a phase of overheating to overcapacity. Since 2001, China's investment rate has been increasing steadily. Investment hit an annual growth rate of 32.9 percent on a year-on-year basis in the first five months of 2009. As a result, China's investment rate may have surpassed 50 percent of GDP.

[4] Xinhua News Agency, 4 June 2009.

The government knows very well that the economy has been suffering from overcapacity. This is why government-financed investment in the stimulus package is concentrated in infrastructure, rather than new factories to further increase China's manufacturing capacity. However, there are three problems with this approach. First, China's level of infrastructure is far ahead of that in other developing countries. Though more infrastructure is needed, waste in infrastructure construction is ubiquitous, due to the scale and hasty implementation of the investment. The future returns on this round of big infrastructure push are worrying. Second, it seems that far more resources should be devoted to providing public goods and building a decent social safety network. However, this is easier said than done. Lack of incentives for the local governments to support this endeavour is one of the most important constraints. Third, public spending should be conducive to private investment and to the development of small and medium-sized enterprises. Unfortunately, it seems that private investors, especially small and medium-sized enterprises, have failed to get much benefit from this spending binge. On the contrary, many local governments are increasingly squeezing small and medium-sized enterprises to compensate for the reduction in their fiscal revenues resulting from the slowdown in economic growth.

Another important feature of China's stimulus plan is the large amount of tax rebates for exports. The amount of rebates was planned to be 670 billion yuan, accounting for some 15 percent of the total central government expenditure. However, it was recently rumoured that to provide exporting enterprises more incentives, the amount of tax rebates would reach 800 billion yuan for 2009. This policy is very problematic. Although some exporting enterprises can survive or linger on for a while because of the policy, its negative impact on resource allocation and rationalization of the economic structure is equally obvious.

In contrast to many developing countries, which do not have adequate fiscal and financial resources, for China, it is not only affordable but also sustainable to carry out a very expansionary fiscal policy. Over the past decade, China's budget deficit as a ratio of GDP was very low. In 2007, China ran a budget surplus. As a result, China's ratio of debt balance to GDP was just 18 percent at the end of 2008. Even after having adopted the

expansionary fiscal policy, by the end of 2009, China's debt balance/GDP ratio should still be lower than 20 percent. Therefore, there is plenty of policy room for the government to manoeuvre.

However, complacency is dangerous. If self-sustained demand cannot be created or revived in a few years' time, the policy space can be used up quickly. Low or even negative returns on the government-financed investment projects will in turn exert increasingly high pressure on the government budget in the future. The non-performing-loan ratio will definitely increase in coming years. The quality and sustainability of growth have been compromised by the overzealous government-led, especially local-government-led, investment drive.

Expansionary Monetary Policy

Table 4. Credit and Monetary Expansion

Billion Yuan, %	May	April	March	February	January
Growth of M1	18.7	17.5	17.0	10.9	6.7
Growth of M2	25.7	26.0	25.5	20.5	18.8
Credit	664.5	591.8	1890	1070	1620
Growth of credits	30.6	29.7	29.8	24.2	21.3

Source: People's Bank of China

Up to May 2009, the increase in bank credits was 5.77 trillion yuan, higher than the official target of 5 trillion yuan for the entire year of 2009. In contrast, the annual increases in bank credits in 2006 and 2007 were 3.18 trillion yuan and 3.63 trillion yuan respectively. The increase in bank credits in the first quarter of 2009 was surprisingly high, and the same was true of the growth rate of broad money M2. The gap between the growth rate of M2 and nominal GDP has broken the historical record (Table 4).

The most important cause of the rapid increase in credits and money supply is the PBOC's expansionary monetary policy. Previously, corresponding to the rapid increase in liquidity caused by PBOC intervention in the exchange market, which was aimed at offsetting the appreciation

pressure on the yuan created by a persistent trade surplus (and capital account surplus), the PBOC sold large amounts of central bank bills to mop up the excess liquidity. Since the fourth quarter of 2008, the PBOC has almost stopped selling more bills. As a result, the liquidity has inundated the inter-bank money market and once even made the interest rates in the inter-bank market lower than the interest on deposits with commercial banks with the same terms of maturity. This was described in China's banking circles as "flour being more expensive than bread".

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

In my view, although monetary policy should indeed be more accommodating, when a large fiscal stimulus package had already been adopted, China's monetary policy in the first quarter of 2009 was too loose. The rapid expansion of credits and money supply was, to a certain extent, the result of non-market interference. There is no sound economic rationale for supporting such a dramatic expansion. If commercial banks had been allowed to make decisions that were purely based on economic considerations, credits and money supply would not have grown so fast. And there would have been less need to worry about the possibilities of a rising non-performing-loan ratio, worsening of economic structure and resurfacing of asset bubbles in the future. Actually, anecdotal evidence shows that a large chunk of excess liquidity has entered the stock and real estate markets. Asset bubbles are returning with a vengeance. The huge gap between the growth rate of M2 and nominal GDP implies very large inflation pressures for the future. Taking into consideration the fact that China has an M2/GDP ratio of nearly 180 percent, the highest in the world, the potential consequences of a loose monetary policy are very worrying indeed.

Chapter 4

STRUCTURAL PROBLEMS IN THE CHINESE ECONOMY

SINCE the beginning, I have not had a shred of doubt about China's ability to achieve a growth rate of 8 percent in 2009. This confidence is based on the following facts:

- Strong fiscal position
- Vast domestic market
- Strong external position.

As a result, the scope for the government to implement stimulus measures is very great. China will effectively be able to spend its way out of the economic slowdown. In fact, at present, "green shoots" can be seen everywhere in the Chinese economy. It is possible that the economy has bottomed out since the end of the fourth quarter of 2008.

According to the most recent government announcement, industrial production rose 8.9 percent in May 2009 from a year earlier, higher than April's 7.3 per cent growth. Retail sales increased 15.2 per cent after a 14.8 per cent rise the previous month. The growth rate of fixed asset investment was 32 percent. The Purchasing Managers' Index (PMI) has stayed above 50 for three months in a row. Housing prices have started to rise in many important cities and the Shanghai Composite Index was approaching 2,700 from the low of 1,600 in late 2008. The bad news is that exports in May fell 26.4 percent from a year earlier, which shows that despite trade promotion policies such as the increase in tax rebates, the recovery of exports is something which cannot be decided by exporting countries themselves alone.

Despite the strong showing, worries about the sustainability of the recovery still linger. The Chinese government is faced with the dual tasks of crisis management and structural adjustment. While we can say that the crisis management has been successful, the same is difficult to say for structural adjustment. To attain a sustainable growth and improve the welfare of the nation, growth should not be achieved at the expense of structural adjustment.

China's structural problems include:

- High external dependency
- High investment rate
- Pollution
- Energy efficiency
- Income distribution gap between different social groups and between rural and urban areas
- Insufficiency in the provision of social goods (social safety net, healthcare, education, etc.).

If China fails to tackle these structural problems, double-dip and W-shaped growth is likely. In order to deal with the structural problems, China should push for more reforms. Actually, the current crisis also presents a good opportunity to speed up reforms. Some key areas of reform include:

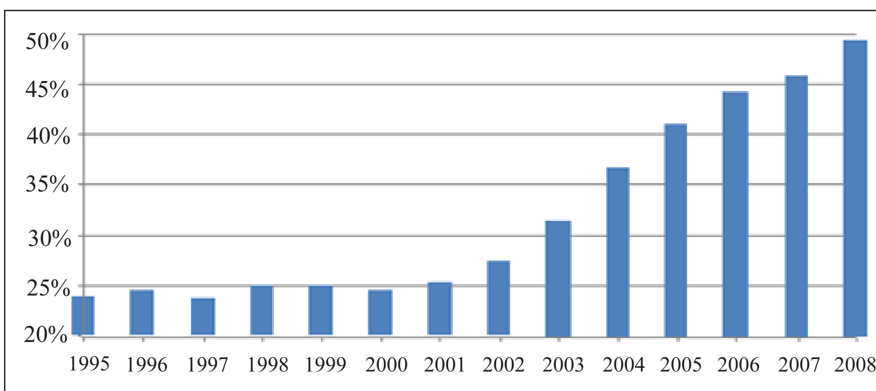
- Liberalize the restrictions to entry into the healthcare, sanitation, education, finance, communication and transportation sectors. Rules of fair competition should be applied to these areas. Anti-monopoly laws should be formulated and enforced in natural monopoly industries;
- Liberalize price controls over energy, water and electricity and allow market demand and supply to determine the prices of these products;
- Further liberalize control on interest rates and establish a more flexible exchange rate regime, and capital controls can be further liberalized side by side with internationalization of the yuan;
- Inefficient enterprises and polluting enterprises should be allowed to go bankrupt, while the government should take more responsibility for providing compensation for the employees of the enterprises;

- A strong policy should be formulated to narrow the income gaps between the rich and poor, between urban and rural areas, and between regions;
- Provision of public goods such as a social safety net, healthcare and free education should be speeded up.

After the global financial crisis, some of China's policy measures are undoing the steps taken previously to rebalance the economy. For example, as a result of the fiscal stimulus package, China's investment rate has become even higher (Figure 5), which means that in the future, China will face even more serious overcapacity. In the pre-crisis period, growth in exports absorbed a large proportion of the overcapacity. In the future, if the growth rate of household consumption fails to increase significantly, fixed asset investment will have to bear an even greater burden of absorbing the overcapacity, or the capital-output ratio will have to increase dramatically. If this happens, the growth miracle of China will come to a sudden end.

The implementation of the investment- and export-driven growth strategy over the past three decades has remade China's economic structure correspondingly. China's investment rate has been significantly higher than even those of Japan and Korea during their high-growth periods. China's trade/GDP ratio is also much higher than that of all major open economies in

Figure 5. China's Investment Rate

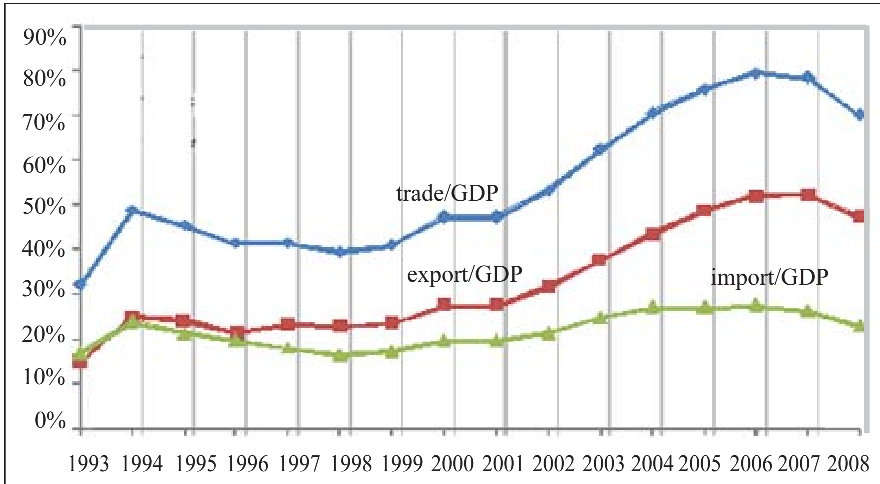


Source: Zhongjing Net databank

the world. In contrast to a ratio of less than 20 percent in the US, in the 2000s, China's trade/GDP ratio has been above 60 percent and rising (Figure 6). Since 2006, as a result of the government's policy of rebalancing, China's dependence on external markets has started to fall. Now as a result of the global financial crisis, the share of China's trade in GDP will fall further. However, this does not mean that China's dependence on external demand has declined structurally.

In short, while I am not at all worried about China's ability to achieve a growth rate of 8 percent for 2009, I am concerned about medium- and long-term structural problems and hence the sustainability of China's growth. Anecdotal evidence shows that low efficiency and wasteful behaviour in investment projects that form part of the stimulus package are prevalent. Asset bubbles aided by excess liquidity are beginning to resurface. It seems that while the Chinese economy is now experiencing a V-shaped rebound, its structural problems are worsening on the whole. This development is indeed cause for concern.

Figure 6. China's Dependence on External Demand (constant prices, yuan)



Source: Wu Haiying, based on Statistical Yearbook of China, various issues

Chapter 5

HOW TO SAFEGUARD THE VALUE OF CHINA'S FOREIGN EXCHANGE RESERVES

The Dollar Trap

THE current global financial and economic crisis was triggered by the bursting of US asset bubbles. Global imbalances were a necessary condition for the formation of the US asset bubble in the first place. Without continuous foreign capital inflows into the US capital market, i.e., without countries like China, Japan and the oil-exporting countries continuously running current account surpluses against the US, the US Federal Reserve would not have been able to maintain the low-interest-rate policy and the long-term yield curve would not have been able to stay flat for so long.

To blame China for the US subprime crisis is ridiculous. However, as I wrote in a paper in 2006 (Yu 2006), "[the correction] of global imbalances not only depends on whether America can reduce its current account deficits but also on how the rest of the world, including China, will respond to the further worsening of [the] US current account deficit. Consensus has been [emerging] that the twin surpluses [in the current account and the capital account] are neither desirable nor sustainable for China. Therefore, China will take actions to correct its imbalances. China's future correction undoubtedly will have [an] important impact on the global imbalances." Unfortunately, China has since failed to do more to correct the imbalances for its own interests.

The global financial crisis and the US government's responses to the crisis have added a new dimension to the issue of rebalancing of the Chinese economy. China's twin surpluses are not just a matter of misallocation of

resources but also a matter of capital losses. As pointed out by some observers, all policy options available to the PBOC aimed at safeguarding the value of China's foreign exchange reserves are unattractive. If the PBOC does nothing and simply holds on to the dollars, the losses will increase. If it buys more to prop up the dollar, it will only face a bigger version of the same problem in the future. If, on the other hand, the PBOC diversifies into other currencies, this will drive down the dollar faster and create greater losses.

What can China do to safeguard the value of its hard-earned foreign exchange reserves? To correct the misallocation of resources embedded in the persistent twin surpluses and to reduce the possible capital losses on its reserves, China should exploit all available channels to rebalance its international balance of payments. The rebalancing problems facing China can be divided into two categories: flow problem and stock problem. Leaving aside for the time being the problem of safeguarding the value of its existing foreign exchange reserves (stock), an important fact is that China's reserves are still increasing at an annual rate of some $200 billion, compared with $400 billion in the pre-crisis period. Therefore, the more urgent task for the Chinese government is to stem the increase in foreign exchange reserves. Only after the reserves stop increasing can China shift its attention to the existing reserve stock. To achieve this objective, the most obvious measure is to run a more or less balanced current account or even a current account deficit, which in turn requires the deepening of structural adjustment to eliminate the savings-consumption gap, reform of the exchange rate regime to minimize government intervention in the foreign exchange market, and elimination of the export promotion policy which creates price distortion.

With regard to the flow problem, there are two things China should do. First, China should reduce its twin surpluses by earnestly implementing the policy measures which have already been agreed upon on paper by government officials and the public. Among the policies, the key one, of course, is to stimulate domestic demand, especially domestic consumption. The global financial crisis may already have had some effect in decreasing the twin surpluses, which may or may not make the US government happier, because the reduction of China's twin surpluses automatically translates into less demand for US Treasuries from China, which is badly needed by the US

government. However, because they have become structural, China will not be able to substantially reduce the twin surpluses, especially the trade (current account) surplus, in a short period of time.[5] Therefore, a key problem China has to tackle head-on is to translate its twin surpluses into assets other than US Treasuries. There are many avenues available to realize this objective.

First, China should promote (it actually has promoted) outbound FDI in developing countries. China has expertise in infrastructure construction while, for many developing countries, lack of infrastructure is the most important bottleneck to economic development. The potential returns on investment in roads, railways and so on in developing countries in Africa, Latin America and some parts of Asia should be relatively high.

Second, China should continue to acquire more strategic resources and increase its reserves of strategic materials gradually.

Third, China should be more actively engaged in M&A (mergers and acquisitions) activities in the developed world.

Fourth, China can adopt a bolder stance when it comes to portfolio investment. Besides US Treasuries, holdings of other types of assets and assets denominated in currencies other than the US dollar should be increased.

Fifth, China should increase lending to international organizations such as the International Monetary Fund (IMF). However, China's claims should be denominated in Special Drawing Rights (SDRs) or yuan. Similarly, China should seek to increase its contributions to the regional financial architecture based on the Chiang Mai Initiative. [6]

Sixth, China should encourage foreign governments and corporations to issue yuan-denominated bonds ("panda bonds"). China can also encourage commercial banks to extend yuan-denominated loans to foreign borrowers. Yuan funds thus raised by foreign entities can be used to buy dollars from Chinese entities.

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[5] Due to constraints of space, this paper will not discuss the issue of how to reduce the capital account surplus.

[6] The Chiang Mai Initiative is a regional currency swap arrangement covering China, Japan, South Korea and the member states of the Association of Southeast Asian Nations (ASEAN).

Seventh, the People's Bank of China should try to increase its currency swaps with foreign central banks.

Eighth, China should increase its aid to the poorest developing countries in the world.

What China can do about its stock of foreign exchange reserves, which is mainly in the form of US government securities, is a more serious challenge. In the next four years, the Obama government is going to sell $3.8 trillion worth of bonds. China cannot help but wonder if there is enough demand for these bonds. In fact, the $3.8 trillion figure is based on very optimistic assumptions on the US recovery; the true amount can turn out to be much larger. On the other hand, with the economic recession, whether US households will have the ability to digest the huge bond issuance is questionable. Currently the US Federal Reserve is implementing very expansive monetary policy, and the excessive reserves (bank reserves in excess of the reserve requirement set by the central bank) have increased from $3 billion to something like $800 billion. The quality of the asset side of the Fed's balance sheet is like junk bond funds. At this moment of crisis, perhaps the policy is acceptable. But when the US economy turns around, risk appetite increases, and people stop hoarding money, inflation can become very serious in the US. China knows neither what the balance of demand for and supply of the US government securities, nor what the Fed's exit strategy, will be. The US government is trying to assure China that its foreign exchange reserves are safe and that the US dollar will remain strong. But the US government and the Fed have failed to provide China with any details of how US policy responses to the global financial crisis will not lead to serious capital losses in China's foreign exchange reserves. Nobody knows whether the US government can, in desperate times, resist the temptation to inflate away its debt burden. The devil is in the details. Empty words of goodwill will not soothe China's nerves. China is worried, and justifiably so. The US government must address China's concern in an earnest manner.

What, then, can China do about its foreign exchange reserve stock? The basic principle should be diversification. This principle should have been heeded a long time ago. Recall that, since 2004, Japan has ceased further

accumulation of foreign exchange reserves by stopping its intervention in the foreign exchange market. In contrast, in roughly the same period of time, China more than doubled its foreign exchange reserves, and surpassed Japan to assume the unenviable position of being the largest holder of US government securities. Even in the second half of 2008, when the prices of US securities were rising, China failed to utilize the opportunity to diversify. If China had done so at the time, it could have succeeded in diversification without dragging down the prices of the US government securities. Instead, China increased its holdings of US Treasuries. However, despite the missed opportunities, China can still do something about the stock of its foreign exchange reserve holdings.

First, China can buy more Treasury Inflation-Protected Securities (TIPS) and the US government should also take the initiative to provide more TIPS-like financial instruments and allow China to convert some of its holdings of US government securities into similar but safer assets.

Second, China should be allowed to convert part of its foreign exchange reserves into SDR-denominated assets. For example, the possibility of reintroducing a substitution account should be considered (see below).

Third, China should not rule out the possibility of selling its holdings of US securities to match the composition of its foreign exchange reserves with that of the SDR. The US government must realize that this is China's legitimate right. In order to avoid bigger losses, China may have to bear some losses due to the sale of the securities. Of course, China should do so with utmost care and with close cooperation with US authorities.

Fourth, if the US government cannot safeguard the value of China's holdings of US government securities, it should compensate China in one way or another. The US should not use the pretext that nothing can be done to interfere with the market mechanism. The US government did not hesitate to protect the money market fund (MMF) market when the funds were facing the danger of "breaking the buck". Some economists have proposed a so-called "grand bargain". This is a proposal worth exploring between the two governments.

Chapter 6

REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Relationship Between Global Imbalances and Global Financial Crisis

THERE is no denying that China has fallen into a dollar trap and indeed this is mostly of China's own making. However, there should be no denying either that the current international monetary system should also share the blame. The fundamental flaw of the system is that the US dollar – a national currency – serves as the dominant international reserve currency. Because the US' obligations are denominated in the dollar, there are no disciplines being imposed on the US monetary authorities. On the other hand, for most countries, China in particular, their claims are denominated in the US dollar and hence there is no way for them to ensure the value of their assets will not be eroded by US policy.

Though a dollar crisis did not materialize in the manner feared by many economists before the global financial crisis, the fundamental problem has not changed. On top of the accumulation of foreign debt, the financial crisis further damaged the credibility of the US dollar. The strong dollar is temporary. If the US fails to rebalance its economy, a dollar crisis will occur, and sooner rather than later. Figure 7 shows that when foreign investors have confidence in the US financial market, despite the accumulation of foreign debts by the US, a dollar crisis will only happen at unsustainability point 2 (the tolerable debt/GDP ratio is relatively high). After foreign investors' confidence in the market has been dented by the financial crisis, for a given debt/GDP ratio, they will demand a higher risk premium and hence a dollar crisis will happen at a lower debt/GDP ratio (unsustainability point 1). As shown in Figure 7, the upward shift of the Triffin dilemma curve

caused by the weakening in the US capital market will bring forward a dollar crisis. To prevent a recurrence of the global financial crisis, and pre-empt a dollar crisis, reform of the international monetary system is indispensable.

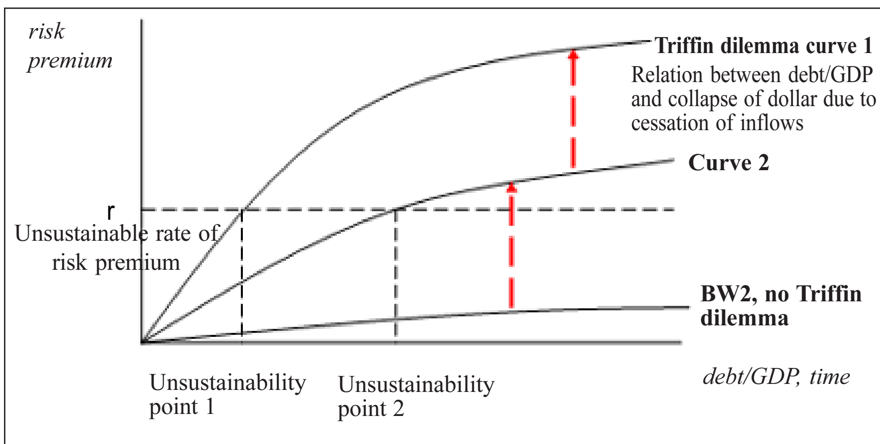
According to the report of a United Nations Commission of Experts (2009) on reforms of the international monetary and financial system, the current international monetary system is flawed and plagued by a number of fundamental problems. China's view on the current international monetary system is not identical to the UN commission's but the two do share many common opinions.

Creation of an International Reserve Currency

Ahead of the G20 summit of major economies in London in April 2009, Zhou Xiaochuan, Governor of the People's Bank of China, released an essay titled "Reform the International Monetary System" (Zhou 2009).

Zhou called for the "re-establishment of a new and widely accepted reserve currency with a stable valuation" to replace the US dollar, a credit-based national currency. The central bank governor noted that the International Monetary Fund's SDR should be given special consideration.

Figure 7. Relationship Between Global Imbalances and the US Financial Crisis



As pointed out by the report of the UN commission (2009), which was led by economist Joseph Stiglitz, there are three fundamental problems with the current international monetary system, which are closely related with the fact that a national currency, the US dollar, is used as the dominant international reserve currency.

First, the system has a deflationary tendency. Under the current system, non-reserve-currency countries have to accumulate foreign exchange reserves and the burden of adjustment is on the current-account-deficit countries, which implies that global purchasing power is withdrawn from the global market.

Second, the system is unequal. Developing countries which have accumulated foreign exchange reserves have to borrow at high interest rates from rich countries or sacrifice the opportunity to invest domestically in exchange for low-yield US government securities. In contrast, the rich countries are able to use cheap capital from developing countries to live beyond their means.

Third, the system is unstable. The dollar as an unchallenged reserve currency enables the US to print money to finance its external debts. As a result, when the foreign debt/GDP ratio reaches a certain level, foreign holders of dollar assets will lose confidence in the dollar, which can lead to collapse of the dollar and upheaval in the international monetary system. As has been shown, the current global financial crisis is at least partially attributable to the inherent instability of the present international monetary system. Therefore, the system should be reformed. The key to the reform is to decommission the US dollar as a dominant reserve currency.

The UN commission suggests that "[o]ne institutional way of establishing a new global reserve system is simply a broadening of existing SDR arrangements, making their issuance automatic and regular. Doing so could be viewed simply as completing the process that was begun in the 1960s, when SDRs were created. The simplest version … is an annual issuance equivalent to the estimated additional demand for foreign exchange reserves due to the growth of the world economy. But they could be issued in a counter-cyclical fashion, therefore concentrating the issuance during crisis periods" (UN Commission of Experts 2009).

The UN commission specifically suggests a few possible approaches. One approach is that countries would agree to exchange their own currencies for the new currency – say, International Currency Certificates (ICC), which could be SDRs – and vice versa in much the same way as IMF quotas are made up today (except that developing countries would only contribute their own national currencies). This proposal would be equivalent to a system of worldwide "swaps" among central banks. The global currency would thus be fully backed by a basket of the currencies of all members.

Another approach is that the international agency in charge of creating global reserves would simply issue the global currency, allocating ICC to the member countries similarly to how the IMF SDRs are issued today. There would be no "backing" for the global currency except the commitment of central banks to accept it in exchange for their own currencies. This is what would give the ICC (or SDR) the character of an international reserve currency, in the same way that acceptance by citizens of payments in a national currency gives it the character of the domestic money. If the global currency is considered a deposit in the IMF or the global reserve bank, and the institution in charge of managing the system is allowed to lend to member countries or buy their government bonds, then those investments would be the "backing" for the global currency just as domestic money is "backed" today by the assets of national central banks (the government bonds in their hands and their lending to private sector financial institutions).

Some economists criticize the UN commission proposals as unrealistic. The main argument against using the SDR as a global reserve currency is that it is not a currency but a unit of account. SDRs can be used to settle accounts with governments and the IMF itself but not for other purposes. They cannot be used to intervene in foreign exchange markets. More generally they cannot be used in transactions with market participants. This means that the SDR is not an attractive form of reserves (Eichengreen 2009).

On 10 July 2009, the IMF Executive Board backed an allocation of SDRs equivalent to $250 billion, as was requested in the $1.1 trillion package agreed at the G20 London summit. According to news reports:

- The SDRs allocated will count towards members' reserve assets.
- The SDR will act as a low-cost liquidity buffer for low-income countries and emerging markets, which will reduce developing countries' need for accumulation of US government securities for the purposes of self-protection and liquidity.
- Some members may choose to sell part or all of their allocation to other members in exchange for hard currency, while other members may choose to buy more SDRs as a means of reallocating their reserves.

The Executive Board decision shows that SDRs are allocated to fulfil the traditional objectives of foreign exchange reserves. Despite the fact that they cannot be used in transactions with (private) market participants, as long as SDRs can be used to settle accounts with governments and the IMF, they can be used to intervene in foreign exchange markets. Hence the increase in allocation of SDRs can lead to a reduction in the accumulation of US government securities as foreign exchange reserves. The decision actually has suggested the direction of how to enhance the role of the SDR in the reform of the international monetary system.

It seems that the use of the SDR as an international reserve currency (not international currency) is not conditional on private demand for SDRs. Bergsten (2007b) even went as far as to say that "the absence of a private SDR market that would permit instantaneous liquidation is in fact a virtue of the scheme, because it reduces the risk of systemic instability, and irrelevant in any event for the massive dollar holders that would still have huge amounts of fully liquid assets after making deposits at the account." As a reserve currency, the SDR would be used only when central banks are intervening in the foreign exchange market. Therefore, the key is whether other *central banks* are willing to accept the SDR in exchange for their own currencies (or accept it as an international fiduciary currency). If this is the case, the need for the accumulation of US government bonds and dollar deposits disappears. When a currency is attacked, the central bank of the country under attack can withdraw SDRs from its SDR account with the IMF and use the SDRs to buy US dollars from the US Federal Reserve. As a result, in the balance

sheet of the country's central bank, both assets (SDRs) and liabilities (commercial banks' reserves with the central bank) will decrease in equal amount. The opposite will be true of the Federal Reserve's balance sheet. There is no change in either country's net assets or liabilities. This arrangement is equivalent to a centralized and controlled system of currency swaps among central banks. It is also a way of multilateralizing current account imbalances.

It seems that this arrangement cannot prevent the US from running current account deficits by printing IOUs. But it will take away a very important incentive for financing US current account deficits from the rest of the world. If there is no country that wishes to run a current account surplus in order to accumulate foreign exchange reserves against the United States, then the latter will not be able to run persistent current account deficits. As a result, a sort of constraint can be placed on the US authorities.

If a country has already accumulated an excessive amount of foreign exchange reserves, the most important question is not whether the central bank can use the SDR to intervene in the foreign exchange market, but whether the SDR can be used as a safe store of value. It seems that an international reserve currency in the form of the SDR would allow the country with excess foreign exchange reserves to convert its dollar assets into SDRs so as to diversify away the exchange rate risks. This is where the idea of a substitution account comes in. As pointed out by Bergsten (2007a), the more immediate threat to international financial stability – that China and perhaps other monetary authorities, together holding more than $5 trillion, will lose confidence in the US currency due to the prospects of huge and sustained budget deficits as well as the financial weaknesses that triggered the crisis itself – could be significantly reduced by creating the substitution account that was actively negotiated in the IMF in the late 1970s and for which detailed blueprints were developed. Instead of converting unwanted dollars through the market, official holders would deposit them in a separate IMF account for the SDR. Their new asset would be liquid and pay a market rate of return. It would provide the desired diversification because the SDR is denominated in a basket of currencies comprising 44 percent dollars, 34 percent euros and 11 percent each yen and sterling. The substitution account simply replaces

one asset with another for a limited group of countries and has no net effect on the global money supply or any other economic variable. The idea of the substitution account shows that the SDR not only can be used by central banks to intervene in foreign exchange markets, but also can replace the US dollar as a more stable store of value.[7]

Nevertheless, there are some questions about the SDR as a reserve currency which need to be worked out. One is: who will bear the exchange rate risk? Changes in the dollar/SDR exchange rate would create losses or gains for the IMF. A sustained decline in the dollar against other currencies that make up the SDR will imply losses (Akyüz 2009).

In my view, the use of the SDR as an international reserve currency and the substitution account are two related but different issues. If it is decided to replace the US dollar with the SDR, the cost of the transformation should be borne by the whole international community. Who has been holding what, is not an important issue. However, if the substitution account is created to allow countries such as China to convert dollar assets into SDR-denominated assets held by the IMF, then there is indeed a question of who will bear the exchange rate risk. In the PBOC's balance sheet, dollar assets will become SDR deposits with the IMF. In the IMF balance sheet, on the liability side, there will be an increase in SDR deposits; on the asset side, there will be an increase in US government securities (denominated, of course, in the US dollar). It is obvious that if China's dollar assets (US government securities) are converted into SDR deposits with the IMF, China will reduce its exchange rate risk and the US will be able to avoid a dollar crisis caused by the dumping of dollar assets by China and other major dollar-reserve-holding countries. If the dollar fails to devalue, with or without the substitution account, nothing serious will happen. If the dollar devalues significantly as expected, it is likely that the IMF's asset losses will be significant. This means that the rest

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[7] According to Bergsten (2007a), the earlier initiative for a substitution account "failed only because the sharp rise in the dollar that followed the Federal Reserve's monetary tightening of 1979-80 obviated much of its rationale and over disagreement between Europe and the United States on how to make up for any nominal losses that the account might suffer as a result of further depreciation of dollars that had been consolidated."

of the member countries of the IMF will have to share the losses that originally would have been borne by China and other reserve-holding countries.

However, it is worth emphasizing that, if it happens, a dollar crisis will be devastating and will seriously hurt everybody, not merely China. With a substitution account, the likelihood of such a dramatic fall of the dollar will be reduced significantly. Hence all members of the IMF will benefit, even if they have to share some losses. Still, there is no denying that China as well as the US will be the biggest beneficiaries of the substitution account and hence they would need to do something to compensate the other member countries. The specific mode of compensation can be worked out beforehand. Bergsten is even more optimistic. According to him, if the substitution account "had been set up in 1980 when previously considered, [it] would have made huge profits for its first five years that would have kept it whole for at least two decades" (Bergsten 2007b).

It is clear that China's interests are not identical to those of many members of the IMF. A substitution account may not be acceptable to many countries which do not hold large amounts of foreign exchange in the form of US dollar assets. This is fine. But if the world enters a "prisoners' dilemma" situation, everybody will be worse off in a big way.

IFI Governance Reform

Creating a global reserve currency or even a substitution account is conditional on reform of the governance of the international monetary and financial system. It seems that at the current stage, reform of the governance of the international financial institutions (IFIs), especially the IMF, is an easier and less controversial issue. The following are some reforms the IMF should begin to implement.

Firstly, the IMF should re-examine its traditional policies and move further away from free-market ideology. Over the past decade, many of the IMF's policy prescriptions, characterized by an underlying dogmatism, have been proven wrong. Diversity of ideas and pragmatic approaches should be encouraged within the IFIs.

Secondly, the governance of the IFIs should be reformed. For decision-making in the IMF to be more inclusive and equitable, at least five things should be done. First, the basic votes should be further increased, so that the share of basic votes in the total votes is higher. Second, the quota formula should be reformed to reflect economic reality. In line with the distribution of quotas, China, India and many emerging economies are under-represented in the current IMF voting framework. This arrangement is totally unacceptable. For China, increasing the quotas of developing countries is probably one of the most essential reforms that the IMF needs to undertake at this stage. Third, double-majority voting should be applied to a broader set of decisions to compensate for voting imbalances. Double-majority voting (shares and chairs) should be extended to the selection of the IMF Managing Director and the chair of the International Monetary and Financial Committee, as well as to key policy decisions. Fourth, consideration should be given to eliminating effective veto powers over decisions to amend the IMF Articles of Agreement. Fifth, selection of IMF and World Bank senior managers should be based on merit and should ensure broad representation of all member countries. The selection process should be made more transparent.

Thirdly, to strengthen the role of the IFIs, their financial resources should be increased. For the IMF, there are two major channels for increasing its financial resources: one is to increase the quotas and the other is to borrow more. The current quota formulation cannot reflect the shift in the balance of power between developed and developing countries. To increase financial resources as well as to improve governance, the quotas of developing countries should be increased as soon as possible. With regard to the increase in financial resources, China will be more than happy to make more contributions to the IMF, and the preferable form of contribution for China is to buy SDR-denominated IMF bonds. China has already officially expressed its desire to invest in bonds denominated in SDR as a way to increase the resources of the IMF. The G20 meeting in London announced a $1.1 trillion package to help member countries overcome the difficulties brought by the global crisis. As mentioned, on 10 July 2009, the IMF board backed an allocation of SDRs equivalent to $250 billion, as part of this package. This

increase in SDR allocation is a very positive step forward towards the strengthening of the IFIs' roles. China's contribution to the London package is $50 billion and it could have contributed more. However, to obtain the support of the public in China, more fundamental reforms of the IMF, such as an increase in China's quota, are indispensable.

Fourthly, as argued by the UN expert commission, to strengthen the role and improve the governance of the IFIs, it is important to involve the UN and other UN organizations. "Neither the G-7 industrialized countries nor the G-20 represents a sufficiently inclusive global steering group for addressing global systemic challenges … While the G-20 (which actually has 22 members) is more broadly based, there is still no representation of the remaining 170 countries" (UN Commission of Experts 2009). The shape of any future governance format must ensure inclusiveness and adequate representation of developing countries. It is therefore important to strengthen international institutions, especially the UN, the body which is the most universal, legitimate and accountable to the people of the world. This inclusive response will require the participation and involvement of the entire international community. As the UN commission suggested, "there should be consideration of a new Global Financial Authority to coordinate financial regulation in general and to establish and/or coordinate global rules in certain areas, such as regarding money laundering and tax secrecy." The re-establishment of the Financial Stability Forum as the Financial Stability Board (FSB) with a wider membership is a step with potential.

Chapter 7

CONCLUDING REMARKS

CURRENTLY, China is faced with three major challenges: arrest the fall of the growth rate and the increase in unemployment; continue to carry out structural reform; and safeguard the value of its foreign exchange reserves. So far the Chinese government has successfully arrested the downturn in the economy. There are few economists in China who doubt that a growth rate of 8 percent can be achieved for 2009. On the structural reform front, success is not so obvious. Though there is some progress, on the whole, the structural issues seem to be worsening. As for safeguarding the value of China's huge foreign exchange reserves, it seems that it is rather late for China to take any initiative. However, better late than never.

More fundamentally, China's task is to change its export- and investment-led growth model. Over the past three decades, owing to gradual reform and opening up to the outside world, the Chinese economy has maintained an average annual GDP growth rate of 9.8 percent. China has become the third largest economy, the second largest trading nation and the largest foreign-exchange-reserve-holding country in the world. China's growth is truly an epoch-making miracle.

Now as the global financial and economic crisis is still unfolding, the growth strategy and economic policy of the Chinese government are put to the test. It seems that the Chinese government has been very successful in responding to the global slowdown in a very swift and determined fashion. As a result, the Chinese economy has been bottoming out. However, the seriousness of the impact of the global crisis on the Chinese economy shows that China needs to speed up its structural reform and adjust its once very

successful strategy and policies in a timely way. Otherwise, the Chinese economy may lose its growth momentum in the near future.

To deal with one of the root causes of the global financial crisis, reform of the international monetary system is also high on the agenda. While actively engaging on this front, China has more initiatives to take in the areas of regional financial cooperation and the internationalization of the yuan. The latter two issues are as important as China's involvement in international monetary reform, but they will be dealt with on other occasions.

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THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON THE CHINESE ECONOMY AND CHINA'S POLICY RESPONSES

China, one of the world economy's great growth success stories, was badly hit by the global financial crisis in 2008. While adverse impacts from investments in toxic financial assets and from volatility in capital flows were relatively limited, the Chinese economy suffered a serious blow from the collapse in demand for its exports.

In response to the growth slowdown, the Chinese authorities adopted expansionary fiscal and monetary policy measures, including a 4 trillion yuan stimulus package and deep interest rate cuts, which sparked an economic recovery in 2009. However, concerns about the longer-term sustainability of China's growth persist, given the many structural problems in the economy. This paper argues the need for urgently addressing these flaws – which range from unequal income distribution to the lack of a social safety net – if China is to embark on a more sustainable growth path. Above all, the author stresses, there should be a rethink of the export- and investment-led growth model which has served China so well but which may now require adjustment.

The global financial turmoil has also highlighted another major challenge facing China: safeguarding its huge stock of foreign exchange reserves against capital losses caused by a declining US dollar. This paper explores the steps that can be taken by China towards this end, including diversification of its reserve holdings and, in the longer run, rebalancing of its balance of payments. In addition, the paper also makes the case for reform of the international monetary system to address one of the root causes of this "dollar trap" and, indeed, of the global financial crisis itself.

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