THE INTERNATIONAL FINANCIAL CRISIS AND CHINA'S EXTERNAL RESPONSE

ZHENG Yongnian & LYE Liang Fook

EAI Background Brief No. 420

Date of Publication: 17 December 2008

Executive Summary

1. China has been inadvertently thrust into the political limelight as the global financial crisis unfolded. With the world's largest foreign reserves of US$1.9 trillion, China has been perceived as a "white knight" or "savior" to stabilize the international financial system or to simply bail out the US economy.

2. Faced with such inflated expectations, China has been pro-actively working with other countries and international institutions to jointly explore ways to restore calm to world markets. Its leaders and officials have been in constant touch with their counterparts in other countries in this effort.

3. China hosted the 7th Asia-Europe Meeting (ASEM) Summit in Beijing and attended the G20 Leaders' Summit in Washington and APEC Economic Leaders' Meeting in Peru. These multilateral forums have had mixed results given the difficulty of coordinating actions across borders. Nevertheless, they show China's readiness to work with the international community to find ways forward.

4. On a smaller scale, China has achieved better results. It was instrumental in the decision by the ASEAN plus Three countries at the 7th ASEM Summit to set aside about US$80 billion in foreign reserves to better protect their currencies against the economic uncertainty. Separately, China joined other G7 central banks in a rare coordinated interest rate cut.

5. However, China is neither willing nor ready at the moment to over-commit itself externally to deal with the global financial crisis. Instead, its leaders have stated its primary goal of keeping its own economic house in order as an important contribution to global financial stability and economic growth.

6. There are strong domestic reasons for China to focus on the health of its economy. The slowdown in growth has led to fears of further socio-economic hardships that may threaten China's social and political stability. Generating

sufficient employment will be a daunting task given the massive layoffs and factory closures.

7. Politically, the Chinese leadership has to be responsive to its people in times of hardship. This is crucial given its pro-people orientation and stress on social harmony. The financial crisis has further triggered an internal ideological debate. Hence, the leadership has to avoid being seen as pandering too much to the West. Premier Wen Jiabao has apparently come under veiled criticism for his advocacy of universal values such as democracy and human rights.

8. Going forward, China's preoccupation will be in maintaining its growth momentum. Despite this domestic orientation, China can be expected to position itself to assume a bigger role in any future financial order. This is not expected to be a smooth process as it would require the US and European countries to share power with China.

9. The current global financial crisis is likely to bring about a significant power shift in global politics. The US will still emerge from the crisis as the leading economic superpower, but politically chastened and economically much weakened. This will provide emerging powers like China and India more international space.

10. It is also worthwhile to note that China has so far only delineated for itself the minimum base position of keeping its own economic house in order. There is sufficient room for China to do more if it decides to do so in the future. China may make a contribution to the international financial institutions in return for a bigger role at these platforms.

THE INTERNATIONAL FINANCIAL CRISIS AND CHINA'S EXTERNAL RESPONSE

ZHENG Yongnian & LYE Liang Fook*

China's Constraints and Calculations

1.1 The financial crisis that originated from the US and subsequently developed into a world-wide phenomenon has unwittingly thrust China into the political limelight. With the world's largest foreign exchange reserves of US$1.9 trillion as at September 2008, and with roughly two-thirds of this amount believed to be held in US-denominated assets, China is being seen as a possible "white knight" or "savior" to stabilize the international financial system or to simply bail out the US economy.[1]

1.2 The calls for China to do more came mainly from Europe and the US. Jose Manuel Barraso, European Commission President, reportedly called on Beijing just before the 7th Asia-Europe Meeting (ASEM) Summit to help resolve the global financial crisis in return for Beijing being granted more say in international financial bodies.[2] Less explicitly, John Lipsky, International Monetary Fund (IMF) first deputy Managing Director, has commented that "it is absolutely natural that China will play an increasingly important role in the world economic affairs".[3]

* Professor Zheng Yongnian is Director of the East Asian Institute at the National University of Singapore. Mr Lye Liang Fook is Senior Research Officer at the same institute. The authors would like to thank Prof John Wong for his valuable advice and comments on improving this paper.

1 "Will China bail out the West?", *BBC*, 15 October 2008 and "China seen as savior in global financial crisis", *Herald Sun*, 9 October 2008.

2 EU presses China to show leadership in crisis, *Reuters*, 23 October 2008.

3 "IMF: China to play more important role in world economic affairs", *China Daily*, 6 November 2008.

1.3 In response, China has indicated its readiness to work with other countries to address the challenges at hand. From the onset of the crisis, President Hu Jintao and Premier Wen Jiabao have engaged in telephone diplomacy with their counterparts from the US and Europe to discuss ways forward. At the working level, the People's Bank of China (China's Central Bank) has stated China's willingness to enhance coordination and cooperation with the US and other markets to overcome current difficulties.[4]

1.4 China hosted the 7th ASEM Summit from 24-25 October 2008 that called on all countries to take "firm, decisive and effective measures" as well as strengthen "coordination and cooperation" to deal with the crisis.[5] President Hu Jintao attended the G20 Leaders' Summit in Washington on 15 November 2008 that approved an action plan to deal with the crisis. Most recently, at the APEC Economic Leaders' Meeting in Peru from 22-23 November 2008, President Hu joined other world leaders to pledge not to implement protectionist measures for the next 12 months – no matter how punishing the global downturn gets.[6]

1.5 Most significantly, the primary role that China has set for itself is to put its own economic house in order. Hu Jintao said in his 7th ASEM Summit opening address that China's "sound economic growth is in itself a major contribution to global financial stability and economic growth".[7] Before the start of the G20 Leaders' Meeting, China announced a domestic economic stimulus package of four trillion *RMB* (US$586 billion) to keep its economy humming. This package helped dampen the expectations of the EU and the US for China to do more.

---

4 "China's central bank welcomes US bailout plan, willing to cooperate on financial issue", *People's Daily*, 4 October 2008.

5 "Full text of statement of the Seventh Asia-Europe Meeting on the International Financial Situation", *Xinhuanet*, 24 October 2008.

6 In his speech at the APEC Economic Leaders' Meeting, President Hu Jintao reportedly said that "a fair and open multilateral trading regime is conducive to the steady growth of regional and global trade, to the sound growth of the world economy and to the benefit of all parties". See "Leaders stand by free trade, vow to revive Doha", *China Daily*, 24 November 2008.

7 "ASEM starts with financial crisis as top agenda", *China Daily*, 24 October 2008.

1.6 China is neither willing nor ready (or financially capable) at the moment to over-commit itself externally to deal with the global financial crisis. The main reason is China's need to grapple with urgent domestic challenges, foremost of which is to sustain the growth momentum of its economy which is already showing signs of slowing down.[8] The decline in export orders and weak domestic demand have led to layoffs and factory closures. Domestic investment is also cooling as companies cut back or put off spending on real estate, factories and other assets. The property market is tanking and stock prices are off 60% compared to a year ago.[9]

1.7 Within China, there is much criticism especially in unofficial circles of the excesses of the US financial system such as spending beyond its means and the lack of regulation and supervision. There is a perception that since the crisis started from the West, it is the responsibility of the relevant parties there to turn the situation around. It is neither right nor fair for China to take on this role. In fact, some have asserted that the US' woes vindicated China's brand of socialism. Others have called on China to take advantage of this crisis to demand a greater say in world economic and political matters.

1.8 As the financial crisis has triggered an internal ideological debate, the Chinese leaders have to tread carefully so as not to appear as pandering too much to the West at the expense of China's interests. Chen Kuiyuan, Chinese Academy of Social Sciences (CASS) President, reportedly said at a forum in July 2008 that there were some in China who ardently talked about following universal values. Chen cautioned that China should not blindly elevate the values of the West as universal values and denigrate the values of the Party and country as belonging to a different category.[10] Chen's comments appeared to be directed

---

8 "Bowring: China can't help", *IHT*, 25 November 2008.

9 "China's economy sputters", *Businessweek*, 2 October 2008.

10 Chen Kuiyuan is also Vice Chairman of the Chinese People's Political Consultative Conference. His July 2008 comments subsequently appeared in the 2 September 2008 issue of the newsletter of the Chinese Academy of Social Sciences. See http://chinausnews.com/html/46/n-1046.html.

at Premier Wen Jiabao who has said that democracy and human rights were universal values and that these values were not the sole preserve of the West.[11]

1.9 China will continue to focus on the health of its domestic economy and be cautious about shouldering additional financial responsibilities on the external front. This, however, does not preclude China from pushing for a retooling of the international financial system to allow a greater voice for developing countries, itself included. This is likely to be a long drawn affair as existing stakeholders in the IMF and World Bank can be expected to quibble over ways of sharing power with China.

China's Calibrated External Response

2.1 China has faced much external pressures to shoulder a heavier burden to help the affected economies. Yet, China has cleverly deflected such pressures by pro-actively working with all concerned to find solutions at the bilateral and multilateral levels. These approaches, however, have had mixed results given the difficulty of coordinating responses across borders. Most significantly, China has introduced bold measures at the national level to keep its economy humming.

2.2 At the bilateral level, China has been in touch with the key affected countries to indicate its willingness to work with them to address the challenges. In a telephone conversation with President George Bush in September 2008, President Hu Jintao reportedly expressed the hope that the package of measures contemplated by the US would lead to a gradual recovery of the financial market.[12] Wen Jiabao apparently went further by expressing China's willingness to cooperate with the US to address the crisis.[13]

---

11 "Hardliners in bid to oust China's PM", *The Sunday Times* (UK), 19 October 2008.

12 "Chinese, US Presidents talk over phone about ties, US financial turmoil", *Xinhuanet*, 22 September 2008.

13 "FM: Premier Wen elaborates China's policies of reform, development during UN visit", *Xinhuanet*, 26 September 2008.

2.3 In particular, US Treasury Secretary Hank Paulson has praised China's cooperation in taming the global financial turmoil and acknowledged his useful and constructive discussions with Chinese Vice Premier Wang Qishan on the issue.[14] At the 5th Strategic Economic Dialogue in Beijing in December 2008, both countries agree to provide an additional US$20 billion to finance trade between China and the US, and between them and other developing economies. Besides the US, Chinese leaders and their officials have also been in touch and held discussions with their respective European counterparts on steps to take to address the crisis.

2.4 At the multilateral level, China has attempted to facilitate a broader response to address the crisis but with mixed results. A primary focus of the 7th ASEM Summit, attended by 45 European and Asian partners in Beijing in October 2008, was to restore calm and ensure future growth.[15] The summit called on all countries to undertake the necessary measures either nationally or jointly to deal with the crisis. The leaders also pledged to undertake effective and comprehensive reform of the international monetary and financial systems.[16]

2.5 Some observers have commented that the summit contained much positive rhetoric but was short on concrete outcomes such as coordinated action.[17] Such comments have to be put in context given the difficulty of coordinating action across borders. Yet, China's role in highlighting the need for concerted action should be acknowledged. Moreover, China was instrumental in the decision of the ASEAN plus Three countries to pool together about US$80 billion in foreign exchange reserves to better protect their currencies against

---

14 Paulson made these remarks at the National Committee on U.S.-China Relations in New York. See "Paulson lauds China cooperation amid market turmoil", *Reuters*, 21 October 2008.

15 This is the largest turnout of Asian and European leaders since ASEM was established in 1996. The large turnout was partly due to the admission of new partners after ASEM's second round of expansion in 2007. Members brought in were India, Pakistan, Mongolia, Romania, Bulgaria and the ASEAN Secretariat.

16 "Full text of statement of the Seventh Asia-Europe Meeting on the International Financial Situation", *Xinhuanet*, 24 October 2008.

17 "Summit big on promises but short on solutions", *South China Morning Post*, 26 October 2008 and "Asia, Europe pledges on financial crisis leave questions", *AFP*, 26 October 2008.

the growing economic uncertainty.[18] In early October 2008, China also joined other G7 central banks in a rare coordinated interest rate cut.

2.6 At the G20 Leaders' Summit in Washington, President Hu Jintao together with other leaders who represent 85% of the world economy endorsed an action plan to deal with the challenges ahead.[19] The key issues agreed included reforming international financial institutions (such as the World Bank and IMF), strengthening financial market transparency and accountability, ensuring banks and financial institutions' incentives "prevent excessive risk taking" and drawing up a list of financial institutions whose collapse would endanger the global economic system.[20]

2.7 China also championed the interest of developing countries through the G20 Summit platform. As the largest developing country, China is best qualified to assume this role, thereby enhancing its legitimacy in the eyes of the developing world. At the summit, President Hu Jintao called on the international community to pay "particular attention to the damage of the crisis on developing countries", especially the least developed ones, and do all it can "to minimize the damage".[21] In particular, the African Union had earlier expressed disappointment over its exclusion from the summit.[22]

2.8 At the national level, China has introduced the most concrete of steps to fight the negative impact of the financial crisis. It repeatedly stressed that its priority was to keep its own economic house in order. In defining this limited role, China adroitly deflected pressures for it to bail out other economies.

---

18 The "ASEAN Plus Three" fund would supersede the Chiang Mai Initiative, which came into being in 2000 in the wake of the 1997 Asian financial crisis to ease mainly bilateral currency swaps.

19 The G20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the UK, the US and the European Union.

20 "Leaders welcome G20 action plan", *BBC News*, 16 November 2008.

21 "Hu urges help for developing nations to cope with financial crisis", *China Daily*, 16 November 2008.

22 "Leaders urge Africa focus at G20", *AFP*, 12 November 2008.

President Hu Jintao set the tone when he said at the 7th ASEM Summit in October 2008 that China's sound economic growth is in itself a major contribution to global financial stability and economic growth.

2.9 Most significantly, on 9 November 2008, China unveiled a comprehensive economic stimulus package of four trillion *RMB* (US$586 billion) to bolster its slowing economy. This amount would be spent by 2010 on a wide array of national infrastructure and social welfare projects, including constructing new railways, subways, airports and rebuilding communities devastated by the earthquake in Sichuan in May this year. This package comes on top of earlier measures to loosen credit and encourage lending as well as increase tax rebates for exporters.[23]

2.10 The announcement of this package was timed almost a week before the convening of the G20 Leaders' Summit in Washington on 15 November 2008. The unequivocal message to the world was that Beijing's foremost duty was to its people. President Hu further said in his address to the G20 Leaders that major developed countries "should undertake their due responsibilities and obligations" by implementing the necessary policies and measures to stabilize their own and international financial markets.[24] This was a veiled call primarily to the US to do more to resolve the crisis.

Pressing Internal Preoccupations

3.1 There are strong reasons behind China's measured external response. The most important is the Chinese leaders' concern that the slowdown in China's economy will engender further socio-economic hardships that may threaten China's social and political stability. China's economic growth slipped to 9% in the third quarter of 2008, down from 10.1% in the second quarter. This is the first time in five years that growth has fallen to single digit.[25] The

---

23 "Economy gets $586 b power dose", *China Daily*, 10 November 2008.

24 "Hu calls for concerted efforts to tide over financial crisis", *China Daily*, 16 November 2008.

25 China's GDP growth in 2007 was 11.4%.

slowdown is partly due to shrinking demand from abroad and partly to worsening downward pressure from weak domestic demand.

3.2 The falling demand has exacerbated layoffs and factory closures. The most hard-hit are the manufacturing and labor-intensive textile, garment and toy sectors. According to official statistics, 67,000 previously profitable SMEs collapsed during the first half of this year.[26] Also, a total of 3,631 toy exporters or around 53% of the industry's businesses shut down in the first seven months of 2008.[27] The brunt of such collapse has been borne by migrant workers who work in these enterprises.

3.3 Finding jobs for the millions of unemployed and the more than 20 million new entrants into workforce next year will be one of the Chinese leadership's biggest challenges.[28] To sustain growth, the government has also recognized the importance of pump priming the economy, stimulating domestic consumption, bolstering and restructuring the export sector, and restoring confidence to China's stock and property markets. Simultaneously, the government is paying more attention to improving social welfare such as education, health care and extending the pension scheme to the rural areas.

3.4 Besides economics, there is also a political dimension to China's reluctance to play a more active external role. This is related to the pro-people orientation of the Hu-Wen leadership, of which a major tenet is to be responsive to the needs of the people. At a time when China is experiencing an economic slowdown and its attendant problems, the people would expect the government to put their needs first. By responding to this need, the government and, more importantly, the Party are renewing their social contract and in the process reaffirming their legitimacy.

---

[26] China's registered SMEs exceeded 4.3 million and contributed almost 60% of GDP, 50% of tax revenue, 68% of exports and 75% of new jobs every year. See "China's small companies warned of hard times ahead", *China Daily*, 20 October 2008.

[27] "Half of China's toy exporters out of business", *Xinhuanet*, 14 October 2008.

[28] "China's worse nightmare: unemployment", *Time*, 31 October 2008.

3.5 The Chinese leadership also has to take into account the surge in criticism among certain quarters within China of the excesses of the US financial system and to some extent the limits of capitalism. To be sure, some of these criticisms are constructive to furthering China's interests. For instance, Wu Jinglian, an economist with the Development Research Center of the State Council, was quoted as saying that the US financial model, based on excessive expenditure, was in need of a review.[29] Others have suggested that China should seize the opening provided by the crisis to secure a bigger say in the global political and economic order.[30]

3.6 Other criticisms are more extreme in that they discredit what the West stands for and attack those in China perceived to be pandering too much to the West. The opening salvo appeared to be fired by Chen Kuiyuan, CASS President, who criticized those who ardently champion universal values at a forum in July 2008. Chen's remarks were published in the 2 September 2008 issue of the CASS newsletter.[31]

3.7 Thereafter, renowned publications such as the *People's Daily* (the Party's Central Committee newspaper), *Study Times* (the Central Party School newsletter) and *Guangming Daily* (the Department of Propaganda newspaper) carried articles that variously questioned the existence of universal values, their applicability to China, and the ulterior motives of those who purportedly subscribe to such values.[32] Without naming names, these articles appear to be directed against Premier Wen Jiabao who has previously spoken about universal values such as democracy, rule of law, freedom, human rights, and equality and how China should work towards these ideals.

---

[29] "Zhongguo ying zhuazhu jiyu baituo mei niuqu jingji" (China should seize the opportunity to break free from the US distortion of economics), *Ming Pao News*, 20 October 2008.

[30] *Ibid*. In particular, these scholars have suggested that China should push for an international financial order where a few major currencies could be readily used instead of only the US dollar. China should also seek a bigger say and participation rights in the area of international financial supervision.

[31] "Yuyong lilun jia weigong Wen Jiabao" (Going through theoreticians to attack Wen Jiabao), *Kai Fang*, October 2008.

[32] *Ibid.*

3.8 The exact individual or persons behind these series of articles remain unknown. However, it is reasonable to conclude that the views contained in these articles enjoy some degree of currency within the establishment and are even being backed by senior Party members. They also indicate that there are differences in opinion within the leadership on the path to take to perfect socialism in China. While they are unlikely to derail the present course that China has set for itself, the Hu-Wen leadership needs to tread carefully and take into account these voices in charting the way forward.

Chalking up Political Mileage

4.1 China has made a conscious effort at portraying itself as a constructive player in the present crisis. China's share of the world's total GDP rose to six percent (amounting to US$3.3 trillion) at the end of 2007, making it the fourth largest economy after the US, Japan and Germany.[33] Given its increasing stake in the world economy, China has displayed pro-activeness to work with like-minded countries and institutions to deal with the global financial instability and economic woes. It has also taken bold steps to bolster its own economy as an indirect way of contributing to the health of the world economy.

4.2 China has further stressed its "responsible and steady attitude" in carrying out the investment of its foreign reserves. Yi Gang, China's Central Bank Vice Governor, has stated that China was not about to panic and sell its enormous US-denominated assets.[34] The reality is that it is not in China's interests to do so since this would not only trigger another bout of financial battering but, more importantly, lead to a significant depreciation of any remaining US-denominated assets held by China.

4.3 China is aware that there is a limit to how much it can do as its economy is presently only a fraction of the US and European economies. It is also aware that there remains much concern in the US and some quarters in Europe over

[33] China's share of the world's total GDP was 1.8% in 1978. See "NBS: China accounts for 6% of world's GDP in 2007", *China Daily*, 27 October 2008.

[34] "China says its economic fundamentals are good", *AFP*, 14 November 2008.

China's rising international stature and its intentions. To avoid ruffling such feathers, China has opted to let the US (where the crisis first originated) and France (as EU Chair) lead the effort to forge an international response to deal with the crisis.

4.4 China has astutely participated in this effort as a concerned and active player who is willing to do its part to alleviate the negative impact of the financial meltdown. The discussions on the financial crisis at the 7th ASEM Summit in Beijing was presented as a logical lead-up to the G20 Leaders' Summit in Washington that would discuss critical issues such as the "principles of reform of the international financial system as well as the stability and development of the world economy".[35] China was careful not to appear to be upstaging the role of the US at the Washington Summit.

4.5 China's current approach harks back to a similar role it played during the 1997 Asian financial crisis. Then, China gained a great deal of political mileage, particularly vis-à-vis ASEAN, when it refrained from devaluing the *Renminbi*. It also made a contribution to a standby credit program for Thailand, where the crisis first started. This time round China is adopting a similar stance, although it has refrained from extending credit to any financial institution.

4.6 China's positive role has not gone unnoticed. Key officials and economists from the World Bank, the US and European countries have complimented China for its economic stimulus package, calling it "timely" and "very wise".[36] Separately, Singapore's Senior Minister Goh Chok Tong was impressed with China's response to the financial crisis. He observed that China had, together with Europe and the US, lowered its interest rates to prevent some competitive leakages of funds to the *Renminbi*. He added that

---

35 "Full text of statement of the Seventh Asia-Europe Meeting on the International Financial Situation", *Xinhuanet*, 24 October 2008.

36 "China's stimulus package timely 'right step' – expert", *China Daily*, 15 November 2008 and "WB, US, Brazil hail China's economic stimulus plan", *China Daily*, 10 November 2008.

China was also committed to keep its economy humming through a series of monetary and fiscal measures.[37]

Possible Next Steps for China

5.1 At the moment, China has delineated for itself a modest external role in dealing with the financial crisis. Its primary preoccupation will continue to be geared towards maintaining the growth momentum of the domestic economy which is expected to experience even slower growth in the months ahead. This domestic orientation is likely to persist in the foreseeable future.

5.2 While opting to let the major developed economies take the lead to address the financial crisis and its economic impact, China has not neglected to capitalize on the situation to further its foreign policy objectives. Most significantly, it has begun to angle itself to assume a bigger role in any future financial order. Already, President Hu Jintao has called for a new international financial order that is "fair, just, inclusive and orderly".[38] This can be taken to mean more say for the developing countries with China as a key player.

5.3 The current crisis can be expected to bring about a significant power shift in global politics. The US will still emerge from the crisis as the leading economic superpower, but politically chastened and economically much weakened (because of its bulging external debt). This will provide emerging powers like China and India with more international space in the future.

5.4 The calls to reform the international financial institutions will mean that the US and European countries will have to share power with China. The calls to improve the international currency system may result in an outcome where other currencies, other than the US dollar, are also readily accepted. These two processes will be wrought with political wrangling given their sensitive nature.

---

[37] "SM impressed by China's response to financial crisis", *Asiaone*, 17 October 2008 http://www.asiaone.com/Business/News/Story/A1Story20081017-94516.html.

[38] "Hu calls for concerted efforts to tide over financial crisis", *China Daily*, 16 November 2008 and "Hu seeks trade boost to fight crisis", *China Daily*, 24 November 2008.

5.5 The present crisis appears to have temporarily put on the backburner issues that used to hobble relations between China and the West. These include disagreements over human rights, democracy, treatment of dissidents, trade, Tibet and the Dalai Lama. Added to these is that China's ascendency has generated some trepidation in the West that the Washington consensus is losing traction. These differences may come to the fore again especially when the current crisis subsides or when China and the West disagree on the shape of the future financial order.[39]

5.6 China may yet have another card up its sleeve. It has so far only set for itself the minimum base position of keeping its own economic house in order. There is sufficient room for China to decide whether it wants to do more in the future. The possibility should not be discounted that at an appropriate juncture, China may decide to make a contribution such as in the form of additional funding to the international financial institutions. It may use this as a bargaining chip for a bigger say at these platforms.

---

39 China's recent decision to postpone the China-EU Summit in December 2008 is primarily directed at France alone and does not appear to have damaged its relations with other European countries.