

HOW SEVERE IS CHINA'S ECONOMIC DOWNTURN?

YANG Mu & LIM Tin Seng

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Executive Summary

1. The global financial crisis has slowed China's economy considerably. In the final quarter of 2008, the Chinese economy registered one of its slowest growths of 6.8 percent. This pulled the economic growth for 2008 down to 9 percent.
2. Despite the poor economic performance, Beijing remains optimistic. In fact, Premier Wen Jiabao is confident that China's economy will continue to grow and even hitting the targeted 8 percent growth in 2009.
3. Indeed, by comparing China's GDP and exports decline with other Asian economies, China's economy seems to be holding up despite being badly hit by the financial crisis.
4. The reason for China's better performance is its sound fundamentals. Unlike its neighbours, domestic demand rather than external demand is the main source of China's economic growth.
5. Throughout China's economic history, fixed investment has always been the major source of China's growth. In fact, the numerous "business cycles" that China experienced tend to swing with the ups and downs of fixed investment.
6. As China's massive stimulus package shows, for this economic slowdown, Beijing plans to induce growth to the economy by boosting domestic demand through government spending.
7. Besides, China's strong fiscal position which includes a small budget deficit and public debt as well as high saving rates can provide the government with extra ammunition to address the downturn.
8. China is also in a better position to deal with the slowdown after reacting swiftly to loosen the country's monetary policies. Interest rates and bank

reserve requirement ratio are revised downwards while money supply is increased.

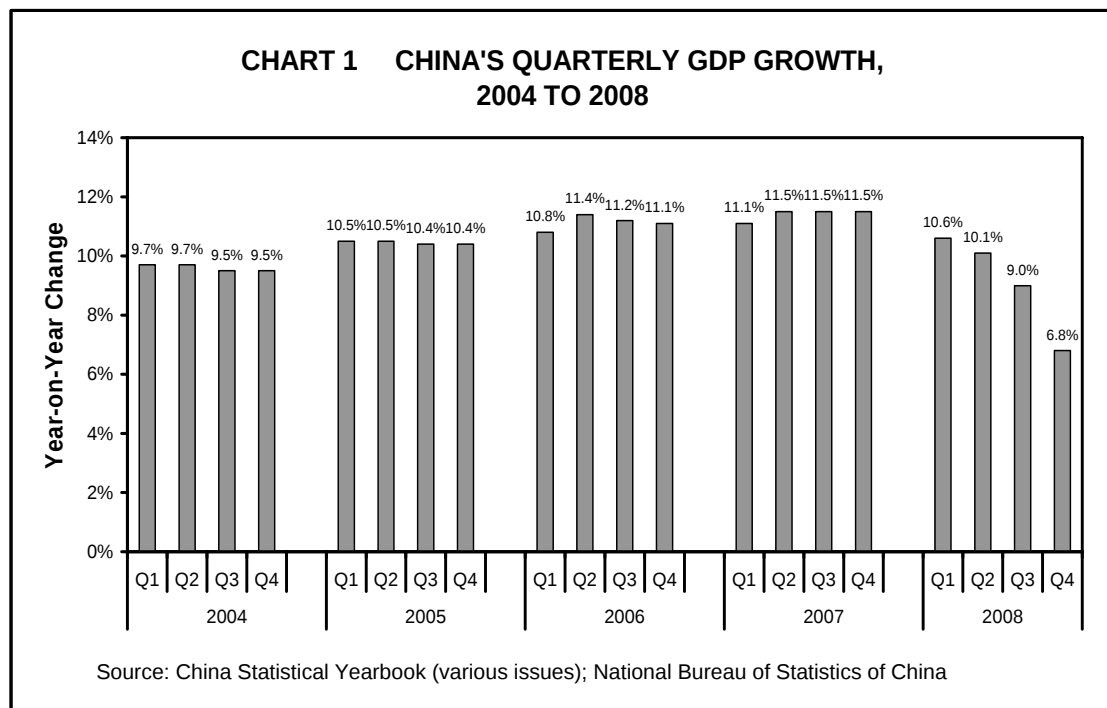
9. However, China would not be able to fully recover from the current global recession if the global economic situation remains weak.
10. Nonetheless, there are signs of picking up in the Chinese economy such as the rise in Purchasing Management Index and bank loans in the first month of 2009.
11. It is still too early to say whether China's economy has started to bottom out. But China is likely to be the first to come out from the recession once the global economic condition stabilises.

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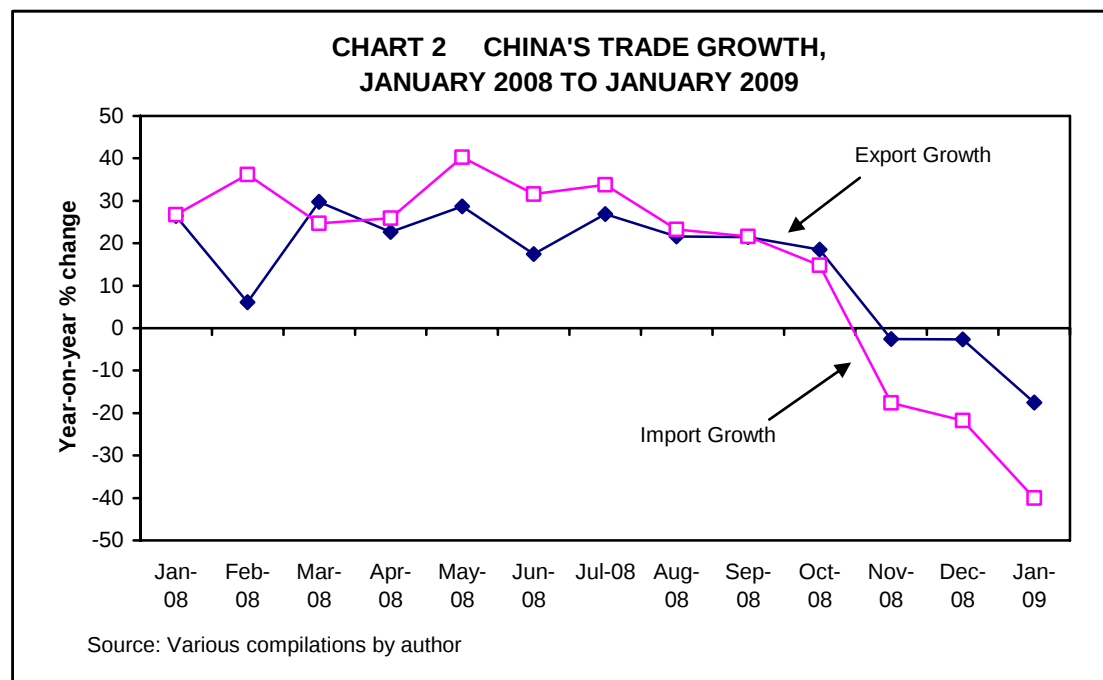
The Slowing of the Chinese Economy

- 1.1 The global financial crisis has slowed China's once red-hot economy considerably. In the final quarter of 2008, the Chinese economy registered one of its slowest growths of 6.8 percent. This pulled down economic growth for the whole of 2008 to 9 percent, ending China's nearly four years of double-digit growth (Chart 1). As 2009 progresses, there is still a high level of uncertainty in China on whether the economy will be able to register the crucial growth of 8 percent for 2009, a level commonly regarded as the minimum growth rate to generate sufficient employment.



* Dr Yang Mu is Senior Research Fellow and Coordinator of China Cooperation Programme at the East Asian Institute, National University of Singapore; Lim Tin Seng is Research Officer at the same institute. They would like to thank Professor John Wong for going through their drafts and giving very helpful comments.

1.2 So far, the stake appears to be against China. In January 2009, China's exports declined for the third consecutive month by 17.5 percent in value from a year ago as global demand for electronics, cell phones, steel products and other goods made or assembled in China plunged (Chart 2).¹ The fall in January 2009 was the largest since October 1998. But above all it indicated troubles ahead for China's all powerful industrial sector.



1.3 Indeed, official report shows that at least 67,000 small and medium size companies across China were forced to shut down in 2008.² For instance, China's toy industry started the year 2008 with more than 8,600 factories producing and exporting 70 percent of the world's toys. But by the end of 2008, only about 4,400 remained.³

1.4 The closure of Chinese factories has adverse effects on China and the global economy. In China, the rate of factory closures is driving the country's

¹ "China's January exports fall 17.5% from a year ago", *Los Angeles Times*, 12 February 2009.

² "Factories Shut, China Workers Are Suffering", *New York Times*, 13 November 2008.

³ "Half of China's toy factories close after exports slump", *The Times*, 10 February 2009.

unemployment upwards at an alarming rate. In February 2009, the Central Rural Work Leading Group stated that more than 20 million migrant workers lost their jobs during the final months of 2008.⁴ This was about 15 percent of the total migrant labour pool.

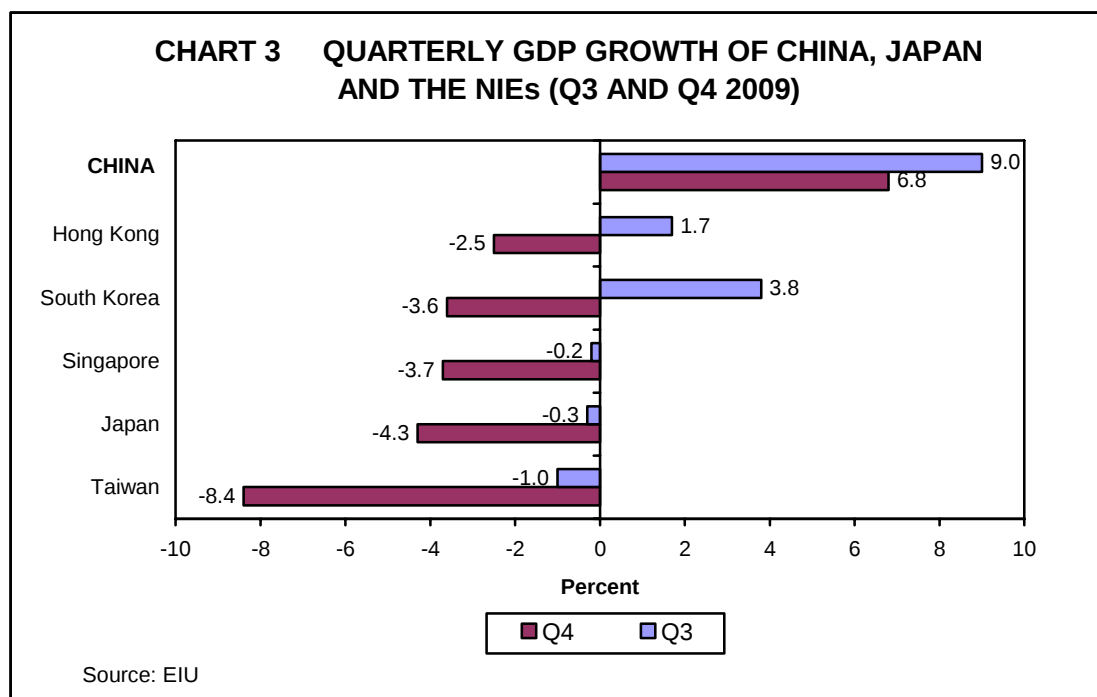
- 1.5 For the global economy, the slowing down of China's industrial sector has led to a sharp decrease in Chinese demand for global supply of equipment and machines and commodities such as crude oil and metals. In January 2009, China's imports slumped over 40 percent in value from a year ago. This has resulted in the swelling of China's trade surplus to a record of US\$39.1 billion, adding tension to the already delicate state of China's trade relations with industrialised economies such as the United States and the European Union.

Optimism Amid Slowdown

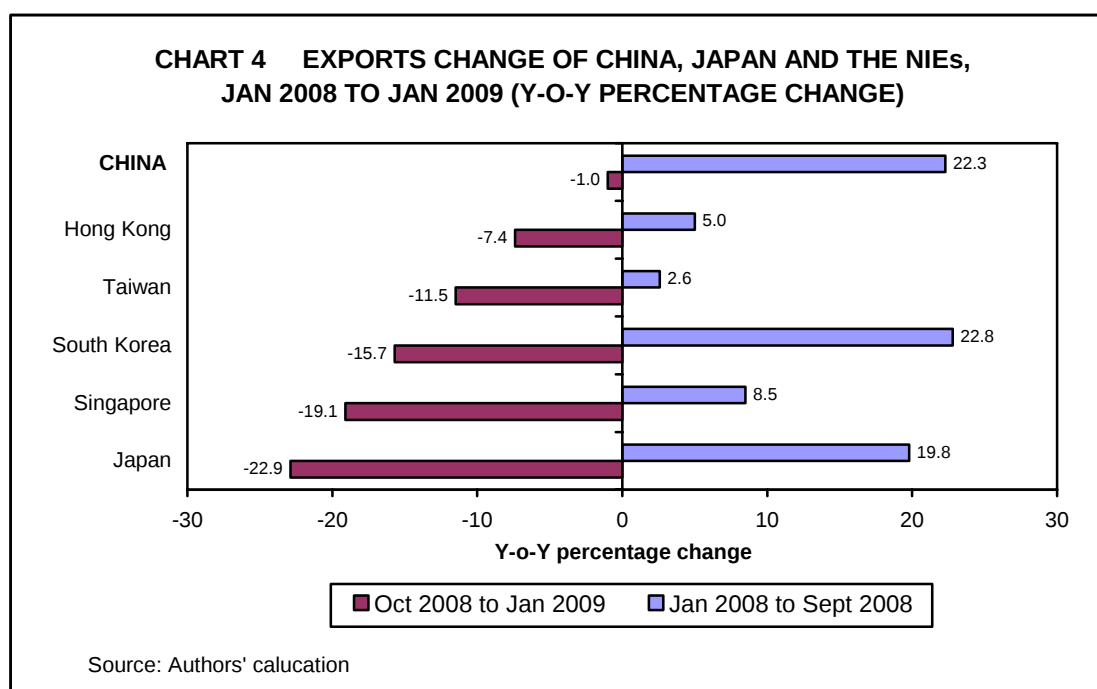
- 2.1 Despite the bleak economic outlook, Beijing remains optimistic. During his "trip of confidence" to Europe in late January 2009, Chinese Premier Wen Jiabao stated in his speech at the World Economic Forum that the Chinese economy can continue to grow amid the global downturn.⁵ Premier Wen's upbeat outlook falls in line with views that China will be the first to recover from the current financial crisis once global demand recovers.
- 2.2 Indeed, by comparing with other Asian economies, China's economy seems to be holding up despite being badly hit by the financial crisis. Although China's GDP declined from 9 percent in the third quarter of 2008 to 6.8 percent in the fourth quarter of 2008, China's overall economic performance is still much better when compared to its neighbours' (Chart 3).

⁴ "Chinese migrant job losses mount", *BBC News*, 2 February 2009.

⁵ "Chinese premier upbeat about China growth, stresses confidence in addressing crisis", *Xinhua*, 29 January 2009.



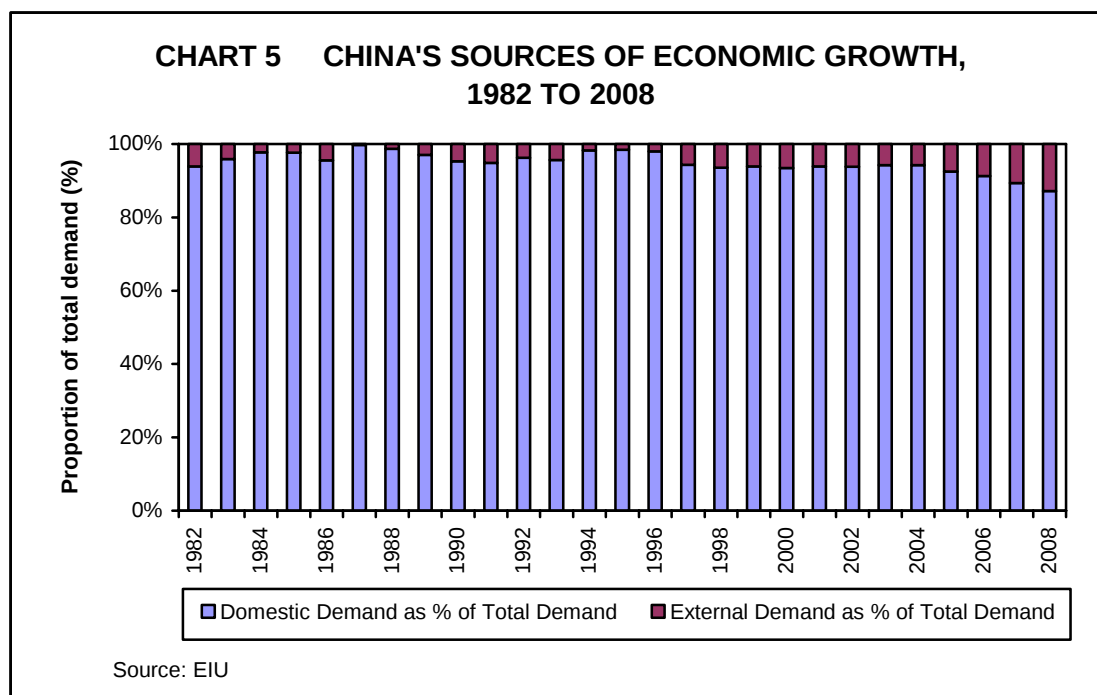
2.3 Furthermore, the decline in the rate of exports is considerably smaller when compared to Japan's and the NIEs'. In January 2009, China's exports declined only one percent year-on-year from October 2008 to January 2009. This is significantly smaller than the average year-on-year decline in the exports of Japan and the NIEs during the same period (Chart 4).



Domestic Demand as a Source of Growth

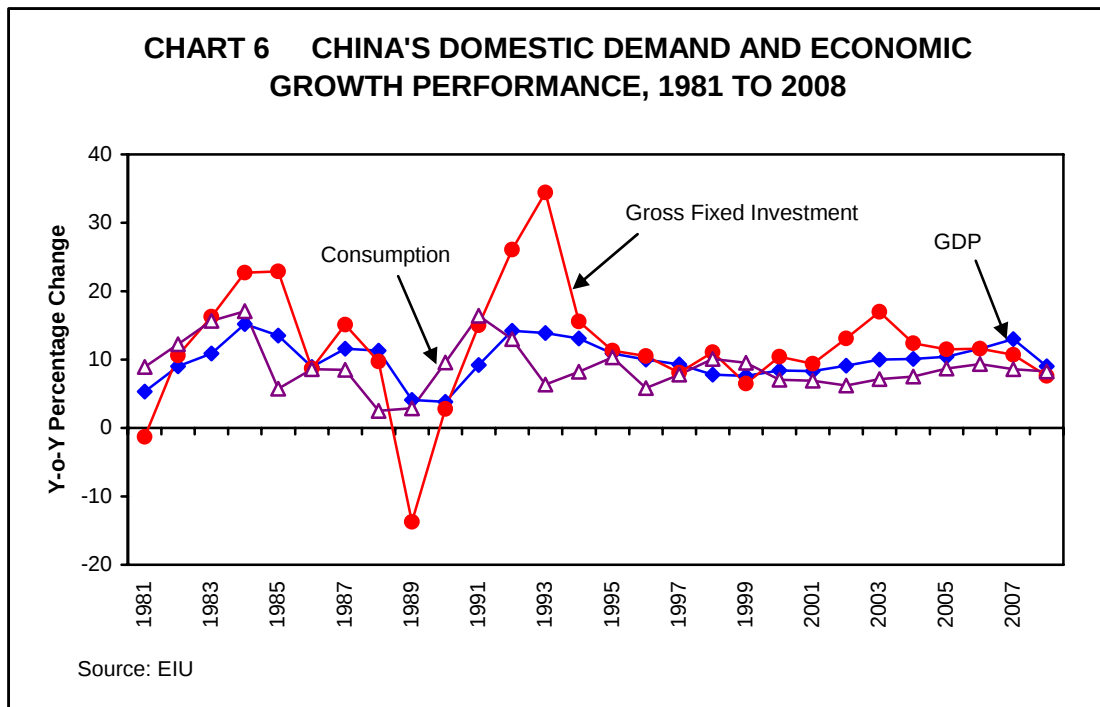
- 3.1 China is in a better position to recover from the global downturn compared to its neighbours because its fundamentals are sound. Unlike most Asian economies, China's economic growth is not solely driven by external demand. Rather, domestic demand, comprising consumption and fixed asset investment, is the main source of growth for China. As a result, this limited China's exposure to the current global financial crisis.
- 3.2 China's reliance on its domestic demand for growth is not a surprise as the country is a huge continental economy with one-fifth of the world's population. Furthermore, China is still in the process of industrialization and urbanization. In fact, China's urban population only amounts to about 43 percent of the country's total population. This means that there is still plenty of room for growth for China's domestic demand through infrastructure and other urban expansion projects. However, China's domestic demand is often overlooked by many Western scholars and media as they often cite the decline in China's exports as the end of its economic growth.⁶
- 3.3 As shown in Chart 5, domestic demand is the mainstay of China's total demand. From the 1980s through the 1990s, the share of domestic demand to China's total demand accounted for an average of more than 90 percent. Even after a surge in China's external trade following its accession to the World Trade Organisation in 2002, domestic demand still constitutes about 85 percent of China's total demand.

⁶ See "Dire Indian and Malaysian Data Fuel Asian Fears", *Financial Times*, 1 March 2009 and "China's Stimulus Challenge", *The Wall Street Journal*, 2 March 2009 for alternate views.

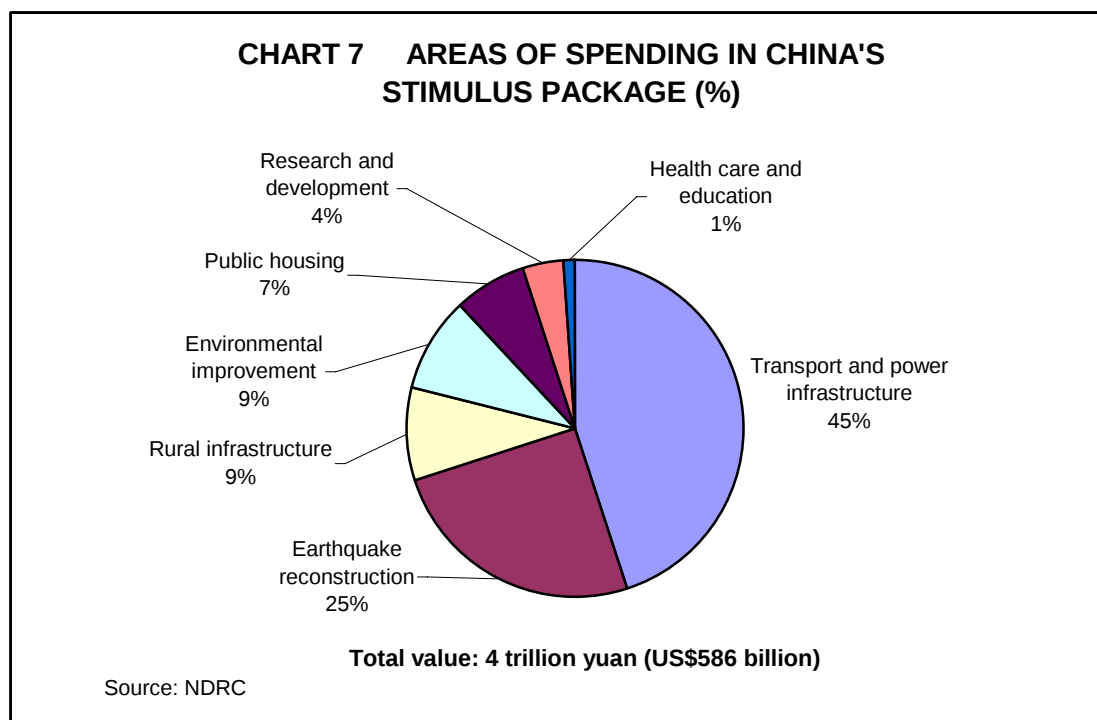


3.4 A study on the fluctuation of China’s past economic growth with the components of domestic demand shows that fixed investment has always been the major source of China’s growth. In fact, the numerous “business cycles” (or variation of economy growth) that China experienced over the past three decades tend to swing with the ups and downs of fixed-assets investment (Chart 6). This relationship also indicates that the central government uses fixed investment as the fiscal instrument to expand the economy when domestic deflation sets in or to curb growth when the economy faces overheating.

3.5 Indeed, local governments’ enthusiasm to develop their economies increased following Deng Xiaoping’s *nanxun* in 1992 led to a surge in domestic investment which in turn resulted in a sharp rise in economic growth. This subsequently caused the economy to overheat. To address it, Premier Zhu Rongji cut fixed investment in the mid-1990s, allowing China’s economy to achieve a “soft landing” in 1996. Fixed investment was then adjusted upwards in the late 1990s to offset the effects of the Asian financial crisis and more recently downwards to cool the economy in late 2007 and early 2008.



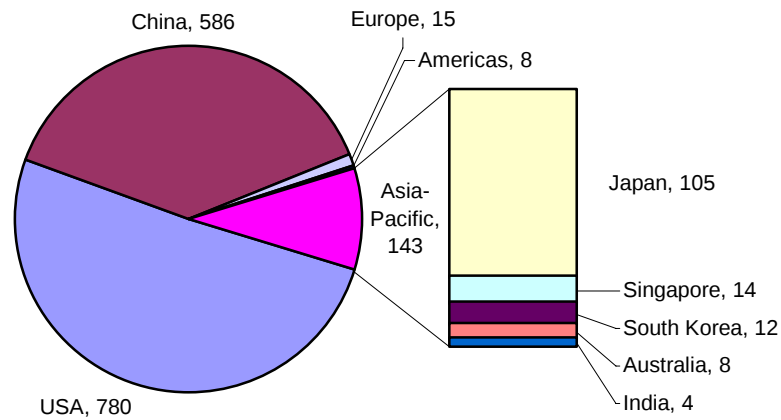
3.6 The stimulus package unveiled by Beijing in November 2008 is the continuation of the central government's practice to peg China's economic growth with the level of fixed investment. In fact, the package is meticulously prepared to boost domestic demand for economic growth. The main areas of government spending include 1) public housing for low-income groups; 2) rural infrastructure such as water supply and conservation, rural roads and power grids; 3) transport infrastructure such as high-speed railways, mass transit systems, highways and airports; 4) healthcare and education; 5) ecological and environmental projects; 6) innovation and R&D, and industrial upgrading, and 7) Sichuan earthquake reconstruction (Chart 7).



3.7 The estimated cost for the first two years of these projects is about US\$586 billion (4 trillion yuan) which is around 15 percent of China's GDP in 2007. On a global scale, China's stimulus package is the second largest in the world after the United States' US\$780 billion "American Recovery and Reinvestment Plan" stimulus package which was passed in February 2009 (Chart 8). It is, however, the largest among the stimulus package unveiled by Asian and European economies.

3.8 Although Beijing's response to the global downturn is focused on boosting domestic demand, this does not mean that it is disregarding its external trade. In fact, Premier Wen urged major economies to continue to maintain a liberalised trading environment, while making it clear that Beijing is against taking on any protectionist measures. The Chinese Premier also admitted that China would not be able to fully recover from the current global recession if global demand remains weak. In all, it shows that China still views external demand as playing a key supporting role in inducing growth to the economy.

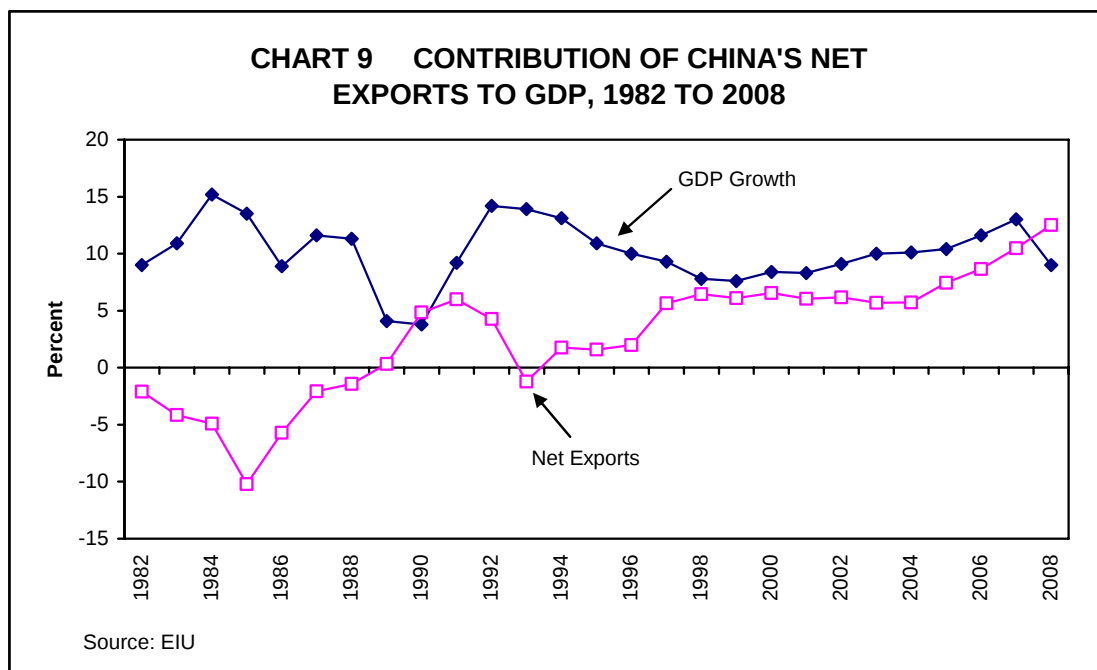
**CHART 8 ECONOMIC STIMULUS PACKAGES WORLDWIDE
(US\$ BILLIONS)**



Source: Asian Wall Street Journal

3.9 In addition, although China's external demand constitutes only a small share of its GDP growth, it has been rising in recent years especially after China's accession to the World Trade Organisation in 2002. As Chart 9 illustrates, the share of net exports to China's GDP growth had been growing for the past decade from about 6 percent in 1998 to over 11 percent by the end of 2008. This rising trend indicates that external demand is set to play a more important supporting role for China's economic growth in the future.

3.10 Above all, industries in Guangdong's Pearl River Delta, which is China's manufacturing and export hub, and other coastal areas are highly dependent on external demand. Therefore it is crucial for the external situation to improve before these regions can recover from the effects of the global financial crisis. These regions of mostly foreign-funded firms were badly hit by the crisis. In fact, Huang Yunlong, vice governor of Guangdong province, termed 2008 as "the most difficult year after the 1998 Asian financial crisis".



3.11 Huang's remark was not an understatement. According to the Guangdong Statistics Bureau, 100,600 new firms were established in 2008 but by the end of the year, more than 62,400 had been eliminated. This alarming closure rate has also resulted in massive job loss. In fact, the Statistics Bureau reported that an estimated 600,000 migrants lost their jobs in 2008.⁷

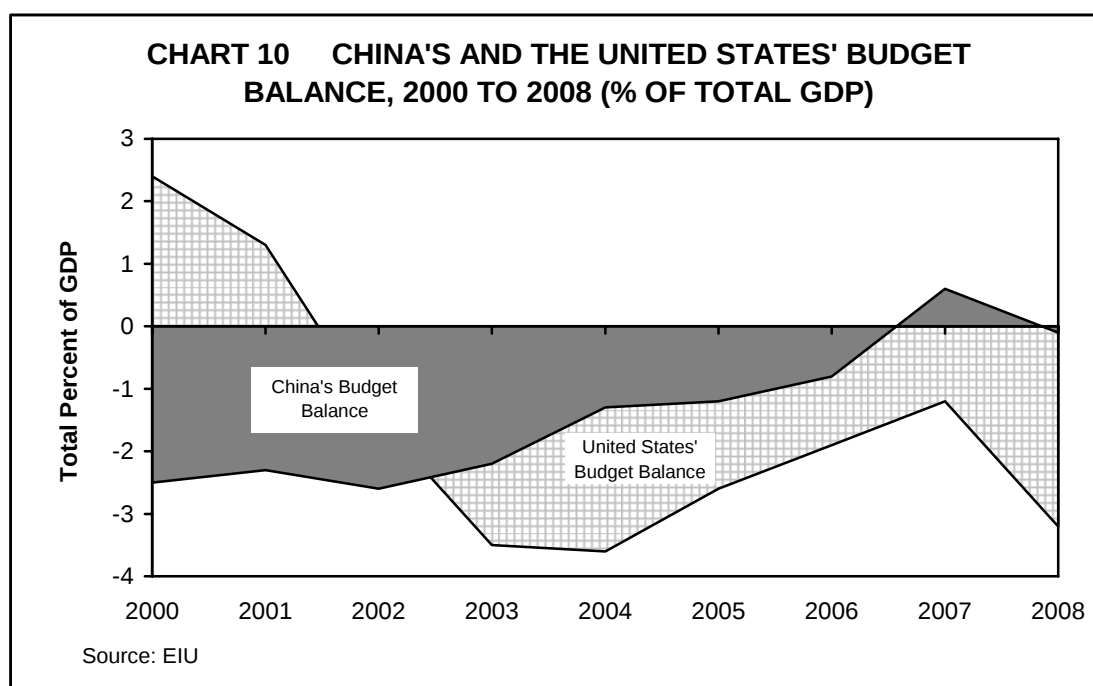
3.12 For this financial crisis, however, the Chinese leadership is more concerned with stimulating domestic demand rather than external demand as it is aware that the weakening global demand is beyond the control of the Chinese government. Nonetheless, it is important to note that most of the measures taken to stimulate the domestic market such as the stimulus projects are also aimed at creating jobs.

China's Strong Fiscal Position

4.1 China's fiscal health explains why it is possible for the Chinese economy to rebound from its current slump faster than regional and western economies. First, China's budget deficit has been decreasing rapidly in recent years. From

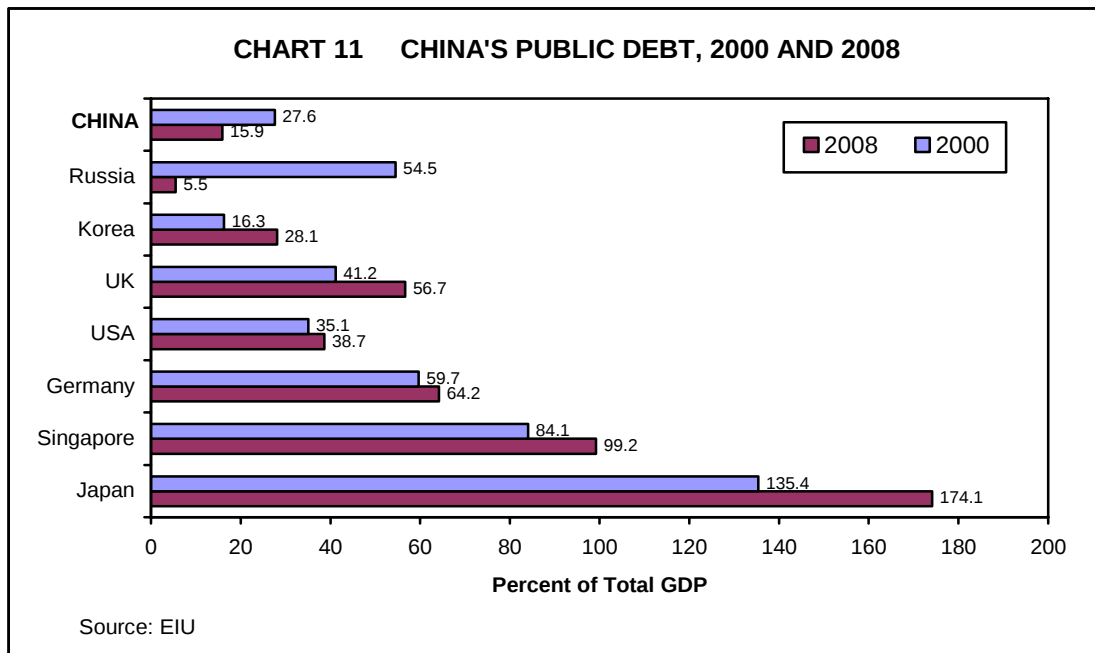
⁷ "600,000 migrant workers leave Guangdong amid financial crisis", *Xinhua*, 9 January 2009.

2000 to the end of 2007, China fiscal balance increased from a deficit of nearly 3 percent of GDP to a surplus of 0.7 percent of GDP. On the other hand, most developed economies, particularly the United States, have been experiencing growing budget deficit and rising public debt. For instance, the United States' budget balance dropped from a surplus of 2.4 percent of GDP in 2000 to a deficit of 3.2 percent of GDP by the end of 2008 (Chart 10).⁸

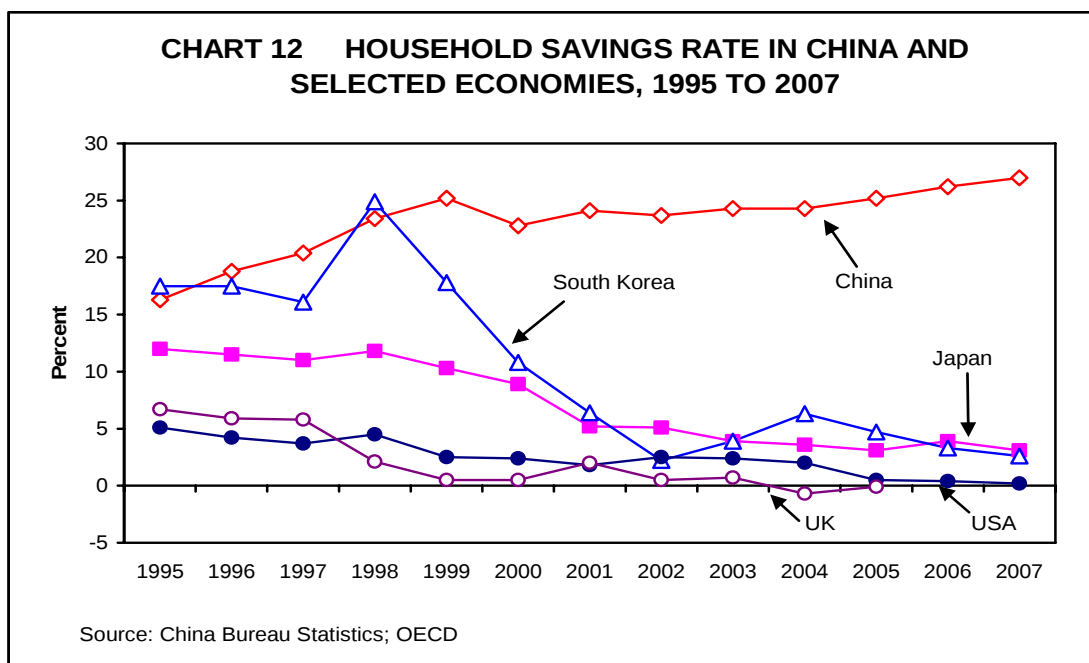


4.2 In addition, China's public debt is declining. This allows Beijing to flex its fiscal muscle to fight the recession. From 2003 to 2007, China's public debt decreased from nearly 30 percent of GDP to only about 18 percent of GDP. In comparison, the United States' public debt increased from 35 percent of total GDP to nearly 40 percent of GDP during the same period (Chart 11).

⁸ Because of the massive fiscal stimulus package, China's budget deficit is posed to increase quite significantly in 2009. In March 2009, Premier Wen Jiabao projected China's fiscal deficit budget to hit 950 billion yuan (US\$139 billion) which will be the highest in six decades. Despite the deficit surge, China's constant deficit drops in previous years provide room for issuing more bonds this year. See "China budgets \$139b fiscal deficit in crisis fight", *China Daily*, 5 March 2009.



4.3 Besides, China's savings rate is very high. On average, a Chinese household saves about 26 percent of total disposable income. This is considerably higher than the savings rate of most developed economies (Chart 12). For instance, United States' savings rate was less than 0.5 percent of total disposable income in 2007.⁹



⁹ "Consumers Are Saving More and Spending Less", *The New York Times*, 2 February 2009.

- 4.4 China's banks are also well-capitalised. In fact, three out of the world's top ten cash-rich companies are Chinese banks (Table 1). Furthermore, the three Chinese banks in the list, namely Bank of China, Industrial and Commercial Bank of China (ICBC) and China Construction Bank, have a total net cash of US\$272 billion which is nearly 55 percent of the total net cash of all the top-ten companies.

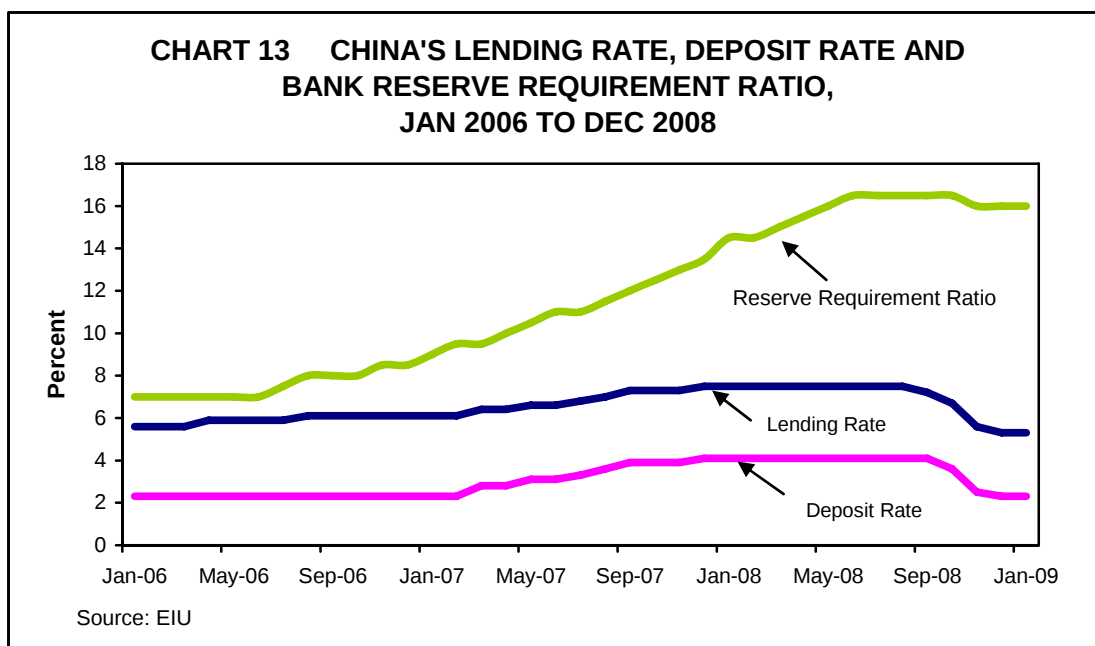
TABLE 1 TOP TEN CASH-RICH COMPANIES AS AT END OF 2008

	Companies	Net Cash (US\$ billion)
1	Berkshire Hathaway	106
2	Bank of China	101
3	ICBC	89
4	China Construction Bank	82
5	ExxonMobil	28
6	China Mobile	26
7	Apple	25
8	Cisco Systems	20
9	Microsoft	19
10	Google	14
	TOTAL NET CASH	540

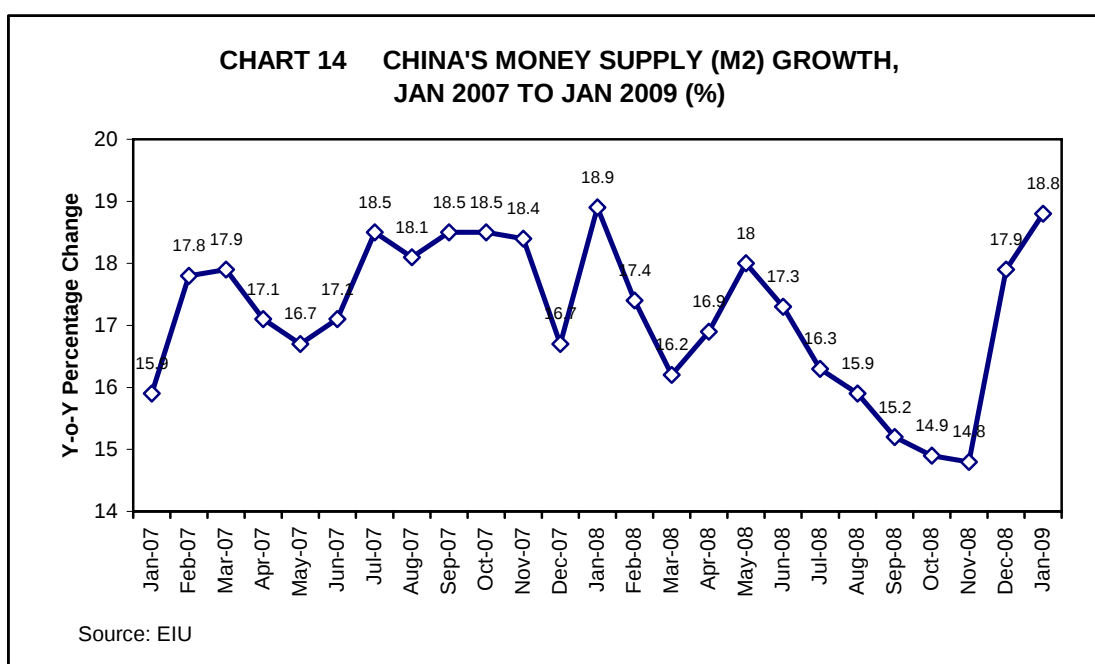
Source: Bloomberg

Loosening Monetary Policies

- 5.1 To fight the recession, Beijing also made important adjustments to loosen its monetary conditions. Some of these measures include cutting interest rates and lifting lending limits on commercial banks. As Chart 13 shows, China's central bank has adjusted lending rates quite significantly downwards in recent months from 7.2 percent to 5.6 percent from August 2008 to November 2008. Lending rate was further revised to 5.3 percent in December 2008. Similarly, the central bank also cut half a percentage point on the reserve requirement ratio for banks from an all-time high of 16.5 percent to 16 percent in December 2008.



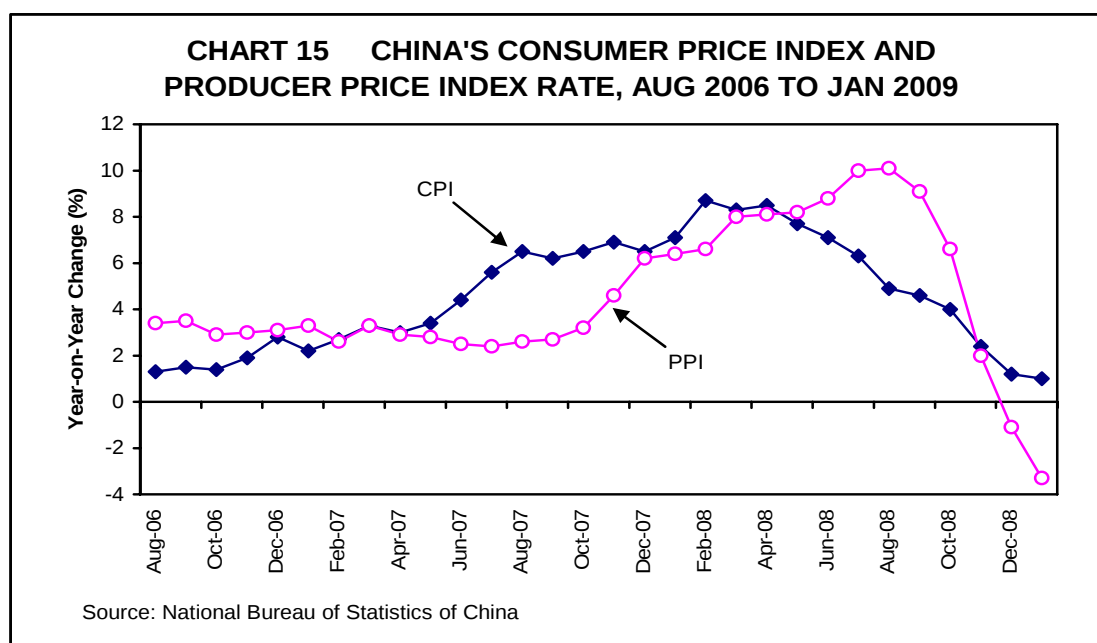
5.2 As part of the blueprint to ease the country's monetary conditions, the central bank has also started to increase China's money supply. As shown in Chart 14, China's money supply in December 2008 and January 2009 registered its highest year-on-year percentage change since May 2008 of 17.9 percent and 18.8 percent respectively. According to the State Council, China will continue to maintain a high level of money supply growth of around 17 percent in 2009.



- 5.3 With the stabilisation of the country's runaway inflation in the second half of 2008, the central government should be able to continue relaxing the country's monetary conditions in 2009. The massive foreign reserves and favourable trade surplus also allow China to maintain the stability of its currency, both of which are important monetary factors for China to maintain the competitiveness of its economy and its attractiveness to FDI inflow.

China's Business Cycle

- 6.1 Unlike the developed economies, particularly the United States, China's current economic slump does not originate from the meltdown of its financial sector. Instead, the slowing down started as part of the process of its economic fluctuation or "business cycle".
- 6.2 In the later part of 2007 and early 2008, the Chinese economy was in danger of overheating. The country's economic growth was clocking double-digit growths and the investment and inflation growth have gone beyond the government's comfort zone. For instance, China's Consumer Price Index was averaging nearly 8 percent from the fourth quarter of 2007 through the second quarter of 2008 (Chart 15).



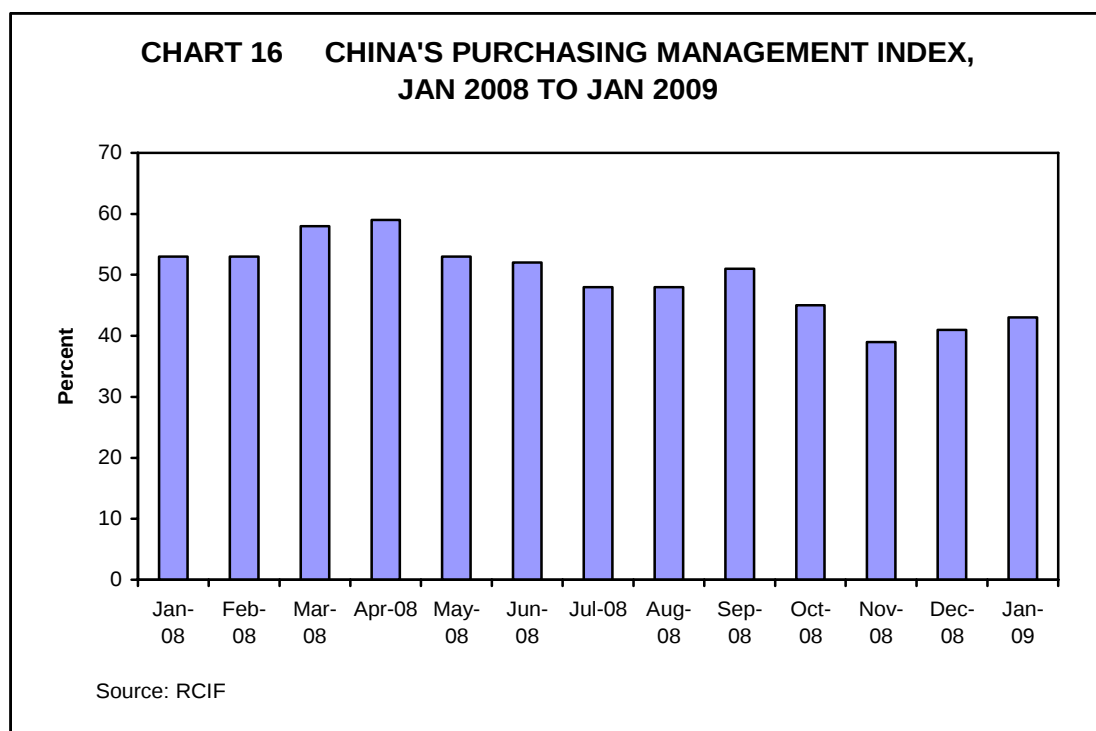
- 6.3 To fight inflation and to cool the overheating economy, Chinese policymakers introduce various tightening measures to slow down the economy. Since domestic demand plays an important role in inducing growth, one of the main strategies was to cut government spending. Indeed, government spending dropped quite significantly between 2006 and 2008 from 11.6 percent of total GDP in 2006 to 10.7 percent of total GDP in 2007 and then 7.6 percent of total GDP in 2008 respectively.
- 6.4 The Chinese authorities also administer policies to tighten the monetary conditions. These include raising interest rates and increasing the banks' reserve requirement ratio. From January 2006 through September 2008, China had readjusted the requirement ratio upwards about 15 times. Similarly, lending rates were also raised more than ten times during the same period.
- 6.5 The central government also implemented a series of measures to slow the growth of industries and to curb overinvestment. These include tightening land supply for industrial use and taking steps to restrict the inflow of FDI. Incentives were also removed from labour-intensive industries and environmental fees were slapped on polluting industries.
- 6.6 To a certain extent, China's current economic slowdown also stems from a whole string of events that disrupted production in the country. These range from the snowstorm in early 2008 to the Sichuan earthquake in mid 2008 as well as the Olympics in August 2008.

Early Signs of Recovery?

- 7.1 It is still too early to conclude if the policies undertaken by Beijing to boost the economy are effective. Not only is the global economic situation difficult, it appears to be worsening. An increasing number of companies are succumbing to mounting corporate debt and defaulting in the United States and other Western economies. By various estimates, it is likely that American companies will default on US\$450 billion to US\$500 billion of corporate bonds and bank loans over the next two years, the most corporate-debt

defaults by dollar amount in the economic history of the United States.¹⁰ The waves of default in developed economies are likely to send jitters to developing economies around the world, including China, especially in the area of attracting foreign capital.

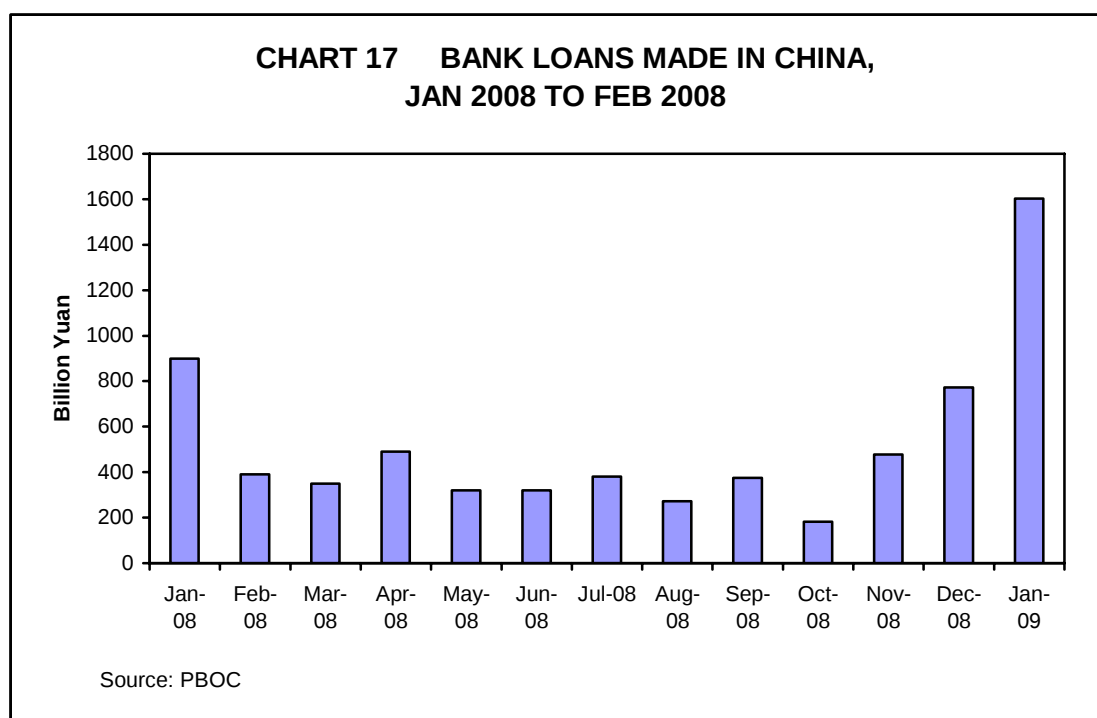
- 7.2 But there are some encouraging signs to show that the steps taken by Beijing so far are yielding positive results for the economy. First, China's Purchasing Management Index (PMI) which measures new orders made by the manufacturing sector registered an increase of 41 percent in December 2008. This has put to a stop the slide of the country's PMI index for the first time since May 2008 (Chart 16). Although the PMI in December 2008 was still below 50 percent, indicating that the economy is still in decline, the index is creeping upwards.



- 7.3 Second, China's credit problem seems to be easing. For instance, bank loans made in China in January amounted to 1.62 trillion yuan (US\$237 billion), a year-on-year increase of over 800 billion yuan or 104 percent (Chart 17). The

¹⁰ "Defaults Mount in U.S.", *The Wall Street Journal*, 16 February 2009.

massive growth in bank loans signals that banks are lining up to provide funds to developers for the stimulus-package projects. This could be a blessing for cash-strapped domestic enterprises trying to stay afloat amid shrinking overseas demand and waning consumer confidence.¹¹



7.4 Overall, it is still too early to determine whether the early signs of recovery are sustainable. But there are definitely indications that the Chinese economy is reacting positively to the central government’s measures. This should place China firmly in pole position to recover from the current global downturn once the global economic conditions stabilise.

¹¹ “China’s bank loans see striking rise in Jan”, *China Daily*, 13 February 2009.