China's Economy 2008 and Outlook for 2009:

Crisis of a sharp slowdown

John WONG*

China's economy ended 2008 with about 9.5% growth, after double-digit rates of growth for five years in a row. All eyes are now on its potential growth in 2009. China started off 2008 with an overheating economy threatened by rising inflation. But the downturn began to surface in the second half, and the deceleration gathered momentum in the last quarter, with industrial production and exports plummeting sharply. The government promptly put together a huge Keynesian type fiscal stimulus package to shore up crumbling growth for 2009. The stimulus spending covers three main areas: (a) urban and rural infrastructure development, including environmental projects; (b) healthcare, education and affordable public housing; and (c) innovation, R&D and industrial upgrading. The package is to cost four trillion yuan (about 15% of China's 2007 GDP). The big economic challenge for China in 2009 lies not in maintaining reasonably high growth but in tackling the knotty unemployment problem. The year 2009 may well be a jobless growth.

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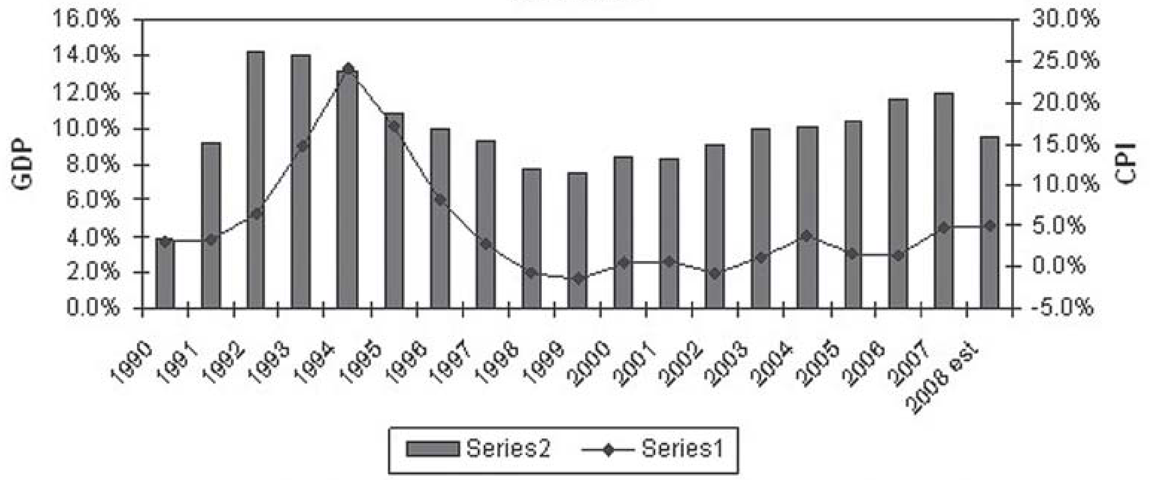
WITH GROWTH in the first three quarters of 2008 already at 9.9% (above the 30-year growth trend of 9.8%), the Chinese economy was set to end the year with about 9.5% growth. Though a marked decline from the 11.9% growth of 2007, the 2008 growth rate will still rank China as the best performing economy in the world based on the expected global average growth of 2.5%. All eyes, both inside and outside China, are now on its potential growth for 2009, which has been variously estimated to be around 7-8%, or possibly lower. But should China's economic growth plunge to 5-6% in 2009, there would probably not be much growth at all in the global economy. (Figure 1)

FIGURE 1 CHINA'S ECONOMIC GROWTH AND INFLATION
1990-2008



Source: China Statistical Yearbook 2008; 2008 figures estimated from IMF

China started 2008 with an overheated economy that was also threatened by rising inflation, after having chalked up double-digit rates of growth for five years in a row. To rein in the runaway economic growth, the government had to introduce tight macroeconomic control measures in the first half of 2008 in the hope of steering the economy to a soft landing. Towards the end of 2008, however, as major economic indicators suddenly plummeted, the government was caught in a completely different macroeconomic scenario underpinned by the spectre of a severe economic downturn or even a deflation. Seldom has the Chinese leadership experienced such a radical reversion of economic fortunes in a short span of just a few months, from the euphoria of high growth to the worry of a sharp downturn.

Indeed, as recent as in early October 2008 when the third quarter GDP figures came out with only 9% growth, the government appeared to be unaware of the strong growth deceleration momentum. It was apparently still thinking of the downturn as merely a consequence of its ongoing macroeconomic policy to cool overheating and the temporary effects of production disruptions due to the Sichuan earthquakes and the Beijing Olympics (shutting down many factories to facilitate this event).

China's economic downturn started to surface in October as production and exports came down rapidly. Worse still, the November figures really took a tumble as industrial production grew only at 5.4% (compared to 8.2% for October), the lowest since 1999 while exports fell by 2.2% (compared to 19% growth for October), the first contraction in seven years. By this time, the government was left in no doubt whatsoever that the economy was heading for a sharp and severe slowdown. In response, the government hastily put together a huge fiscal stimulus package of four trillion *yuan* (US$590 billion) designed to boost economic growth for the next two years.

In the initial phases of the global financial crisis, many Chinese economists and policy makers believed that China could be "decoupled" from its negative impact on account of China's strong internal and external balances (its huge foreign reserves) plus the existence of capital control measures, even though the Shanghai Stock Exchange had plunged more than 60% by mid-2008. Subsequently, as the global financial tsunami deepened, throwing the US and Japan into recession, China was still optimistic that its "real economy" (production and exports) could somehow escape from such a severe external impact. It is commonly assumed that China's economic growth, technically speaking, is mainly driven by domestic demand, particularly domestic investment.

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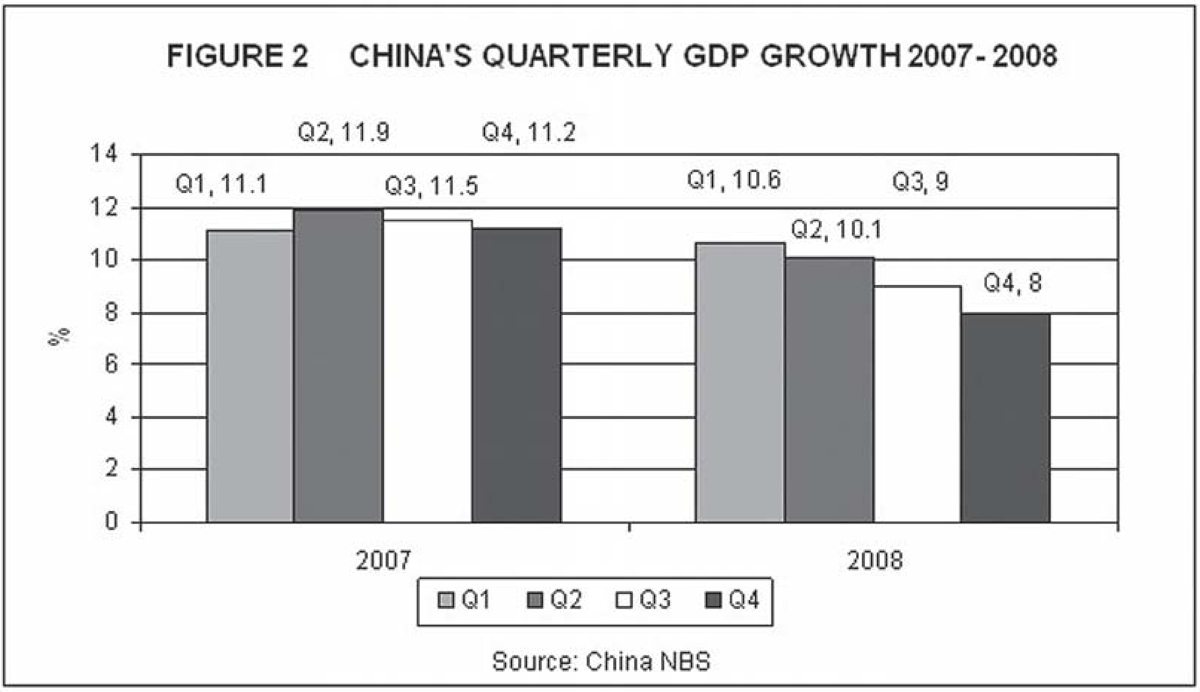
Why was there such an abrupt about-turn in the government's economic mood? It seems that the government had initially misread or simply ignored, long before the crunch in the final quarter of 2008, several telltale signs of the downward growth momentum as manifested in the growing bankruptcy of many small and medium enterprises and production cutbacks in many key industrial items like electricity, steel and metal products, cement, automobile, petrochemicals and so on. As shown in Figure 2, China's quarterly GDP growth had started to decline from its peak of 12% in Q-2 of 2007 to the 9% in Q-3 of 2008, partly as a result of the tightening in macroeconomic policies. Initially, the government might have taken the downward trends as part of the normal process of industrial restructuring caused by such policies as the new labour protection law.

Subsequently as the situation rapidly deteriorated, the government was alarmed by the swiftness and ferocity of the sudden economic downturn. This explains why, in addition to the fiscal stimulus package, the government has also applied other direct policy intervention measures aimed at stimulating exports (e.g., more tax rebates) and promoting rural consumption (through direct subsidies) as well as adopting a loose monetary policy (with inflation now being a non-concern) and even mulling over the possibility of devaluating the *Renminbi* (RMB) to promote exports. In fact, almost all available government policy instruments are utilised for the single-minded objective of boosting economic growth in 2009.



The World Bank's forecast of 7.5% growth for 2009 seems quite realistic. But it is likely that the Chinese government would push growth to 8%, as 2009 is an important year for China politically, being the 60th anniversary of the founding of the People's Republic. Apart from the political need for high growth, it is also socially imperative for China to maintain 8% growth, commonly regarded as the required minimum growth rate to generate reasonable employment. The double-digit rates of growth of the past five years had, on average, created 17 million new jobs a year. With about five million of new entrants to the labour force every year, any sharp economic slowdown would thus bring about serious unemployment, which is unacceptable to a government much in fear of social instability.

With all available fiscal and monetary ammunitions at its disposable and with strong external reserves and a comfortable fiscal surplus, the Chinese government is thus institutionally and economically capable of achieving the 8% growth target for 2009, even against the background of a weak external demand for its exports. In the long run, a lot of infrastructure investment will expand the future growth capacity of the economy. In the short run, however, the problems of inefficiency and wastage arising from investment duplication or lack of proper coordination are bound to arise when growth is rammed through such a set of hastily packaged stimulus policies. For long-term benefits, the

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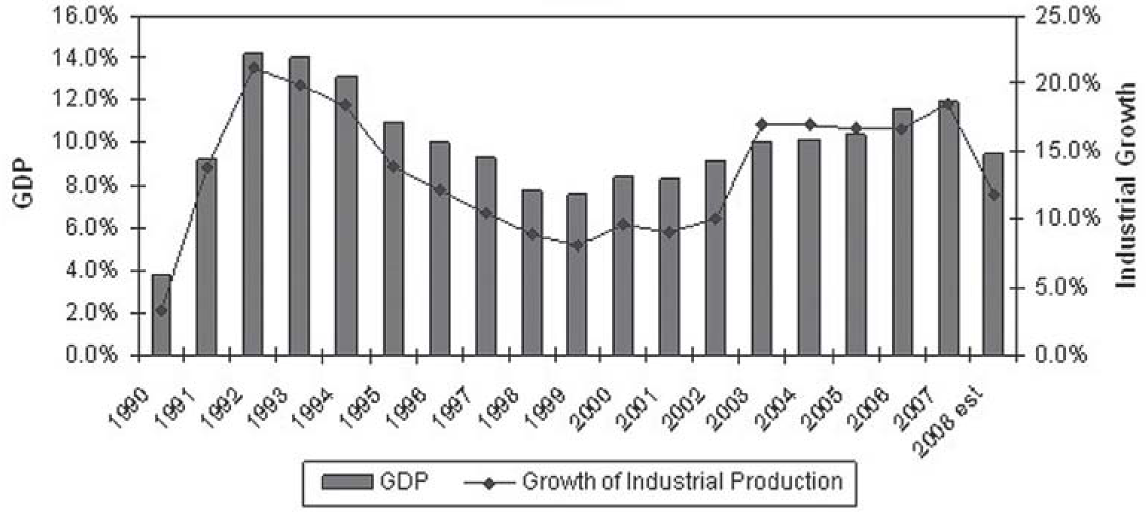
government should make proper use of the stimulus measures to rebalance the economy for a more sustainable growth.

Pattern of Growth Remains Unchanged

The pattern of economic growth for 2008 was pretty much the same as that of last year, despite the slowdown. The supply-side aspect of growth is focussed primarily on the productivity growth of its major sectors. Manufacturing is a large sector in China, accounting for 43% of its GDP in 2007 (only slightly smaller than the 49% of the service sector), and it also grows much faster than other sectors. China's economy is basically pulled along by its rapid industrial growth. As shown in Figure 3, industrial growth follows closely GDP growth. Since 2002, the manufacturing sector has been growing at an average of 17%, which gave rise to over 10% GDP growth for this period. For 2008, industrial production sharply came down to about 12% compared

FIGURE 3 GROWTH OF INDUSTRIAL PRODUCTION AND GDP 1990-2008



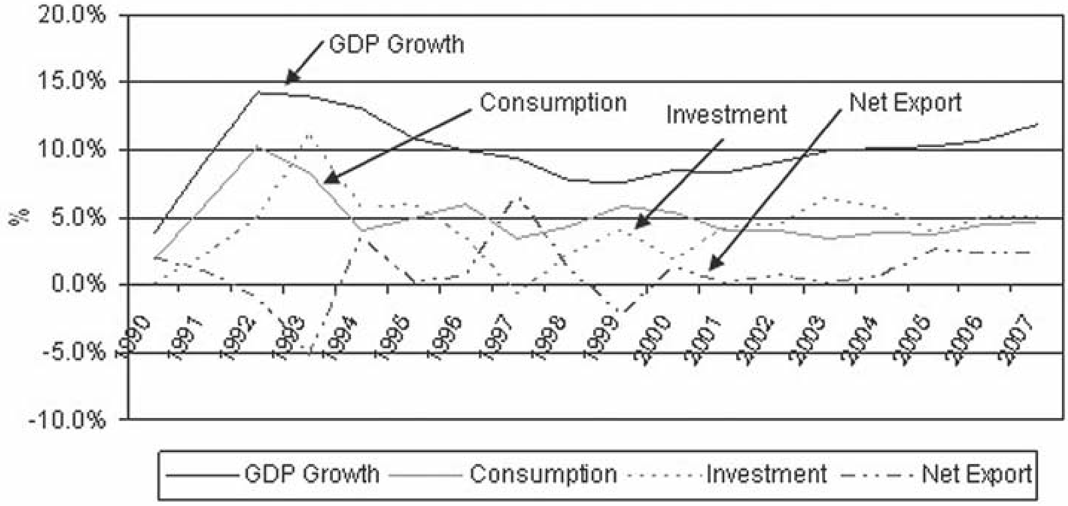
Source: China Statistical Yearbook 2008; China Monthly Statistics 1-2008; 2008 figures estimated from IMF

to almost 19% for 2007. Hence a much lower GDP growth for 2008. As noted earlier, industrial production for November 2008 plummeted even further to 5.4%, and that certainly augurs ill for 2009.

For the demand-side source of growth, increases in GDP stem from the rise in both domestic demand (domestic investment and consumption) and external demand (net exports). China's economic growth, as shown in Figure 4, is basically fuelled by domestic demand, particularly domestic investment. Of the 11.9% GDP growth in 2007, investment contributed 4.9% and consumption 4.7% while net exports only 2.3%. This also explains why the current government's expansionary fiscal policy of boosting growth is heavily concentrated on investment.

Specifically for the first 11 months of 2008, fixed investment still grew at 27% in

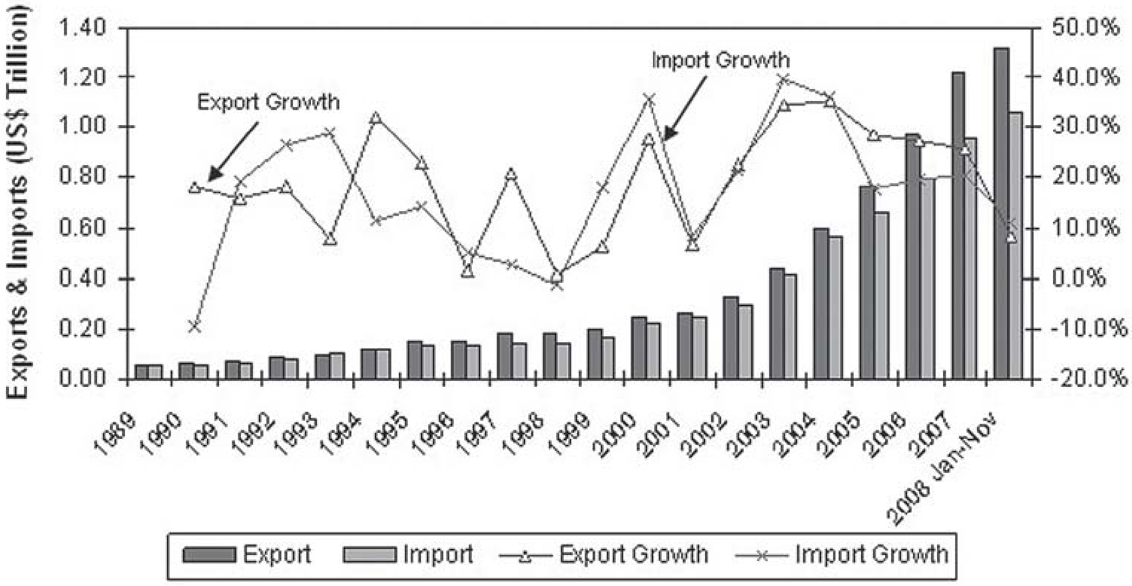
FIGURE 4 CONTRIBUTION OF DOMESTIC DEMAND AND EXTERNAL DEMAND TO CHINA'S GDP GROWTH 1990-2007



Source: China Statistical Yearbook 2008

nominal term (same as in 2007), but actually slower in real term as a result of the government's macroeconomic squeeze. For consumption, growth declined to 9.8% from 16.4% of 2007. Export held up quite well despite the revaluation of the RMB, as it still grew at 19.3% for the first 11 months, though down from the 25.5% of 2007. Weaker demand for Chinese exports from the developed economies had been partially compensated by China's greater market shares in the emerging economies. All in all, this translated to lower GDP growth for 2008. But it should be noted that export growth

FIGURE 5 CHINA'S TRADE GROWTH 1990-2008 (US$ TRILLION)



Source: China Statistical Yearbook 2008; various compilations by author started to decline to 19% in October and nosedived to -2.2% in November. In a way, the slump in exports this time was the signal of the general economic slowdown. (Figure 5).

The importance of external demand in China's overall growth, expressed as "net exports", can be misleading. As clearly shown in Figure 4, the contribution of net exports to overall growth, particularly prior to 2005, has been mostly marginal or even negative. This is mainly because China has been a huge "export processing zone" for the world – nearly 60% of China's exports are done by foreign enterprises. China has to import a lot (raw materials, intermediate products and machinery) before it can export. In other words, China's exports initially generated only a small proportion of domestic value-added, thus making a small contribution to GDP growth. Since 2005, the share of net exports has increased, and its contribution to GDP growth has also increased, currently at about 20% to overall GDP growth.

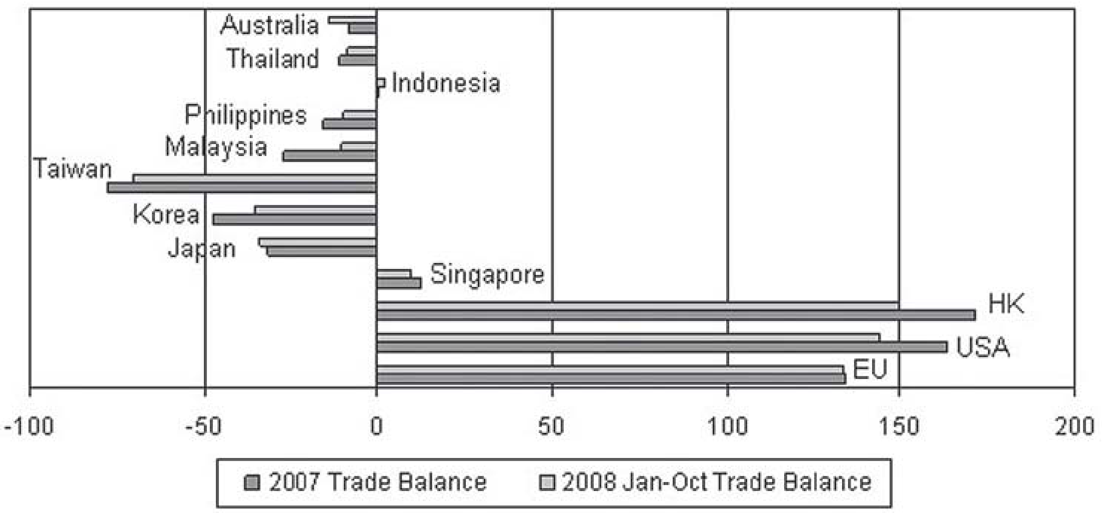
China's swelling external surplus has aggravated its macroeconomic imbalance towards over-production and over-investment, and put pressure on the RMB to revalue.

Still, such a simple demand analysis as shown earlier has grossly underestimated the actual economic importance of exports in China's economy, because it has missed out a great deal of highly important "indirect" economic activities that are connected with the export sector. A large export-oriented industry creates many supporting local service activities as well as investment in upstream and downstream industries, not to mention the multiplier effect on the broader economy generated by its employees. Not surprisingly, the loss of growth momentum in exports in the second half of 2008 (which has also brought down domestic consumption) prompted the government to take action to cope with the economic downturn.

China's total trade from January-November 2008 rose 20.9% to US$2.4 trillion, yielding a total trade surplus of US$256 billion, up 6.9% year on year. China has had sizable trade surplus since the early 2000s, largely because about half of China's exports are processing trade, which by its very nature will inevitably yield China a trade surplus as domestic value-added (for the service performed). This, along with the large annual inflow of FDI (which amounted to US$84 billion in 2007 and is expected to exceed US$90 billion in 2008), constitutes China's "twin surpluses" (also the "twin engines" of China's export-led growth). The sustained growth of surplus led to the rapid build-up of China's foreign reserves standing at US$2.1 trillion by the end of 2008.

China's swelling external surplus has actually aggravated its macroeconomic imbalance towards over-production and over-investment, and put pressure on the RMB to revalue. Through 2008, the RMB had appreciated 8.1% year-on-year against the US dollar, 20.3% against the Euro, and 32.1% against the British pound while depreciated 7.6% against the Yen. From July 2005 to September 2008 (before the outbreak of the global financial turmoil), the RMB's REER (real effective exchange

FIGURE 6 CHINA'S TRADE BALANCE WITH SELECTED COUNTRIES US$ Billion



Source: China Statistical Yearbook 2008; China Monthly Statistics 11-2008

rate) had appreciated 21.8%. The rising RMB has been one of the contributing factors for the export decline.

Figure 6 brings out China's unique pattern of trade balances with its major trade partners. For many years, China has been incurring trade deficits with its neighbouring economies in Asia, which are making use of China's vast domestic markets (for both manufactured goods, intermediate products and raw materials) for their own economic growth. China turns around by running trade surplus with the EU and USA – in a way, implying that China is a proxy holder of trade surplus for Japan, Korea and Taiwan in these two markets. Such a trade pattern also reflects the pivotal role of China in the global trade balances. For 2009, as the EU and US economies will sink deeper into recession, trade frictions are expected to intensify.

How Will the Economic Tonic Work

Towards the end of every year China holds the Central Economic Work Conference to map out policies for the following year. For 2008, the focus was naturally on shoring up economic growth for 2009. Coming out of this meeting, top leaders like Hu Jintao all pledged strong efforts to ensure a "stable and relatively faster" economic growth by boosting domestic demand and restructuring the economy at the same time. The economic growth objective mainly relies on the stimulus package targeting at infrastructure investment. Apart from restoring economic growth, the next emphasis is on employment creation, which requires spending in social areas such as rural development, education, healthcare and those directly related to "improving the people's livelihood".

During the 1997 Asian financial crisis, Premier Zhu Rongji had also had to boost China's sagging economic growth with expansionary fiscal policies; Zhu's task at that time was much more daunting due to chronic fiscal deficits and an ailing banking system. This time round, Premier Wen Jiabao is obviously facing much less challenges, thanks to China's comfortable fiscal surplus, strong external balance and well-capitalised state banks. Hence, on 9 Nov, the government was able to promptly put up a pro-active fiscal stimulus package.

The main areas for government spending cover: (a) Public housing for low-income groups; (b) Rural infrastructure such as water supply and conservation, rural roads and power grid; (c) Transport infrastructure such as highways, railways and airports; (d) Healthcare and education; (e) Ecological and environmental projects; (f) Innovation and R&D, and industrial upgrading; and (g) Sichuan earthquake reconstruction. The costs of these projects for the first two years were estimated to be four trillion *yuan* or about 15% of China's 2007 GDP. The central government has already committed 1.18 trillion *yuan*, with the rest to be jointly financed by local governments through various means including bank loans and debt issues.

With all these vigorous pro-growth fiscal and monetary policies in operation, the government is probably able to prop up GDP growth in 2009 to 8%, though much still depends on the state of the global economy.

While mega projects like railways clearly belong to the central government, a lot of other smaller ones, particularly related to the social service areas, will largely depend on local initiatives. Many local governments are heavily in debt, and they are not permitted to issue debt... But the rich provinces can do a lot, not just for activities in education, healthcare and public housing but also in many large-scale projects such as urban mass transit, water supply and environmental protection. Shortly after the announcement of the four trillion stimulus package, several rich provinces like Guangdong, Jiangsu and Shandong put up their own trillion-*yuan* worth development programmes, totalling over 14 trillion *yuan*! Clearly, the success of the stimulus package depends critically on local initiatives.

To complement this Keynesian-type fiscal policy, other supporting measures have been introduced. The most important is the easy monetary policy. On 23 December, the People's Bank of China announced another interest rate cut of 23 basis points, not long after the massive cut of 103 basis points in November. The series of rates cut along with the lowering of reserves requirement for banks are designed to inject more liquidity into the economy in order to help the business sector and the housing market.

With all these vigorous pro-growth fiscal and monetary policies in operation, the government is probably able to prop up GDP growth in 2009 to 8%, though much still depends on the state of the global economy. Beijing has already made clear that the government would do more should the global economic environment worsen. But employment remains a big challenge.

Expansionary fiscal and monetary policies may successfully pump prime the economy with short-term GDP increases, but they are ineffective in resolving the unemployment problem. As can be seen from the Table, China's double-digit rates of economic growth since 2002 have on average created about 17.4 million new jobs a year, giving rise to an average growth-employment elasticity of 0.189 — i.e. every 1% of economic growth generates about three million new jobs, and vice versa for more unemployment. With the expected lower growth in 2009, there will certainly be many more millions of unemployed.

Even more serious will be the problem of the "educated unemployed", as at least one-third of China's six million or so new university graduates in 2009 will not be able to find a job. Hence, the big economic challenge for the Chinese leadership in 2009 lies not so much in maintaining the 8% growth as in coping with the rising unemployment problem.

CHINA'S ECONOMIC GROWTH AND EMPLOYMENT, 2003-2007

Year	GDP Growth (%)	Total Labour Force (mil) Force (mil)	Yearly Increase in Labour	Yearly Employment Creation	Percentage Increase in Employment	GDP – Employment Elasticity
2003	10	744	6.9	10.2	1.38	0.138
2004	10.1	752	7.7	20.5	2.75	0.272
2005	10.4	758	6.3	19.2	2.56	0.246
2006	11.6	764	5.8	19.8	2.62	0.226
2007	11.9	770	5.9	17.1	2.23	0.187
Average 2003-2007	10.8	758	6.5	17.4	2.53	0.189

*Note: Percentage increase in employment is calculated as the ratio between employment creation in the present year and total labour force in the previous year. i.e. .E=(Dt/Bt-1)*100%*

Source: China Statistical Yearbook, 2008