China's Economy 2009 in Review:
Rebound First and Rebalance Later

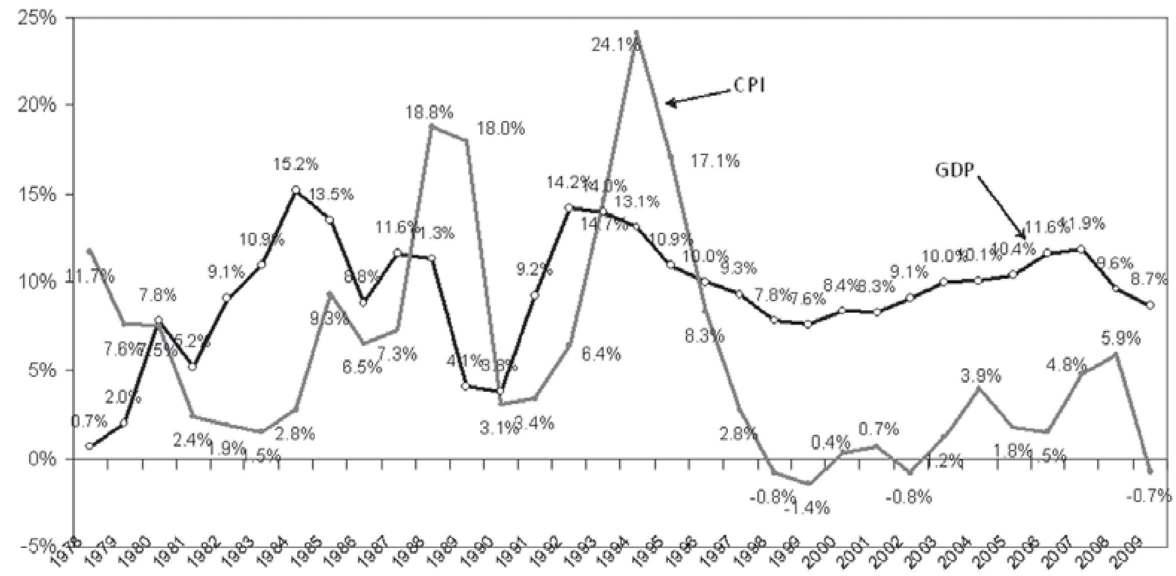
John WONG*

The Chinese economy in 2009 had clearly rebounded, with 8.7% growth. The year started with China's economic growth in Q1 plunging to 6.1%. Alarmed, the Chinese government immediately put up a huge stimulus package of four trillion yuan (US$586 billion). Together with massive bank loans (nine trillion yuan), the pro-active stimulus polices quickly produced results, and the economy bottomed out in Q2. The decline in foreign trade growth had not altered China's global trade patterns but had lifted China to become the world's largest trading nation.

CHINA'S ECONOMY ended 2009 with 8.7% growth, which is lower than the 9% of 2008 (real growth for 2008 was recently revised up to 9.6%) but well above Premier Wen Jiaobao's "bottomline" rate of 8% that he pledged to maintain (*bao-ba*) for the crisis year. Towards the end of 2009, China's economy had clearly regained a lot of its former growth momentum, and is slated to grow by at least 9.5% in 2010 with moderate inflation. (Figure 1).

* John WONG is Professorial Fellow at the East Asian Institute, National University of Singapore.

FIGURE 1 CHINA'S GDP GROWTH AND CPI, 1978-2009



Source: NBS, World Bank and MIIT

China's economy entered 2009 – what Premier Wen recently called a "scary year" – with much trepidation due to the sharp decline in exports and industrial production along with rising industrial layoffs in the export-oriented coastal regions, in sympathy with the general slump in the global economy. China's growth in Q1 of 2009 plummeted to 6.1%, the lowest quarterly growth for more than a decade. There was indeed tremendous uncertainty or even gloom and doom for this high-performance economy.

Initially, as the global financial crisis was starting to unfold in the Wall Street, many in China had expected China to be largely "decoupled" from its adverse impact because China's financial sector was basically not exposed. But the actual event had turned out to be different. In fact, the US financial troubles quickly reverberated in China's export sectors. The credit crunch in the US had immediately disrupted the shipping of China's exported goods and this, along with the expected fall in US consumer confidence, had created a chain reaction of preemptive cancellation of orders for factories and the instant drying up of credit finance for production, leading to widespread factory closures and massive retrenchment across the Pearl River Delta and elsewhere in China. Few had expected China's export industries, particularly those labour-intensive ones, to so quickly and so easily succumb to the Wall Street crisis.

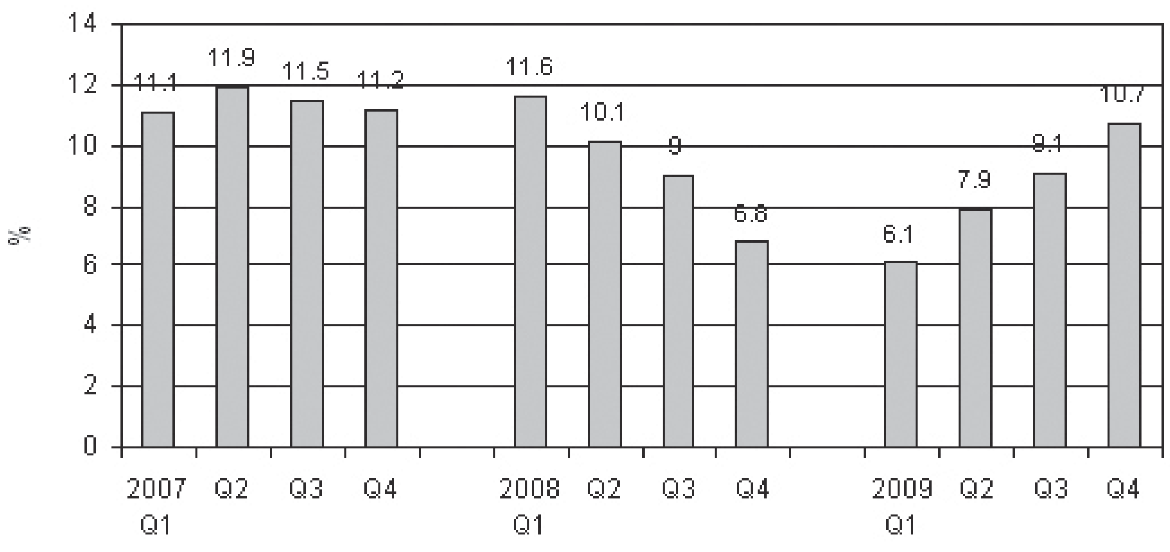
The rapid spread of the contagion effects of the global financial meltdown, particularly the ways that they had so quickly reached Chinese shores, had evidently alarmed the Chinese leadership. Before 2008 came to an end, Premier Wen had already put up a huge stimulus package of four trillion *yuan* (US$586 billion or 15% of China's 2007 GDP) over two years. The bulk of the stimulus spending was earmarked for infrastructure development and other government-backed heavy industry projects. But, for the first time, a great deal of government spending had also gone to boosting domestic consumption, including spending in rural development and other areas of social services.

It is important to note that the actual scale of China's total stimulus spending for 2009 was actually much bigger, far exceeding the fiscal package of the announced four trillion *yuan*, as many projects were also supported by huge bank loans and other means of finance from local governments. In the first 11 months of 2009, for instance, the banks, fuelled by a loose monetary policy, had advanced a record 9.2 trillion *yuan* (almost 30% of China's GDP) of new loans, far surpassing the full-year target of five trillion *yuan*. It should also be mentioned that a lot of new credit and loans – some six trillion *yuan* – had gone into real estate and stock markets, which produced the same effect, albeit indirectly, of stimulating GDP growth. A buoyant property market brought back the brisk construction activities across China's major cities – housing prices have been on the rise since early 2009 in 70 large and medium cities.

Under these circumstances, the stimulus policy promptly produced its results, with economic slowdown starting to bottom out in Q1 of 2009; and in Q2, it chalked up a strong growth of 7.9% (annualised 17%). As can be seen from Figure 2, this is a typical V-shaped rebound. In fact, the ways in which the Chinese economy had so quickly bounced back in growth had taken many foreign commentators by surprise – even the World Bank had twice revised upwards its forecast of China's economic growth over the year.

Looking back, it is actually not hard to explain why China could have reversed its economic fortunes so easily and so fast. Firstly, the Chinese economic downturn starting

FIGURE 2 QUARTERLY GROWTH RATES, 2007-2009



Source: NBS database

in Q4 of 2008 was not entirely caused by the global financial crisis, but also partly due to the legacies of the government's macroeconomic squeeze introduced in the first part of 2008 to curb inflation. Secondly, China did not have to begin the stimulus package fresh from "the drawing board" as many large-scale infrastructure projects like the rebuilding of the Sichuan earthquake zones or the construction of the national high-speed railway network were planned and started well before the recession. This means little time-lag for the working of the stimulus package.

When Premier Wen announced his stimulus package on 9 November 2008 and his government's determination to maintain 2009 growth at eight percent, quite a number of foreign commentators remained sceptical. But those with deep knowledge of China (like many of my colleagues at EAI) were from the outset quite confident that Wen would be able to deliver. It is pretty much in the nature of the Chinese Communist leadership to mobilise all available resources to achieve whatever targets they have set their sights on (as opposed to rhetoric). Specifically for such a massive stimulus package, China had very strong financial muscles to pull it off quite easily on account of its comfortable fiscal surplus and huge domestic savings (both household and corporate). Strong economic fundamentals did in fact facilitate recovery.

Furthermore, most Chinese leaders at both central and local levels are essentially "economic growth freaks". They want high GDP growth for various political and social reasons such as maintaining the ruling Party's legitimacy and the country's social stability. At the local levels, in particular, one can find strong pro-growth coalition everywhere, with local officials, businesses and related interest groups joining hands to push for growth-oriented projects. The current global financial crisis has further strengthened China's "economic growth consensus" both at the national and local levels. Not surprisingly, the Chinese economy towards the end of 2009 quickly bounced back to vigorous economic growth.

If the 2009 rebound was to extend into 2010, then the 2009 crisis looks increasingly like a mere "hiccup" in China's long process of high growth. Indeed, 2009 had also been an important economic watershed for China. Not just that China is the only major economy that has chalked up such highly creditable growth performance amidst the global slump, but also, China's growth carries tremendous global implications for both global and regional rebound. The current crisis, in diminishing the economic strength of the developed countries, had also presented China with the opportunity to narrow its gaps with major developed economies. Beijing has lately revised its GDP upwards by correcting its previous underestimates of the service sector. This puts China's GDP in 2008 at US$4.6 trillion and about US$5 trillion for 2009. In other words, China is about to replace Japan as the world's second largest economy any time in 2010.

Besides, China in 2009 scored a number of important "firsts". Apart from being the world's largest creditor country with its foreign reserves bulging at US$ 2,300 trillion, China, with its eight percent share of global trade, is about to replace Germany as the world's largest trading country. With its automobile sales in 2009 exceeding 10 million units, China has already replaced USA as the world's largest automobile market.

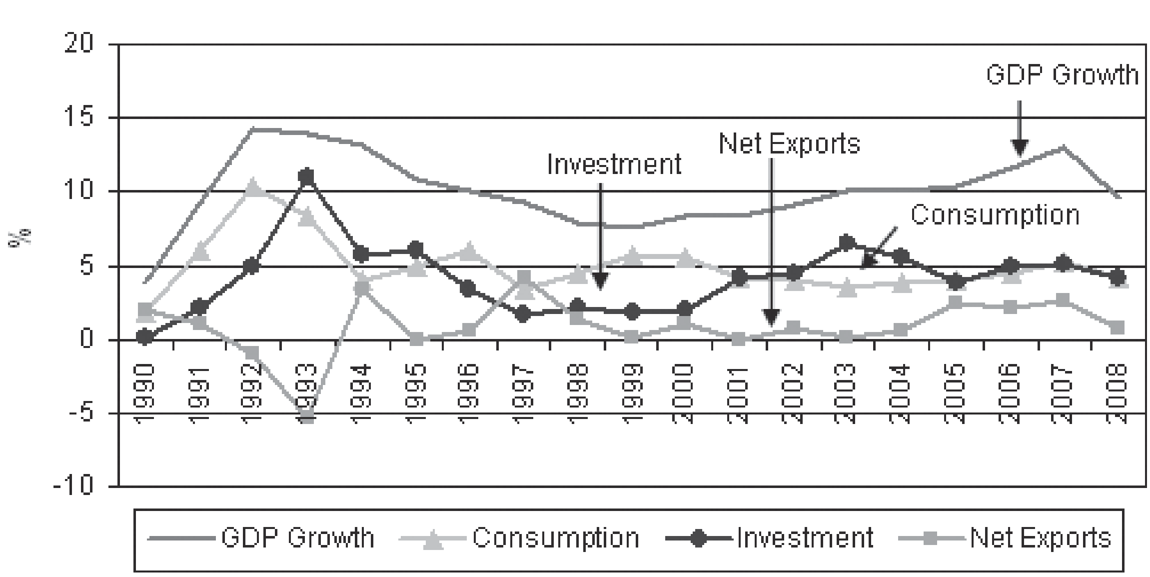
Accordingly, one finds the Chinese leadership emerging from the crisis with much more self-confidence; its top leaders have been busily hopping around attending various international and regional conferences with increasing clout. The Chinese leadership seems quite content with putting its economy back on its fast track first while leaving the problems of restructuring and rebalancing to be tackled in future.

China has announced that the present pro-active stimulus policies will be carried forward to 2010. If there was no further deterioration in the global economy, China is likely to expand its growth further to 9.5% for 2010. In the meanwhile, there are many short-term and medium-term structural problems, from industrial overcapacity to over-lending by banks, which are crying out for attention from the government. One disturbing trend is that the state sector has come out as a clear winner in this recession "at the expense of the private sector". Chinese domestic critics called this *guojin mintui*.

Basically the Same Growth Pattern

The best starting point to analyse the growth of an economy is to look at its sources of growth on the demand side, i.e. how the increase in GDP is generated by the rise in both domestic demand (domestic investment and domestic consumption) and external demand (net exports). For years, China's economic growth, as shown in Figure 3, has been basically fuelled by the rise in domestic demand, particularly domestic investment. Of the original nine percent GDP growth in 2008 (lately revised to 9.6%), domestic investment and domestic consumption each accounted for 4.1 percentage points while net exports (exports minus imports) as external demand made up only 0.8 percentage point. In previous years, the relative shares for domestic investment and net exports

FIGURE 3 CONTRIBUTION OF DOMESTIC CONSUMPTION, INVESTMENT AND EXTERNAL DEMAND TO GROWTH, 1990-2008



Source: China Statistical Yearbook, 2009 had been higher. But the macroeconomic controls in the first half of 2008 and the plunge in exports in its last quarter had obviously trimmed down their relative shares.

For the first 11 months of 2009, domestic investment grew at a hefty rate of 32.1%, compared to the same period of 2008. Domestic consumption grew at a moderate rate of 15.3% while net exports at negative 30.6%. The changes in the relative contribution of the three components to growth in 2009, with investment constituting the major source of growth, have been more profound than those in 2008. In other words, the recession had clearly made a significant impact on the 2009 growth pattern. Viewed from a different angle, the 2009 pattern of GDP growth is actually the outcome of the stimulus package, which essentially pump-primes economic growth by massive investment spending.

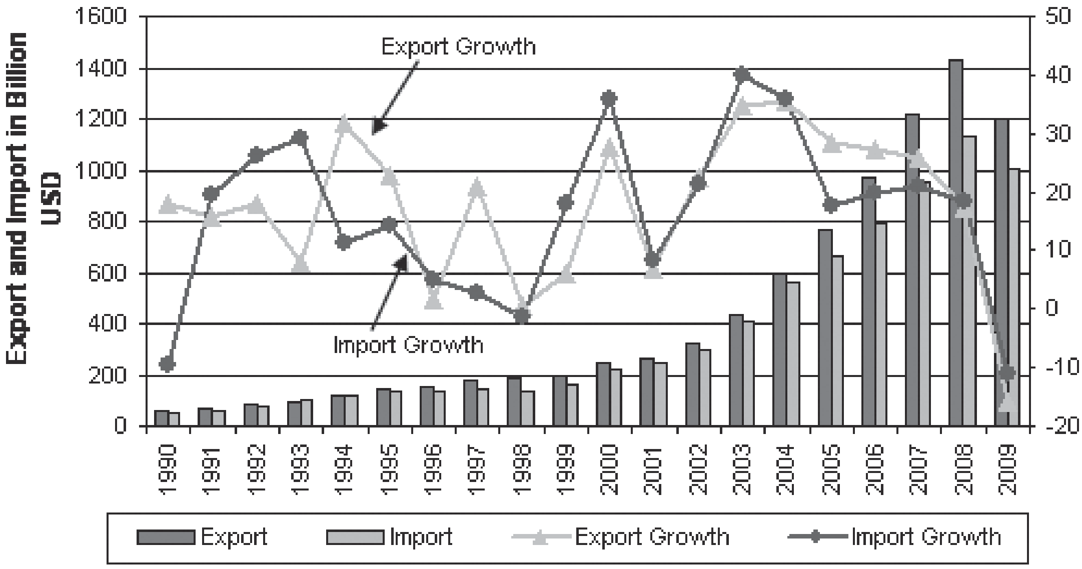
As discussed earlier, most of the stimulus spending was earmarked for large infrastructure projects in connection with high-speed railways, new expressways, ports, airports and so on. On the demand side, the Chinese appetite for more infrastructure projects does seem inexhaustible for a long time to come. As a big, continental-sized economy, China is still badly in need of more infrastructure investment, even though China has already achieved a lot over the past 10 years – e.g., China now has the world's second largest highway network after the USA. Future infrastructure investment will include more environmental projects, new waterworks, and new energy as well as a wide variety of social infrastructure projects such as housing, schools, hospitals, and urban amenities.

Currently, both Shanghai and Guangzhou are full of frenzied infrastructure construction activities in preparation for the Expo and the Asian Games respectively. Other major cities are also rapidly expanding their urban facilities like building new subways. Is China over-investing in too many mega-projects, which can be wasteful or having low capacity utilisation? Many projects are clearly not viable in the short run. But then, large public projects are not appropriate for the conventional cost-benefit analysis. In the long run, China as a large and rapidly growing economy would be able to absorb such inefficiencies and externalities. In the meanwhile, the continuing demand for infrastructure development will underscore China's continuing high economic growth for a long time to come.

By comparison, the consumption component of growth for 2009 was still very much lagging behind investment, despite the government's various incentives to stimulate larger consumption demand by giving subsidies to rural households to purchase home appliances and incentives for urban people to buy cars. Overall, consumer spending in 2009 had been on the rise; but the rise had not been substantial enough to significantly offset the decline in external demand. In short, China's economy remains largely growth-biased and investment-biased, and there are too many institutional and economic constraints to expanding domestic consumption. The case in point is the widening income inequalities, which are certainly not conducive to the government's policy of promoting greater consumer spending.

As a source of growth, the "external demand" component can be quite misleading. In general terms, the Chinese economy is considered quite dependent on trade as its

FIGURE 4 CHINA'S EXTERNAL TRADE GROWTH, 1990-2009



Source: China Statistical Yearbook 2009; Various compilations by author

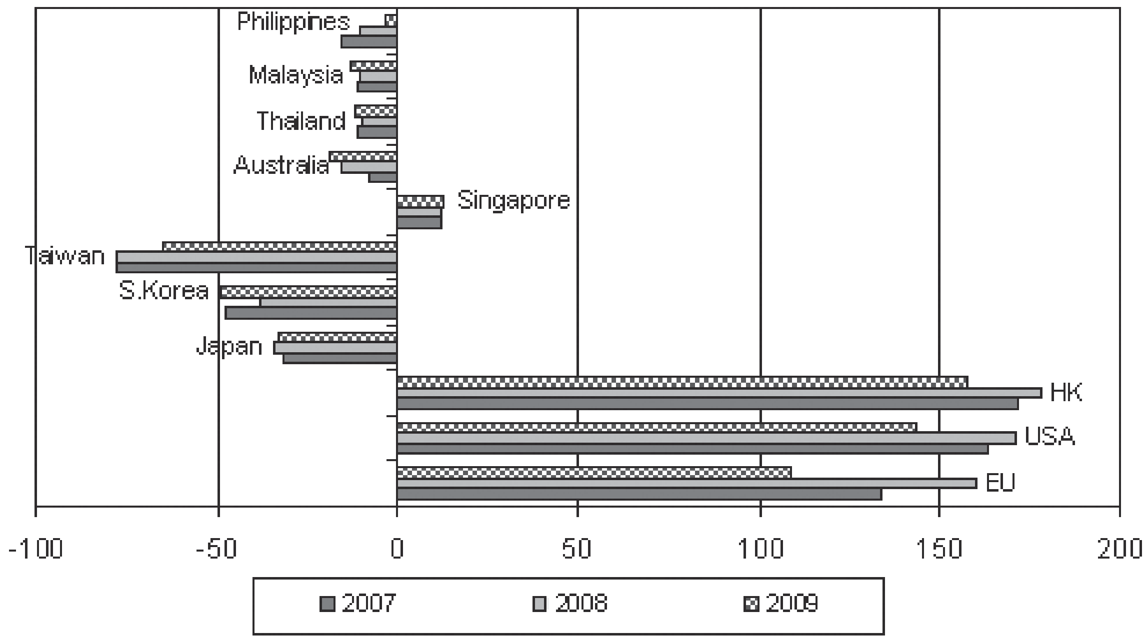
exports amount to about 30% of GDP. But GDP is a value-added concept, and the direct contribution of net exports to China's GDP is actually much lower, particularly since a lot of China's exports are processing products with low domestic value-added. In 2009, total trade actually contracted by 13.9%, year on year, to US$2.21 trillion. (Figure 4). Accordingly, the contribution of "external demand" to GDP growth for this period was a negative 44.8%. (This does not mean that exports in 2009 did not add value to GDP at all. Indirectly, export industries generate GDP through the multiplier effect by generating employment).

On account of the general slump in global demand, China's export growth for the first 10 months of 2009 had been on a decline, turning around only in November. In 2008, China chalked up a huge trade surplus of US$298 billion, but the trade surplus for 2009 will be much smaller. The recession has made no significant change to China's global trade patterns, even though China has now become the world's leading trading nation.

In the regional context, however, the recession has much strengthened China's economic relations with its Asian neigbhours, as rising Chinese demand has partially made up for the weaker demand from the developed countries. In 2010, China-ASEAN Free Trade Agreement will be fully operational, and China is expected to have a more prominent economic presence in the region, through not just more trade but also more outgoing FDI from China.

Figure 5 brings out China's unique pattern of trade balances with its major trade partners. China has continued to incur trade deficits with its neigbhouring economies in

FIGURE 5 CHINA'S TRADE BALANCE WITH SELECTED COUNTRIES, IN BILLION USD



Source: China Statistical Yearbook 2009; China Monthly Statistics, Dec 2009

Asia, which are using China's vast domestic markets (by exporting manufactured products, intermediate goods as well as energy and raw materials to China) for their own economic growth. China turns around by running a huge trade surplus with the EU and USA (China's largest two trade partners); in this way, China is a proxy holder of trade surplus for Japan, Korea and Taiwan in these two markets. China's trade frictions with these two trade partners are expected to worsen in 2010.

Such trading patterns are further reinforced by the existence of numerous global and regional production networks (or supply chains) that are based in China. In this way, China's economy actually operates as an engine of economic growth for its Asian neigbhours while at the same time, carrying out an important role of integrating these economies. Because of this, China's recent economic rebound has greatly helped and spurred regional and global economic recovery.

After the Rebound, Now the Hard Part

Fundamentally, it is hard to fault China's basic strategy of bringing back economic growth first and then tackling the long-term structural problems. Most governments are adopting similar strategies. A year ago, Chinese leaders did make it clear that the crisis also presented itself as an opportunity for China to restructure and rebalance its macro economy, especially by boosting domestic demand. The stimulus package did in fact provide for more government spending in many social areas such as rural development, healthcare, education and public housing that are directly related to "improving the people's livelihood".

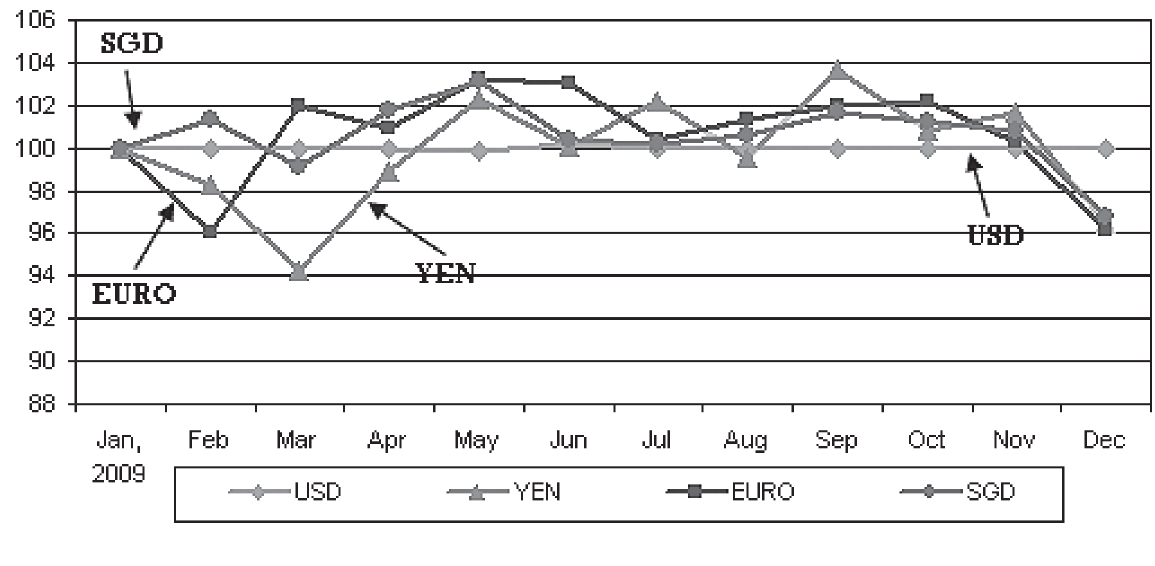
A year later, the government has achieved a lot in terms of restoring economic growth, but preciously little in terms of restructuring and rebalancing the economy. China's basic growth patterns, as explained in the last section, have remained largely unchanged, being still heavily dependent on investment and exports (though exports have yet to fully recover). Domestic consumption is still a weak link in China's economic growth. What has happened?

One simple explanation is that the growth pattern of any economy evolves from its own economic and institutional characteristics. This cannot be easily changed overnight. The case in point is domestic consumption. In China, the share of "wages and salaries" accounts for only 42% of national income, compared to 55% for the developed countries. Furthermore, households, state corporations and government together put aside almost 50% of China's GDP as savings. How can the government effectively expand domestic consumption?

Restructuring has to be a long-term strategy. Some Western economists and commentators have continued to urge Chinese policy makers to undertake the task of rebalancing China's economic growth patterns, which is crucial for global macroeconomic rebalancing efforts. Evidently, the Chinese leadership has no clear consensus on this strategy, and many Chinese leaders themselves are apparently not convinced that China, at its present stage of development, should take the lead in such global endeavours.

Take the RMB (*renminbi*) exchange rate as an example. It is well known that China's present "unbalanced growth" primarily stems from its over-saving, over-production and over-export (just as under-saving, over-consumption and over-import in the US

FIGURE 6 MONTHLY AVERAGE EXCHANGE RATE OF RMB AGAINST OTHER CURRENCIES, JAN TO DEC 2009 (JAN 2009 EXCHANGE RATE = 100)



Source: People's Bank of China. Forex Street and author's calculations economy). If the Chinese economy today were much less dependent on exports, it would not have been so exposed to the global financial crisis.

The simple first step towards restructuring and rebalancing is, therefore, to allow the RMB to appreciate, as this will also help restore domestic monetary balance as well as reduce China's unwieldy surplus. After all, the RMB, since its re-pegging with the US dollar at the beginning of the crisis last year, has fallen against all major currencies. (Figure 6)

However, Premier Wen declared on 27 December 2009 that China would not bow to international pressure and revalue the RMB. Admittedly, China has its own domestic politics for protecting its large export sector for the sake of preventing unemployment. Some Chinese economists have also argued that global macroeconomic rebalancing is basically a collective effort, and China should not be forced to undertake it alone. China is still haunted by the past Japanese experience of unilaterally revaluing the yen, which turned out to be very bad for the Japanese economy but at the same time did not cause the US economy to rebalance itself. Finally, whether or not the present Chinese economy is over-dependent on exports is a matter of personal judgment, not supported by any economic theory. Both the Japanese and German economies at their present level of development are still highly export-oriented.

Suffice it to say that China may have its own political and economic imperatives for sticking to its existing development strategies. But its policy makers should also be aware of the costs and risks of pursuing such short-term strategies. Specifically for 2010, the global economy is still under a lot of uncertainty. For China, its major challenges in 2010 are to sustain and manage its economic rebound. At the same time, it still needs to fine-tune its policies and make adjustments in order to enhance the "quality" of its economic recovery.