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**CHINESE ECONOMY 2008:
A TURBULENT YEAR AMID THE WORLD FINANCIAL
CRISIS**

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Executive Summary

1. The year 2008 marked China's success after 30 years of economic reforms but it was a turbulent year amidst an unprecedented world economic crisis that started in the USA and Europe and subsequently affected the rest of the world.
2. Apart from the crisis, China endured severe snowstorms in the first few months of the year followed by a devastating earthquake in Sichuan in May 2008 which took about 90,000 lives and left millions homeless.
3. Except for the successful 2008 Beijing Olympics, the year was a challenging and painful one for the country.
4. Nevertheless, China achieved a respectable GDP growth of 9%. Having surpassed Germany in 2007, China maintained and strengthened its position as the world's third largest economy, with a GDP of RMB 30.1 trillion (US\$ 4.42 trillion) measured in current values.
5. Its total fiscal revenue in 2008 was RMB 6.13 trillion, up 19.5% from 2007.
6. China's volume of trade reached US\$2.56 trillion, rising 18% from the previous year, generating a trade surplus of US\$29.6 billion, up 6.8%.
7. During the year, China received US\$92.4 billion of foreign direct investment (FDI), an increase of 11.3% from the previous year.
8. The above-mentioned growth records were, however, the lowest in the last seven years. Moreover, many macroeconomic indicators deteriorated sharply in the second half of the year with a clear downward trend continuing into 2009.
9. Nonetheless, the impact of the crisis on China has been smaller than on the USA, Japan, Germany, the UK and other key industrialised economies, with the UK and other large industrialised economies experiencing negative growth, while China continued to grow at a fast, albeit subdued, rate.
10. The current economic crisis may therefore present an opportunity for China to speed up its economic convergence with the industrialised world.
11. China may most likely overtake Japan to become the world's second largest economy in 2009, or latest by 2010, in nominal dollars instead of 2018 as previously predicted by the first author two years ago.
12. Strong monetary and fiscal packages have been designed in order to achieve a growth of 8% in 2009 against a deeply depressed world economy.
13. A 4-trillion-yuan fiscal plan was announced in late 2008, which was committed to invest heavily in infrastructure, agriculture, science and technology, environment protection, and education and healthcare.
14. Being far more open than before, China's economy has become more vulnerable to external shocks, yet at the same time it has had a bigger

influence on other countries. This suggests China has to work closely with the rest of the world to tackle the current economic crisis, and *vice versa*.

15. China managed to avoid the Asian Financial Crisis in 1997-98. Similarly in the current crisis, China will not be hit as hard as the major western economies because of its relative lower level of development
16. The current crisis will instead enable China to shorten the time needed to overtake Japan and the USA to become the world's largest economy and the next superpower.
17. Meanwhile, the real worry for China is that it may become the centre of the next worldwide economic crisis. If that happens, China's bid to become the world's largest economy will still become stalled or be significantly slowed down.
18. Hence, the challenge for China today is not just to cope with the current economic crisis, but to take preventive efforts so that its next stage of development will not bring about another major crisis.

Chinese Economy 2008: A Turbulent Year Amid the World Financial Crisis

Shujie Yao and Minjia Chen*

Dramatic Changes of Economic Prospects and Macroeconomic Policies

- 1.1 China kicked off the year 2008 with an overheating economy, featured by high inflation and growth. Its GDP growth in 2007 was 13%¹, the fastest since 1995 and represented its fifth consecutive year of double-digit growth. In the industrialised world, there had been warnings of an upcoming economic downturn since the second half of 2007. China however did not experience any signs of cooling until the third quarter of 2008 although share prices on both the Shanghai and Shenzhen stock markets had been declining sharply since December 2007 following a six-fold gain in the previous two years. GDP growth in the first quarter stood at 10.6% coupled by an inflation rate of more than 8%. The focus of government economic policy in the first half of 2008 was still on preventing the economy from overheating and capping inflation. The prevailing view then largely underestimated the impact of the US sub-prime crisis.
- 1.2 However, 2008 turned out to be a tough year for China. From late January to the Chinese Lunar New Year, most of South China was swept by the severest snowstorms in a century. Snow, sleet and subzero temperatures firmly gripped areas that usually had mild winters, disrupting transport and causing price hikes in food and other goods. The disaster exacerbated the worst-ever power shortage in the country and forced factories to suspend production. The direct economic loss caused by the storms amounted to RMB 152 billion². Besides casting a shadow over the Spring Festival celebrations, the disaster pushed the inflation rate even higher. The consumer price index (CPI) climbed up to 7.1% in January and 8.7% in February.³ As expected, the National Development and Reform Commission (NDRC) in February stipulated clearly that the state macroeconomic policy of “two preventions (overheating and inflation)” would not be revised even after the snowstorms.⁴
- 1.3 While the economy was still recovering from the snowstorms, the western province of Sichuan was hit by an 8.0-magnitude earthquake in Wenchuan, devastating the whole province of Sichuan and the neighbouring provinces of Shaanxi and Gansu. The calamity killed 90,000 people and left millions of others homeless. The direct economic loss reportedly totalled RMB 845 billion (US\$ 124 billion).⁵ The government mobilised more than 100,000

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1 The figure was only revised from 11.9% to 13% by the NBS on the 14 Jan 2009. *Xinhua News*, 14/01/2009, “NBS Published the Final Verified Data for 2007, GDP Growth 13%”, http://news.xinhuanet.com/fortune/2009-01/14/content_10656031.htm, accessed on 22/01/2009.

2 Data source: Ministry of Civil Affairs.

3 Data source: NBS.

4 *Xinhua News*, 15/02/2008, “NDRC: The Macroeconomic Policy of “Two Preventions” not to be Altered by the Snow Storm”, http://news.xinhuanet.com/fortune/2008-02/15/content_7609374.htm, accessed on 22/01/2009.

5 *CCTV News*, 04/09/2008, “The Loss from Wenchuan Earthquake 845.1 Billion yuan,

troops, rescuers, medical workers and other personnel to carry out relief work, which added to the cost of the disaster. Direct economic losses from these two significant natural disasters accounted for nearly 4% of the nation's GDP in 2007.

- 1.4 While China was fighting natural disasters, the US sub-prime crisis had spread in the developed world via multi-national banks, evolving into the most severe global economic crisis in decades. While most people in China were focusing on the disaster relief work and the Beijing Olympic Games, export-oriented businesses and policymakers were starting to feel the chill of an economic downturn. After May 2008, the government turned down its stress on "preventing economic overheating" and instead emphasised the importance of reducing inflation. From May onwards, many major economic indicators, such as GDP growth, CPI, export growth, import growth, foreign direct investment (FDI) inflow and fiscal revenue, started declining.
- 1.5 China won wide praise for successfully holding the Beijing Olympic Games. Since 2001 when Beijing won the bid to host the games, the central and local governments had been investing enormous amounts on this biggest-ever global sport event. The precise investment figure is hard to estimate because of difficulties in quantifying heavy investments in improving infrastructure and air quality on top of direct spending on running the Games and on the construction of sport venues. The Beijing Olympics Committee and the Beijing municipal government estimated that the operational investment on the Games at about US\$ 2.2 billion, 37% more than the estimated budget in 2001. The investment on sport venues was about US\$ 1.9 billion, and on infrastructure in Beijing about US\$41.2 billion.⁶ All in all, the total cost of the Games amounted to more than US\$ 45.3 billion (or RMB 300 billion), representing about 1% of China's GDP in 2008. This made the Beijing Olympics the most expensive in the Games' history, costing about thrice as much as the Athens games in 2004.
- 1.6 On the operational side, the Games' organiser managed to achieve a small surplus. The Olympics certainly started a construction boom in Beijing as well as in several other hosting cities. Many economists believed that the properties that have been built in Beijing and elsewhere were responses to strong genuine demand arising from high economic growth and rapid urbanisation, the Olympics represented but only a small stimulus. Besides, the huge event provide some other knock-on effects in that it spurred fast growth and changes in several areas, including tourism, environmental improvement, etc. The Games attracted large numbers of spectators from all over the world. China launched 20 projects to improve the quality of Beijing's environment with an overall investment of US\$12.2 billion, according to the Beijing Sustainable Development Plan. The huge investments supporting the Olympics had a ripple effect on economic growth, particularly in Beijing. Beijing's municipal statistical bureau estimated that the Games have added 2.5 percentage points to the city's annual growth of GDP since 2002. The enthusiasm shown by the Chinese

Death and Missing Toll 87,000", <http://news.cctv.com/china/20080904/102837.shtml>, accessed on 22/01/2009.

⁶ CCTV News, 04/08/2008, "Beijing Olympic Games Investment More Than 300 Billion Yuan", <http://www.cctvfinance.com/CaiJingZiXun/HTML/205734.html>, accessed on 22/01/2009; and *People's Daily*, 22/08/2008, "Beijing Olympic Games Expenditure 37% above Budget, to Have Surplus", <http://npc.people.com.cn/GB/14840/7706185.html>, accessed on 22/01/2009.

for the Games has also helped to develop the potential of the country's sport industry, which was still relatively less developed.

- 1.7 However, the Olympics effect could not prevent the Chinese economy from slowing down. From the second half of the year, the downturn started becoming obvious. In the third quarter of 2008, GDP growth was 9.0%, which considerably slower than the rates of 10.6% and 10.1% in the previous two quarters. Export growth slowed down by 4.8 percentage points, resulting in a decline in trade surplus of US\$ 4.7 billion in that quarter. Industry output growth, which is the most important factor of China's economy, slowed to 11.4% compared with 18% in the same quarter in 2007. The CPI also declined to 4.6% in September.⁷
- 1.8 During the run-up to the Olympic Games, the central government had already realised the potential risk of the western economic recession. Half a month before the Games started, the State Council called for a change in the main target of China's monetary policy to "safeguarding growth and containing inflation." By the time the Olympics and Paralympics had finished, tens of thousands of factories in the coastal provinces that produced export goods had shut down due to lagging foreign demand, causing hundreds of thousands of workers to be laid off. According to estimates by the transportation department, millions of migrant workers in the eastern areas had returned to their inland hometowns. The education authority predicted that about a quarter of the 5.99 million graduates in 2008 would not be able to find a job after graduation. Indeed, the biggest worry for the Chinese economy in the wake of the global financial crisis is serious unemployment for both unskilled and skilled workers.
- 1.9 In late September and early October 2008, following the collapse of international financial giants such as Lehman Brothers, Fannie Mae, Freddie Mac, Merrill Lynch, and AIG, the world economy took a sudden and decisive turn for the worse. When central banks of key industrialised economies realised that they had seriously underestimated the profound effects of the financial crisis, they hastily put strong expansionary monetary policies into force. Most countries introduced large rescue plans to prevent major commercial banks, followed by large car makers, from collapsing. However, all these efforts could not stop the global economy from worsening. The crisis in the financial sector quickly spread to the real sectors. Many world-leading automobile makers went to the brink of bankruptcy. In response to the swift aggravation of the world economy, China, in line with major western central banks, lowered its benchmark interest rate in September for the first time since 2006.
- 1.10 From early November, the macroeconomic target of the Chinese government was modified again to "guaranteeing growth." Up until then, most economic indicators had left Chinese policymakers without any doubt that the economy was heading towards a sharp and brutal slowdown. The central government rapidly put together a huge stimulus package of RMB 4 trillion (US\$590 billion) as well as other fiscal policy support, aiming at boosting the economy through investment in the following two years. In the last quarter of 2008, inflation concern eased with the CPI slowing to 2.4% in November. It further dropped to 1.2% in December, raising concern of possible deflation in the coming months instead. The overall CPI was 5.9% for the whole year, 1.1% higher than in 2007⁸, but the

7 Data sources: NBS.

8 Data source: NBS.

downward trend was sharp towards the end of the year.

- 1.11 The annual Central (Communist Party Committee) Economic Work Conference in early December re-emphasised the importance of "guaranteeing growth" and set a GDP growth target of 8% for 2009. Many Chinese officials have expressed confidence of achieving the growth goal and governments at all levels have made specific plans to meet the goal. However, the World Bank forecast that realistically the figure may only be 7.5%, while many economists think it may be as low as 6% given the dire external environment with China's major trading partners experiencing significant economic contraction in 2009. For example, the World Economic Forum held in January 2009 in Davos, Switzerland warned that if China's growth were to slow to 6% or lower in 2009, it would worsen and prolong the current global economic crisis. Although a 6% or 8% growth would still be much better than the negative growth in most western economies, it would be the lowest growth for China in two decades. As the employment elasticity of growth in China has been low, this level of growth means that tens of millions of migrant workers and university graduates may not find jobs or lose their jobs, subjecting their families to severe economic hardship, which in turn may result in social and political unrests.

The Financial Crisis and Its Impact on China's Economic Status

- 2.1 The global financial crisis is the result of the bursting of financial and housing market bubbles in the developed world. The collapse of the US sub-prime mortgage market and the end of housing market booms in some other advanced economies have severely affected the world economy. The financial institutions have lost trillions of dollars and may cost global taxpayers even more to shore up many of the world's largest banks and other multinational corporations through various government bail-out plans.
- 2.2 For example, house prices in the UK fell 16.2% in 2008 as a result of the financial crisis and the collapse of its banking system.⁹ House prices dropped 18.2% in 20 major US cities in 2008, the sharpest fall in nearly two decades.¹⁰ Stock markets on the major exchanges plunged in the past year due to the lack of confidence and the uncertain economic outlook (Table 1). The Dow-Jones and FTSE 100 indices fell more than 30%, while the Dax in Frankfurt and Cac 40 in Paris dropped more than 40%. Asian markets fared even worse, with the Shanghai Composite Index plunging 65%. Steep losses in the stock market value were also largely caused by the failures of major investment banks and mortgage lenders. For example, the Royal Bank of Scotland (RBS) unveiled the biggest loss in British corporate history of up to GB£28 billion in 2008.¹¹ Its share price went into a free fall from around GB£7 per share in March 2007 to

9 *Guardian*, 02/01/2009, "Housing Market Braced for Brutal 2009 as Prices and Mortgage Lending Plunge", <http://www.guardian.co.uk/business/2009/jan/02/halifax-house-prices>, accessed on 22/01/09.

10 *Guardian*, 27/01/2009, "US House Prices Continue to Plunge", <http://www.guardian.co.uk/business/2009/jan/27/us-house-prices-plunge>, accessed on 02/02/09.

11 *Reuters*, 19/01/2009, "RBS Loss a Record for a UK Firm, Shares in Freefall", <http://www.reuters.com/article/businessNews/idUSTRE50I06320090119?feedType=RSS&feedName=businessNews>, accessed on 02/02/2009.

GB£0.10 in January 2009, losing 96% in 2008 alone.¹² RBS is one of the many horrific examples of failure in the financial sector of the major western economies. The current crisis is truly the worst ever in history, and even worse than the Great Depression in the early 1930s because of its worldwide impact.

Table 1 - World stock markets 2008

New York	-34%
London	-31%
Paris	-43%
Frankfurt	-40%
Mumbai	-52%
Singapore	-49%
Sydney	-41%
Hong Kong	-48%
Shanghai	-65%
Tokyo	-42%

Sources: Danny Quah (2009) 'Will Asia save the world?' *The World Economy Asia* Lecture presented in January 2009, Kuala Lumpur, Leverhulme Centre GEP, Nottingham.

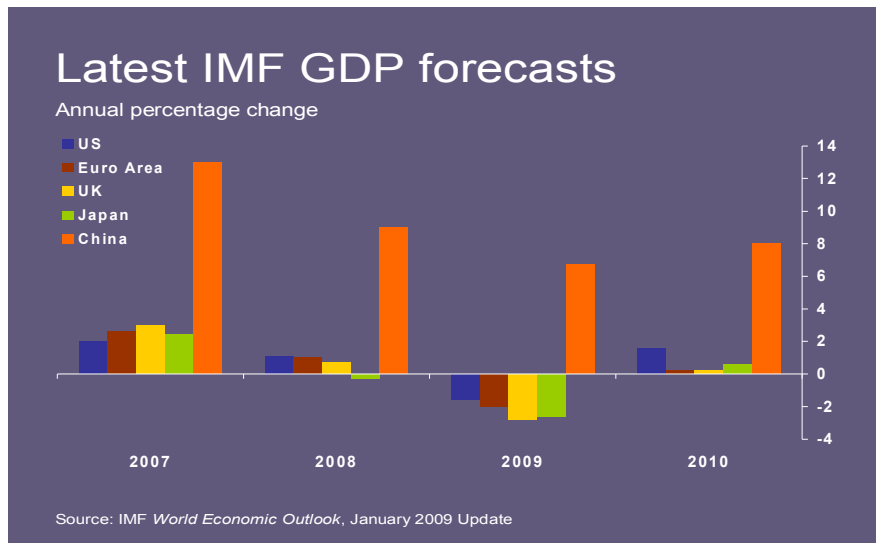
- 2.3 The deep troubles in the financial sector have cost governments trillions of dollars to bail out because they could not afford to let the major affected institutions fail. The potential cost is expected to increase in the near future, further worsening the economic outlook. Therefore, the financial crisis may ultimately result in a global economic rebalancing. The years 2008 and 2009 have seen, and will see, the world's largest and industrialised economies such as the US, Japan, Germany and the UK falling into deep recession. The UK economy shrank 0.6% in the third quarter of 2008 and 1.5% in the fourth quarter. The German economy contracted by up to 2% in the fourth quarter in 2008. Over the same period, exports from Japan declined by 35%. In its most recent projections the International Monetary Fund (IMF) expected world GDP growth to be just 0.5% in 2009. The US economy is expected to contract by 1.6%, the euro area by 2.0% and the UK by 2.8% in 2009 (Figure 1).¹³ If realised, these projections would constitute the slowest level of world GDP growth, and biggest contraction of the UK economy, since World War II.¹⁴

¹² Data source: Yahoo finance.

¹³ Andrew Sentence (2009), The global financial crisis: causes and consequences, seminar paper presented at the School of Contemporary Chinese Studies, University of Nottingham, 10 February 2009.

¹⁴ David Blanchflower (2009), Macroeconomic policy responses in the UK, public lecture given at the Leverhulme Centre of Globalisation and Economic Policy (GEP) of the University of Nottingham, 29 January 2009.

Figure 1 - GDP growth of the world largest economies, 2007-2010 (%)



Based on previous economic crises in the 1980s and 1990s, it is predicted that an economic crisis of this scale will last for one and a half years and it will take another three years for the hard-hit economies to recover to their pre-crisis level. This implies that China's key competitors, including the US, Japan, Germany and the UK will not recover to their 2007 output level until 2011 or 2012. The Chinese economy, on the other hand, is expected to expand at 7%-8% in 2009, which is a high rate by any standard even during times of prosperity. Although there is no prediction of how fast China will grow after 2009, the tone set by the Chinese government is for China to resume normal economic growth after 2009. This means that China may try to achieve a 9%-10% growth rate again in 2010 and beyond for a certain period of time.

2.4 This brief analysis points to the following proposition: the current economic crisis has hit every country hard and China is no exception. However, the crisis gives China a 'once-in-a-century' opportunity to achieve a much speedier economic convergence with the world's largest industrialised economies, including the US, Japan, Germany and the UK. Table 2 shows that China had become the third largest economy in the world by 2007. The year 2008 reinforced this position. It is most likely that China will surpass Japan to become the second largest economy of the world either in 2009 or latest by 2010 in nominal dollars, instead of by 2018, as previously predicted by the first author of this review two years ago. With this trend, China will greatly shorten the time needed to catch up with the US and become the world's largest economy although the likelihood of this happening in the next two decades is less certain. It is worth noting that China became the world's largest market of vehicle sales in January 2009 for the first time, with total sales of 870,000 units, or about 78,000 units more than sales in the US in the same month.¹⁵

Table 2 - GDP (US\$ trillion) in the top five economies

GDP	US	Japan	Germany	China	UK
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¹⁵ BBC Radio 4, Business News, 9 February 2009.

2005	12.38	4.55	2.79	2.29	2.24
2006	13.25	4.37	2.90	2.79	2.39
2007	13.84	4.38	3.32	3.47	2.77
2008	14.10	4.68	3.37	4.42	2.73

Source: World Bank *International Comparison Program 2005*, *The Economist Intelligence Unit, Country Profile 2007 & 2008*, and NBS of China. Data in 2008 for the US, Germany, Japan and the UK are estimated by authors according to the published growth rates.

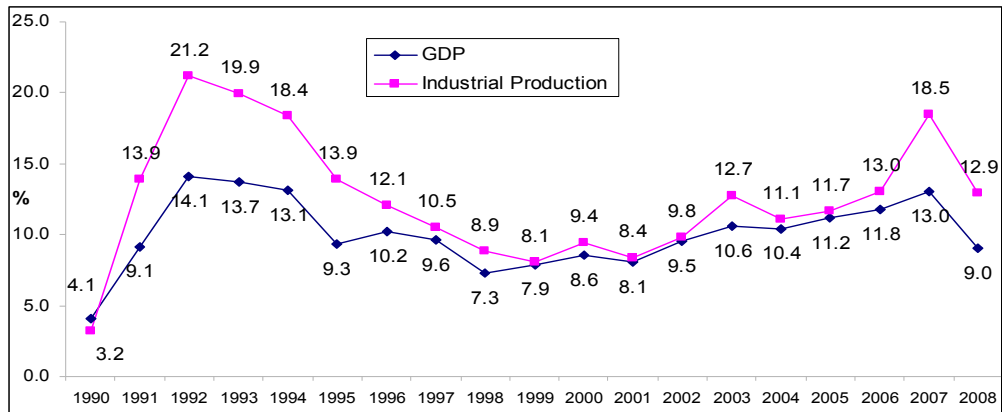
- 2.5 **Another potential impact of the global financial crisis is that it may change the consumerist behaviour in advanced industrialised societies. This crisis may have made some consumers realise the high risks of over-consumption and low savings to their households and the economy. This may be positive for improving the economic structure in those countries.**
- 2.6 One further implication is that China may take advantage of the low prices of oil and raw materials in the current financial crisis to fuel its next stage of industrialisation and urbanisation.

Economic Growth

- 3.1 The pattern of economic growth and structure remained pretty much the same compared with a year ago except during the slowdown. Industrial production was still the most important source of GDP growth for China. Figure 2 shows that since the beginning of the 1990s, GDP and industrial production have always grown in step with the latter leading the way. In 2008 industrial production growth fell steeply from the previous year and so did GDP growth. In November 2008 industrial output rose only 5.4% from a year earlier – the weakest pace in a decade -- compared with 8.2% in October and 11.4% in September. Around the world, industrial output has been plunging due to lack of demand. In China, the December figure went up slightly to 5.7%, ending the year with an annual industrial output growth of 12.9%, much lower than the 18.5% in 2007. Although the annual growth rate of GDP was 9%, the growth rate in the fourth quarter was only 6.8%, down from 9.0% in the third quarter and over 10% in the first two quarters. The secondary and tertiary sectors maintained stronger growth at 9.3% and 9.5% respectively, than the primary sector's 5.5% in 2008.¹⁶

Figure 2 - GDP and industrial production growth rates (%), 1990-2008

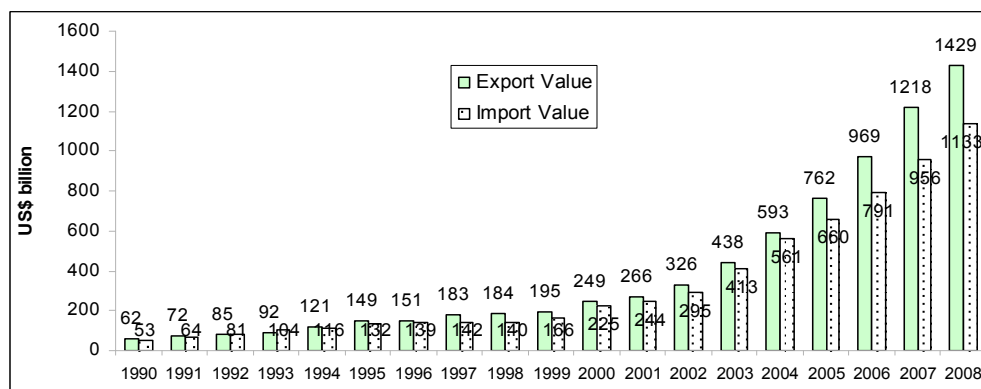
¹⁶ Data source: NBS.



*Data source: *China Statistical Yearbook* various issues, China Statistics Press, Beijing.

3.2 The three main drivers of China's growth -- investment, export and consumption -- had quite different experiences in 2008. Figure 3 shows a surge in trade volume from 2000 followed by a slowdown in 2008. Since most of China's trade is made up by processing trade, weak export activities directly lead to slower import growth. This hurt countries that supply raw industrial materials and components to China. Exports experienced the biggest decline in more than a decade in the last two months of 2008 (Figures 4 and 5).

Figure 3 - Exports and imports, 1990-2008



*Data source: *China Statistical Yearbook* various issues, China Statistics Press, Beijing.

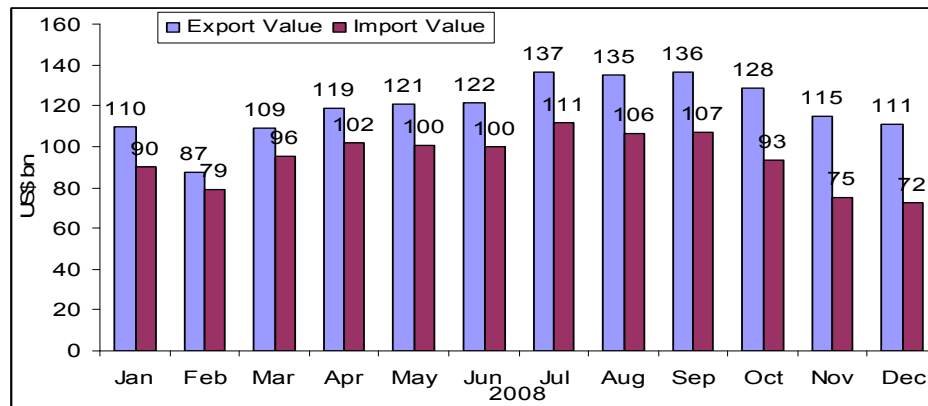
From the middle of 2008, growth in international trade slowed down sharply, entering negative territory in November and December. The last time China experienced negative growth of trade was at the nadir of the 1997-98 Asian Financial Crisis.

Although China managed to maintain positive growth of trade in the first 10 months of 2008, the rates of growth had been declining gradually (Figure 5). By November, exports had fallen 2.2%. It then dropped 2.8% in December¹⁷. In the same two months, imports fared even worse,

¹⁷ *International Financial News*, 06/01/2009, "Export Growth Appears to be Negative for the First Time in Seven Years", http://news.xinhuanet.com/fortune/2009-01/06/content_10609747.htm, accessed on 22/01/2009.

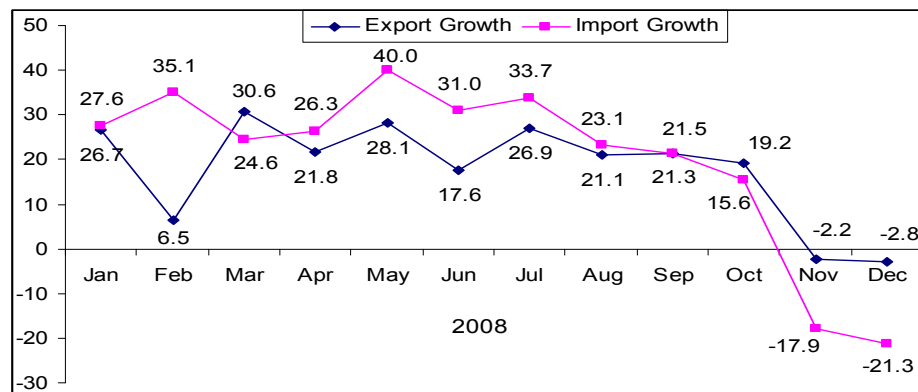
declining by 17.9% and 21.3% respectively. In Figure 6, however, we see that actually since the early 1990s, the growth rates of exports and imports in China have been closely correlated and both had shown large fluctuations. Therefore, statistically, it should not be surprising to see the big declines in their growth rates similar to those in 1992-93, 1995-96, 1996-97 and 2000-2001. Nevertheless, the negative growth in the last two months of 2008 and the uncertainty in 2009 have two important implications. First, as China is far more open now than before, it is not protected from the current economic crisis. Second, as China has become one of the largest drivers of world economic growth, a slowdown in China's imports will exacerbate the economic recession faced by its main trading partners. Consequently, joint efforts between China and the rest of world are required to steer the world away from the current crisis. ***In other words, China's role in the world economy has expanded rather than weakened as a result of the current economic crisis.***

Figure 4 - Exports and imports by month in 2008



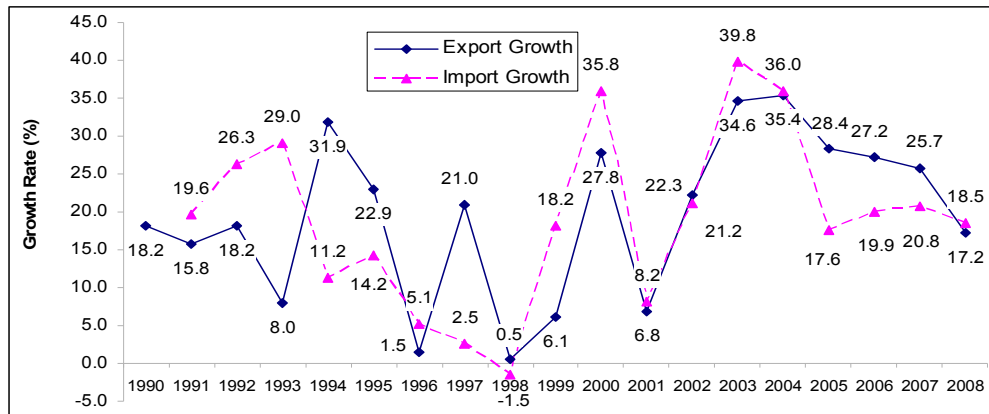
*Data source: Ministry of Commerce.

Figure 5 - Monthly growth of exports and imports (%) in 2008



*Data source: Ministry of Commerce.

Figure 6 - Annual growth of exports and imports (%), 1990-2008



*Data source: *China Statistical Yearbook* various issues, China Statistics Press, Beijing.

Table 3 shows the volumes of import, export and total trade of the world's five largest economies in the 2005-2008 period. In 2008, China surpassed Germany to become the world's second largest importing and exporting economy after the US. In GDP terms, China is still ranked below Japan, but in trade terms, its importance is almost twice as much as Japan in the world (Table 3).

Table 3 - Export and import of top five economies 2005-08 (US\$ billion)

Export	US	Japan	Germany	China	UK
2005	1283.8	600.2	999.4	762.0	603.0
2006	1457.0	639.3	1122.4	968.9	693.3
2007	1645.7	734.3	1348.0	1217.8	726.0
2008	1843.0	767.8	1388.0	1428.5	690.4
Import					
2005	1995.0	520.8	798.4	660.0	680.8
2006	2210.0	572.2	922.5	791.5	772.9
2007	2346.0	639.7	1074.6	956.0	817.4
2008	2520.1	727.8	1112.0	1133.1	767.4
Total trade					
2005	3278.8	1120.9	1797.8	1421.9	1283.7
2006	3667.0	1211.5	2044.9	1760.4	1466.3
2007	3991.7	1374.0	2422.5	2173.7	1543.4
2008	4363.0	1495.6	2500.0	2561.6	1457.8
Rank in 2008 by trade	1	4	3	2	5

*Data Sources: US Department of Commerce; Statistics Bureau, Japan; Statistisches Bundesamt Deutschland; NBS, China; National Statistics, UK. The data for the US and China are measured in US dollars. The original data for Japan, Germany and UK are in Japanese yen, Euro, and British pound respectively. We use the simple annual average exchange rates ((beginning of the year price + end of the year price)/2) of these currencies (see table 4) to US dollar to calculate the dollar values.

3.3 Besides weak external demand, the appreciation of the RMB against major

western currencies (US dollar, British sterling and Euro) has also had a significant downward pressure on China's exports. On the first trading day of 2008, the exchange rates were US\$/RMB=1/7.2996, Euro/RMB = 1/10.6611, and GB£/RMB = 1/14.4904. By the last trading day of the year, the rates were respectively US\$/RMB = 1/6.8346, Euro/RMB = 1/9.6590, and GB£/RMB = 1/9.8798. This indicates that the RMB had appreciated 6.8%, 9.4% and 31.8% respectively against the three currencies in one year (Table 4). As the US, the Euro zone and the UK are expected to endure negative economic growth in 2009, the RMB is likely to remain strong and may appreciate even further against its counterparts. This will squeeze the profit margins of China's exports and/or lead to a more severe decline in China's exports to these economies.

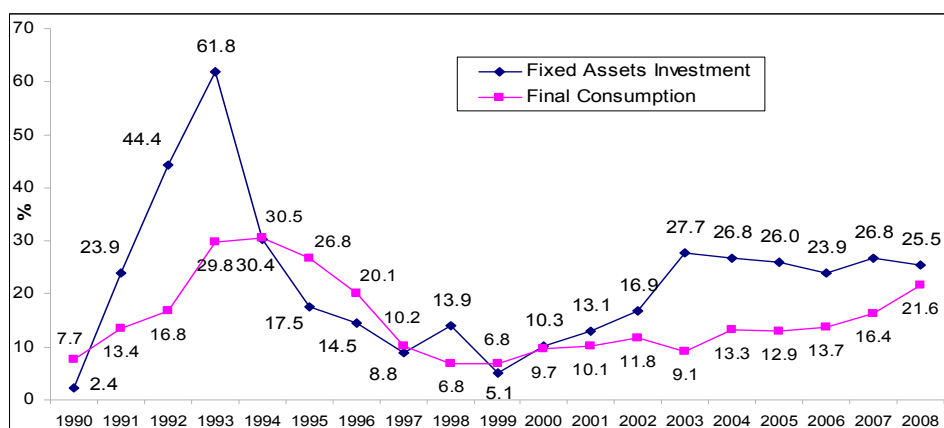
Table 4 - Exchange rates of 1 US dollar to four major currencies

Beginning of the year	Japan, JPY	Germany, EUR	China, CNY	UK, GBP
2005	102.67	0.74	8.28	0.53
2006	116.04	0.83	8.07	0.57
2007	119.35	0.76	7.82	0.51
2008	109.33	0.68	7.28	0.51
2009	92.17	0.72	6.83	0.69

* Data source: Yahoo finance.

3.4 Domestic investment has long been the biggest contributor to growth, which is why the government's current fiscal stimulus plan focuses heavily on investment. Despite the dramatic weakening of external demand, domestic demand has not been affected much. Domestic fixed assets investment in 2008 kept a similar and high growth rate as in 2007 (Figure 7). In 2008 it reached 17.23 trillion yuan, up 25.5% from a year earlier. Domestic consumption continued its growth momentum in 2008. With rapid increases in personal incomes, the country has been moving gradually towards a consumption-based society. As consumption demand from ordinary Chinese people increases, domestic demand has become an increasingly important determinant of GDP growth. The RMB 4 trillion-fiscal stimulus package also aims to boost domestic consumption by improving the country's social security system and direct subsidies to rural households. Relatively low household consumption has been attributed to precautionary savings due to inadequate social welfare provided by the state.

Figure 7 - Growth of fixed assets investment & final consumption (%), 1990-2008



*Data source: *China Statistical Yearbook* various issues, China Statistics Press, Beijing.

3.5 The global financial crisis has reduced the total flows of FDI in the world. Despite this, China is still one of the largest recipients of foreign capital. In 2008, FDI inflow rose 23.6% -- the highest increase since 1994 -- to US\$92.4 billion from US\$83 billion in 2007 (Table 5).¹⁸

Table 5 - FDI inflows of key economies 2007-2008 (US\$ billion and %)

2007			2008		
Country	\$ bil	Share (%)	Country	\$ bil	Share (%)
USA	233	12.7	USA	220	15.2
UK	224	12.2	France	114	7.9
France	158	8.6	UK	109	7.5
Holland	99	5.4	China	92	6.4
China	83	4.5	Hong Kong, China	61	4.2
Hong Kong, China	60	3.3	Spain	57	3.9
Spain	53	2.9	Brazil	42	2.9
Germany	51	2.8	India	37	2.6
Belgium	41	2.2	Sweden	37	2.6
Italy	40	2.2	Holland	30	2.1
World total	1830	100.0	World total	1446	100.0

Notes: Share = % share of world total.

Sources: People's Daily, 26/1/09, p3.

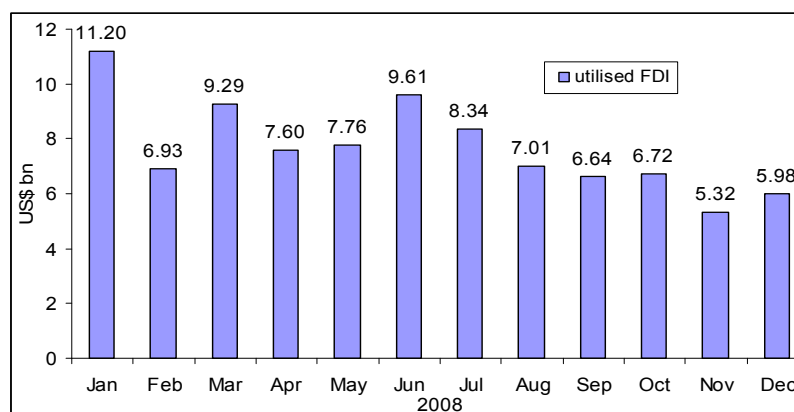
It was probably because of the poor economic performance in the developed world and many other developing economies that China seemed to present relatively more attractive investment opportunities. The top 10 FDI originating countries remained the same as in 2007, with a slight shuffle in the rankings, led by Hong Kong, the British Virgin Islands, Singapore, Japan, Cayman Islands, Korea, USA, Samoa, Taiwan and Mauritius. These countries accounted for about 87% of China's total FDI.¹⁹ The monthly data shown in Figure 8 indicates a downwards trend in FDI inflow. The vital role of FDI in the Chinese economies has been demonstrated by many studies. China has recently been trying to secure more FDI on the belief that this will be mutually beneficial for the state

¹⁸ Data source: Ministry of Commerce.

¹⁹ *Ibid.*

and its partners in the economic downturn.

Figure 8 - Utilised FDI inflows by month in 2008



*Data source: Ministry of Commerce.

- 3.6 By the end of 2008, the national balance of foreign exchange reserves was US\$1.95 trillion, up 27.3% from the previous year.²⁰ This maintains China's position as the world's largest holder of foreign exchange reserves, well ahead of second-ranked Japan. However, the 27.3% increase in the reserves was much lower than the 43% in 2007. The total amount also did not exceed the symbolic level of 2 trillion US dollars as expected, which reflects the sharp drop in trade surplus towards the end of the year.
- 3.7 To cope with the current financial crisis, China plans to invest heavily in infrastructure, especially in the railway system. According to the government budgetary plan, 1.8 trillion yuan out of the 4 trillion yuan-stimulus package will be spent on transportation infrastructure and power grid construction. This was in addition to previous plans. Between January and November, investment projects amounting to RMB 3.5 trillion had been launched to improve the country's transportation system.²¹ In November 2008 alone, there were over 150 railways under construction. The total investment committed to these projects was more than RMB 1.2 trillion. Completed investment in railways in 2008 was estimated at RMB 300 billion.²² In 2009, this figure is to increase to RMB 701 billion, according to the Ministry of Railway. In 2008, 5609 kilometres of new railway and 99851 kilometres of highways, including 6433 kilometres of motorways, were built in 2008.²³ The railway system is the least developed among all the forms of transportation in China such as highways, civil aviation and waterways. The Eleventh Five-year Plan (2006-2011) has placed an emphasis on railway construction, which suggests that a high-speed railway system across the whole country will be completed in the near future.
- 3.8 Meanwhile, grain output expanded to 528.5 million tons in 2008, up 5.4%

²⁰ Data source: People's Bank of China.

²¹ Data source: Ministry of Transport.

²² *China News*, 09/11/2008, "China Building Railway System in Large Scale, 150 Railways under Construction Involving More than a Trillion yuan of Total Investment", http://news.xinhuanet.com/politics/2008-11/09/content_10332157.htm, accessed on 22/01/2009.

²³ Data source: NBS.

from the previous year, marking the fifth consecutive year of production increases. The central government has planned more large-scale policies to support agricultural production and improve rural living standards. The Communist Party Central Committee has issued its first policy document for 2009, which focuses on solving the agricultural and rural problems. This is the sixth time the Committee has focused on agriculture and the rural economy in its first annual policy document, highlighting the importance of agricultural and rural development. It also reflects the long-lasting and difficult challenges that the country has to overcome in order to make China a prosperous and fair society. The pro-agricultural and pro-rural policies are critical to reducing the ever widening rural-urban income gap in China. It is hence expected that with policy support, development in the agricultural sector will be positive in the coming years.

- 3.9 Government fiscal revenue is often viewed as the barometer of the economy. Total revenue in 2008 was RMB 6.13 trillion, up 19.5% from 2007. While the overall growth rate was strong, most of it had been generated in the first half of the year. For comparison, fiscal revenue had in the past been recording growth rates of more than 30%. Since June 2008, it had been slowing down rapidly. In October, it fell 0.3% -- the first negative growth in 12 years.²⁴ While revenue in December was up 3.3% compared with the same period in 2007, it was still much lower than that experienced in the first half of the year. There is significant uncertainty regarding the budgetary situation in 2009. A slow rate of growth in fiscal revenue will hamper the country's ability to stimulate the economy, which has been showing clear signs of weakening.
- 3.10 Amidst the bleak economic situation, improvements made by China in energy efficiency have been encouraging. Energy consumption per ten thousand yuan of GDP fell 4.21% in 2008. This was bigger than the energy saving of 3.66% in 2007 and 1.79% in 2006.²⁵ China's Eleventh Five-Year Plan aims to reduce this benchmark ratio by 20% from the 2005 level by the end of 2010. Given China's development style and momentum over the past 30 years, this presents a truly challenging target. Nevertheless, it is promising that the government is determined to make the economy more energy efficient and environmental friendly.

Tumbling Stock and Real Estate Markets

- 4.1 The Chinese stock markets were extremely volatile from 2005 to 2008. The Shanghai Stock Exchange (SSE) Composite Index surged more than six-fold from 1,012 in 2005 to 6,124 by the end of 2007. It then declined continuously to reach a low of 1,708 in November 2008, representing a drop of 72% from its peak in one year (Figure 9). Although the market downturn may have been caused by the financial crisis in the US and the rest of the world, the extreme fluctuations of stock prices pointed to a big market bubble and its subsequent deflation. This had to be explained by intrinsic characteristics, or the economic psychology of Chinese investors. Based on a detailed market data analysis, Yao and Luo (2009) attributed the development of the stock market bubble to three key psychological factors -- 'greed', 'envy' and 'speculation' -- and the burst of the bubble to three opposing factors, 'fear', 'lack of confidence' and 'disappointment.'

24 Data source: Ministry of Finance.

25 Data source: NBS.

However, they also suggested that a prolonged bearish stock market was inevitable because of the world financial crisis. The crisis has affected every country in the world from September 2008 after the spectacular failures of Lehman Brothers, Merrill Lynch, AIG, the Royal Bank of Scotland and many other world-class financial institutions.²⁶

Figure 9 - SSE Composite Index, July 2005-September 2008



Source: SSE Composite Index, <http://finance.yahoo.com>.

- 4.2 It is to some extent a coincidence that the Chinese stock markets had plummeted alongside the major western stock markets. Both the Dow-Jones and FTSE 100 indices dropped more than 30% in 2008, more or less reflecting the economic climate in line with the timing of the financial crisis and recession, whereas the Chinese stock market can somewhat only be explained by market psychology, as Chinese firms generally had a better market outlook.
- 4.3 China's prosperous housing market also went into a price adjustment stage after more than 10 years of strong gains. Increases in house prices in big cities slowed in 2008. In some cities, such as Shenzhen and Guangzhou, prices had even declined sharply. According to the National Development Research Council (NDRC) the house price index of 70 large and medium-sized cities fell 0.4% in December, marking the first negative growth figure since the index was established in July 2005. While many inland cities still saw strong price increases, such as 9.1% in Yinchuan, 21 out of the 70 cities reported lower prices for that month. In Shenzhen, prices slumped 18.1%, leading the downward trend. For the whole year, the index climbed 6.5%, slower than the 7.6% in 2007.
- 4.4 It looks like another coincidence that the price trend of China's real estate market corresponded with those of housing markets in the US and the UK. Again, the cause for the price drops in the US or the UK is fundamentally different from that underlying the Chinese market. The housing bubbles in the US and the UK had been triggered by low borrowing costs and flaws in their financial regulatory systems which had allowed mortgage products that subsequently led to the subprime crisis. On the other hand, China's

²⁶ Shujie Yao and Dan Luo (2009), The economic psychology of stock market bubbles in China, *The World Economy*, forthcoming.

housing boom was brought about by fast economic expansion and urbanisation. Besides, mortgage-holders in China were mainly urban middle- and high-income households. Chinese banking regulations also required a minimum down-payment of at least 30% of home values. The down-payment requirement was nevertheless reduced to 20% of home values in response to a sluggish housing market from the second half of 2008. Therefore, Chinese mortgage lenders had been exposed to a smaller mortgage default risk than their western counterparts. Chinese banks' investment in US subprime mortgage securities had also been insignificant. Thus, the US subprime crisis has had a limited influence on Chinese banks. The price adjustment in the real estate market may continue in the near future due to the economic slowdown as housing construction and demand decrease.

- 4.5 The poor performance of the housing market has affected the profitability of the banking sector. Still, relative to the deeply troubled western banks, Chinese banks have outperformed their global counterparts in terms of profitability. For example, Industrial and Commercial Bank of China realised RMB 65 billion (US\$ 9.6 billion) of after-tax profit in the first half of the year, which was 57% more than the same period in 2007, making it the most profitable bank in the world then.²⁷ It also claimed that it had fully accounted for the risk associated with the US subprime products. China Construction Bank (CCB) had also reported RMB 93 billion (US\$ 13.7 billion) of profit in the first three quarters of 2008, up 47.7% over the same period in 2007.²⁸ According to the statistics of China's Banking Regulatory Commission (CBRC), the balance sheet for the banking sector improved in 2008. Total bad loans fell from RMB 700 billion (US\$ 103 billion) in 2007 to RMB 568 billion (US\$ 83.5 billion) in 2008. The ratio of bad loans to total loans dropped to 2.45% from 3.71% in the same period. Compared with the badly-shaken banking industries in the US and the UK, the relative improvement in the Chinese banking sector represents significant dividends from banking reforms over the last 10 years.²⁹
- 4.6 Even though the central bank is expected to lower interest rates again sooner or later with the expected worsening of the worldwide recession, more than 70% of banking institutions in China, including foreign-owned ones, anticipate their profits will not drop in the coming year, according to a recent survey conducted by the Shanghai Bureau of CBRC.³⁰ Most of these institutions also expect the real estate market to stabilise rather than contract further.

New Challenges

- 5.1 The most challenging task for the Chinese government in the coming year

²⁷ *Shenzhen Economic Daily*, 22/08/2008, "ICBC: Profitability in the First Half of the Year Top the World Banking Sector", http://cs.xinhuanet.com/gg/03/200808/t20080822_1563482.htm, accessed on 22/01/2009.

²⁸ *Shanghai Security News*, 28/10/2008, "CCB: Profit as Expected", <http://bank.hexun.com/2008-10-28/110544559.html>, accessed on 22/01/2009.

²⁹ Yao, Shujie; Zhongwei, Han and Genfu, Feng (2008), Ownership reform, foreign competition and efficiency of Chinese commercial banks. A non-parametric approach, *The World Economy*, 31 (10), 1310-21.

³⁰ *People's Daily*, 19/01/2009, "Over 70 Per cent Banks Expect Profits not to Drop in 2009", <http://finance.people.com.cn/GB/8695091.html>, accessed on 22/01/2009.

is obviously to live up to its promise of delivering GDP growth of 8%. The government is expected to maintain an acceptable level of social stability, which is the most important factor for promoting economic growth in China. People are counting on the 8%-GDP-growth to create jobs and further improve living standards. Domestic and foreign investors are anticipating potential business opportunities. Since the early 2000s, China's GDP increments have been contributing to more than 10% of world economic growth every year, with China being the biggest contributor since 2007, according to estimates by the China's National Bureau of Statistics (NBS). Given the recession in major industrialised countries, the United Nations forecast in January 2009 in its *World Economic Situation and Prospects 2009* report that the Chinese economy would expand 8.4% and account for about half of world growth in 2009. This again reflects the restructuring effect of the global financial crisis, and growing external recognition of the importance of China's economic growth.

5.2 China possesses one of the best fiscal conditions in the world. Its debt accounts for about 20% of GDP, compared with the standard of 60% in the EU and 80% in the US. Coupled with the growth prospects of the Chinese economy, the government has sufficient room and ability to carry out bold expansionary fiscal policies to achieve the targeted 8% economic growth rate. Figure 10 shows changes in the benchmark interest rates in the major economies. Taking into account the 23-basis-point-cut by the Chinese central bank on 23 December 2008, China still has the highest interest rate, which means that its monetary authority has plenty of room to manoeuvre.

Figure 10 - Interest rates in the major economies



Data source: *World Economic Situation and Prospects 2009*, UN Publications.

5.3 With rigorous pro-growth fiscal and monetary policies in operation and its determination, the Chinese government is very likely able to achieve the 8%-growth goal, though much still depends on the situation of the global economy. Meanwhile, the economic efficiency of the stimulus policy remains a question. The central government hurriedly put together a RMB 4 trillion fiscal package in late November 2008, of which RMB 100 billion was to be invested by the end of 2008. The majority of the funds would be invested in infrastructure projects, whereas only 1% of the fund was

designated for social welfare projects such as health care and education which constitute the neediest areas.

- 5.4 Using infrastructure investment to stimulate domestic demand was a key policy instrument employed by former Chinese Premier Zhu Rongji 10 years ago to counter the Asian Financial Crisis. Over the last decade, China has constructed a comprehensive network of motorways totalling more than 45,000 kilometres. The motorway system has greatly improved China's transportation capability although the economic efficiency of its investments is questionable. Some policy analysts argue that stimulating private consumption may be a more effective way to boost economic growth than investing in infrastructure in a crisis situation. However, private consumption in China has been weak due to high household savings which are a direct result of inadequate social security. Ordinary Chinese people have had to keep a large proportion of their income as precautionary savings to protect themselves from potential huge hospital bills and higher education fees. Therefore, the stimulus package may again generate duplicate investments with low long-term value rather than stimulate strong domestic demand. Instead, infrastructure investments may only benefit vested interests and further limit the effectiveness of an investment-driven economic recovery.
- 5.5 There have been some positive signs from the most recent economic data since December 2008. Although exports declined by 2.8%, export of products which received tax subsidies under a new export policy increased by 4.8%.³¹ Money supply bounced back strongly in December after declining more than six months. New RMB-denominated loans at financial institutions soared to RMB 771.8 billion yuan (US\$ 113.5 billion) in December.³² These indicate that the expansionary monetary policy may be beginning to show some results.
- 5.6 Currently, the most difficult job for the government is to deal with an unprecedented scale of unemployment associated with rural-urban migration. The last wave of unemployment in China in the late 1990s took place when most state-owned firms were restructured. Unlike the present situation, the scale of unemployment was smaller and mainly involved urban workers rather than rural migrants. The government is alarmed by social unrests linked to the unemployment problem. It also has to deal with a new problem -- graduate unemployment. The government stimulus package may not generate enough employment even if it did prop up GDP growth.
- 5.7 Moreover, with the worsening recession in the western economies in the coming months, trade protectionism may revive, particularly in countries with left-wing governments. China is bracing itself for more anti-dumping cases, and other hidden forms of trade barriers. China's currency is expected to become the target of attacks again by its main trade partners. All kinds of trade disputes would be seen to support western politicians' claims of protecting jobs in their countries. These would add to the costs of Chinese exporters and reduce their chances of survival or growth.
- 5.8 By and large, China has ploughed through an unusually tough year with a performance more satisfactory than not. Many have argued that China is going to transform its economy to become demand-led rather than supply-

31 Data source: NBS.

32 Data source: People's Bank of China.

led under any circumstances, so now would be the right time to adjust the country's industrial structure by letting go of factories that assemble cheap goods for export. It is indeed the government's medium-term goal to optimise its economic structure, but the most immediate problem is how to survive the next few months amid a severe global recession. While the Treasury has the resources to introduce measures to help individuals and businesses, the key question is how to use the stimulus package most efficiently and effectively. For a vast and diverse country like China, there is no easy method to solve the overall complex economic problem.

- 5.9 The global financial crisis presents huge challenges to world leaders. The year 2009 is fraught with uncertainties. If China can handle the crisis well, it may have a once-in-a-century opportunity to shorten the time needed to catch up with the more advanced economies and enhance its status in the world political-economic system. If on the other hand it fails to deal with the crisis properly, the country may lose its growth momentum, undermining its hard-gained achievements in the past 30 years.

Key Conclusions

- 6.1 The year 2008 for China was a turbulent one despite its success in holding the Beijing Olympics. At home, it grappled with disasters including snowstorms and the Sichuan Earthquake. Externally, it had to contend with the world financial crisis.
- 6.2 China managed to deal with its domestic disasters but it had to face the tough challenges brought about by a worldwide economic recession that was unprecedented in decades.
- 6.3 Despite those difficulties, China achieved significant and positive growth in GDP, trade, FDI and state revenue but the outlook for all these macro-economic indicators deteriorated rapidly from the second half of the year and into 2009.
- 6.4 Still, China has suffered less than its main competitors in the crisis, which has several important implications for its future development and position in the world economy.
- 6.5 Firstly, the time needed for China to overtake Japan and the US in becoming the world's largest economy will be shortened.
- 6.6 Secondly, China will benefit much more than other economies from depressed prices of oil and raw materials in the next stage of its industrialisation and urbanisation.
- 6.7 Thirdly, China will become even more important in the world economic-political system as a result of crisis.
- 6.8 The biggest challenge for the country is not only to cope with the current financial crisis but also to avoid a similar crisis that could be triggered by China itself in the coming decade.