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**Research Report**

## China's policies for overcoming the crisis: old reflexes or strategy for a new reform miracle?

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## China's Policies for Overcoming the Crisis: Old Reflexes or Strategy for a New Reform Miracle?

Since China's accession to the World Trade Organisation the world has witnessed the country's development with a mixture of admiration and fear. The economic growth rates have been extremely impressive, and cities like Beijing and Shanghai today do more and more resemble if not outperform other metropolis. At the same time, China's impact on global markets and on the environment, as well as a certain difficulty to understand the political logics of China, have created the idea of China being a challenge. One common misunderstanding in this context is to think of China as a monolith, centrally steered according to the will of the Chinese Communist Party. Though not totally wrong, this assumption easily neglects the fact that even at the level of the central government, discussions among politicians and experts prevail for each and every policy

field, and published policies are generally compromises that still have to prove their effectiveness.

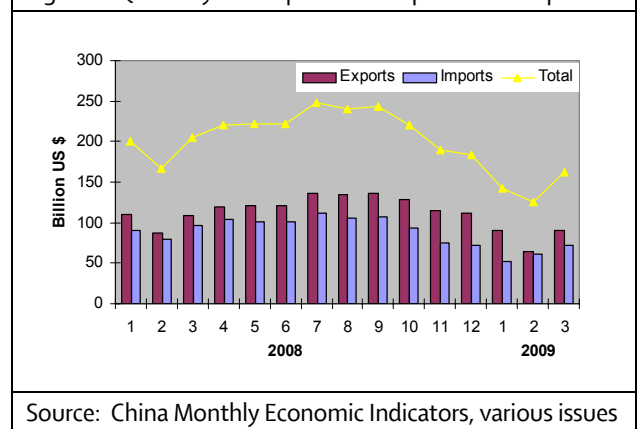
Especially, in the years before the global financial crisis hit China, internal debates about suitable economic strategies for the country's long-term well-being proliferated. Since the crisis touched China, the government has initiated a number of policies in order to prevent a serious national economic downturn. The mix of policies initiated highlights conflicting positions within the government. External evaluations of China's reaction to the crisis should take the involved conflicts and compromises into account as they hint to different ideas concerning China's future, be it in terms of the role of the state, environmental policies or social equity.

### The impact of the financial crisis

The global financial crisis reached China in autumn 2008. China has not been infected via the financial sector but by the crisis of the real economy that followed the financial crisis. Imports and exports stagnated since August and started to decline in October 2008. Foreign direct investment in China grew by 28 per cent in the first half of 2008 in comparison to the same period of 2007, but dropped by 7 per cent in the second half of 2008. The lower engagement of foreign enterprises is also reflected in the decline of processing trade by about 30 per cent in the first quarter of 2009. Many Asian firms have in the past invested in China in order to profit from the lower wage levels for the labour intensive parts of their production chains.

Concurrently, the indices for the economic climate, business climate, and internal consumption published by the National Bureau of Statistics started to fall sharply in the fourth quarter of 2008. The decline of these indices continued during the first quarter of 2009 though the industrial climate index indicated a slight upward turn in March. Monthly freight volumes have seen a downturn since November 2008 with railway and waterway freight traffic being especially affected. Monthly air cargo ton-km shrank to 675 million in February 2009, down to the level of mid 2006. The lower freight volumes correspond with sharp declines in the production of pig iron, crude steel, coke and a number

Figure 1: Quarterly development of imports and exports

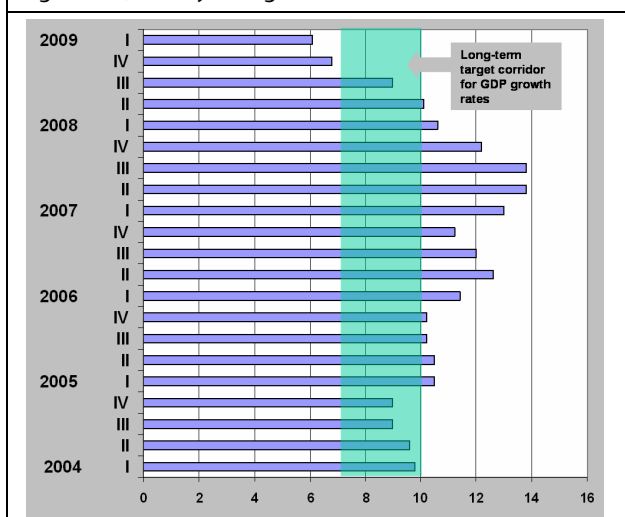


Source: China Monthly Economic Indicators, various issues

of basic chemicals and other products. The consumer price index and the producers price index have been declining since mid 2008 and prices actually decreased throughout the first four months of 2009. These sobering developments lead to – for Chinese standards – moderate growth rates of gross domestic product (GDP) rates (figure 2).

Though it may be argued that growth rates of 9 per cent (IV quarter 2008) and 6,1 per cent (I quarter 2009) do look rather comfortable compared to the much lower or even negative growth rates currently experienced by other countries, the downside of growth rates does create serious concerns within the Chinese government for the following reasons:

Figure 2: Quarterly GDP growth rates



Source: China Monthly Economic Indicators, various issues

- GDP growth rates below 7 per cent are considered critical as they would limit the possibilities to create employment for millions of workers that are entering the urban labour market each year. Everything above 10 per cent is generally not favoured because it could lead to bottlenecks and imbalances in the economy, a phenomenon described as ‘overheating’.
- Overheating had actually been identified as the main problem of China’s economy in the years up to 2008. Policies were formulated accordingly. Thus the crisis hit China at a time when domestic economic policies were rather tuned to slow growth, a fact that may have added to the stagnation of growth in the second half of 2008. In any case, a slide from nearly 14 per cent growth in mid 2007 to 6,1 per cent in early 2009 is rather dramatic and does not pertain to the ‘soft landing’ that had been intended.
- The impact of the crisis on employment is still not clear. The Chinese government has so far been reluctant to publish absolute numbers of employment for late 2008 and early 2009. According to official estimations, about 20 million migrant workers were expected to have difficulties finding jobs after the spring festival holidays. In addition, the absolute number of ‘working places’ in industrial enterprises decreased by 7,3 per cent between the fourth quarter of 2008 and end of March 2009. The central government claims an increase of ‘newly created urban jobs’ of several hundred thousand for each month since September 2008, with a clear monthly increase for 2009, while at the same time the official rate of ‘registered unemployed urban people’ rose from 4,0 to 4,3 per cent. However, this rate is not considered to be in any way a reliable indicator of the real scope of unemployment. The Chinese Academy of Social Sciences that started to publish an alternative unemployment rate some years ago, has estimated the unemployment rate to be 9,4 per cent last summer, i.e. at a time before the crisis hit

China. Based on this rudimentary information the absolute number of urban job losses due to the crisis may be anywhere between one and six million (not including unemployed migrant workers).

- The number of graduates from Chinese universities has been increasing in recent years, but the demand for graduates has been stagnating. Around 1 million graduates from 2008 still have not found jobs, and the government expects 6,1 million additional graduates to enter the labour market this year. As student protests have had important impact on China’s politics in the past, not least in 1989, these numbers are especially worrying for the Chinese government.

The impact of the crisis on employment and the resulting potential for social conflicts, public unrest and political instability have pressed the Chinese government into early action against the crisis.

### The main economic policy initiatives

China’s vulnerability in the face of the crisis results from a high dependence on foreign trade. The decrease of demand from the industrialized countries, especially the US, endangers export processing and export oriented industries. Also the overall decline in trade volumes has repercussions on logistics and shipping industries. The political initiatives to counter the crisis concentrate on three aspects: Stabilizing exports as much as possible in the short run, stimulate domestic demand in the short and medium run, and enter a new model of development and trade patterns in the medium to long run: While the latter target has been on the political agenda since 2007, the current challenge is not to sacrifice the longer term goals by short term programs targeting at the crisis.

### The 4 Trillion-Program

In November 2009 the government announced a 4 trillion Yuan (570 billion US\$ / 459 billion Euro) two year stimulus package of which the central government intends to invest 1,18 trillion Yuan while the rest is expected to come from local governments, banks and enterprises. A first tranche of 100 billion Yuan was approved in late 2008. Further details of the program were debated during the meeting of the National People’s Congress (NPC) in March 2009. Somewhat surprisingly, the NPC debates resulted in changes of the planned spending structure. While the NPC delegates cut down spending for basic investment and energy saving/ environmental protection, they voted for larger budgets for cheap housing, health, education and culture as well as innovation and structural change (see table 1).

Obviously the delegates were more inclined to social aspects and support of the private economy. How well this will be accepted at the local level and whether banks and private investors are willing to contribute to the investment in social projects remains to be seen.

Table 1: Composition of the stimulus package before and after March 2009		
	Before NPC	After NPC
Total (billion Yuan)	4000	4000
Safe housing, cheap housing	280	400
Rural infrastructure (water, electricity, heating etc.)	370	370
Basic investment (railways, highways, airports, waterways etc.)	1800	1500
Health, hygiene, education, culture	40	150
Energy saving and environmental protection	350	210
Innovation and structural change	160	370
Post-disaster reconstruction	1000	1000
Source: Own compilation		

### *The 10 Sectors Recovering Program*

As a second major initiative the government has announced recovering programs for 10 major industries in January and February, namely the automobile, steel, textile, electronics and IT, nonferrous metal, logistics, machine and plant manufacture, shipbuilding, petrochemical, and light industries. Detailed strategies have been published since the end of March for the first six industries listed above.

Though different in detail, the published programs share some common traits.

- a focus of supporting the largest enterprises by mergers and group building,
- the idea to reduce overcapacities by accelerating the closure of smaller enterprises and backward production capacities and technologies,
- the attempt to support exports by raising export tax rebates,
- support for enterprises by reduction of taxes, fees, loans, and investment in public infrastructure,
- encouraging innovation,
- stimulation of domestic demand, i.e. by paying a bonus for scrapping of old three wheel cars and slow commercial vehicles in rural areas.

Most of the sector programs are based on and extend ideas already formulated for the current Five Year Plan, and some of the targets even remind of industrial policies developed during the 1990s.

### *The “Household Electronics for the Villages” program*

Urban-rural inequality has been one of the major concerns of the recent government policies for several reasons. Apart from potentially leading to social unrest, it has been identified as one reason for the relatively slow growth of domestic demand. As the crisis has highlighted the low level of domestic demand, the “Household Electronics for the Villages” program, initiated in February 2009, has two aims: To enhance living conditions in rural areas and to compensate for the decline of

external demand by stimulating domestic demand for important consumer goods, namely colour TVs, refrigerators, mobile phones, washing machines, air conditioners, electric, fuel or solar energy hot water boiler, computer, microwave oven and electromagnetic oven. Each rural household is entitled to subsidies for two pieces of each category of these household electronics. The subsidy is 13 per cent of the buying price. Price caps, for example 3500 Yuan for a colour TV set, have been set in order to ensure that the subsidized goods are mainly from domestic production. Lengthy instructions for this program have been published in April, indicating the concern of the government that the program may be misused. The program will run for three to four years in most of the central and western provinces of China.

### *Restructuring program for South China*

South China, especially the Pearl River Delta, has in the past contributed most to China’s export oriented growth model. Labour intensive production, rather weak environmental, social and legal standards provided steam for China’s number one growth engine. Even before the crisis the limitations of this growth model had become obvious, as Guangdong enterprises increasingly encountered difficulties to attract migrant workers. Also, environmental problems became very serious. The economic crisis only increased the pressure on the government to rethink its growth model. Thus, the ‘Reform and Development Guidelines for the Pearl River Delta Region’ published in late 2008 and endorsed at the beginning of April 2009 are not solely a reaction to the current crisis, but they perfectly reflect the political dilemma of current policies. The focus of the guidelines is to establish a growth model based on innovation and high tech, resource efficient and environmental friendly production, more liberal policy processes and close international cooperation. The idea behind the guideline is to once again make South China an experimental area for important shifts and changes in China’s policies and institutions. At the same time, the short term remedies concentrate on government investments, the idea to increase domestic demand for household electronics, cars, housing and tourism. While the guidelines themselves put emphasis on innovation and environmental goals, the policy document accompanying the endorsement of the guidelines stress clear absolute targets for GDP levels in the short (2009), medium (2012) and long-term (2020), thus somehow belying the emphasis of a more comprehensive and sustainable understanding of development stressed in the main document.

### **Ongoing debates**

The government’s reaction to the crisis has been lauded all around the world as being swift, substantial and well chosen. This international appraisal reflects a common agreement that the China has to stimulate domestic demand as a contribution to lessening global trade imbalances and that the chosen policy packages do aim

at this target. It also reflects successful policy communication and media guidance by the Chinese government. Yet, it should be acknowledged that there are policy conflicts inherent in the recent programs and related discussions:

- State vs. private economy: Parallel to this year's NPC session China's private entrepreneurs were very active in order to ensure that the stimulus package does pay more attention to the needs of the private economy. Their intervention has partly been successful as the changes in the budget structure show (see Table 1). Still, the selection of sectors for the ten sector recovering program has been criticized in China as focusing on industries dominated by large state enterprises. The restructuring plans nourish the idea of creating large, state-dominated business groups competing at a global level but still allowing for the government to control and steer major parts of the economy. This kind of structure-oriented industrial policies had been favoured during the 1990s but became less influential after the Asian financial crisis (1997) and China's accession to the WTO.
- Growth vs. sustainable development: With establishing concepts like 'scientific development' and the 'harmonious society', the current political leadership has tried to change the growth patterns of the Chinese economy. Since 2006 numerous strategies concerning energy saving, renewable energy development, climate change etc. have demonstrated the government's acknowledgement of the energy, environmental and social challenges created by the past growth model. The current policies to combat the crisis do only partially reflect this commitment. The resources reserved for energy saving in the original version of the stimulus package have been downsized during the NPC debates. But it would be too easy to just blame the NPC delegates. The first documents accompanying the stimulus package in November 2008 did stress the intention of accelerating output in terms of tons of steel, cement etc. at least as much as the possible investments in environmentally friendly technologies. Clearly there are ongoing discussions about how much environmental policies can be afforded in the short run especially if they come at the cost of lower growth rates. On the other hand, a 'development and recovery program' for new and renewable energies is currently in the pipeline. If this were promulgated soon, it would somehow balance the rather conservative impression created by the selection of sectors for the ten sector recovering pro-gram so far. It could also indicate that the central government tries to offset the NPC decision to lessen investment in energy efficiency and environmental protection.

- Employment vs. innovation focus: The question whether labour intensive production should continue to be the backbone of China's development or whether a quick shift to a technology driven development path is necessary has already been debated for some years. The crisis has not abated this discussion. On the one hand the high level of dependence on exports has been the leverage for the crisis to reach China. Thus, for those people stressing China's need to develop indigenous innovation and the knowledge economy, the crisis proves the weaknesses of depending on processing trade and concentrating on low value links within international production chains. On the other hand, the crisis in the industrial countries may increase the demand for cheap products thus enhancing China's competitive advantage in labour intensive production due to the still existing abundance of cheap labour.

### Perspectives

Against the background of past internal discussions the different programs to address the crisis look like a conglomeration of initiatives that try to meet all kinds of expectation and appease major interest groups. Different factions in the political leadership try to push their agendas as part of the stimulus policies. The external crisis is in some cases used as a stick to push for goals they have already been striving for in the past.

So far, this approach seems to be successful in creating widespread optimism that China will gain competitive edge during the crisis. This optimism itself may be the most important factor for the recovering process as it can become a self-fulfilling prophecy for the short and medium term. Yet, the signals resulting from the stimulus packages in terms of the long term perspectives for the economic system and growth model are contradictory at best. Thus, current optimism as expressed around the globe concerning China's long-term economic future may be premature. In any case, serious efforts to understand the internal dynamics of China's politics and the ongoing conflicts would be helpful in order to prevent surprises and to – eventually – strengthen those groups and trends that are conducive for international cooperation and integration of China in processes of global governance and global crisis prevention.



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