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China in the global economy

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**Working Paper No. 642**

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**China in the Global Economy**

by

**Sunanda Sen**

Levy Economics Institute of Bard College

**December 2010**

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## **ABSTRACT**

China occupies a unique position among developing countries. Its success in achieving relative stability in the financial sector since the institution of reforms in 1979 has given way to relative instability since the beginning of the current global financial crisis. Over the last few years, China has been on a path of capital account opening that has drawn larger inflows of capital from abroad, both foreign-direct and portfolio investment. Of late, a surge in these inflows has introduced problems for the monetary authorities in continuing with an autonomous monetary policy in China, especially with large additions to official reserves, the latter in a bid to avoid further appreciation of the country's domestic currency. Like other developing countries, China today faces the "impossible trilemma" of managing the exchange rate with near-complete capital mobility and an autonomous monetary policy. Facing problems in devising and sustaining this policy, China has been using expansionary fiscal policy to tackle the impact of shrinking export demand. The recent drive on the part of Chinese authorities to boost real demand in the countryside and to revamp the domestic market shows a promise far different from that of the financial rescue packages in many advanced nations.

The close integration of China with the world economy over the last two decades has raised concerns from different quarters that relate both to (1) the possible effects of the recent global downturn on China and (2) the second-round effects of a downturn in China for the rest of world.

**Keywords:** Trade Surplus; Official Reserves; Impossible Trilemma; Integration; Capital Account Opening; Financial Crisis; State-owned Enterprises; Stock Markets; Volatility

**JEL Classifications:** P31, P33, P34, P45, Q53

China occupies an unique position among growing countries in the developing region for at least four reasons: These include: (a) its large volume of exports and trade surplus, the latter at around 10% of its GDP, the huge official reserves at \$2.58 trillion by end of February 2010 (with \$2.28 trillion invested in securities, large portions in US Treasury bonds);<sup>1</sup> (b) the growing trade, as well as investment links with Asia (especially with Hong Kong, the self-governing territory of the Peoples' Republic of Mainland China); (c) the country is a major importer, especially of intermediate goods from neighboring countries in Asia; and (d) China's success in achieving reasonable stability in the financial sector since the beginning of reforms in 1979 and also of late, during the recent global financial crisis. The latter, however, had given way to signs of potential instability, especially since the onset of the global crisis in the autumn of 2008. This has been with efforts on the part of the monetary authorities to cope with free capital flows while maintaining national autonomy in monetary policy and management of exchange rates—a situation described in the literature as an “impossible trilemma” (Glick and Hutchison 2008).

The close integration of China with the world economy over the last two decades has raised concerns from different quarters which relate both to (a) the possible effects of the recent global downturn on China and (b) the second-round effects of a downturn in China for the rest of world. If affected adversely by the crisis, the Chinese downturn will directly impact nations that are its major trading partners. A majority of these supply-chain countries are in developing Asia. We would like to examine both issues (a) and (b), as mentioned above, in this paper.

As had been held by one school in 2008, China was and might have been heavily affected by the global crisis. As argued, “China is supported by a three-legged stool, but two legs (exports, real property) are now broken.” The last of these include government spending. “So what is left is government spending.... but can increased government spending make up for the other legs of the stool?” (Ng 2008).

A similar position, offered in 2009, ran as follows: “China's real exposure to the global financial crisis is huge and has many dimensions [...which include...] international trade [...] as well as foreign direct investment.” Moreover, China's foreign reserves, at about \$2.58 trillion in 2010, with more than half invested in US government and agency bonds, does matter for the United States and hence for the rest of the world. Finally, “... over 25 million Chinese

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<sup>1</sup> *International Reserves by Reporting Country*. Washington, DC: International Monetary Fund (last updated April 11, 2010).

employees now work for overseas companies inside China” (Gu 2009). This makes it important for China that FDI flows do not dry up.

Going by an opposite view offered in December 2008, “China...is in a very unique position in that it has \$1.9 trillion in foreign currency reserves. China...can now...divert the focus away from an export-driven economy to one that begins to focus on domestic demand.” Moreover, “...while every other country is desperately trying to formulate a rescue plan fuelled with an increase in the national debt, China does not have this worry and this will form its primary advantage” (Huges 2008).

China over the last few years has been on a path of capital account opening which has drawn larger inflows of capital from abroad, both FDI and portfolio types. Of late, a surge in these inflows has introduced problems for the monetary authorities in continuing with an autonomous monetary policy in China, especially with large additions to official reserves, the latter in a bid to avoid further appreciation of the national domestic currency. Liberalization of capital flows has also changed its composition, with volatile flows of portfolio capital having a much larger share, an aspect which will be discussed later in this paper.

Summing up, China today seems to be closely integrated with the outside world, not only with its huge exports and FDI inflows, but also in terms of short-term capital flows. The first two contribute to output and employment, while generating foreign exchange, contributing substantially to the \$2.58 trillion in official reserves of the country. As we will point out later, FDI has also been instrumental in providing a major share of exports and gross domestic capital formation, apart from providing employment.

## **THE CHANGING PATTERN OF TRADE INTEGRATION**

To assess the implications of the evolving pattern of China’s trade, we look at the changing mix of her trade partners, identifying the countries/regions that of late have been important in China’s trade. Tracing back the changes in the shares of different regions, it is revealing that the relative share of the industrial and developed country exports in China trade has been changing dramatically over 1990–2007. While the developing region absorbed nearly two-thirds of China’s exports in 1990, the share got reduced to less than half by 1999, while exceeding half again by 2007. The opposite was the case with industrial countries, with their current share dropping to less than half by 2007. Incidentally, continuing the earlier pattern, the United States

has continued to absorb nearly one-fifth or a little less of China's exports and Hong Kong also has remained a major trade partner. Asia today stands out as a major export destination for China, catering to more than one-third of exports in 2007. However, the share of South Asia in China's total exports has been consistently low (at around 1.5% in 1990 and 2.8% in 2007) (IMF, various issues).

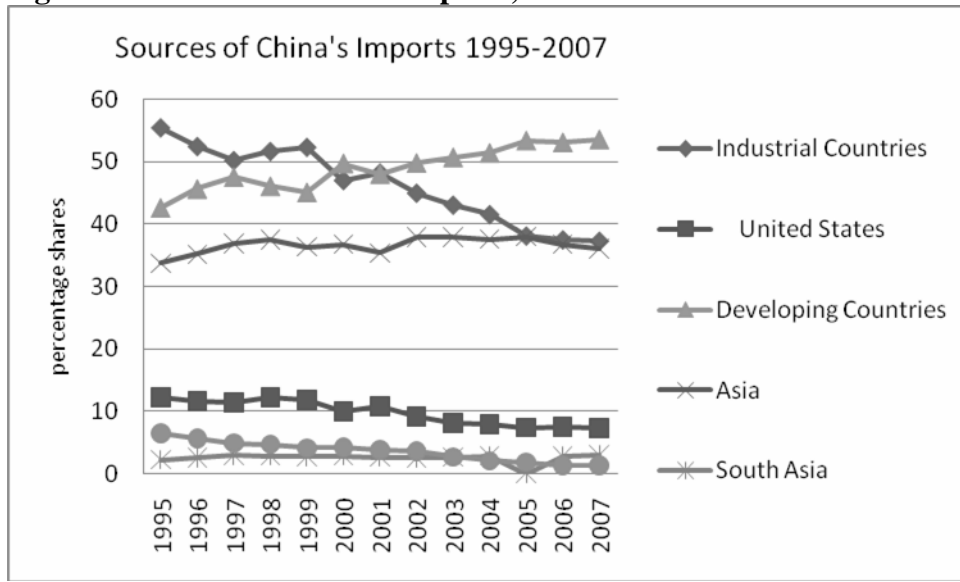
**Figure 1. Share in China's Exports**



**Source:** International Financial Statistics

China's trade links with the rest of world also rely on her growing imports, with Asia staging a comeback as a major source of imports. Incidentally, unlike the case with exports, Hong Kong was never a major source of imports for China. As for industrial countries, their share had fallen behind those of developing countries since 2000. The United States, as can be expected from its large trade deficits with China, is not a major import source for China. This may reflect China's low-end manufacturing exports and US's high-end manufactures.

**Figure 2. Sources of China's Imports, 1995–2007**



Source: International Financial Statistics

China's exports grew at an annual average rate of nearly 22% over 2005–07. Of late the slump in the world economy has affected China's exports, especially with her close links to the United States, which had been absorbing more than 20% on an average since 2000. During 2009 the value of goods exported was \$1.2 trillion, down 16% year-on-year, while the value of goods imported was \$1.01 trillion, decreasing by 11.2% from the previous year.<sup>2</sup> As for the impact of the recent global economic crisis and the recession on China's trade, a clear picture of the effects will emerge when more data is available.

Consequences of the recent turmoil in global markets can be partly assessed by having a look at the monthly figures for aggregate exports and imports that are available for 2008. The trade data indicate moderate to sharp declines in both exports and imports by the last quarter of 2008 when the world-wide slump had began. The country's aggregate exports started faltering since the last quarter of 2008, sliding down further in the first quarter of 2009. A large part of it was related to the recession in the rest of world, and especially in the advanced countries, while such tendencies were reinforced by the ongoing protectionist moves in the United States and other advanced capitalist countries.

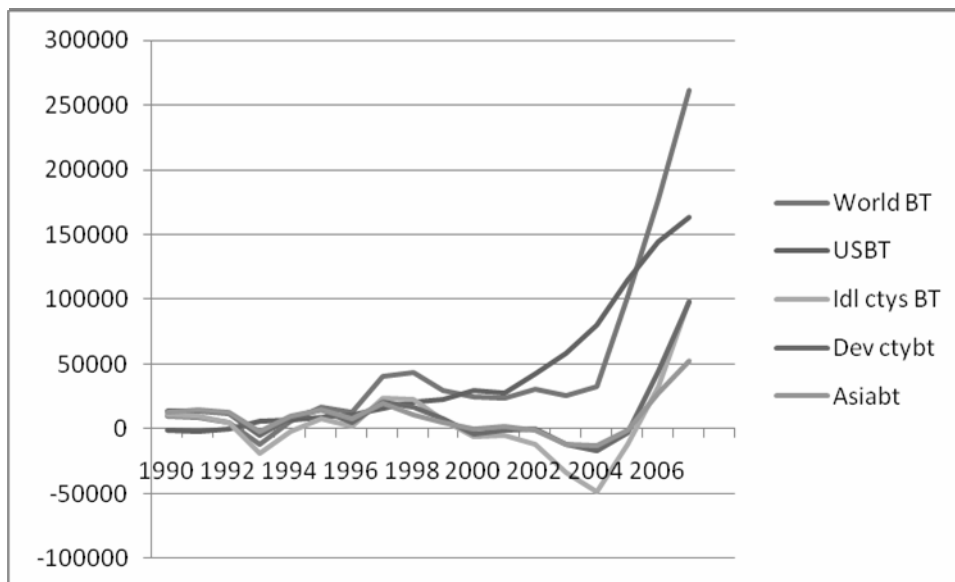
<sup>2</sup> *China Daily*, April 28, 2010

**Figure 3. China's Monthly Trade, 2003–08**



Source: International Financial Statistics

**Figure 4. China's Trade Balance (\$ Millions)**



The changing shares of the different regions and countries in China's exports and imports get reflected in the trade balance across the same groups. However, it continues to be the case that United States contributes most of China's trade surplus and even finances her deficits with other regions, including industrial countries and developing countries from Asia. Hence, it is natural that a recession in advanced economies—especially the United States, a major destination of China's exports—impinges heavily on China's exports and thus the



accumulation of huge official reserves. We may recall here that exports from China dropped by 40% during 2008–09. Chinese exports plummeted 21.8% through the January–June period in 2009 which was the sharpest decrease in a decade after the global financial crisis. The declining exports drove down the trade surplus to \$96.94 billion in the first half of 2009, down 1.3% year-on-year. Despite the above, China’s foreign exchange reserves topped \$2.13 trillion by the end of June 2009, up 17.84% year-on-year.<sup>3</sup>

## **FINANCIAL INTEGRATION OF CHINA WITH THE REST OF WORLD**

The extent to which an individual country relies on the rest of the world economy also depends on the extent of deregulation of the financial sector, which affects the magnitude as well as the composition of capital flows. It can be observed that deregulated finance encourages capital flows of a short-term nature; this can impact the functioning of the country’s stock market, the level of official reserves, and even the exchange rate. This also happened in China with the deregulation of the financial sector after 2005.

China’s entry to the global financial market seems to have gone through two distinct phases. The *first* between 1978 and 2005 when China maintained relatively strict controls over the financial sector. While some concessions to capital account were made with China’s membership to the WTO in 2003, controls continued to remain over capital flight, following a strategy of an “easy in and difficult out” capital flows. The 1997 Asian financial crisis influenced such as strategy. The *second* phase started from 2005, signaling considerable relaxation of earlier controls and regulation, over inflows of overseas finance and over the exchange rate of RMB, which was until then under a fixed dollar peg. FDI, as well as portfolio capital inflows, have gone up since then, at a pace that had continued until the onset of global the economic crisis in the fall of 2008. The exchange rate of the RMB also has gone through upward adjustments, recording a 20% appreciation during 2005–08. However, by July 2008 the US dollar started appreciating, recording a 20% hike against euro. In the meantime the Chinese monetary authorities had stopped monitoring the RMB peg with dollar, which also slowed down inflows of hot money to China, relieving the upward pressure on RMB and the constraints on credit so far faced by monetary authorities in China. Easier bank credit followed, which helped

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<sup>3</sup> *China Daily*, May 1, 2010

growth in China during 2008–09. However, the near-zero interest rate policy in the United States (largely in response to the on-going crisis), along with the moderate drop in dollar rate in 2010, has again revived the stream of hot money flows to China, largely with expectations of further rise in the RMB rate. This also has compelled China to reactivate a constrained credit policy, largely with higher reserve ratios and open market policies in the bond market (McKinnon 2010). The development as above can also be viewed as one where China's monetary policy is no longer dictated by her own dictates, with cheap credit policy in the United States forcing accommodative actions by China. However, on the whole, China has been able to withstand the near 40% drop in export earnings by means of credit expansions, almost 30% in 2009 and of late, with fiscal expansions in 2010. The looming currency war between China and the United States is possibly not that imminent, with the US Treasury stalling a bill that was about to name China as a currency manipulator (McKinnon 2010).

China, in the earlier years of financial opening (until about 2005), provides a unique example of liberalizing its financial sector with close state monitoring, which we have described elsewhere as a situation of “guided finance” (Sen 2007). Banks in China have continued to remain as the main conduit of financial intermediation within the country, until recently handling 80% or more of financial flows in the country, with four major state-controlled banks (SoBs) controlling 70% of deposits and advances in the banking industry. Thus the security sector in China remained at a nascent stage until recently and no Chinese bank was permitted to invest in securities. Again, despite having access to the market for securities, the state-owned enterprises (SoEs) relied on banks rather than the stock market for finance. For example, in 2001 the SoEs raised only \$14 billion by floating shares and borrowed more than \$157 billion from banks (Green 2003). Banks in China were closely guided by the State Committee, not only in terms of handling the balance sheet, but also in terms of the direction provided by the state in the allocation of credit. Credit advanced by banks was subject to monitoring, if not control, by the state, in terms of the “guidebook” provided by the State Committee, which specified the desired directions (not volume) of credit. Reforms of China's financial institutions even accommodated state guidance with initiatives by the latter in the handling and cancellation of doubtful assets held by the SoBs.

The security market in China thus maintained a rather low-key performance as an alternate source of finance in China, a fact that was reflected in the hesitant flows of portfolio finance until about 2004–05. Stock market capitalization in China, net of nontradable shares,

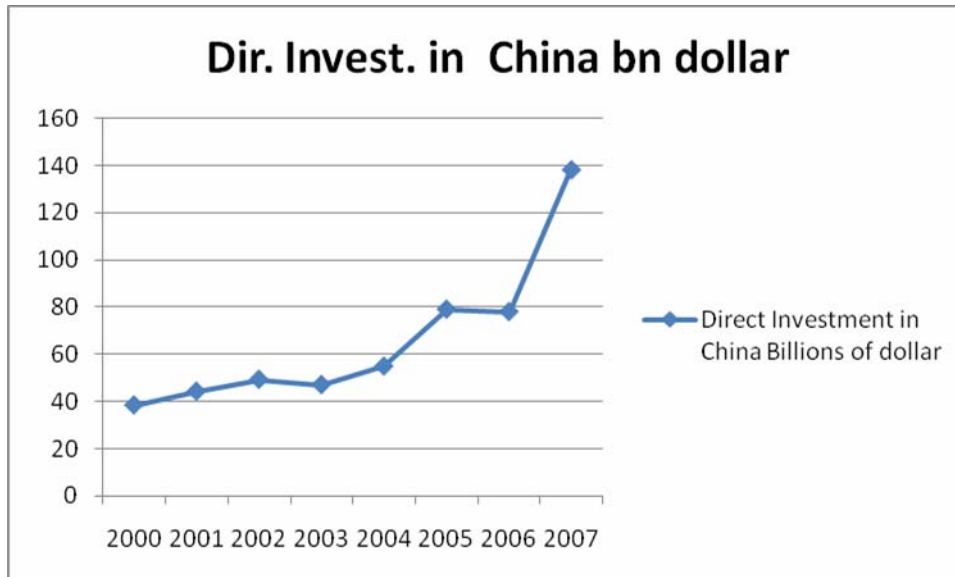
had been rather low at 17% of GDP during 2000–05, as compared to such ratios in similarly situated developing countries like Korea (52%), Malaysia (136%), and Singapore (136%) around the time (Green 2003).

“Guided finance” in China even separated shares sold in the stock market by currency denomination according to whether these were RMB or dollar denominated. The government also restrained the tradability of nearly two-third of shares in the market, thus leaving only one-third of shares to be exchanged. Stock exchanges, initiated in Shanghai and Shengen in December 1990, had a bifurcated structure in terms of distinct share categories, with A shares denominated in RMBs and B shares in US dollars. Qualified FIIs (QFIIs) were approved by the China Security Regulatory Commission (CSRC) to deal only in B shares. The stock market thus had few takers despite the industrial boom in the country, which was largely driven by domestic banks and FDI.

Regarding capital inflows and China’s global integration, we can observe the spectacular rise in FDI to China over the last two decades (figure 5). State directives to banks in the disbursement of credit and the initiatives offered by the state to provide facilities for industry in China worked as an incentive to foreign investors. Clearly, a large part of these FDI inflows are likely related to the success of China in having a “guided financial market.” In the process, benefits of these inflows were reaped by both industry and finance, as opposed to a situation of finance-led growth alone in other deregulated financial markets, where speculation dominates the financial flows.

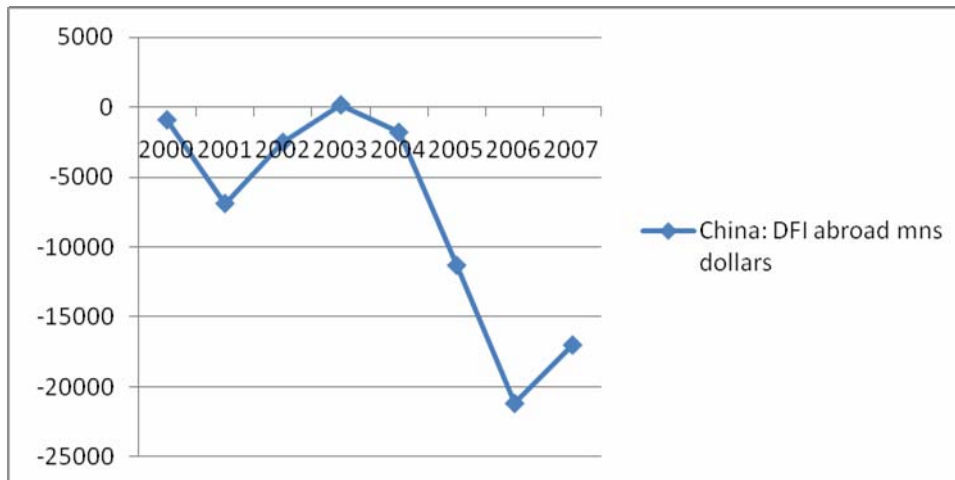
In China the regulatory institutions in the area of banking, securities, and insurance were given wide-ranging powers, keeping a close vigil on the functioning of both finance and industry. Banks, a few of which could float equities in the market, were also forbidden to enter as buyers of stocks, a practice that reminds us of the norms of segregated banking and the Glass-Steagall Act of the United States. As we have pointed out elsewhere, universal banking—the much acclaimed practice of financial markets in the era of global finance—while creating opportunities for profitable speculation, can ignore the real sphere of the economy at the expense of production and employment (Sen 2003).

**Figure 5. FDI Flows to China (\$ billions)**



**Source:** International Financial Statistics

**Figure 6. FDI Outflows from China (\$ millions)**



**Source:** International Financial Statistics

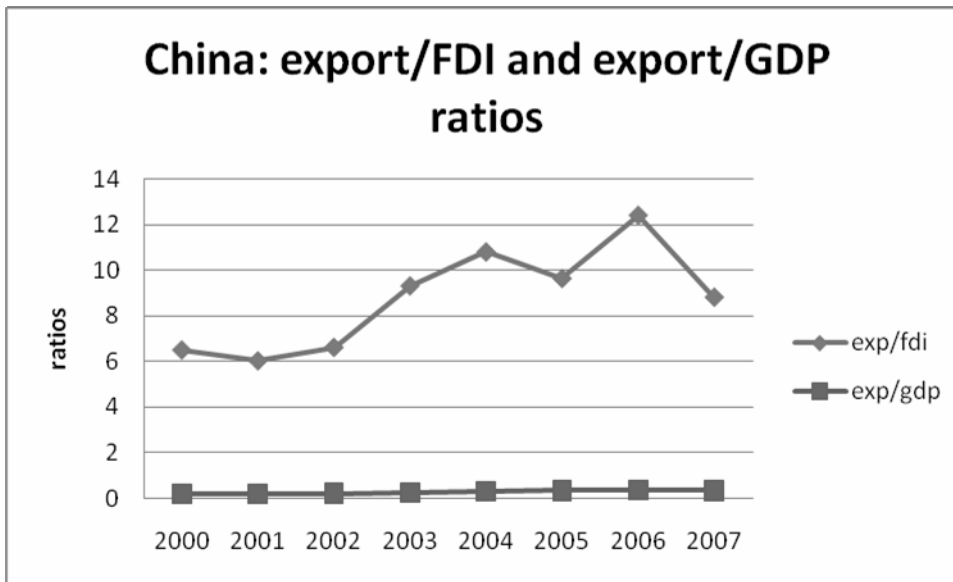
China, however, has also been a significant investor abroad since 2004. The flow has tapered off slightly in 2007. As commented in a newspaper, “Even as global financial flows have slowed sharply overall, China has dramatically stepped up its outbound investment. In 2008, its overseas mergers and acquisitions were worth \$52.1 billion—a record, according to the

research firm Dealogic. In January and February of 2009, Chinese companies invested \$16.3 billion abroad, meaning that if the pace holds, the total for 2009 could be nearly double last year's" (Washington Post Foreign Service 2009).

Recent news reports also indicate that China has stepped up its purchases of raw materials from other developing countries, possibly to take advantage of the low prices in the downswing and keep up with increasing demand at home. The same report points out "Chinese companies have been on a shopping spree in the past month, snapping up tens of billions of dollars' worth of key assets in Iran, Brazil, Russia, Venezuela, Australia, and France in a global fire sale set off by the financial crisis" (Washington Post Foreign Service 2009). These developments illustrate how China is inextricably linked to the developing world.

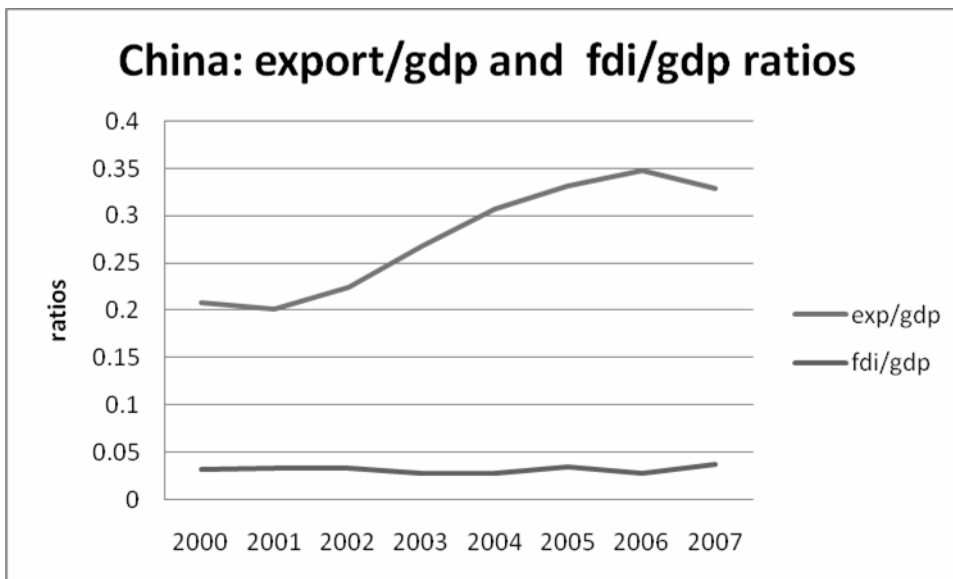
It is important to recognize that exports from China and FDI inflows bear a high export/FDI ratio of 10.01 on an average between 2000 and 2007. Much of these exports might have been FDI-driven. Using panel data for six dominating export and FDI-receiving manufacturing sectors over period from 1995 to 2004, a recent paper suggest that FDI inflow to China has a statistically significant positive effect on the exports as a whole, but its specific impacts vary by sector. It also suggests that FDI to non-labor-intensive sectors is more efficient in stimulating exports than those to labor-intensive ones (Awokuse and Gu 2007); thus exports are likely to face a second-round shock if FDI flows to China falter as a consequence of the crisis. FDI also seems to have been important for China's gross domestic capital formation. Thus the annual average ratio of the gross domestic capital formation to FDI has been 10:1 or even above between 2000 and 2007. Much of the former must have been financed with the FDI inflows. China's links with the crisis-ridden advanced economies through exports and FDI thus remain important in determining the impact of a crisis originating in those economies on the domestic economy of China.

**Figure 7. Export/FDI and Export/GDP Ratios**



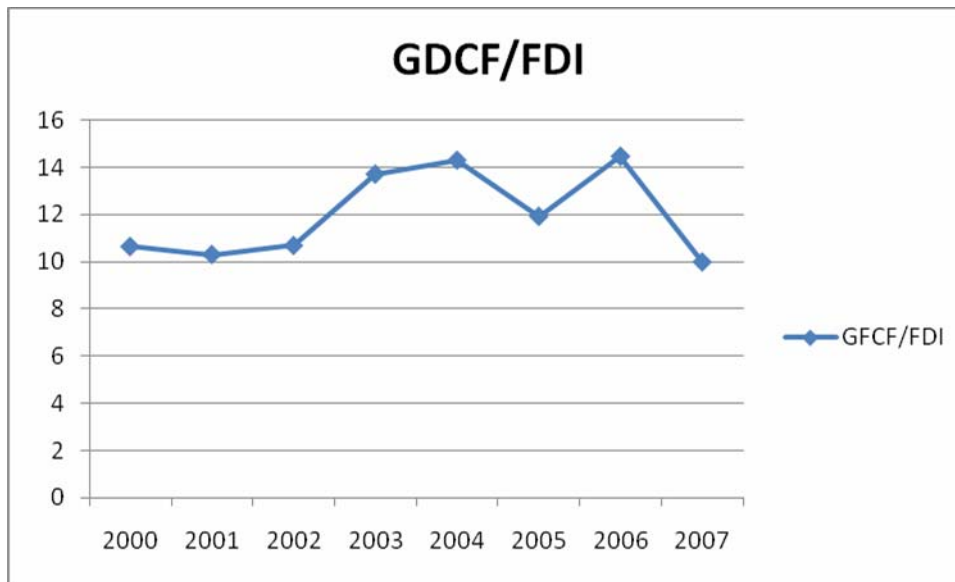
Source: International Financial Statistics

**Figure 8. China: Export/GDP and FDI/GDP Ratios**



Source: International Financial Statistics

**Figure 9. Ratio of Gross Fixed Capital Formation (GFCF) to FDI**



**Source:** International Financial Statistics

As we have mentioned above, China has gone through a rapid pace of financial liberalization since 2005. By June 2005 foreign investors were allowed to have stakes in the publicly listed firms and buy their tradable A shares. As reported by the domestic media, this was part of an ongoing plan to do away with nontradable State shares. However, foreign investors taking strategic stakes through their purchases of A share were subject to “lock-in” periods and they could sell these shares only at the end of such time.<sup>4</sup> The year 2005 also marked the delinking of RMB to dollar peg, followed by the appreciation of the nominal RMB rate by 20% between 2005 and 2008. Controls over foreign finance were further loosened by 2007 as Chinese investors were permitted to buy H shares in the Hong Kong exchange. Until the middle of 2007, such investments were only permissible on part of the Qualified Domestic Institutional Investors (QDIIs), which included banks and other domestic financial institutions. This reflects attempts on the part of the monetary authority to offset some of the capital inflows pouring into the country through FDI-led corporate investments and the soaring trade surplus (Bradsher 2007). By July 2007, the inflation rate within the country had soared to 5.7%, largely with high domestic demand.<sup>5</sup>

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<sup>4</sup> “A shares to be open to non-Chinese investors.” [www.chinaview.cn](http://www.chinaview.cn); see also, [www.nytimes.com/2007/8/20/business](http://www.nytimes.com/2007/8/20/business)

<sup>5</sup> “China sees threat from abnormal capital flows.” *Financial Express*, December 3, 2009

Capital inflows by way of speculative portfolio capital became substantial by 2008, with FDI and trade surplus accounting for only 52% of net accumulations to reserves (Ma and McCauley 2007). These portfolio flows were often motivated by an expected appreciation of the RMB rate until July 2008 when the currency peg of RMB was fixed at 6.83 per dollar. Understanding the consequences of an overheated financial sector, the Chinese State Administration of Foreign Exchange (SAFE) sought to tighten its control to stop over-invoicing of exports, remittances, and FDI, especially the latter two which were linked to Hong Kong.<sup>6</sup> Restraints on credit expansion were relaxed for some time after July 2008 as inflows of hot money tapered off due to the relative stability of the dollar-RMB rate. However, the low interest rate in the United States dampened the dollar rate by September 2009, prompting speculators to expect RMB appreciation (McKinnon 2010). This has brought back credit restraints in China, with higher reserve ratios, as well as bond sales. Interest rates, however, were not used as a tool of monetary management.

The steady dismantling of controls that has taken place in China's financial sector had generated a qualitative change in the composition of financial inflows, with portfolio investments shooting up by 2006. The measures also impacted China's stock markets, which faced an unprecedented boom in turnover as well as in share prices since 2006.

An approximate indicator of volatility is provided figure 11 (below) on Shanghai stock index.<sup>7</sup> As one commentator observes, "With the Chinese index up sevenfold during the past five years, and valuations stretching into P/Es of 60 or more, the Chinese stock market has little to do with fundamentals. Although many liken it to a casino, a better analogy is a game of musical chairs. The object is to make sure you get a seat before the music stops." Again, as for the impact, "...the collapse of China's stock market could be a lot worse than previously thought. Merrill Lynch estimates that Chinese retail investors—up to 150 million people—have sunk 22% of their capital into the stock market. Say the stock market drops by half (it's already down about 20%) and Chinese urban households will lose about 20% of their overall net worth. Pundits estimate that a 50% decline in the stock market might lop 1–1.5% off China's double-digit percentage GDP-growth rate."<sup>8</sup>

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<sup>6</sup> "Hot Topic: Beijing Capital Controls" *Economic Browser* August 23, 2007

<sup>7</sup> <http://www.theglobalguru.com/>

<sup>8</sup> <http://www.theglobalguru.com/>; see also [CESAR BACANI / HONG KONG](#) for Wednesday, July 1, 2009; "Is a China stock bubble forming?" <http://www.time.com/time/world/article/0,8599,1908032,00.html>; and "Global FDI

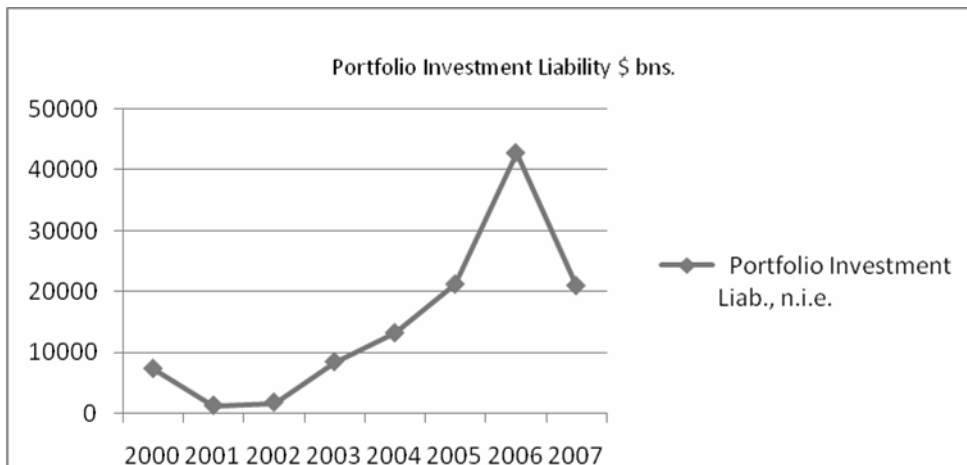


Of late, foreign institutional investors have been active in pumping money in and out of China's stock markets. Thus the Shanghai stock market had been subject to volatile moves, including a 6.7% tumble on Monday, August 31, 2009, the biggest single-day fall in fifteen months.<sup>9</sup>

All told, China's recent financial developments paint a rather awkward picture when one views the country's integration to the world economy, especially after the global economic crisis. One witnesses declines in both portfolio and FDI flows to the country since the onset of the global crisis in the fall of 2008. As for FDI, there has been a change in recent times with advanced industrialized countries—which have been China's major investors through Hong Kong—now staying away. According to some sources, "China's main FDI sources viz. the United States, Europe, and Japan are languishing and there is no sign that their economies are bottoming out. This has blurred the prospects for FDI into China." However China is still considered as the most favorable destination for investment by foreigners (Qingfen 2009).

The fact that foreign investments to China have been hit by the global economic crisis is rather evident by now. FDI flows have been more than halved between the Q12008 and Q12009. Portfolio investments, as pointed out above, have also plummeted occasionally, causing sharp declines in stock indices.

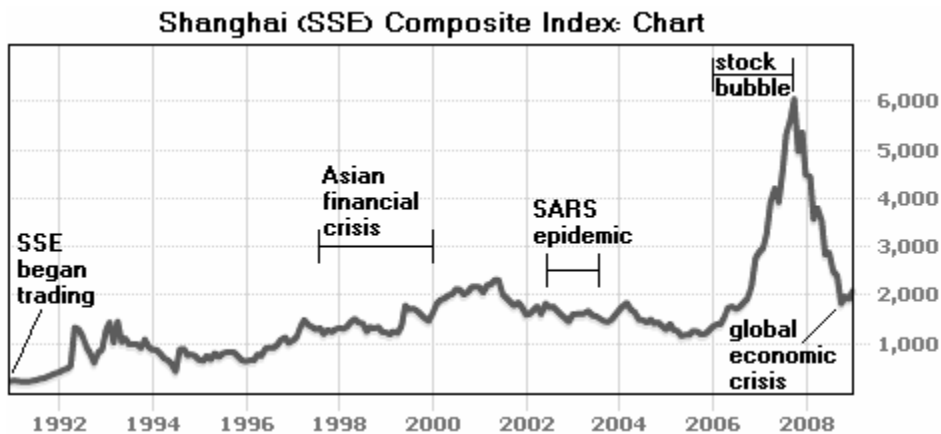
**Figure 10. Portfolio Investments in China (\$ billions)**



Source: International Financial Statistics

flow halved in first quarter of 2009 primarily from rich nations." <http://www.mysinchew.com/node/26403>  
<sup>9</sup> "China's stock gyrations not the work of small investors." *Asia Markets*, Sept. 2, 2009. Available at: <http://www.marketwatch.com/story/>

**Figure 11. Shanghai Composite Index**



Source: [http://en.wikipedia.org/wiki/Shanghai\\_Stock\\_Exchange](http://en.wikipedia.org/wiki/Shanghai_Stock_Exchange) - 98k -

Of late, China's economy, like other emerging markets, is facing a renewed surge of portfolio capital inflows, with a large part directed by speculation. As we have pointed out above, a large part of this is related to the United States of having a near-zero rate of interest and the related downside in the dollar rate. With the surge in these capital inflows causing upward pressure on the RMB rate and the domestic interest rate failing to provide an "uncovered parity" in terms of the two exchange rates, it was natural that expectations of a RMB appreciation surfaced in the market, providing an impetus to currency speculation.

Analyzing further, China, like some other developing countries, today faces the "impossible trilemma" (Krugman 1999) of managing the exchange rate with near complete capital mobility and national autonomy in their monetary policy. However, while China is able to sustain the current spread between its prime lending rate at around 5.36% in the face of the US rate at 0.25%,<sup>10</sup> it does not signify China's success in avoiding the hazards of a typical trilemma as arises with open capital flows, managed exchange rates, and an autonomous monetary policy.<sup>11</sup> China has been steadily sterilizing a significant part of the rising capital inflows by selling government bonds and with higher rates of cash reserves (see figure 12), which partly reduces the related expansion of high-powered money (reserve money) and money supply. However, selling government bonds is bound to face its own limits, especially in terms

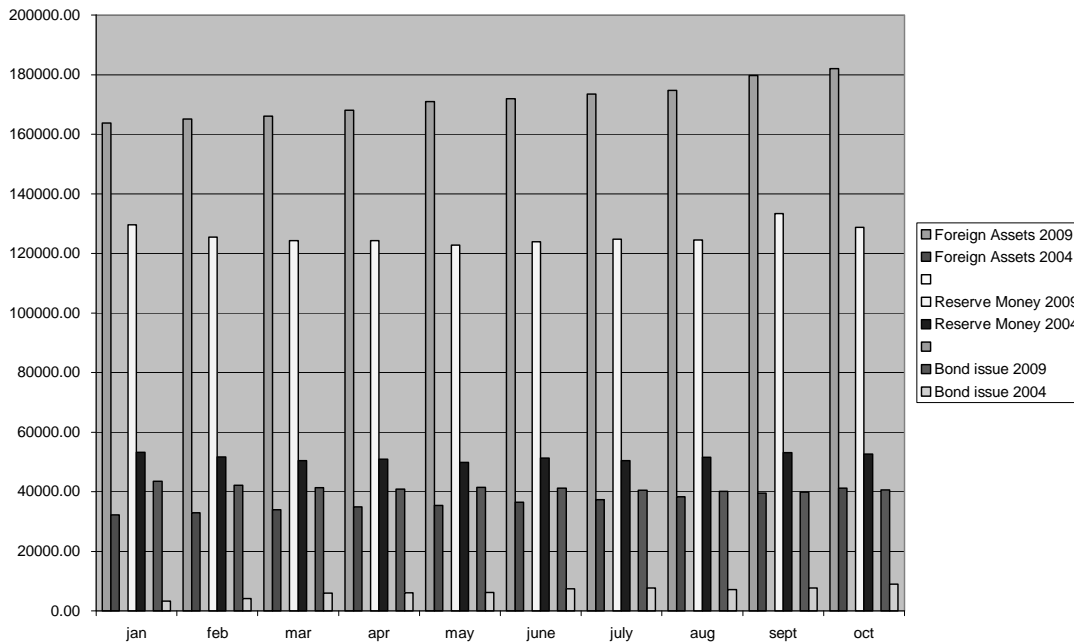
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<sup>10</sup> "FactBox-Global interest rates in 2010." Reuters, London, April 6.

<sup>11</sup> According to one view, the fact that China's interest rates do not follow changes in US interest rates is indicative of autonomy in China's monetary policy. The view however, can be contested, as shown in the text above.

of the related fiscal burden of the rising interest costs.<sup>12</sup> These developments indubitably indicate the seriousness of the trilemma currently faced, as well as handled, by China—keeping its capital flows free and managing both monetary policy and the exchange rate in the interest of the national economy.

**Figure 12. Foreign Assets, Reserve Money, and Bond Sales (Millions of RMB)**



*As for the role of China as a growth propeller, integrated with the rest of world, the high-growth Chinese economy has still been propelling growth elsewhere. Concerns expressed by the rest of world on the trade-displacing effects of the cheap exports alone, however, appear exaggerated if we remember that China is also a large importer, especially of intermediate goods. Its exports are import-intensive, much of which is generated by operations of the subsidiaries of foreign firms in China. While it is too early to have a total picture, the growing alliances within Asia between China and other Asian countries in terms of trade integration signifies a decoupling tendency between the industrialized and the developing countries.*

<sup>12</sup> At the same time, a higher interest rate is what makes possible the sale of bonds by making those attractive to the public and simultaneously dampen the rate of inflation. But the higher rate may also encourage further inflows of capital, with interest rate differentials (from overseas) which add to currency speculation, betting against the managed exchange rate which is expected to appreciate. Finally the higher rates also go against the interests of the real economy.

However, this may also go with further changes in the composition of trade within Asia, with Chinese manufactures displacing those from other Asian countries. The new pattern of Asian economic integration may also dampen the impact of further decelerations in the West on Asian economies, at least via the trade route, if not via capital flows. We also need to remind ourselves that growth in China is not just a case of a typical export-led process as happened in some other countries in Asia. It is an instance of a state-led industrialization, as in Japan earlier and more recently in Korea, along with the opening up of large domestic, as well as external, markets. Also, industrialization in China has not remained confined to an export enclave, especially with its vast territory and the swarming population providing the base for economic expansion from within. As pointed out by a recent study, much of the domestic activities (as well as exports) are generated by domestic demand (Pairault 2009). Of late, the second-generation FDI inflows from the EU, Japan, and the United States have been directed to a niche within the home market, unlike the first-generation flows that catered more to export markets (Ali and Guo 2005).

We also need to recall the role of the “three legs” (exports, property market, and government spending) that are considered to support the Chinese economy; of these, government spending seems to be functioning better. One needs to focus on the changes in the rising value as well as the composition of such spending in China since the onset of the global economic crisis. As mentioned earlier, with problems faced in devising and sustaining autonomy in monetary policy, China has been using expansionary fiscal policy to tackle the impact of shrinking export demand. The recent drive on the part of Chinese authorities to boost real demand in the countryside and to revamp the domestic market shows a promise much different from the rescue packages for the financial sector in advanced nations. Of late, China has announced a four trillion RMB (\$586 billion) package of fiscal expenditure, which represents about 16% of China’s economic output last year and is roughly equal to the total of all central and local government spending in 2006. New spending of even half that amount would be next to China’s six trillion RMB annual budget for this year. Strategies as above aim to bolster domestic demand and help avert a global recession by spending on housing, infrastructure, agriculture, healthcare, and social welfare, along with tax deductions for capital spending by companies.<sup>13</sup> Concerns, however, have been raised on the inadequacy of those

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<sup>13</sup> Comparing notes, the United States pushed through a \$168 billion stimulus package earlier this year, equal to about 1% of gross domestic product, and the Federal Reserve has aggressively cut interest rates, complementing the Treasury’s \$700 billion for troubled financial institutions. Japan has a \$51.5 billion package that largely consists of

measures on employment and poverty in the countryside, one which may not be achieved much by the priorities in achieving infrastructural development! On the whole, it is possibly too early to identify the possible impact of this expansionary spending on China's economy. Data from China's National Bureau of Statistics project a year-on-year 11.9% output growth rate in the first quarter of 2010, while predictions by the Chinese Academy of Social Sciences (CASS) and the Asian Development Bank (ADB) respectively put the 2010 GDP growth at 9.9% and 9.6% (Sin and Rabinovitch 2010). However, questions are raised as to how the overall growth satisfies the needs of the economy, especially with what is described as a "jobless recovery" and with migrant workers continuing to face serious crisis.<sup>14</sup>

## CONCLUDING REMARKS

Analysis of China's integration with the rest of world provided in the paper generates the following observations: China's trade integration has of late been more with Asia rather than with the advanced countries. Even the share of Hong Kong, which used to be treated as a corridor for China's trade with the industrialized countries, has diminished in recent years. Given the pattern of growing instability in advanced economies, this may work out as a favorable factor for China in terms of withstanding the potential hazards of a sudden collapse of export markets in the advanced countries.

The pattern, however, is very different in regard to capital flows. China today is integrated closely with the financial markets of advanced economies, both with the long-term FDI and the short-term portfolio capital flows. While FDI forges links between China's real sector and the rest of world—especially with China's exports and capital formation, as well as employment generated from the FDI controlled units—portfolio flows open up the possible dangers of a sudden flight of capital. The latter makes the country's economy vulnerable to shocks from outside and can affect the domestic financial structure, including the exchange rates, as well as monetary management in future.

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payouts to families and tax relief for businesses and Germany is moving on tax breaks and loans that will cost the government around \$29.9 billion over four years. "China Sets Big Stimulus Plan In Bid to Jump-Start Growth" *Wall Street Journal*, October 8, 2008. Available at: <http://online.wsj.com/article/SB122623724868611327.html>

<sup>14</sup> "Economics Focus: Surplus ca Change." *The Economist*, April 22, 2010.

On balance, the new pattern of China's integration with the rest of world is thus beset with both positive and negative signals for the Chinese economy. Given that China's growth and stability have assumed a degree of importance for the rest of world that was never as significant as it has of late been, the future of the Chinese economy remains an important issue for the world as a whole.

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