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Editorial

China after the Global Financial Crisis

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> *"Quand la Chine s'eveillera, le monde tremblera ..."*
>
> *["When China rises, the world will tremble ..."]*
>
> Napoleon Bonaparte [1]

> *"The maximum amount of bilateral trade possible between us ... is infinitesimal in terms of our economy"*
>
> Henry Kissinger, 1972 [2]

For decades China's economic progress was stifled and hidden from the rest of the world behind Chairman Mao's "bamboo curtain." However, the remarkable growth over the post-1978 reform period has launched the country into a major player in the world economy. Although unforeseeable at the time of Nixon's 1972 visit, the People's Republic of China has become the United States' second largest trading partner and its soaring bilateral trade surpluses (over $273 billion in 2010) have repeatedly raised the ire of congress. In addition to maintaining real growth rates consistently close to 10% per annum, mainland China's financial development has been such that four of the ten largest banks in the world based on market capitalization are Chinese, with the Industrial and Commercial Bank of China and China Construction Bank ranking first and second, respectively. Meanwhile, the Shanghai Stock Exchange, not reopened until December 1990, has seen its total market capitalization rise from less than $0.3 trillion in 2005 to $2.7 trillion at the end of 2010, putting it in fifth place among all world stock exchanges. Shanghai also ranked in sixth position amongst the world's top financial centers in the 2011 Dow Jones International Financial Centers Development Index, ahead of Paris and Frankfort and just two places behind Hong Kong [3]. Even prior to the onset of the global financial crisis, many tough challenges remained for China, however. This included the sustainability of China's exchange rate policy and the accompanying capital controls, ongoing concerns about nonperforming loans in its banking system, and the extreme boom-bust cycles seen in its equity and housing markets. The Shanghai A-Share Index, for example, after rising more than fivefold over the 2005–2007 period, plunged from its record high of 6395.76 in October 2007 to below 1900 in November 2008.

Whereas the global financial crisis that began in 2007 induced recessions in many western economies, Chinese growth remained quite robust despite the damage to many of the nation's main export markets. Domestic demand was boosted by a huge fiscal stimulus package equivalent to $600 billion (or 20% of China's GDP) that was launched in November 2008 in conjunction with calls for the nation's banks to boost their lending rates. Indeed, by 2009 concerns shifted toward avoiding inflationary pressures. The quite restrictive monetary stance of the People's Bank of China since then stood in sharp contrast to the continued easy money policies of the US Federal Reserve System, which initiated yet more quantitative easing in 2010-2011 to address the lackluster growth in employment. China's relative strength has also been accompanied by renewed controversy over the exchange rate between the renminbi and the US dollar. In resisting outside pressures to allow greater flexibility, Chinese officials point to the vulnerability of the banking and

financial system as well as the export job losses associated with any sharp appreciation in the national currency.

This special issue focuses on the impact of the global financial crisis on China and its economic prospects going forward. One of the key issues is the state of China's banking system and asset markets. Notwithstanding apparent strong performance, there has been concern about the rapidity of the lending growth rates seen since 2009 and the threat of asset price bubbles. Exchange rate pressures are another key challenge and it is important to consider whether renminbi appreciation is justified on the Chinese side rather than merely concentrating on how such a move might benefit the United States. Meanwhile, Chinese policymakers' shift from massive stimulus in 2008 to retrenchment in 2009 begs the question of why economic recovery was so much more immediate in China than in the Western world. It is also important to consider whether this rapid turnaround reflects a decoupling from events in the Western economies and the extent to which China's financial system remains relatively insulated today.

The paper authored by N. Zhang et al., in the special issue, focuses directly on how the global financial crisis has impacted mainland China's financial markets and macroeconomy. A major theme of the paper is that we should not be too ready to embrace the premise that China's growing economic strength has led to a true decoupling from developments in the advanced economies. Even though China may be exerting an increasingly large impact on the global economy, economic interdependence runs strongly in both directions. Indeed, the shortfall in China's growth in 2008 relative to its prior trend exceeded that experienced by the United States in absolute terms. A second theme of the paper is that, notwithstanding its heavy export dependence equal to roughly 40% of its GDP, China has been able to effectively boost domestic demand to reduce the negative effects of the global recession. This has not been without its costs, however. The expansionary policies have led to inflationary concerns, and the extraordinary gains in the real estate sector could well leave China at serious risk of a bursting asset price bubble. Meanwhile, more than half of the largest commercial banks reported over 10% growth in nonperforming loans over 2010-2011 while China's credit-to-GDP ratio rose from 120% at the end of 2008 to 166% by March, 2011. Other challenges include the disposition of China's massive, largely dollar-denominated foreign exchange reserves and how best to proceed with financial market liberalization and capital account liberalization without undue disruption. China's external role also needs reassessment and the nation must come to grips with its increasingly important role in promoting international and regional economic and financial cooperation.

The paper authored by N. Horesh examines the evolution of the renminbi as an international currency. Although not widely known, China played the role of international currency provider in the past. Traditional Chinese copper coins were a model for the early currencies of Japan and Korea and served as an East Asian and Southeast Asian monetary benchmark for a millennium or so before being displaced by western coinage in the late nineteenth century. Chinese coins even circulated in India and Ceylon between the 7th and 14th centuries. Moreover, rather like today, financial assets long flowed into China from the West in the face of substantial Chinese trade surpluses. The question of how soon, and to what extent, China's currency will regain its old global role is heavily dependent upon the authorities' willingness to further relax capital controls and, most likely, accept additional renminbi appreciation. Thus far, Chinese policymakers have shied away from any overt challenge to the US dollar's reserve currency role and seem to envisage the renminbi being just one of many alternatives to the dollar in any potential new global standard. The author argues that the future role of the renminbi depends not only upon the pace of domestic reform but also upon the role China elects to play with respect to such international edifices as the IMF, World Bank, and the G20. Moreover, renminbi internationalization may not necessarily end up being as dependent upon the depth of domestic capital markets as was true under the establishment of previous hegemony under the pound sterling and its US dollar successor. We should not rule out a more distinct Chinese path to global economic eminence any more than we should forget that China's increasingly important role as a major global player is, after all, nothing new.

The paper authored by R. Burdekin and R. Tao examines the relationship between bank lending, inflation and China's stock market over the 2004–2010 period. There has been particular concern that rising reported bank profitability was occurring amidst substantial funds being used not in financing real economic activity but in speculation in the nation's stock and property markets. Such claims came to a head in 2009 with a surge in bank lending prompted by Chinese government efforts to support the economy during the global financial crisis. For the 2004–2010 period as a whole, People's Bank of China survey data on banking activity and inflation expectations are found to support a causal relationship between inflation expectations, banking activity, and the stock market. The results imply that fears of inflation amidst surging bank lending and share prices are neither misplaced nor just a figment of the 2009 experience alone. Banking business seems to be driven by stock market moves, and concomitant inflation concerns, rather than being the actual cause of any overheating that takes place, however. This leaves open the question of whether heightened bank lending is more a symptom than a cause of inflationary pressures in the economy, with the stock market seemingly moving before the banks. Nevertheless, stock market strength in China appears to carry with it not only rising inflationary concerns but also increased bank lending activity and reduced banker confidence that stable conditions will be maintained. This offers at least some justification for the People's Bank continuing to pay attention to the stock market in determining its monetary policy stance and suggests that the Shanghai index might actually serve as a useful indicator variable in China.

The paper by S. Zhou et al. employs a dynamic computable general equilibrium model to gain perspective on the impact of the government's stimulus package on the Chinese economy. This stimulus program, focusing primarily upon

housing projects and other infrastructure development, undoubtedly played an important role in supporting continued robust economic growth in 2008 and 2009 even amidst the worst of the global financial crisis. The authors' simulation analysis permits a comparison with how the Chinese economy might have fared had the stimulus program not been enacted when the financial crisis intensified in the fall of 2008. The basic dataset is a 2007 social accounting matrix incorporating a 135 sector input-output table and such other data as customs taxes, the international balance of payments, and flows of funds. The authors' estimates suggest that the GDP growth rate would have fallen to 2.36% in 2009 without the stimulus package before rebounding strongly in 2010. Expanding investment under the stimulus package is seen as the key driver in allowing for up to 9.1% growth in 2009. The estimated long-term impact of the stimulus package decays over time, however, producing an average 7.61% growth rate over 2011–2015 compared to 7.38% with no stimulus package and 7.94% if there had been no financial crisis in the first place. Meanwhile, sharp falls in exports and imports in 2009 followed by a rebound in 2010 are seen with or without the stimulus package. Consumption receives an estimated 1.5%–2% boost, however, while government income and household income also benefit. On the downside, the investment expansion brought about by the stimulus package adds to energy consumption and CO_2 emission, implying 2015 levels 1.9% and 2.3% higher than under the baseline scenario.

The paper by A. Strutt and T. Walmsley employs a dynamic global general equilibrium model to quantify the longer-term impacts of the financial crisis on the Chinese economy. This model incorporates such features as bilateral trade flows, consumer demand and intersectoral factor mobility, and foreign ownership of capital and investment behavior. The impact of endogenous capital accumulation can be captured under this approach along with the movement of investment between countries in response to changing expected rates of return. Following a common downturn during 2007–2011, the model's results suggest quite divergent longer-term effects on China compared to the United States, the European Union, and Japan in the aftermath of the financial crisis. In particular, higher relative returns on investment in China are seen inducing a substantial reallocation of investment towards China that encourages recovery there but only extends the growth declines experienced elsewhere. Overall global trade is seen falling by 13.7% relative to the 2020 no-crisis baseline case, while the composition of trade shifts in favor of investment goods and in line with the pattern of Chinese demand. The authors also consider the consequences that would follow if the crisis was more protracted and extended beyond 2011 into 2015. Although this naturally results in more severe output and export losses, a similar reallocation of investment towards China is predicted under this more adverse macroeconomic backdrop.

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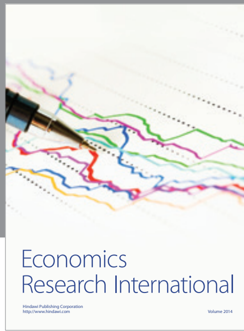

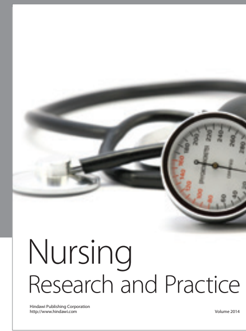

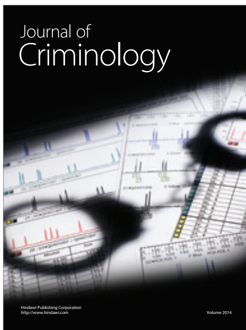

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