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China and the global economic crisis

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As THE FINANCIAL crisis has metamorphosed into global recession, international perceptions of China are changing. For years, foreign critics have accused China of engaging in unfair trade practices, stealing jobs, running up excessive current account surpluses and manipulating its exchange rate. Such complaints have not gone away. However, China is no longer viewed just as a source of disruption, but also as an indispensable partner – just conceivably a leader – in hauling the world out of trouble.

China was long consigned to the margins of the G8. But last November's hastily convened G20 summit in Washington marked a turning point. At that gathering, and at this month's follow-up meeting in London, Hu Jintao, China's president, occupied a place of honour that recognised both the country's economic importance and its status as *primus inter pares* among the other developing nations represented at the table.

That others should expect much of China is understandable. It is the world's third largest economy and one of the few still registering positive growth. As second largest exporter and third biggest importer, with almost $2,000bn in foreign exchange reserves, it has an obvious stake in global prosperity. It is also relatively well placed to weather the storm: its banking system has escaped the direct impact of the financial crisis, its public debt is modest and its fiscal position strong.

However, expectations that China will ride to the rescue of the global economy are misplaced. Not only is it ill-equipped to perform such a role; pressures and priorities at home may yet drive it to act in ways that create renewed tensions with trade partners, particularly in the west.

Notwithstanding its size and growth record, China cannot act as global locomotive, even if it wished to. A rebound by its economy could help developing-country resources producers and neighbours, such Japan and South Korea, whose growth depends heavily on exports

SUMMARY

Will the current crisis change China's role in the global political economy? China has long been criticised by its partners for unfair trade practices, stealing jobs, running up excessive current account surpluses and manipulating its exchange rate. With the current economic crisis, however, China is no longer viewed as just a source of disruption, but also as an indispensable partner. In this Policy Brief, Guy de Jonquières analyses the main trends in China's economic policy-making and international positioning. He argues that China still has an uncertain commitment to economic rebalancing. Despite its new political assertiveness, it remains ambivalent on exerting leadership in international fora. Yet as China's economic and financial importance continues to expand and world leaders seek global stability, deeper engagement between Beijing and other power centres remains indispensable.

to the mainland. However, the weakness of domestic consumer demand restricts the amount of "pull" that China can exert.

It is still a poor country, with *per caput* income of less than $3,000. On a purchasing power parity basis, that is one eighth the US level and puts China in 97th place worldwide in the International Monetary Fund's rankings. Consumption accounts for barely a third of GDP, a remarkably low figure even for a developing nation, and its share has dwindled steadily for 20 years. Consumer credit, other than for mortgages, is extremely limited. Chinese households have a deeply ingrained savings habit, saving more than a fifth of their disposable income. In uncertain times, they might well choose to salt away, rather than spend, any windfall income.

Beijing has acted to revive growth, which has tumbled to an annual rate of around 6 per cent from almost 12 per cent in 2007. Late last year, it unveiled a stimulus package with a headline value of RMB4,000bn, or almost US$600bn, over two years. At first sight, that looks impressive. But closer inspection reveals less than initially met the eye. Only about a third is estimated to be new money, and it is still unclear exactly how it will be raised and spent.

Meanwhile, monetary policy has been loosened and interest rates cut. But monetary policy in China is a crude instrument, and its impact is limited, because bank lending accounts for less than half of corporate financing. In January, there was a sudden explosion of bank credit. However, little of it appears to have funded productive economic activity. Instead, much went into short-term discount bills, as companies seized the opportunity to arbitrage between interest rate differentials, and into stock market speculation.

Evidence that the stimulus is buoying up the real economy remains fragmentary and tentative. Beijing has nonetheless forecast growth of 8 per cent this year, and it is a fair bet that its official GDP statistics will turn out to be close to that target. That is less because China's leaders possess demonstrably superior economic management skills than because of political necessity. Hitting the target has become a test of their claims to competence and, hence, the popular legitimacy of a regime that has never shrunk from massaging the macro-data when expediency demanded it. In any case, Beijing has said further stimulus measures will be taken, if need be.

China has plenty of fiscal firepower in reserve. Its central budget deficit is 3 per cent – modest by US and European standards. Public borrowing levels are low and creditworthiness sound. Beijing can also lean on large and (apparently) well capitalised state-owned banks to supplement recovery efforts by stepping up lending. So there are grounds for confidence that the economy will at least stabilise in the near-term.

EXPORTS ARE MORE ABOUT CREATING JOBS THAN WEALTH

However potential hazards and pitfalls lie ahead. One is that China's recovery hopes rely to an extent on expanding exports, which have fallen sharply since the end of last year.

Exports, though large, generate relatively little wealth: according to the most reliable estimates, they accounted for roughly a sixth of China's GDP in 2007, while net exports contributed about a fifth of growth. The reason is that many involve labour-intensive assembly of imported components, and generate modest local value-added. Politically, however, exports matter a lot, because they create large numbers of low-skilled jobs. As unemployment rises sharply, the spectre of mass social unrest, the Chinese leadership's perennial nightmare, looms larger.

Boosting exports in the face of contracting world demand will be a tough task, all the more so because China already commands large market shares in many categories of manufactured products. Though it has so far avoided a currency devaluation, which would risk triggering an international spiral of beggar-my-neighbour action, it has taken other measures to support exporters. If effective, they could trigger a protectionist backlash elsewhere. No wonder Beijing is anxiously lecturing other countries on the virtues of open markets, while trying to buy them off with promises of state purchases of commercial aircraft, power stations, luxury cars and other big-ticket items.

The main thrust of China's stimulus is aimed at reviving fixed asset investment, which has been severely curtailed by a crackdown instituted two years ago when the economy was overheating. Physical investment, particularly in construction and property, has long been the mainspring of China's growth, and the severe crackdown, since hastily reversed, is the primary cause of the economic slowdown. The collapse of exports, which has intensified the pain, began later.

China could use more investment in certain types of infrastructure, notably a modern rail network and power grid. However, there is a danger that in their eagerness to pump up the economy, the authorities will open the investment floodgates too wide. The result would be waste and the construction of yet more under-utilised highways, bridges, airports and grand public buildings, of which the country already has more than it needs.

Still worse, a new investment binge could create yet more surplus manufacturing capacity, the output from which could not be absorbed domestically and would be obliged to seek outlets on shrinking global export markets.

That would repeat the flawed formula on which China's growth has been based so far, and which has built up huge distortions in its economy. As well as increasing the immediate risk of frictions with trade partners, more of the same would store up problems for the future, by generating further unsustainable imbalances and structural instability in China's own economy that would hobble its longer-term growth.

China is not doomed to repeat the mistakes of the past. It can avoid doing so – but only by fundamentally re-engineering its development model. That will mean switching the emphasis away from physical investment, particularly in construction and manufacturing, as the main driver of its economy, and relying more on consumption and service industries to power growth.

That is the direction in which China's leaders say they want to move. Indeed, Wen Jiabao, the prime minister, has described China's current growth model as "unbalanced, unco-ordinated and unsustainable". However, changing it will be a formidable task that will require much political firmness and determination.

It will involve, among other things, reducing precautionary household savings by creating properly funded social security, pension and healthcare systems and by improving education; modernising China's backward financial system and capital markets, to enable them to intermediate the country's vast savings more efficiently; and stimulating the expansion of services markets by loosening the grip of the state industries that dominate many of them.

This is a huge undertaking. Building an effective social security infrastructure will take years, perhaps decades, and will involve recruiting and training legions of qualified managers and professionals. Achieving genuine competition in services markets and financial reform on the scale needed will require both a willingness to take on politically influential producer interests and the development of effective regulation.

A STILL UNCERTAIN COMMITMENT TO ECONOMIC RE-BALANCING

Whether China's leaders possess the commitment needed to meet those challenges remains an open question. Although spending on social services has been rising sharply, it remains modest in relation to what is needed. Opening up monopoly services markets and accelerating financial reforms are low down, if not entirely off, the agenda.

Why is Beijing so cautious? One reason is that it is no longer ruled by one or two strong men, as it was under Deng Xiaoping and Zhu Rongji, but by a collective leadership riddled with factions. Some want to press ahead with reforms designed to increase economic efficiency; for others, led by Messrs. Hu and Wen, populist income redistribution is the priority. Given such divergent goals, preserving unity makes muddy compromises and trade-offs inevitable.

Despite their differences, China's leaders are bound together by one common imperative: maintaining their grip on power; and in a crisis, they will do whatever they judge necessary to achieve that goal, above everything else.

That does not necessarily spell confrontation with the rest of the world – though renewed conflicts over trade and currency issues may be hard to avoid. China's leaders value stability, both domestically and internationally – particularly in relations with the US and with regional neighbours. The country has gained greatly from open global markets. It will not jeopardise those benefits needlessly. However, its actions and policies are governed, first and foremost, by priorities and challenges close to home.

Given China's developing-country status, and the scale and complexity of its economy, its leaders' fixation on domestic concerns is understandable. Like the US in the 19th century, its conduct on the international stage has been determined, not by any clearly discernible long-term geopolitical strategy, but by opportunism and the dictates of its continued economic and industrial development.

Its foreign policy, particularly its increasingly active deployment of "soft" power and its growing trade and investment links with resource-rich developing countries, has been driven largely by economic need. China's decision to join the World Trade Organisation was also taken primarily for domestic reasons: to tie its own hands and prevent backsliding on economic reforms, rather than to obtain more secure access to others' markets – though the latter obviously counted for something.

That task accomplished, China, like many other countries, has turned increasingly to bilateral diplomacy to manage trade relations and promote liberalisation. Contrary to fears expressed by some a few years ago, it has not proven a disruptive force in the WTO – though it shares responsibility for precipitating the breakdown of the Doha talks last summer by digging in its heels over agricultural safeguards.

However, that incident, and the circumstances that prompted it, conforms to China's pattern of behaviour in other multilateral organisations. Its long-standing policy has been to keep its head down and raise its voice only when its most vital and sensitive national interests are at stake. For most of the time, it has been content to leave others to make the running.

Some China scholars argue that this preference for a pragmatic, low-profile, approach has deep historical roots. Orville Schell, director of US-China relations at the Asia Society, traces it back to principles set out in The Seven Military Strategies, a series of texts on warfare written more than 2,500 years ago. These counsel victorious strategies based on patience, stealth and even subterfuge. Likewise, Deng Xiaoping, China's supreme leader, urged his compatriots in the 1980s to "observe developments soberly, maintain our position, meet challenges calmly, hide our capacities, bide our time, remain free of ambitions and never claim leadership."

China responded to the outbreak of the current economic crisis by adopting a studiously detached and noncommital posture. It has repeatedly argued that the west created the financial mess and should take responsibility for cleaning it up. The main contribution China could make, it insisted, was to keep its own economy stable and growing, as it did after Asia's 1997 financial meltdown, while quietly supporting efforts at international co-operation initiated by others.

However, recent events have made it harder to continue taking a backseat "follower" role in global financial and economic policy-making, while also providing China with new opportunities to make its views heard. The most striking evidence is the call shortly before the G20 London summit by Zhou Xiaochuan, governor of the People's Bank of China, for the gradual replacement of the US dollar as a reserve currency by IMF Special Drawing Rights.

NEW ASSERTIVENESS, OLD DEFENSIVENESS

Mr Zhou's proposal has been widely interpreted as a sign of a new and uncharacteristic assertiveness by Beijing. Rarely has it articulated demands so clearly and openly, and never before in the form of such a carefully crafted proposal for international negotiation and co-ordinated action. At last, it seemed, China was starting, in a measured way, to flex its diplomatic muscle on a scale commensurate with its economic weight.

That is undoubtedly true. However, Mr Zhou's *démarche* can also be interpreted in a different light. Rather than a bold attempt to set the agenda for global financial reform, it was a tacit admission of Chinese frustration at its continuing subservience to US economic and monetary dominance and was directed at least partly at impressing a domestic audience increasingly impatient for change.

Certainly, the proposal falls some way short of a realistic and actionable blueprint, as Mr Zhou himself is undoubtedly well aware. Not only would it have to overcome US resistance; it is, at best, a very long-term proposition, not least because it implies substantial progress towards full convertibility of the renminbi, which remains a remote prospect.

If it was intended as a warning shot across America's bows, its effectiveness is equally questionable. Any attempt to pressure Washington by threatening to diversify out of dollars on a large scale would be likely to produce the very result that Beijing is most anxious to avoid: a collapse in the value of the US currency and a sharp rise in US interest rates that would send the economy into a still deeper tailspin.

Thus China is caught in a dilemma. To a great extent, it is one of its own making. By choosing to link the renminbi exchange rate closely to that of the dollar – a decision that domestic politics makes hard to reverse – it has largely surrendered control of national monetary policy to the US Federal Reserve, which has no remit to take China's interests into account. Equally problematically, from China's perspective, the bulk of its foreign exchange reserves is held in US dollars, over the purchasing power of which Beijing has only indirect influence.

China's concern about the fate of the reserves is some-what irrational. From the perspective of its domestic economy, they are largely "dead" money, the inevitable product of the country's tendency to save more than it spends or invests in its own economy. To be used productively at home, they would have first to be converted into renminbi, propelling its exchange rate sharply upwards and squeezing more of China's troubled export industries.

Nonetheless, the reserves' fate is an increasingly sensitive and emotive issue for the Chinese public, much of which regards them as an emblem of national pride and prestige and the hard-earned reward for the country's labour. When China Investment Corporation, the sovereign wealth fund, made a series of disastrously ill-judged investments in US financial institutions last year, it was widely vilified at home for recklessly squandering the nation's wealth.

Indeed, for a growing section of public opinion, the reserves have become a touchstone of China's place in the world. Many Chinese are eager for their country to become fully master of its own destiny and resent externally-imposed constraints on its freedom of action – even when they are more imagined than real. The national mood has recently been caught by "Currency Wars", a book that purports to expose a sinister conspiracy by foreign bankers to manipulate international finance at China's expense. It became an instant best-seller and is said to have been widely read by top Chinese officials and businessesmen.

AN AMBIVALENCE TOWARDS THE WORLD

The Chinese have no monopoly over paranoid fantasies about scheming foreign powers: Beijing's shrillest US critics are prone to similar feverish imaginings. However, China's ambivalence about its international role runs deep. It will have been evident to anyone who watched last year's Beijing Olympics ceremonies. These displayed at the same time the brimming self-confidence of a nation on the move, and a curiously insecure yearning for validation and endorsement by the rest of the world.

Formidably monolithic as the country may appear from the outside, it vacillates internally between robust affirmation of its own importance and a lingering sense of national victimhood and vulnerability. Those contradictory impulses – and the continuing need to devote attention to pressing challenges at home – mean China is still a long way from being ready to act as a fully-fledged superpower and embrace wider global responsibilities that match its economic weight.

True global leadership requires a capacity to articulate and promote a concept of the common good that goes beyond immediate and, in China's case, often crudely materialistic national interests. Beijing is many years, perhaps decades, away from being able to take such a broad view with self-assurance. Its political mindset, though continuing to evolve, is still adjusting to the consequences of the country's rapid integration with the global economy. As long as that gap remains, China is likely to be an unpredictable and sometimes awkward partner. The most, perhaps, that other countries should realistically expect is that China will not rock the boat too much – not that it will propel it vigorously forward.

Yet as China's economic and financial importance continues to expand, so, inexorably, will its inter-action with the rest of the world. The impact will be felt as much inside China as outside it, as its rulers are increasingly obliged to cope with the intrusion of external factors that impinge directly on domestic concerns. If global stability – that condition so highly prized by the Middle Kingdom – is to be maintained, deeper engagement between Beijing and foreign power centres will be not merely desirable, but unavoidable.

Mr Zhou's currency proposal may be best seen as an early recognition of that trend. It deserves to be taken seriously, not so much because of its technical details, but as a signal that China's national self-interest and the logic of its own development are impelling the country increasingly to look outward and, albeit gingerly, to seek a more prominent place on the international diplomatic stage. That process looks set to continue in the years to come. How it is managed will be a test of maturity, statesmanship and resourcefulness – in Beijing and in other capitals around the world.

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