Introduction

This study seeks to explain China's economic policy during the global financial crisis of 2008–09 and to analyze the challenges China's leadership faces in sustaining growth over the medium term. China's policymakers responded strongly to the global financial crisis. They launched a major economic stimulus program that largely offset the negative effect on the Chinese economy of a sharp slowdown in global trade. While China's growth in 2009 did slow compared with the trend of prior years, the slowdown was quite modest, especially when compared with the absolute shrinkage in global output. A central thesis of this study, however, is that the policy mix that brought China so well through the biggest global financial and economic crisis in several decades will be less successful going forward.

Chapter 1 provides an overview of the policy response to the global financial crisis and a more detailed analysis of the criticisms that have been made of this program by both external and Chinese observers. Among the most important conclusions is that the stimulus program did not advantage state-owned companies at the expense of private firms and, more importantly, did not alter the long-term trend of China's reform, in which private firms have increasingly become the most important driver of economic growth. Of particular note, the chapter shows that, contrary to the often repeated assertion, bank loans in 2009–10 did not flow primarily to state-owned companies and that the access of both private firms and household businesses to bank credit improved considerably.

While the stimulus program was successful in sustaining China's economic growth during the global crisis, it was not intended to address the longer-term structural problems that led China's premier, Wen Jiabao, to characterize China's growth as early as 2007 as "unsteady, imbalanced, uncoordinated, and unsustainable" (Wen Jiabao 2007). Chapter 2 lays out the nature of the economic imbalances that emerged after the early 2000s, notably China's heavy reliance on investment and exports to generate growth; the decline in household disposable income as a share of GDP; the relatively low and still declining share of consumption in GDP; the reemergence of a relatively outsized manufacturing sector and a correspondingly underdeveloped services sector; and a sharp increase in the national savings-investment imbalance, reflected in the emergence of an unusually large external surplus.

Chapter 3 examines the policy options that are available to the government to address these various imbalances and assesses the progress to date and prospects in each of the policy domains. Several broad conclusions emerge. First, among options available to Chinese policymakers to achieve their rebalancing objectives, further fundamental reform of the financial system is central. Over the past decade several indicators—negative real interest rates on household savings, an increasingly elevated required reserve ratio (the share of deposits that commercial banks must place at the central bank), the emergence of a significant informal credit market, a sharp decline in the share of government bonds held by the public—all suggest that China's financial system has become more repressed. The negative real interest rate on savings that emerged since 2003 has suppressed the growth of household income below the level it would have achieved had the government not abandoned its policy of interest rate liberalization after 2004. Negative real deposit rates, in turn, appear to have led to an increase in the household saving rate and simultaneously led households to allocate a rising share of these savings to real estate, where real returns have become much more favorable over time relative to bank deposits. Resuming the policy of gradual interest rate liberalization, which was largely abandoned in 2004, is a prerequisite to rebalancing and sustaining China's rapid economic growth.

Chapter 3 also explores the relationship between negative real deposit rates and other dimensions of financial repression that emerged after 2003, on the one hand, and the government's policy of keeping the exchange rate of the renminbi undervalued, on the other hand. The central bank has kept the currency undervalued by intervening massively in the foreign exchange market, ultimately buying up more than $3 trillion in foreign exchange. To prevent the resulting expansion of the domestic money supply from leading to high inflation the central bank has engaged in large-scale and sustained sterilization operations. It accomplished this by raising the required reserve ratio to an extremely high level and issuing large quantities of central bank bills to China's commercial banks. The chapter explains how the central bank has controlled interest rates in order to hold down the costs of these sterilization operations and why a more flexible exchange rate is an important prerequisite for liberalizing interest rates.

In addition to allowing the market to play a greater role in determining the value of the renminbi and liberalizing interest rates, the government should simultaneously continue to build a stronger social safety net to facilitate a reduction in the household saving rate and undertake long-promised fundamental reforms of factor prices, not only for capital but also for water, electricity, and fuels. Chapter 3 also examines the possibility that the widely noted increase in real wages in the past few years could simultaneously raise both the share of wages in GDP, thus boosting consumption as a source of growth, and production costs relative to China's trading partners, thus reducing China's external surplus. While real wages have been rising rapidly for many years, the growth of labor productivity in the tradable goods sector has been just as rapid. Thus relative to its trading partners China's unit labor costs apparently are not increasing, so that endogenous rebalancing through rising real wages is not yet underway.

Chapter 4 addresses the international implications of a rebalancing of China's growth. China and the United States were the principal sources of the large global economic imbalances that emerged in the decade leading up to the financial crisis. The interaction of these imbalances with weak financial regulation and credit market distortions in many advanced economies, along with the loose monetary policy stance of the US Federal Reserve, led to the global financial crisis. China has been a key participant in the Group of Twenty process that has led to the adoption of a set of indicative guidelines to address persistently large external imbalances in order to achieve strong and sustainable global economic growth. Thus there now appears to be an alignment between China's stated national and international economic policy objectives.

Despite this alignment of national and international objectives, it is far from clear that China will embark on the concerted and sustained effort needed to remove the underlying distortions that stand in the way of the economic rebalancing necessary to sustain economic growth in the current global environment. These distortions include financial repression, an undervalued exchange rate, and subsidized factors of production. Chapter 5 explores how the beneficiaries of imbalanced growth—including export and import competing industries (which have enjoyed elevated profits at the expense of firms in the services sector), coastal provinces (which have enjoyed supercharged economic growth at the expense of inland regions less able to tap into the growth generated by trade expansion), the real estate and construction industries (which have benefited from interest rate policies that have made residential property a preferred asset class), and China's commercial banks (which enjoy lofty profits that come with high spreads between deposit and lending rates generated by the central bank's interest rate policy)—have acquired a disproportionate influence over economic policy and to date have been able to block most needed policy reforms. China's National People's Congress in the spring of 2011 reflected a renewed emphasis on the policies necessary for rebalancing, and most of these policies were enshrined as well in the 12th Five-Year Plan (2011–15), which was made public shortly after the Congress adjourned. Whether or not this renewed emphasis on policies intended to rebalance China's economy will be enough to overcome the existing domestic political constraints to further economic reform has yet to be seen.