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What Doesn't Kill You Makes You Stronger: China and the Global Financial Crisis

Malcolm Manson

ABSTRACT

The financial crisis of 2008 has caused serious problems around the world. Recent developments indicate that China has and will be affected. However, if China acts quickly and effectively, it may be able to come out of the crisis stronger than before. The Chinese strategy to combat these effects is to attempt to boost domestic demand through an economic stimulus package. This paper highlights some of the weaknesses of the Chinese economy that will be amplified by the crisis. Specifically, the underdevelopment of its financial system, social security system, and the size of its saving rate will play a role in the way that China is affected by the crisis. In addition, it also makes recommendations on how to lessen the impacts of the financial crisis. Recommendations include improving the current financial and social security systems, a campaign to educate rural citizens, rural business incentives, and increasing the financial stimulus package.

INTRODUCTION

The current global financial crisis has seemingly only just begun to affect the world economy. American and European financial institutions have crumbled, there have been massive job losses, and world economic growth has slowed significantly (BBC News, 2008a). Over the last six months, the United States has lost 1.55 million jobs (BBC News, 2008b). Shocks are hitting the economies around the world, and some have been much worse than expected. This essay addresses the effects of the financial crisis on China and recommends ways that China can lessen its impact.

China is not expected to enter a recession, but its economy is expected to slow its growth significantly. It is estimated that 10 million migrant workers had lost their jobs due to the crisis in November (Anderlini, 2008a). The Royal Bank of Scotland estimates that China's growth could be as low as five per cent (Anderlini, 2008b). The World Bank estimates China's economic growth rate for 2009 will be 7.5 per cent. The Gross Domestic Product (GDP) growth rate estimated to allow new Chinese graduates to obtain jobs is estimated to be eight per cent (Rachman, 2008). Both of the mentioned estimates are lower than eight per cent, and if either is accurate the effect on the Chinese economy will be very damaging. However, China is implementing an economic stimulus package in an attempt to counter these effects.

This financial crisis has the potential to vastly change the Chinese economy. On one hand, social unrest caused by unemployment could cause serious problems for the entire country. On the other, the crisis may act as a catalyst which, in the long-run, may make China an even more formidable economic force than before. In any event, China should be prepared for the worst.

BRIEF ECONOMIC HISTORY AND THE URBAN-RURAL DIVIDE

China has a gigantic population, estimated in July 2008 to be 1.33 billion. It has a Gini coefficient of 47 (Central Intelligence Agency, 2008). Before Mao Zedong's death, China had a planned economy (Zhao Z., 2008a). The planned economy had many negative effects on China, of which the most important for this essay is the exacerbation of an urban-rural divide in Chinese society. One of the reasons for this divide was the hukou (residence permit) system.

¹ I want to acknowledge Allen, J. Qian, and M. Qian for previous recommendations (in 2007) on improving the Chinese financial system. Some of their recommendations were relevant to the situation today and were incorporated into this paper.

There are essentially two types of hukou: urban hukou and rural hukou. The type of hukou determined where one could work and a child's parents determined what type of hukou the child would have. This created immobility in the population; farmers could not move to the cities, which had better living conditions than the countryside (Zhao Z., 2008b). In 2006, about 577 million people lived in urban areas, while 737 million lived in the rural areas. The urban population includes migrant workers with rural hukou (National Bureau of Statistics China, 2007).

The late Deng Xiaoping succeeded Mao, and in 1978 started to implement economic reforms aimed at changing China's planned economy into a market economy. The reforms have been slow and cautious. This allowed the Chinese to experiment with new economic policies. Areas were converted into Special Economic Zones (SEZs), and if the new policies were beneficial, they would become permanent. This resulted in less harmful consequences should a new economic policy fail. One of the results of Deng's reforms was to drastically reduce the instances of poverty in China. However, the reforms have not solved the problem of urban-rural division (Ray, 2002). That being said, hukou is not nearly as important as it was during the communist era. Many people from the countryside have migrated to the cities. This allows them to earn more money for themselves and their families. They send much of their earnings back to the countryside, which improves the household incomes in the rural communities. This process is called remittance and is important for the modernization of rural China (Luo & Zhu, 2008).

THE FINANCIAL CRISIS: CHINA'S STIMULUS STRATEGY

As mentioned before, China is a major exporting nation and has so far suffered a concerning drop in exports. China had anticipated this problem, and its response has been to plan a four trillion renminbi (RMB; US\$586 billion) economic stimulus package, in addition to lowering taxes and easing credit. The stimulus package is to be spent on low-income housing, infrastructure, environment protection, research and development, and disaster relief. 400 billion RMB is to be spent by the end of the fourth quarter of 2008. The goal of this package is to boost domestic demand (Xinhua News, 2008a). This would essentially lead to jobs in those areas mentioned previously replacing jobs lost in export industries. In addition, some extra goods that could not be exported could also be used to supply the stimulus-funded jobs.

ANALYSIS

Weaknesses of China before September 2008

There are several important problems worth mentioning that relate to the outcome of the Chinese strategy. Specifically, these consist of the Chinese financial systems, the Chinese social security systems and the Chinese savings rate.

Financial systems. China's financial systems are much weaker and inefficient than their Western counterparts. There are four main majority state-owned banks in China: Bank of China, China Construction Bank, Agricultural Bank of China and Industrial Commercial Bank of China. Chinese banks have a relatively high amount of non-performing loans (NPLs), which could lead to serious problems in the future. In fact, Allen, J. Qian, and M. Qian surmise that the number of NPLs may be much higher than the information made available by the banks and government (2007). In addition, the stock markets of China are inefficient. This is due in part to inadequate regulation of the listed firms. Additionally, the process that firms must undertake to become listed gives former state-owned enterprises (SOEs) an advantage, as these firms have better connections with government officials. This process results in an inefficient selection process for listed companies in Chinese stock markets (Allen et al., 2007).

² Disaster relief is mainly for assisting victims and rebuilding infrastructure in Sichuan province, which had a major earthquake in 2008..

Social security. China's current social security system is very underdeveloped. The vast majority of employees who are effectively covered under old age, disability, survivor, medical, maternity and unemployment insurance are urban workers. In most cases, employers and employees both contribute to pension accounts. The government may bail out or subsidize accounts if needed (International Social Security Association, 2006). However, the government has recently created a National Social Security Fund, which aims to improve social security. It is financed through the privatization of SOEs, government funding, and money earned through investment (National Council for Social Security Fund, 2005). As one can see, there is a serious deficiency in rural citizen social security.

The savings rate. The Chinese savings rate is quite high: estimated at around 40 per cent in 2004 (World Bank, 2005). The underdeveloped social security system and financial systems are contributing factors to this (Maps of the World Finance, 2008). I spoke with a young man by the name of Zeng Luyou with a rural hukou from Fujian province. Fujian province has developed faster than other provinces in China, and many of the rural citizens of this province are richer than other rural citizens in China. They are even able to afford cars with their income. Some migrant workers also choose to move to richer rural areas rather than cities because the prospects are better. However, Zeng said his family was poorer than many of the other rural citizens in Fujian. Their savings were stored in their home, and there was a substantial amount considering his father's income. The money was necessary to compensate for lack of social security. In addition, his family had to save to send him to school in Beijing. The bank is a 40-minute-drive away, but they still chose to keep the money in their home. One of the reasons he gave me for this was his parents' lack of knowledge regarding investments. In addition, we talked about some Chinese traditions relevant to the savings rate. In his case, his family needed to save to cover medical expenses and to assist other family members if need be. Essentially, the only investments that these poor families make are in their children. When the child's parents become too old to work, the child must take care of them. This is a major difference from Western culture, where we have pensions or hospitals for the elderly. He told me that there were three different groups of households. The first group consisted of the poorest rural families. Their savings are to ensure medical security and to invest in their children if possible. The second group consisted of richer families, whose elders lacked higher education. These families also saved a significant amount of money. This money was for their children's education, cars, and other luxury goods. In addition, some families have a tradition of buying their children a new home when they graduate. The third group consisted of richer families with high education. These families were not as traditional as the second group, and Zeng said that they would probably not buy them a house upon graduation. They had much more of an individualist identity, rather than a collectivist one. The third group would fall more into the urban population of China (2008). The way the first two groups save is not helpful to the Chinese economy. Storing money in their homes when it could be put to better use lowers the economic potential of these people.

New Problems

As a result of the financial crisis, there are several new problems that are beginning to manifest themselves or have been predicted to occur in the Chinese economy. Specifically, there has been a significant drop in exports and there is a possibility that deflation will occur.

Loss of exports and resulting unemployment. China has seen its exports fall by 2.2 per cent in November 2008, down from a growth of 19.1 per cent in October 2008 (BBC News, 2008c). This decline in exports is extremely concerning to the Chinese government, as the Chinese economy is mainly based on exports. As economic difficulties hit China's major trade partners, exports may continue to fall and have a serious effect on China's GDP growth. In turn, this would affect the Chinese unemployment rate. The consequences of a large rise in unemployment are very dire. Millions of migrant workers send remittances to their families, who in turn use the remittances to support themselves. In addition, the money earned by migrant workers may be used to support investments, either in agricultural or non-agricultural products. A decline in remittances and earnings for return-migrant workers may have the effect of stunting the already slow modernization of the countryside.

Some return-migrants may also use skills acquired from their migration to become entrepreneurs (Zhao Y., 2002). I asked a student from Chongqing who is studying in Beijing about this, and she gave me a story about her cousin from the countryside. He went to the city to work at a barbershop. After he had made enough money and learned the art, he returned to the countryside. He opened a barbershop in his town and, according to her, was very successful (Chang, 2008). It would be unfortunate if the loss of jobs hampered rural entrepreneurs from starting businesses.

Additionally, an increase in unemployment could cause social unrest. In fact, China has already had protests by workers who have been laid off (Anderlini, 2008a). Migrants are also starting to return to their homes in the countryside (Xinhua News, 2008b). As mentioned before, it is estimated that China needs a growth rate of eight per cent to ensure that new additions to the labor force have jobs. There are about 1.5 million unemployed job-searching students right now (Anderlini, 2008a). If that number, along with the number of unemployed migrant workers, increases drastically there could be widespread protests. The fact that many students and workers migrate will make this a nation-wide problem. Students with rural hukou only have a certain amount of time to find a good job after they graduate. If they cannot find one, they must return to the countryside (Zhao Z., 2008b).

Deflation. Recently, there have been predictions that China may enter a period of deflation. This would primarily be because the fall in exports would lead to an excess of goods, which Chinese businesses would want to sell in their domestic market (Anderlini & Dyer, 2008). In fact, the Consumer Price Index (CPI) and Producer Price Index (PPI) have fallen from the period between June and November 2008 (National Bureau of Statistics China, 2008b). Appendix I shows these drops. While these indices are still higher than they were in the past year, it is a disturbing trend. Deflation is most dangerous when there is a quick drop in demand and extra goods on the market, all of which are relevant in China. Consumer expectations of increasing drops in the price level could further decrease demand (*The Economist*). Considering the current savings rate, it is difficult to imagine that savings could become much higher. It may increase more in urban areas, where income and demand for goods are higher. Lack of education may also ease this problem in the countryside. Interest rates have also been cut to 5.31 per cent (Anderlini, 2008b), which may also counter other negative effects of deflation. Deflation will probably affect urban areas more than rural ones, given that there is greater education and greater demand for goods in urban regions.

RECOMMENDATIONS

The Chinese government is taking steps in the right direction. Boosting domestic demand is the best way to save their growth rate. However, the forecasted growth rates for 2009 are likely to be insufficient and may cause political problems. Essentially, China is just replacing lost jobs with new ones and buying up some of the excess goods. Replaced jobs do not mean that more shoes or toys will be bought in China. Additionally, these jobs are only temporary; after these projects are finished, they will need to be replaced again. Exports may have recovered by this time, but there is no certainty that in two years everything will be as it was before. China needs to act fast, and do more than just tackle unemployment. The high savings rate presents an opportunity to do this. Although a significant reduction in the savings rate may not be possible, a change in the way money is saved in rural areas will help to increase domestic demand. In fact, boosting domestic demand in a sustainable way may allow China to come out of this financial crisis even stronger than it was before. However, there are many changes that need to be made in order for this strength to be realized. Quick, effective reform in the financial and social security systems is of the utmost importance in order to prevent economic catastrophe.

Financial Systems

Allen, J. Qian and M. Qian feel that the one of the ways to solve the problem of NPLs in the banking system would be for the government to privatize the banks. In addition, allowing entrance of more domestic and foreign banks would also be beneficial. These changes would lead to greater efficiency and competition, which would force banks to reduce their NPLs. Given the seriousness of China's economic situation, the government should, as much as safely possible, further privatize the banks in the short-run to ensure better management.

However, they must first ensure that there is better transparency regarding the banks' financial systems. As mentioned before, the official number of NPLs owned by these banks is the subject of skepticism.

Allen, Qian and Qian also give recommendations for reforming the Chinese stock markets. Key suggestions include better government regulation and easing the process with which non-former SOEs are listed. This would decrease the risks involved in current investments and allow for more efficient firms to become listed (Allen et al., 2008).

Social Security

With improved financial systems, China can begin to create a more effective social security system. The lack of development in social security is one of the reasons for high savings in rural areas. Indeed, rural social security essentially comes from farmers' children and whatever amount retirees may have saved. Addressing this problem is a major challenge, considering the size of the rural population. It is the sheer size of the population that makes China's ability to implement a social security system at the same level as Canada's highly improbable.

However, the Chinese government should start to develop a better social security system that targets rural citizens. This would allow insurance organizations to invest more money and further increase domestic demand. As Zeng mentioned to me, one problem with implementing such a system is the rural population's lack of education regarding social security. Rural citizens may not be willing to invest their money in social security, as they will not see the full benefits. Education is the key to solving this problem, and is discussed in the next section. Another problem is the actual value of the savings of the rural citizens. Initially, it may not be enough to adequately fund old age and medical insurance pensions for every person. The government may need to subsidize these funds. However, as the countryside modernizes, the government may be able to phase out these subsidies as the funds become more sustainable. A decision must be made regarding the ownership of the pension organization(s): either state-owned, domestic, foreign or some combination. Presently, foreign investment in insurance is on China's list of "restricted foreign investment industries" (Investment Promotion Agency of Ministry of Commerce, 2007). China could benefit from an import of foreign expertise (even though a cynic might say that foreign expertise seems to have caused its problems in the first place). However, given the current investment climate, investment may not be appealing to foreign parties. The fact that investment is restricted will also deter foreign investment. The risk and restriction may be too great a problem, and China should consider revising restricted industry laws and economic policies to encourage foreign investors. On the other hand, if China chooses state ownership, the risk of lost pensions may not be as great. Major problems that may occur in this case are corruption and suboptimal investment decisions. Multiple domestic firms with government incentive plans may be more efficient, but the risk of default may also be higher. Corruption and suboptimal investment decisions may also pose problems in this case. Critical government regulation must take place in any of the mentioned alternatives.

Administration would need to take place at the town-level to ensure that rural citizens have adequate access to their funds. Transactions should occur at banks at the town-levels, and any organization should ensure that is sufficiently integrated within the banks.

In any case, the Chinese government must decide whether to encourage foreign investment or pursue a domestically-owned organization. The Chinese government needs to carefully plan its strategy to avoid problems in the future. Prudent analysis will be needed to determine the actual coverage, as welfare conditions vary significantly over China.

Education

Government education will be very important in ensuring that Chinese citizens are willing to participate in social security. The government may want to hire new graduates to speak face-to-face with the rural folk. Explaining to them, in a clear and honest way, the benefits of social security will make participation in the program more likely. This method has an additional bonus of temporarily employing job-seeking students. From personal experience, it seems to me that many of the people of China have inherent respect for the Communist Party. Their influence will be a major asset to this project. In addition, education during this period should also cover investments, such as productivity-boosting agricultural equipment, that may be available to farmers.

Incentives

It is critical that the government plays a role in the development of pension and insurance funds. If the government decides to take a more passive approach to social security, incentives should be put in place to make domestic and/or foreign investment in the industry more attractive. Tax breaks should be considered where possible. It may be better to avoid subsidizing new organizations, since this may lead to suboptimal investment decisions. However, subsidies are also something that should be considered in specific cases.

Incentives should also be given to certain entrepreneurial ventures in rural communities and to skilled labour who work in the countryside. This would help to increase the rate at which the countryside is modernized, which in turn should help raise living standards and increase demand in rural areas.

Subsidy incentives for any industry in response to the financial crisis also will need to ensure that they comply with World Trade Organization (WTO) law, as China is a member of the WTO.

Increasing Expenditures on Infrastructure

In addition to the above recommendations, China should strengthen its stimulus package further. The stimulus plan was created before the new data on lost exports was released, and thus probably did not take it into account. Replacing the jobs lost by migrant workers is essential in the short-term to avoid social unrest. However, China should ensure that any additional investments included in a larger stimulus package are beneficial to its people, especially the rural group.

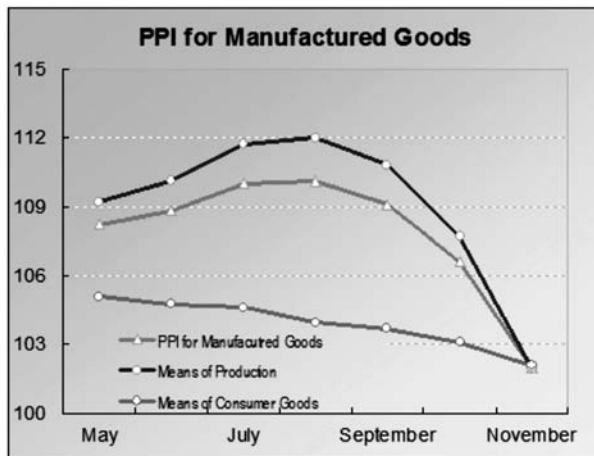
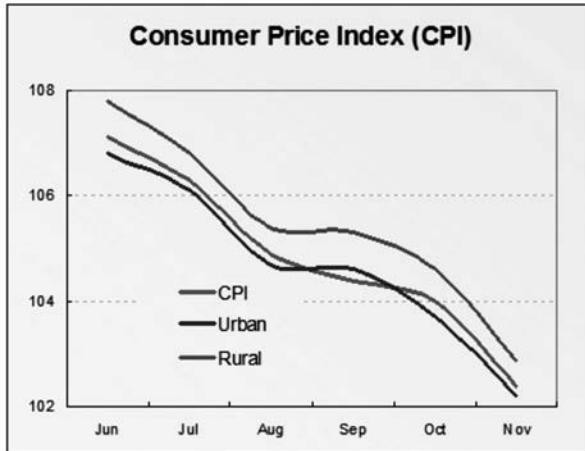
Other Thoughts

The tradition of buying a house for one's child upon graduation contributes to a high savings rate in China. While it is not my place to challenge tradition in a foreign culture, I will objectively state that individualism may be more beneficial to the Chinese economy than collectivism in this case. Buying a house requires a considerable sum of money, and if these savings were freed up it would help to further boost domestic demand.

CONCLUSIONS

Altering the way that money is saved, and attempting to decrease the savings rate in the countryside will help boost domestic demand by freeing up more funds for investment. In addition, rural citizens will be able to enjoy a better standard of living with less uncertainty. The process will help to modernize the countryside and this may help create a better domestic market. An increase in domestic demand will also lessen the effects of the imminent deflation. These recommendations may seem somewhat ambitious, but the Chinese government needs to act fast to reduce the threat of dangerous social unrest. Supplementing of the current stimulus package with the previous recommendations may be one way to accomplish this. However, the speed of these implementations are critical. At the same time, extreme caution must be taken in order to effectively implement them. Reforms also need to occur with a degree of simultaneity. It will be a delicate balancing act, as whatever actions taken to soften the impact of the financial crisis will surely affect China in the long-term. If China can keep its economic growth at a sustainable level, it may be able to come out of the crisis stronger and better developed than ever before.

Appendix I: CPI and PPI Indices between June and November 2008



Source: National Bureau of Statistics China

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