ISPI Analysis
ISTITUTO PER GLI STUDI DI POLITICA INTERNAZIONALE

Simone Disegni

China's rise and the global economic downturn: threat to steady growth or opportunity to rebalance?

No. 107 – APRIL 2012

Abstract

Deeply involved within the highly interconnected flows of today's global economy, China has not been spared by the financial melt-down spreading from the US since late 2007, witnessing in particular a dramatic short-term drop in its export capacity, which has caused painful business shutdowns and job losses. Migrant workers and young graduates have been hit with particular severity.

Whereas Beijing's government has managed to contain the direst effects of the crisis by launching a huge stimulus plan in 2009, the global downturn seems to have taught China some hard lessons: not only is its export-led development model less and less sustainable, but internal inequalities between different regions and parts of population risk engendering serious social tensions in the face of economic slowdowns or price surges.

In the persistently weak global environment, the only credible solution to avoid both dangers – this analysis argues – is for China to shift towards a more balanced growth pattern, by sustaining domestic demand, expanding the social safety net and tackling unjustified internal inequalities.

Simone Disegni is a young graduate student at ULB, specializing at the Insitute for European Studies and Member of Writing Team and Project Manager at ThinkYoung, a Brussels-based advocacy group.

Growing at an average rate of almost 10% over the last three decades, China has staged over this period the most impressive resurgence of a single country in modern history. It has recently overtaken Japan as the second largest world economy, and is doomed to surpass the US themselves soon, perhaps within no more than a decade. If by all forecasts the 21st century will be regarded as "the age of Asia"[1], in sum, counting on the largest demographic basis in the world and a strong national determination to translate that fact into widespread economic well-being, the PRC (Popular Republic of China) looks clearly bound to lead such Eastern *revanche*. Deeply involved within the highly interconnected flows of today's global economy – particularly after its accession to the WTO in 2001 – China can however not ignore, let alone celebrate, the troubles that have affected Western economies in recent years.

If the EU is stuck into a painful sovereign debt crisis, and the US struggle to find the path of recovery, however, how has exactly the international financial crisis affected China since its eruption in late 2007? To what extent has its production suffered, its growth slowed, its trade vitality contracted? Has the crisis left deep signs that will complicate the country's rise on the medium term, or is China set on a healthy recovery? Besides the macroeconomic picture, finally, how has the global downturn affected the Chinese society? What has been its impact on inequalities within the country, and how has it reverberated on employment dynamics? Understanding these and other factors appears indeed of fundamental interest not just in a vein of intellectual curiosity towards the destinies of such a fascinating country, but most importantly considering the place that China already occupies within the international system: the second largest economy after the US, China has established itself as the first single world exporter and the second largest importer of goods, while its Cen-

[1] See among others F.A. GUNDER, *ReOrient: global economy in the Asian Age*, Berkeley, 1998.

tral Bank is holding the largest foreign exchange reserves (up to $3.2 trillions) and about 8% of American publicly held debt[2]. Whether China's rise will be steady and sustainable or weaker and troubled in the coming years, in this light, will indeed have a significant impact on the development of the world's economy, and of international relations. This analysis seeks to provide indications to answer such questions: while on the one hand we shall examine the extent to which the crisis has endangered the "engine" of Chinese growth – in the macroeconomic environment, in a first part; on Chinese society, in a second one – we shall also highlight on the other hand the "constructive" effect that the slowdown may have ironically produced, teaching China's leadership useful lessons on the direction to impress and the dangers to avoid in their country's development trajectory.

Keeping the giant growing

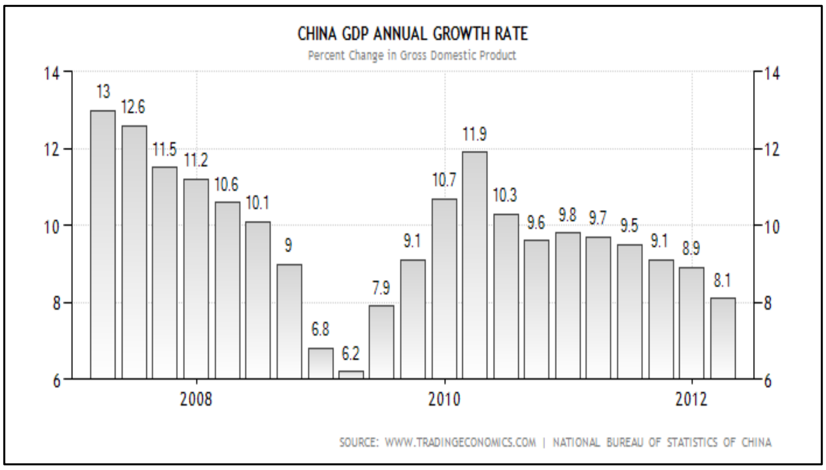
Since the historic turn to capitalism in 1978 and the consolidation of a market-based economy in the following decade, Chinese leaders have made a clear bet towards the long-term development path of their country: mobilizing domestic capitals and opening up the economy to foreign ones while enhancing the productivity of its vast labour force and keeping related costs, including wages, at record lows. Through such policy China has been able to attract an ever-growing amount of Foreign direct investments (FDIs) from companies seeking to improve their competitiveness, axing its growth path on a strong export capacity and literally turning into "the world's factory", particularly for low added-value products in fields such as the textile, electronic equipment or manufacturing industries. Precisely that key ingredient in Beijing's growth recipe has revealed to be however a source of serious troubles after the eruption of the financial crisis in the US and its spreading to the world between 2007-2009. In the short term, China has indeed suffered bitterly: as global demand dropped throughout 2008, exports slumped, causing up to 670,000 businesses to shut down and up to 10 millions jobs to be lost according to official estimates. In the first quarter of 2009, exports tumbled by 17% on an annual basis, while domestic demand and investment also contracted significantly. Manufacturing growth thus slowed sensibly, while prices dropped from a "hot" inflationary rate of over 8% to -2% deflation within a year (see table 1).

By spring 2009, overall, Chinese economy thus registered a sharp slowdown, falling from the peak high of 13% in early 2007 to a "modest" 6,2% growth rate (see table 2) – although some observers highlighted how the contraction had partly begun earlier for endogenous reasons, notably government efforts to prevent overheating through credit tightening[3]. A fundamental ring in the world economy's chain of production and trading flows, China was in sum not spared from the painful consequences of the US-born financial turmoil. Its authorities sensed indeed the danger that the downturn could hinder the country's long-term rise and intervened boldly to invert the trend.

Table 1 - Consumer price index (CPI), 2008-2011

[2] CIA, *The World Factbook*, 2012.
[3] See «The Economist», *Bamboo shoots of recovery*, 16/4/2009.

Table 2 - GDP growth rate by quarters, 2007-2011



By November 2008, the government launched an extraordinary 4trillion yuan (US$586 billions) stimulus package including a set of measures aimed at bolstering its economy and sustaining domestic demand: public investments especially targeted at the development of new infrastructures, "livelihood projects" for low-income housing, health and education services, energy-saving construction and renovation and environmental protection, and the rebuilding of communities devastated by an earthquake in the Sichuan province

Exploiting a wide margin for fiscal manoeuvre, the plan also foresaw various forms of tax breaks and subsidies for industries and SMEs particularly affected by the drop in domestic and global demand. On the monetary side, at the same time, the Bank of China took bold anti-cyclical measures, cutting the deposit reserve ratio and the benchmark lending rates in aggregate by about 3 percentage points[4]. Falling almost entirely under governmental control, banks reacted promptly to such policy impulses easing significantly access to credit, so that another 7 trillion yuan of liquidity was pumped into the market through the banking system.

Stretching on a two-years period, the "shock therapy" has indeed helped taking the sick man out of the danger zone and back to health, at least at first sight. Reacting effectively to fiscal and monetary easing, the Chinese economy has started to recover since the mid-2009 and more convincingly throughout 2010: private consumption has increased significantly and so has industrial production, while prices have gradually retaken an inflationary path (see table 1). Growth has thus been restored overall, climbing back fast to pre-crisis, double-digit levels by the last quarter of 2009 (see table 2). Whereas America finds itself stuck into a sluggish, jobless recovery, and the EU appears on the edge of even more serious problems related to its own debt crisis, China has thus led the way among big economies to rapid recovery, making the bitter slowdown look as a short-lived, "V-shaped" disturbance to its steady rise.

GDP growth in real terms was 9.2% last year and is expected at 8.2% in 2012 according to the latest World Bank figures[5], signalling a moderate slowdown with respect to last year: such relaxation is of course related to the continuously weak global economic environment, particularly in Europe and the US, but is also party explained by a gradual return of more standard macro policy conditions but. If they have succeeded in restoring overall positive conditions, Chinese authorities have indeed had to cope with a number of unwanted consequences related to the stimulus package. As commonly forecasted by economic theory, bold credit easing has contributed to a significant rise in prices, with inflation surging up to 6% in the first half of 2011; the strong support provided to the construction sector has also fuelled worries of a potential overheating in the property market, while sceptic observers have more broadly denounced the medium-term "bubble" dangers of exaggerate public investments

[4] OECD-ILO, *Generating employment in the post-crisis period*, G20 Country Policy Briefs – China, September 2011.
[5] World Bank, China Quarterly Update – *Sustaining growth*, April 2012, p. 17.

and subsidies[6], creating an artificially improved but unrealistic level of domestic demand. Ironically to a European ear, in sum, China's concern in the current framework may well lie not in insufficient, but in excessive – or unbalanced – growth. As the senior economist of a big Asian bank has put it, in other words, «the biggest problem for China is not growth deceleration, it is inflation»[7]. The social implications of China's boom and recent V-curved growth dynamic, which we examine in the next section, may indeed give him good reasons to think so.

Poverty reduction and social protection: an unfinished job

When the Chinese leadership drove the historic turn from a centrally planned to a market-based economy, it also undertook a development path that implicitly sacrificed social equality for the sake of long-term growth. In a cynical view, income inequality would amount in other terms to a sort of temporary "necessary pain" in order to be able to enjoy and better redistribute the fruits of growth in a coming future. China's three-decade long spectacular rise has indeed translated into remarkable growth in per capita income – around 8% yearly – which in turn has resulted in dramatic progresses in poverty reduction, lifting over half a billion people from extreme poverty between 1981 and 2007[8], tackling decisively the long-standing plague of rural poverty in particular.

Despite such remarkable progresses – which make it one of the few emerging countries to be in line with the related 2015 Millennium Development Goal – China still bears enormous social contradictions; up to a tenth of the population is estimated to be living at present with less than US$1 per day, more than a third with less than US$2. The country's economic progress, in particular, has entailed growing inequalities amongst the population and between regions. The Gini coefficient, a measure of overall income inequality[9], has risen steadily since the 1990s, up to quota 0.45, a significantly high rate among large economies (by comparison, the index is estimated at 0.31 for the EU and 0.37 for Japan, although it is on a similar level for the US). The gap has particularly widened along the urban/rural divide: the related income ratio has grown from 1.86 in 1985 to 2.79 in 2000 and up to 3.33 in 2007[10], whereas a half of rural residents live with a sixth of the average urban income. Besides households' earnings, conditions differ widely also in terms of access to welfare provisions, as the government has only recently started to expand basic social programmes and services in the countryside. Unequal living standards and access to health services imply life expectancy is over five years longer for urban than rural citizens and twenty years longer for rich Chinese than poor, while under-five and maternity mortality rates in the countryside double those in the cities[11]. Development is also sensibly unequal on a regional basis. This is boosted in part by China's early policy of concentrating growth and investments into selected Special Economic Zones: the eleven costal provinces alone attract in fact more than 80% of FDIs and contribute to around 60% of national GDP and over 90% of import and export flows. Per capita income in those regions is thus 2.9 times higher on average than in the rest of the country, while the gap rises to an even more striking 13:1 if the richest

---

[6] The share of investment has risen to 45% of GDP with the introduction of the stimulus plan, according to the mentioned OECD-ILO joint report to the G20.
[7] C. LEUNG, senior economist at DBS Bank, quoted in *China's economic growth slows amid monetary tightening*, «BBC News - Business», 13 July 2011.
[8] World Bank estimates.
[9] Named after its creator, the Italian statistician Corrado Gini, the so-called Gini coefficient (or Gini index) is a measure of statistical dispersion in a given frequency distribution, widely used in social as well as natural sciences to evaluate inequality among a set of values (in our case, income levels in a country). A Gini coefficient of zero expresses perfect equality, a coefficient of one maximal inequality among analyzed values.
[10] National Bureau of Statistics, 2008.
[11] United Nations Development Programme, *Human development report 2007-08 – Access for all: basic public services for 1.3 billion people,* Beijing: China Translation & Publishing Corporation, 2008.

province – Shanghai – and the poorest – Guizhou – are compared[12]. Besides regional discrepancies, China's income distribution is also increasingly shaped by shifting patterns of productivity and wage adjustment across different sectors. A well-known phenomenon in Europe in recent decades, wage-push inflation is now a less uncommon trend in China, particularly in those sectors where private profits are growing more decisively, such as the higher tech. Wages are similarly on the rise also in publicly-held companies, often due to "political" decisions.

In terms of policy-led distortions, however, the most striking social plague in China is certainly represented by the persistent discriminations related to the *hukou* system. Dating back to Mao's era, such scheme was intended at guaranteeing a strict separation between industrial and agricultural activities and required each citizen to be registered as a resident of its birthplace: its implementation was *de facto* at the origins of the "legalized" differentiation between urban and rural citizens, with the former being essentially excluded from public welfare and impeded internal migration. If rising labour demand in the cities and massive rural unemployment have attracted nonetheless a growing number of migrant workers since the 1980s, this "floating population" – estimated today around 150 million people – is still denied legal urban residential status, a pre-requisite to accede to basic rights and public services. Banned from some key economic sectors – such as State enterprises and the public administration – migrant workers are thus brought to accept the least attractive jobs, often within the "informal sector", that is to say with little if any social protection.

It is no wonder, therefore, that when the crisis has hit China in 2008 rural-urban migrants have been the first victims. They were in fact the first category concerned by layoffs of businesses struggling to keep up production: around 20 millions are thought to have gone back to their villages because of the bleak employment prospects according to official figures, increasing rural surplus labour and putting pressure on rural incomes[13]. Overall, the impact of the downturn on employment broadly followed the growth rate pattern: job creation shrank in late 2008 to 380,000 from a pre-crisis level of about 1.2 million units monthly, and the cumulative job loss over the period is estimated at 10 millions. Besides rural migrants, university graduates were another category particularly exposed to the rise in urban unemployment. The return of high growth and specific measures targeted to revitalizing the labour market made job creation climb back to pre-crisis level, re-absorbing many of the job seekers. In both rural and urban environments – as mentioned data show – hundreds of millions of Chinese live however on or close to the poverty line, often barely meeting ends to fulfil their basic needs. In this context, even a minor percentage rise in registered unemployment or a surge in prices of basic products can entail dramatic social effects and fuel protests around the country[14]. As the consumer price index rose up to 6% last year, and over 11% for food prices, Chinese authorities have in fact rapidly changed their policy priorities, targeting inflationary pressures as the number one danger. Besides tightening the tap on domestic security to prevent or suppress any sign of dissension, however[15], the government needs to look at credible measures to eradicate such social vulnerability in the medium term. The crisis itself, ironically, may well have provided a few good tips in that sense.

China's development path: lessons learnt and challenges ahead

Chinese authorities may have understandably sighed with relief at the success of the bold policy reaction implemented and the return of strong growth, yet the recent downturn has also highlighted hard realities and dangers implied in the development strategy pursued over the last few decades.

---

[12] Regional inequality estimates from F. HAY - Y. SHI, *Introduction générale – La Chine, au cœur de la croissance mondiale?*, in F. HAY - Y. SHI, *La Chine: forces et faiblesses d'une économie en expansion*, Rennes, 2006, p. 20 and F. LEMOINE, *L'économie de la Chine*, Paris, 2006.

[13] OECD-ILO…, cit., September 2011.

[14] J. ANDERLINI, *Surging Chinese price rises fuel protests*, in «Financial Times», 14 June 2011.

[15] *Rising power, anxious State*, in «The Economist» - Special report on China, 23/7/2011.

If they can learn the lesson, this crisis will really have been useful. Betting on cheap and abundant labour to produce low added-value products for foreign markets at unbeatable costs has certainly been one of the key secrets in determining China's spectacular growth pattern. Yet the 2008 global recession and the continued stagnation in Europe and the US have shown clearly the drawbacks of such a strategy.

On the social side, at the same time, the impact of the downturn first and the heating inflation later have increased the pressure on the most vulnerable elements of the society. In a year marked by widespread social unrest related to corruption, inflationary pressures and poor employment prospects throughout the Arab world, Chinese authorities look with horror at the prospect of similar uprisings. Both problems can best be solved drawing a bold shift in the country's development strategy, reducing its dependency on exports by sustaining domestic demand, through better income redistribution, the expansion of social safety net and other important reforms.

It needs to be acknowledged, in this context, that the government's moves and strategic papers in the last few years seem indeed to go this way. Since Hu Jintao and Wen Jiabao took the reins of the country in 2003, the key imperative of economic growth has been coupled with the overarching objective of building a "harmonious society": a number of reforms has indeed been launched in this vein, resulting in remarkable progress in the improvement of social protection. Programmes recently launched include two minimum living standards guarantee schemes for low-income citizens in both urban and rural areas; a rural pension system which is set to be expanded to universal coverage by 2020; two new health insurance programs targeted at rural and economically inactive populations[16]. The 12th five-year plan unveiled early this year, more broadly, has further strengthened the previous plan's focus on inclusive growth: rebalancing the economy from exports to consumption has been enshrined as a policy priority and attention has shifted from quantitative targets to the quality of growth and its impact on "people's livelihood", to be improved by sustaining household incomes, investing in human capital and environmental protection and strengthening the social safety net. Such a complete rebalancing of China's development trajectory is likely to have a lasting impact on its production structure, perhaps reducing the rhythm of growth by a few percentage points over the coming years. If the mentioned principles are translated into tangible reality for the vastest population on Earth, however, China's rising path will grow more sustainable and less vulnerable to other external shocks.

[16] See ILO, *Social protection floor intitative – SPF country brief: China,* June 2010.

Le pubblicazioni online dell'ISPI sono realizzate anche grazie al sostegno della Fondazione Cariplo.

ISPI
Palazzo Clerici
Via Clerici, 5
I - 20121 Milano
www.ispionline.it