JICA Research Institute

JICA-RI Working Paper

The Second East Asian Miracle?:
Political Economy of Asian Responses to the 1997/98 and 2008/09 Crises

China and the Two Crises: From 1997 to 2009

Barry Naughton

No. 53

January 2013

JICA Research Institute

JICA Research Institute

JICA Research Institute
10-5 Ichigaya Honmura-cho
Shinjuku-ku
Tokyo 162-8433 ,JAPAN
TEL: +81-3-3269-3374
FAX: +81-3-3269-2054

China and the Two Crises: From 1997 to 2009

Barry Naughton*

Abstract

China appears to have successfully weathered the worst impact of both the Asian Financial Crisis (1997-98) and the Global Financial Crisis (2008-2009). Chinese leaders did respond quickly, and on occasion massively, to the challenge of external crisis. In retrospect, however, each crisis response can be seen to have involved an element of over-shooting, which was followed by domestic reformulation and retrenchment. This paper will track commonalities and differences of the two crises in three dimensions: immediate macroeconomic crisis response; institutional adaptations; and trade and exchange rate policies. The discussion will clarify that the very "success" of the response to the AFC laid the foundation for deeper economic problems relating to the GFC. In turn, the response to the GFC gave government officials and state-owned enterprises control over an even larger volume of resources, and reduced the accountability of both officials and financial institutions, changes that inevitably have softened budget constraints, reduced individual risk, and encouraged even larger investments. In consequence, the Chinese economy now faces accumulating problems from the maladaptation of domestic institutions, a maladaptation that is not unrelated to the crisis response.

Keywords: China, Asian Financial Crisis, Global Financial Crisis, monetary policy, stimulus, economic reform.

* School of International Relations and Pacific Studies, University of California San Diego (bnaughton@ucsd.edu)

Introduction

On first look, China appears relatively less affected than other countries by both the Asian Financial Crisis (1997-98) and the Global Financial Crisis (2008-2009). China was not the epicenter of either crisis; it responded relatively effectively to both; and it managed to sidestep the worst impact of both crises. Chinese resilience has long been a theme of accounts of the 97-98 Asian financial crisis (AFC). Sharma, for example, characterizes China as "the domino that did not fall" (p. 252). It would be tempting to think that China is only marginally affected by these external crises, and that it marches to a different drum, to a cadence driven by its own vast domestic market and its own internal political dynamics.

But in fact, both crises had a profound impact on China, and there are important parallels between the two. Chinese leaders have paid great attention to the potential impact of external crisis, and have responded quickly, and on occasion massively, to the challenge of external crisis. During the earlier AFC, China tried out a domestic stimulus package that had an important impact on its performance. Ten years later, in the GFC, the response was an order of magnitude bigger, and was deployed even more decisively. The response to the GFC at first seems to mimic many of the relatively successful responses to the AFC.

When we examine the impact of external crises on China's institutional and policy evolution we begin to uncover the deeper significance of these crises with respect to China's development and growth. Each of the two crises gave impetus to significant institutional change in China. Crises serve as change accelerators, but crucially crisis at first leaves the general policy direction unaffected even as it speeds up the pace of policy-making. As a result, external crisis at first makes China intensify its existing policy orientation. Yet, the crisis-impelled acceleration of policy does not last. Crisis conditions fade, and the crisis response, in retrospect, appears to have been excessive. Certain things that were seen as absolutely necessary later seem quaint, and are quietly discarded. On the other hand, some measures that were taken in haste as temporary responses become ingrained into the institutional and political economy fabric. The ultimate impact of crisis and response turns out to be full of ironic twists and unanticipated consequences. In the end, it is the crisis *and the extreme measures taken in response* that determine the long-run impact of the crisis.

Looked at from this perspective, the ultimate impact of the two crises appears increasingly distinct. In the case of the AFC, China at first accelerated the pace of institutional reform, but also became more cautious—more defensive—in its external economic policy. But as a new administration took over in 2002-2003, the pace of institutional change slowed dramatically, while the cautious external policy was maintained. Subsequently, these choices set the stage for China's response to the GFC, but did not produce continuity in that response. Indeed, China's response to the GFC reflected a set of policy choices that were almost the reverse of those made in the face of the AFC. Institutional reforms were non-existent, while the stimulus response relied on direct government action and co-optation of the banking system to support those government-sponsored activities. The consequences of these choices today and in the future will be profound.

The first two sections of this chapter describe and analyze China's response to the Asian and then Global Financial Crises. The discussion tracks commonalities and differences in three dimensions: immediate macroeconomic crisis response; institutional adaptations; and trade and exchange rate policies. What emerges is that while the immediate macroeconomic response to crisis was similar in both crises, the institutional adaptation was very different, and in some respects opposite. The third section of the paper delves into the institutional implications of China's response to the GFC, and contrasts it with the AFC. In the fourth section, I examine the path from the AFC to the GFC and beyond. I develop some of the causal links, and show some of the ironies involved. In some ways, the very "success" of the response to the AFC laid the foundation for deeper economic problems relating to the GFC. At the same time, the complex aftermath of the AFC helps explain why China was able to respond in such a decisive manner to the GFC. The fifth section examines the state of the Chinese political economy in 2012: After successfully managing two external crises, the Chinese economy now faces accumulating problems from the maladaptation of domestic institutions, a maladaptation that is not unrelated to the crisis response.

1. China's response to the Asian financial crisis, 1997-1998

Like nearly everyone, the Chinese were caught by surprise by the Asian Financial Crisis. The crisis began the day after the long-anticipated resumption of sovereignty over Hong Kong on July first. On July 2, 1997, Thailand was forced to abandon the peg of the Thai baht to the dollar, and it depreciated 17% on that day. For the first several months of the crisis, Chinese policy-makers mainly focused their attention on Hong Kong, which was far more vulnerable to the initial phases of the crisis. In fact, the full force of the crisis hit Hong Kong in the fall, when the very large and very international Hong Kong Stock Exchange came under speculative attack. During this period the benchmark Hang Seng index fell from its pre-crisis peak of 16,800 to almost 9,000, including two days in late October when the Hang Seng index fell more than 1,000 points in a single day.[2] Ultimately, the Hong Kong government abandoned its long-held policy of non-intervention and organized a coordinated market rescue program. The government

2. "Asian Financial Crisis "亚洲金融危机，" Article in Hudong Chinese Encyclopedia, accessed May 14, 2012 at http://www.hudong.com/wiki/%E4%BA%9A%E6%B4%B2%E9%87%91%E8%9E%8D%E5%8D%B1%E6%9C%BA

invested the equivalent of 110 B. HKD (about $12.5 billion) in the market from foreign exchange reserves, while the large blue-chips and Chinese government firms listed on the market engaged in big stock buy-backs. The PRC government actively supported the Hong Kong effort, although probably with a relatively modest financial commitment. Within a few months, capital returned to the Hong Kong market, and the situation was stabilized (Jao 2001). The experience showed that the Chinese government was willing to intervene in markets, and also probably taught Chinese policy-makers a lesson about the wisdom of intervening early and forcibly. The episode also provided raw material for a narrative of national solidarity, in which Chinese people in the mainland and in Hong Kong stood together to defeat international speculators (personified in this case by George Soros.)

In fact, Chinese policy-makers had their hands full with domestic economic problems. Earlier in the decade, the policy stalemate between conservatives and reformers had been broken with the aid of Deng Xiaoping's "Southern Tour" of 1992. Major economic reforms had taken place, but they had been accompanied by a tremendous inflationary surge. The top economic policy-maker, Zhu Rongji, had been struggling to bring down the inflation rate, while also preparing the ground for the next wave of economic reforms. When the AFC arrived, Zhu was finally close to his goal. After 21 straight quarters above 5%, the rate of inflation had been brought down below this "red line" for the first time in the second quarter of 1997. Monetary restraint was paying off, and the economy seemed to be close to a "soft landing," controlling inflation without too excessive a cost in terms of foregone growth. The arrival of the AFC was thus exceedingly unwelcome.

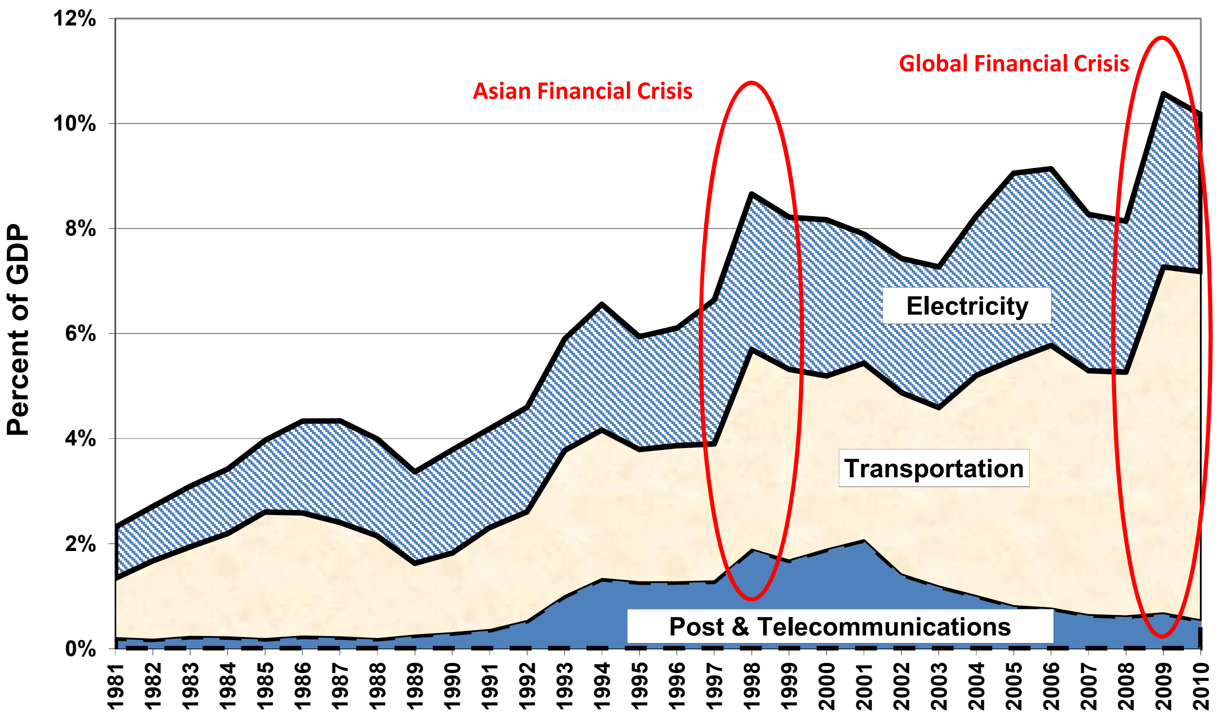
The biggest dilemma facing Zhu Rongji was to what extent to allow the downward pressures of the AFC to continue to slow the Chinese economy. Dis-inflation, combined with a new attitude toward state ownership, was already driving a dramatic down-sizing of the Chinese state sector. In 1996, more than 7 million workers had been furloughed from Chinese public enterprises, and the question was whether this punishing down-sizing would continue. In the end, Zhu maintained the policy course. The number of newly furloughed workers remained above 5 million annually through 2000, and furloughed workers either found new jobs outside the state sector, or transitioned to retirement or open unemployment.[3] By the end of the process, the number of workers in traditional state-owned enterprises had declined by two-thirds, and the total employed by public enterprises of all kinds fell by about 40%. In the long run, then, the AFC fit into a process of domestic transformation, painful but necessary for the country's economic progress.[4]

Of course, the policy response was not that simple. Zhu Rongji was slow to perceive the potential threat from the AFC, and it was not until the very end of 1997 that Chinese policy began to adapt fully to the consequences of the AFC. Since monetary policy had been effective in controlling inflation, and had just recently achieved a degree of credibility, the brunt of the policy response fell on fiscal policy and, to an extent, exchange rate policy. China had been maintaining a budget deficit below 1% of GDP as a rule of thumb, but now allowed the deficit to inch higher in 1998, and expand to 1.9% in 1999 and 2.5% in 2000. As Figure 1 shows, nearly all the increase in fiscal effort was recorded as increased physical infrastructure investment. For the first time, China's core physical infrastructure investment surged above 8% of GDP, creating a precedent for later policy. More broadly, a campaign was launched to "keep growth at 8%," which gave government officials a certain amount of leeway to initiate projects; pressure companies to restrain lay-offs; and exaggerate their reported production figures. In the event, 1998 GDP growth was initially reported at 7.8%. Subsequently, though, China's statisticians have

3. Barry Naughton, *The Chinese Economy: Transitions and Growth*. Cambridge, Mass.: 2007, pp. 185-89.
4. The similarities with the 1881 Matsukata Deflation in Japan are substantial.

quietly lowered the rate to 7.3%, even as they have revised GDP growth rates upward in other years (see Appendix Figure A1).

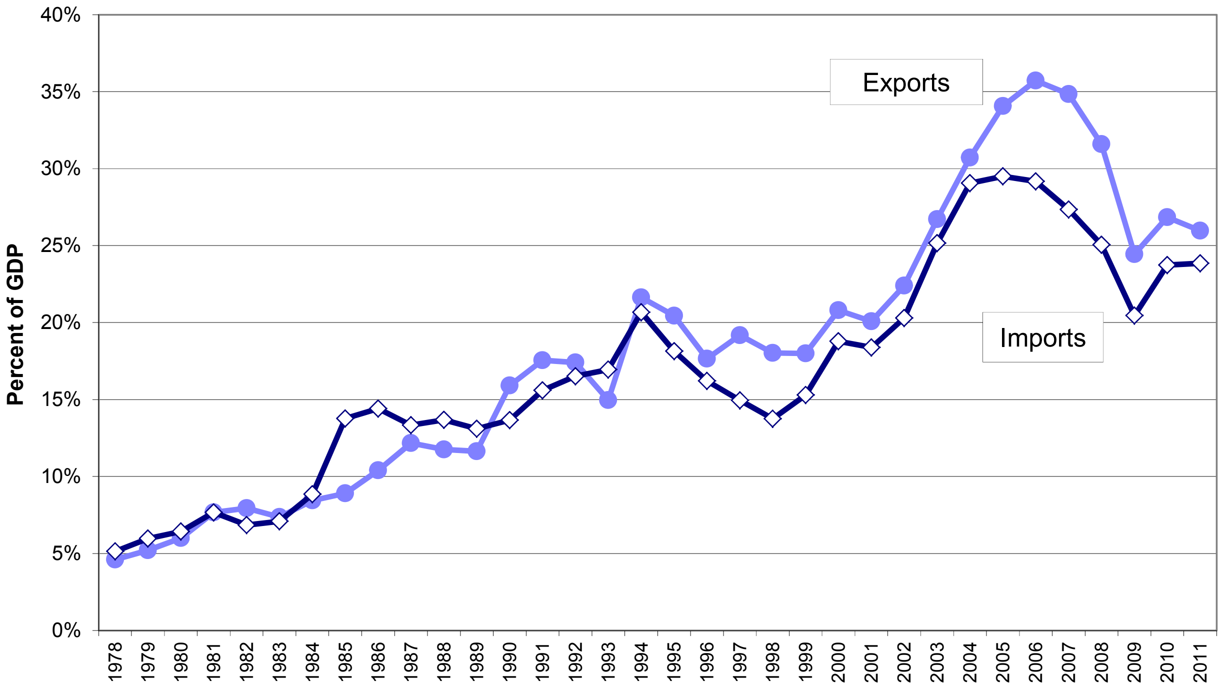
Figure 1. Physical infrastructure investment



The best-known Chinese policy response to the AFC involved doing nothing. That is, China maintained the value of its currency, the RMB, pegged at 8.28 to the US dollar, while the crisis-effected economies were devaluing substantially. This was a positive move that contributed to the stabilization of the overall situation. However, it should also be noted that China did not have to bear a great deal of pain to carry through this policy. China had dramatically devalued its currency back in 1994, when it unified the prior dual exchange rate. Since then, inflation had been pushing up China's real exchange rate, but nevertheless China's imports had grown slowly, declining as a share of GDP through 1998. Exports, meanwhile, had grown rapidly, keeping pace with GDP growth. The result was that China was running large trade surpluses over 4% of GDP in both 1997 and 1998

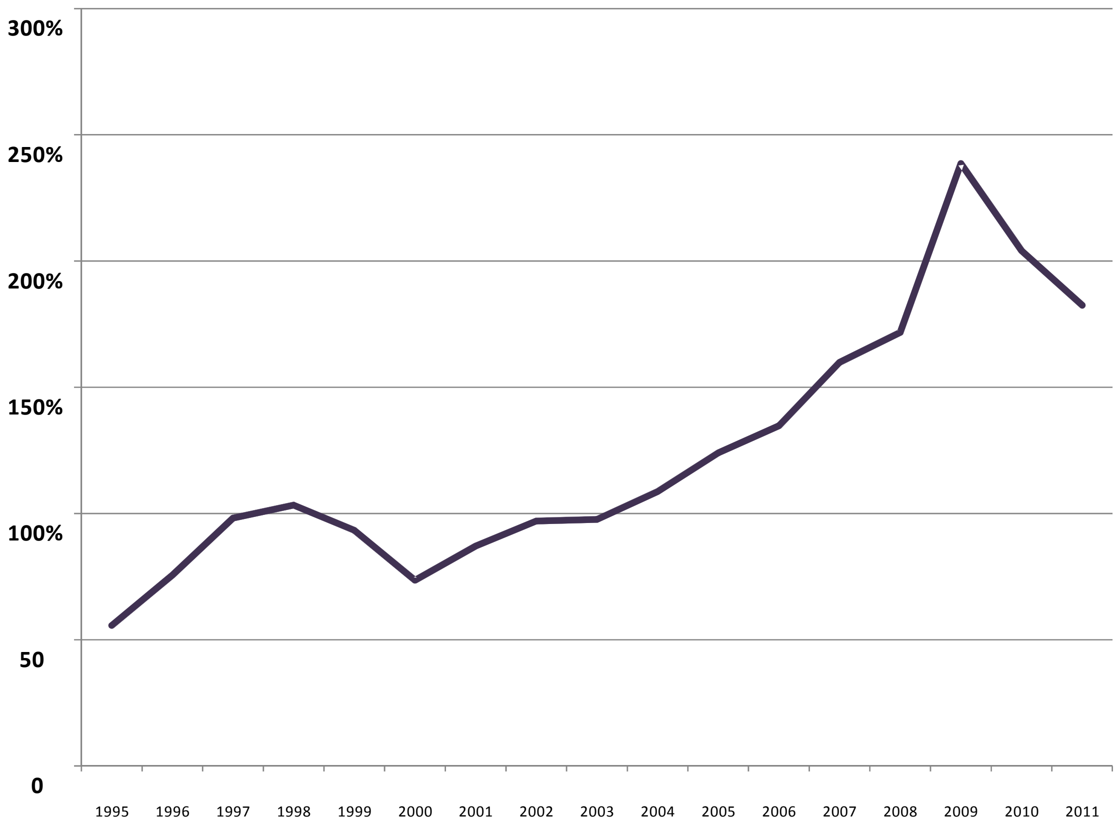
(See Figure 2). One result was that China's foreign exchange reserves were adequate, equal to 100% of annual imports (Figure 3). With those kinds of numbers, it was not hard to wait out the crisis with a fixed rate. There was some capital outflow, and capital controls were tightened somewhat, but the decline in reserves was quite manageable (Figure 3).

Figure 2. Exports and imports (share of GDP)



In short, China's direct macroeconomic responses to the AFC were moderate and appropriate. Compared to later interventions, their scale reflected the fact that China had far less skin in the game. Trade was already moderately large, as a share of GDP, but not as large as it would be ten years later. China's financial system was still largely closed, so risks of financial contagion were insignificant. Most crucially, with a comfortable trade surplus and a balanced budget, China was not constrained to adopt pro-cyclical policies of austerity or monetary contraction, as were the worst-hit Asian economies. As a result, China could roll out a modest stimulus to help offset the external downturn, and given the reasonable economic health of the developed economies that were its biggest export markets, wait out the rest of the crisis. This decision was facilitated by the fact that Premier Zhu Rongji had already decided that it was worth absorbing a certain amount of pain in pursuit of state-sector restructuring, and he was not interested in throwing away the credibility that had already been achieved at substantial cost.

Figure 3. Official FX reserves. year-end as share of annual imports



Despite the relatively modest direct impact of the AFC on China, one of the most important results was the lesson China learned about vulnerability. In one sense, China learned the same broad lessons about more prudent international policy that the most directly affected crisis countries learned: keep the currency low enough to maintain consistent export surpluses; build up foreign exchange reserves; avoid reliance on short-term bank loans; and above all, never allow yourself to become dependent on the IMF for macroeconomic insurance. In another sense, the lesson China learned about vulnerability was a lesson about its own systemic features that could easily lead it into crisis. As Steinfeld (2008, 188) points out, “the cautionary note—indeed alarm—heard in China was not about the risks of capitalism but, rather, about those of socialism.” The financial difficulties experienced by banking systems throughout East Asia convinced Chinese leaders that their own banking system was even more precarious than they realized, and desperately needed restructuring and recapitalization. The collapse of the majority of the Korean chaebols convinced policy-makers that the largest state firms could not simply be made into national champions through investment and expansion, but instead needed radical reform and corporatization. The harshness of global competition seemed to strengthen the conviction of China’s top leaders that China needed to enter the World Trade Organization (WTO) in order to consolidate and protect its status as one of the world’s leading trading economies.

The results of these lessons were soon apparent in Chinese economic policy. In November 1999, China finally reached agreement with the U.S. on their bilateral accord that paved the way for Chinese entry into the WTO in December 2001. Equally significant, China set about restructuring its banks. First, China wrote off trillions of RMB in bad loans; then injected trillions of RMB of government money into the banking system. On the foundation of these improved balance sheets, foreign strategic partners were solicited to take stakes in the healthiest banks. With strategic partners lined up, the better banks were then restructured and listed on the Shanghai and Hong Kong stock markets. It was an impressive, costly, and professionally executed effort. China pumped about 28% of GDP into its banking system in this period, counting only the first wave of large commercial banks.[5] Perhaps most strikingly, China had recognized that the banking system could not be used indefinitely as a prop for inefficient and loss-making state-owned enterprises. After the state enterprise sector was downsized, the next step was to bring the state banks out of their near-insolvent position, restructure their incentives, and give them the opportunity to adapt to a more competitive economy. Thus, in two important respects China came out of the AFC determined to continue with reforms that made its economy more productive and more resilient.

2. China's response to the global financial crisis (2008-9)

A decade later, China confronted a new external crisis. There were some odd parallels with the earlier crisis. The global financial crisis hit—with the collapse of Lehman Brothers and AIG on September 15, 2008—shortly after China finished staging the Beijing Olympics in August. The Olympics had been long anticipated in China as a symbol of China's emergence, and was certainly the biggest national celebration since the return of Hong Kong in 1997 (on the eve of the AFC). The external crisis also hit just as a domestic program of inflation fighting and macroeconomic contractionary policies were beginning to bite (discussed below). In comparison with the earlier crisis, China's response to the global crisis of 2008-2009 was unusually bold and decisive. In retrospect, it is clear that the decisiveness of the crisis response reflected an unusual combination of conditions: the threat was exceptionally clear, and China was unusually well positioned to respond. At the front end, the global crisis produced an unusually high level of consensus among policy-makers, so they had little trouble agreeing on policy. Moreover, it was obvious to Chinese policy-makers that globally the crisis was being taken very seriously, and that the threat to China was substantial. Moreover, China was in a good position to

5. A good account that elucidates the overall costs is Guonan Ma, "Sharing China's Bank Restructuring Bill," for more background, and a more critical view, see Walter and Howie, *Red Capitalism;* See also Naughton, *Chinese Economy*, pp. 460-67.

respond, largely because of the prudential policies first set in place after the AFC. Foreign exchange reserves were large: with almost $2 trillion in reserves, China had 170% of 2008 imports (Figure 3). The government budget was balanced. The state-owned enterprise sector had returned to profitability after its restructuring at the turn of the century.

Perhaps most important, the Chinese banking system was in a strong position. The difficult and protracted process of bank reform, recapitalization, and restructuring that had been carried out between 2003 and 2006 had left the banks with reasonably strong core capital and low burdens of non-performing loans. By the eve of the financial crisis, in mid-2008, non-performing loans in the system had officially been brought down from crisis levels to a tolerable 5.6% of total loans (7.4% for the biggest state-owned commercial banks).[6] The bank reform process had finally reached the most troubled bank, the Bank of Agriculture, which was restructured at the end of 2008 (but not listed on the stock market until August 2010, due to the impact of the crisis). Thus, the last reform launched by Zhu Rongji had finally reached conclusion after years of effort and billions in costs. In essence, then, China was in a strong economic position because of strong fundamentals and prudent macroeconomic policies, but even more so because it was reaping the benefits of difficult and thorough reforms carried out in the 1990s and early 2000s.

The Chinese response to the global financial crisis can be dated precisely. On November 5, 2008, a joint meeting of the State Council and the Politburo—the highest governmental and Communist Party bodies—decided on a 4 trillion RMB (US$586 billion) stimulus investment program. That money, equal to 12.5% of 2008 GDP, was to be spent beginning immediately, and with utmost urgency, putting shovels in the ground

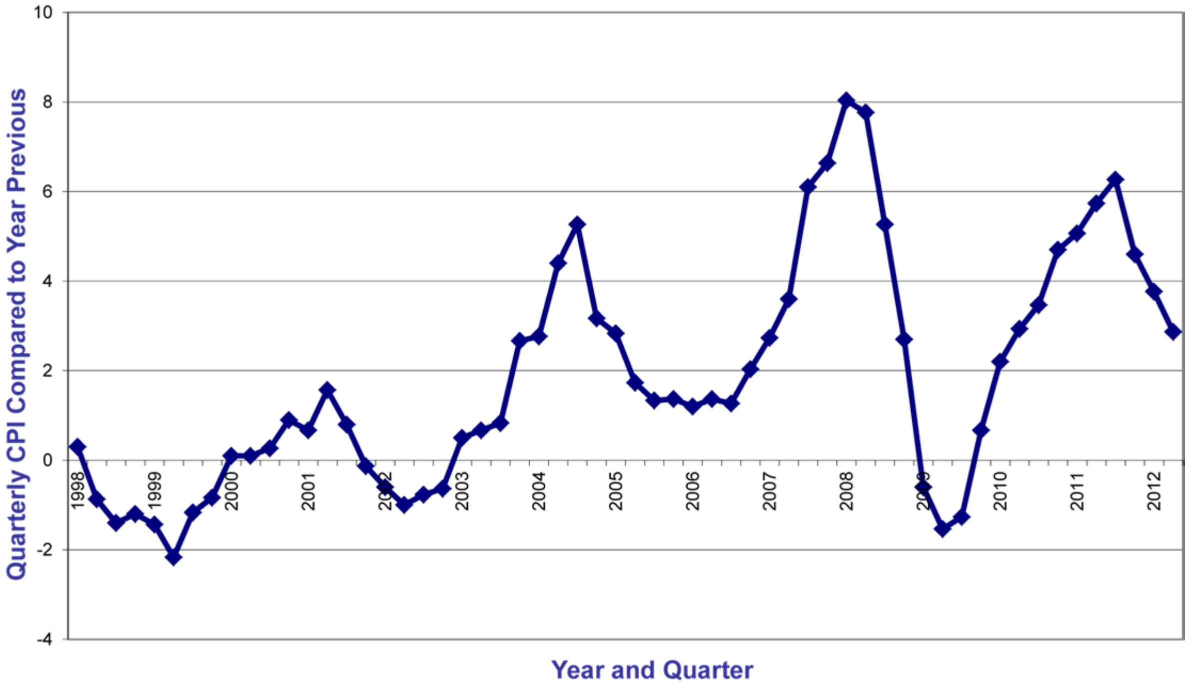
6. China Bank Regulatory Commission, “Non-performing loans of Commercial Banks 2008,” January 16, 2009, accessed at http://www.cbrc.gov.cn/chinese/home/docView/200805143C8CC3952D9998C2FF10B864C3433900.html; for analysis of the crisis that compelled the reform, see Lardy (1998). On subsequent trends in non-performing loans, see the analysis in Brandt and Zhu (2007).

as quickly as possible. Outlays were to begin during the fourth quarter of 2008, and to be expended through the end of 2010. This decision marked the unambiguous beginning of the full crisis response.

In fact, the stimulus decision marked a remarkable turn-around in Chinese policy. Only five months earlier, China's central bank had still been trying to slow the economy in order to fight inflation. As Figure 4 shows, Chinese inflation had soared during 2007 to truly worrying levels. On June 25th, 2008, the final in a string of increases in bank reserve requirements had taken effect, restricting money supply by requiring commercial banks to keep more funds on deposit with the central bank, and pushing the rate to a historic high of 17.5%. Indeed, Chinese policy-makers, and especially the central bank, had been concerned with the overly rapid pace of expansion for some time. In the middle of the decade, exports grew dramatically (Figure 2), and GDP growth accelerated (Figure A-1). The Chinese economy and the inflation rate were both accelerating during 2007 in a way that was fundamentally unsustainable. GDP growth hit 14.6% for the year, and inflation rose above 8%, the highest rate in over a decade.

These challenges highlight how different economic developments in China were during the period between the AFC and the GFC compared to those countries hit hard by the AFC. The crisis countries experienced a sustained drop in GDP growth and a decline in investment rates that both lasted through the 2000s (Park, Shin and Jongwanich 2009). This was not true at all for China, where investment rates inched steadily upwards and GDP growth accelerated. Indeed, China was the primary beneficiary of the round of global growth acceleration that made 2003-2008 the period of the most rapid expansion of the global economy certainly since the 1960s and perhaps ever. For China, GDP growth stayed above 10% from 2003 onward, before hitting stratospheric levels in 2006, 2007. Under these circumstances, the attention of the Chinese central bank understandably turned to fighting inflation and moderating growth. From November 2007, bank officials were not only tightening monetary policy, they also allowed the RMB to begin to appreciate substantially against the dollar (about 1% per month). Yet still the global bubble grew. As the Chinese central bank was tightening monetary policy, the US Federal Reserve Board was expanding the US money supply, pumping dollars into the system in an attempt to avert collapse. Global oil prices followed the Fed's policies, accelerating through the first half of 2008, until they finally closed at $145 per barrel on July 3, 2008, which proved to be the peak. By far the world's largest importer of commodities, the Chinese economy was quite exposed to the rapid increase in commodity prices that took place during 2007-2008, and this made the fight against inflation fiendishly difficult.

Figure 4. China consumer price inflation (1998-2012)



While the struggle against inflation was difficult, the pain felt in the domestic economy was almost immediate. When macroeconomic policy shifted, in November 2007, the stock market, at historic highs, promptly collapsed. In the five years since, the Chinese stock market has never reached one half of its November 2007 peak. The political leadership finally permitted the RMB to appreciate at a reasonably rapid rate at the same time. Exporters screamed that they were squeezed between rising wages and soaring commodity prices, on the one hand, and a higher currency on the other. Real estate developers protested as property prices came down. Both lobbied Beijing intensively. Facing contradictory pressures, the Chinese leadership began to back away from anti-inflationary policies in July 2008. It was hard for them to tell how rapidly economic conditions were changing, with the Beijing Olympics going on in August, but concerns clearly grew, focusing on the export sector. Appreciation was halted; some export tax rebates were revived; and the People's Bank of China (PBC) changed course and began to cut interest rates. Within five months, Chinese policy-makers' action changed 180 degrees. Of course, these five months, between June and November, were the months in which the global financial crisis rippled out from New York, as stresses in the US markets erupted and the collapse in global markets began after October 1.

When China's top leaders did decide to act, there was nothing to inhibit a vigorous stimulus response, and it was in fact forthcoming. Policy-makers rolled out a stimulus program heavy on infrastructure investment. The program's initial price tag of 4 trillion RMB was translated by international press reports into a precise-sounding 586 billion U.S. dollars, but this was really just a big, round number which had not been fleshed out with concrete projects and programs, merely divided up into plausible sectoral allocations. Indeed, the fact that China was able to come up with even the outline of a plan after two weeks of quick work is impressive. Since 2009, the 4 trillion stimulus program has come to serve as a shorthand designation for the Chinese response, but it is in some respects extremely misleading. It gives the impression that the Chinese response was predominantly fiscal, carrying out an infrastructure investment program orchestrated by the central government. Neither of these is true. In fact, the response was primarily monetary (rapid expansion of credit) that funded initiatives organized by local governments. Moreover, the "transmission process" that got money flowing into the economy was highly politicized, relying on Communist Party channels to convey commands with urgency, rather than standard financial channels.[7] These characteristics would have substantial implications for the long-run effects of the stimulus response.

Of the initial 4 trillion, the central government committed to directly fund 1.18 trillion, about 30 percent of the overall program. Moreover, the program was written to include some 1 trillion RMB that had already been committed for reconstruction after the devastating May Sichuan earthquake. Of the remaining 3 trillion RMB, 60% was earmarked for transport and energy infrastructure; 33% for smaller-scale infrastructure, such as affordable housing; environmental projects and village projects; and the rest for technological upgrading, health, and education. The NDRC head Zhang Ping stressed that none of the investment was going to ordinary industrial sectors, which were widely thought to have surplus capacity.[8] As Figure 1 showed, China's overall infrastructure effort did increase substantially, jumping about two percentage points of GDP in 2009.

In fact, the real action was going on behind the scenes. Joint with the State Council meeting, there was a Communist Party Politburo meeting, which is where the real power lies in China. When an authoritative document on the stimulus was issued, it was sent out from the Party Politburo, through Party channels. This document, Central Document No. 18 of 2008 (Zhongfa 2008, 18), has never been published, since, like many central Party documents, it was considered secret and in any case was distributed through internal Party channels. However, the contents have often been referred to in other sources, and we have a good idea of the contents. It was accompanied by a document drafted by the top planning agency, the National Development and Reform Commission

7. For contrasting views, see Lardy (2012), pp. 7-41, and Naughton (2009).
8. Wang Changyong, "Facelift for China's Economic Stimulus Plan," *Caijing*, 6 March 2009, accessed at http://english.caijing.com.cn/2009-03-06/110114405.html.

(NDRC) that specified ten policy measures, including 100 billion RMB increase in government investment for the fourth quarter 2008, and injunctions to loosen monetary policy, and provide bank credit to support investment and small business.

However, by far the most important element of Document No. 18 was the general sense of urgency that was displayed, which was reiterated in coming weeks. When the NDRC met on November 10 to allocate the first tranche of 100 billion RMB, it declared that for all government agencies currently "the absolutely most important economic work is to urgently implement the center's increased investment and other measures to increase domestic demand... [and] make every second count."[9] The decision to send the document down through Party channels added to this sense of urgency, because it conveyed the sense that it was permissible to overturn ordinary obstacles to spending the money.

This action on the part of the central authorities was complementary to one of the most basic characteristics of the Chinese system. Local governments throughout China typically have a virtually inexhaustible demand for local infrastructure and construction projects. Local government officials have a distinctive incentive system, in which they are evaluated for promotion largely on the basis of their performance in regional economic growth. Confronted with the need to make a difference in their locality; attract attention from superiors; reward friends and clients with lucrative projects; and make a name for themselves before they move on (typically in 3-6 years), local government leaders have a strong demand for investment projects. Local governments typically have a "wish" list of projects they would undertake if they could; more fundamentally, they carry a latent insatiable demand for investment projects. The central government triggered the emergence from this latency of insatiable demand in late 2008 in two ways: by soliciting local projects for inclusion in the stimulus plan and—even more important—by slackening

9. National Development and Reform Commission, "Mingque renwu zhua luoshi, kuoda neixu cucengzheng [Clarify responsibility and grasp implementation; expand domestic demand and foster growth]" November 10, 2008, at http://www.ndrc.gov.cn/xwfb/t20081110_245192.htm

the financing constraint that had long held back ambitious local politicians. Thus, Central Document No. 18 initiated a structured bargaining process between the center and the localities.[10] The center signaled the type of projects it wanted locals to propose, laying out six areas in the initiating document. The center also gave the provinces a rough idea of the amounts they might expect, based on the province's population and its historic degree of reliance on central government investment.[11] The provinces then responded with a list of proposed projects.

Local governments were eager to seize this opportunity. Within days, local governments were convening meetings to discuss, propose projects, and strategize over Central Document No. 18. For example, a special Shandong provincial meeting called on the evening of November 11 (!) was urged by the provincial Governor to "seize the favorable opportunity created by expansionary fiscal policy and the 'appropriately loose' monetary policy."[12] The same evening, in Wugong County in Shaanxi Province, a new "County Leadership Small Group for Implementing Central Document No. 18" held its first meeting. The county head—having already attended a higher-level provincial meeting—urged his colleagues to take advantage of "an extremely rare and precious opportunity…….Getting more project funding is our top current task."[13] Without doubt, meetings like this were being held in thousands of counties, and hundreds of cities, across China in mid-November.

10. Based primarily on Xiao Liang, "1300 yi zhongyang touzi jihua kaishi bushu 950 yi jiang peigei difang [130 billion central investment plan has begun to be allocated; 95 billion will be allocated to localities]," *21 Shiji Jingi Baodao*, February 3, 2009, accessed at http://finance.sina.com.cn/roll/20090203/01305807294.shtml
11. Per capita GDP and fiscal revenue are also indicators. Provinces get preference for being northern, being province-level municipalities, and having minority populations.
12. "Qiang Daming: Jiakuai tuijin shiguan Shandong changyuan fazhan de xiangmu jianshe [Qiang Daming: Speed up the construction of projects the affect Shandong's long-term development]" Dazhong Daily, November 12, 2008, accessed at http://www.gov.cn/gzdt/2008-11/12/content_1146573.htm.
13. Yi Ming, "Woxian zhaokai guanqie luoshi zhongyang 18 hao wenjian jingshen gongzuo huiyi [Our county convenes a work conference on implementing the spirit of Central Document No. 18]," Posted November 13, 2008 at http://www.snwugong.gov.cn/Html/xwzx/zwyw/20081113112400.html

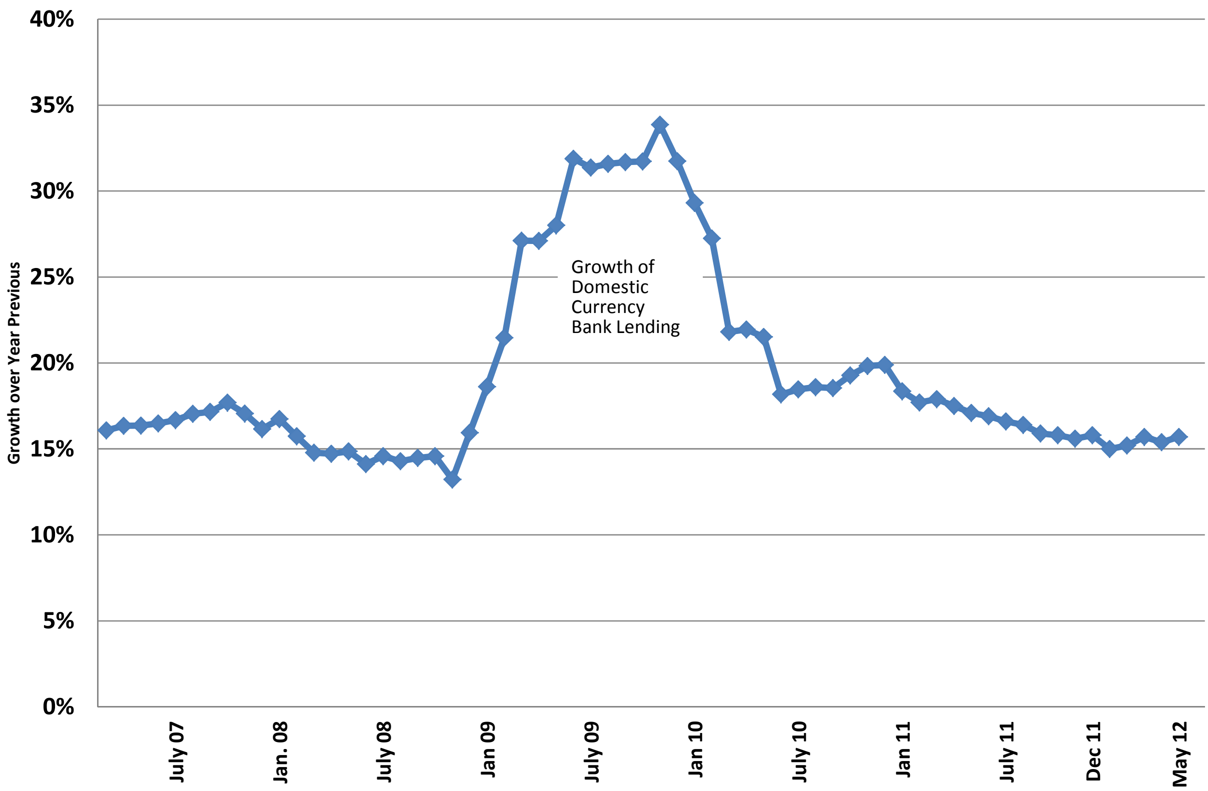
This process certainly displayed its strengths, for it elicited a rapid start to tens of thousands of investment projects. Kanbur (2009), in an interesting discussion of crisis responses, makes a distinction between those that are easy to ramp up but hard to wind down (like food subsidies), versus those that are hard to ramp up but relatively easy to wind down (such as public works projects). It is a peculiarity of the Chinese system that public works projects are much less difficult to ramp up than in a "normal" economy. In the event, Chinese local officials revealed that they had "shovel-ready" projects on the shelves they good quickly pull down and put into operation. Within a month of the center's requests (from the NDRC), 18 out of 31 total provinces had proposed projects with a total budget of 25 trillion, over 80% of annual GDP.[14] With this embarrassment of riches, it was relatively easy for NDRC to award project approvals with quick and rudimentary inspection of documents, or by cutting everyone's wish lists back equally. The result was that the resource mobilization was much more rapid in China than in most countries. In the US, for example, the maximum impact of the early 2009 fiscal stimulus bill did not occur until the second quarter of 2010. It was eighteen months after the beginning of the crisis hit that the maximum fiscal impact was felt. In China, it was possible to observe the initial effects of new and accelerated projects in the Chinese economy within weeks, and certainly by the beginning of 2009.

None of this was possible without a funding mechanism. The center did distribute a significant sum of money to the localities for these investments, about 800 billion RMB. Thus, local governments controlled about three-quarters of the fiscal stimulus. However, that sum pales beside the financing needs of the vast array of projects local governments wanted to start. In fact, the only possible source of funding of this magnitude was the banking system. The central government had already prepared the ground for a substantial

14. Huo Kan, Wang Changyong and Wang Jing, "Can Stimulus Light China's Consumer Fire?" *Caijing*, March 6, 2009, at http://english.caijing.com.cn/2009-03-06/110114349.html

mobilization of credit resources (and an associated relaxation of credit standards). Interest rates and reserve requirements were lowered. These explicit policies designed to ease provision of credit, were mixed with the urgency and politicization of the stimulus itself. Together these measures sent a powerful signal to banks that they are expected to ramp up lending quickly, and suggested to bank loan officers that they would not be held accountable for loans that turned sour later.

Figure 5. Growth of domestic credit



Inevitably, the banking system responded with a flood of lending. As Figure 5 shows, bank lending exploded during the early months of 2009. During the first quarter of 2009, total RMB bank loans outstanding increased by a whopping 4.6 trillion RMB.[15] This

15. Credit data are at www.pbc.gov.cn. The data for March 2009 are given at http://www.pbc.gov.cn/detail.asp?col=100&ID=3174

can be put into perspective in two ways. First, the increase in bank credit during the first three months of 2009 was more than the total planned 4 trillion investment stimulus package, which had been intended to stretch over more than two years plus one quarter. Second, if we roughly calculate what ordinary credit needs would have been during the first quarter of 2009, then the *excess* credit above normal just in this one quarter was equal to 10% of annual GDP. This is a huge amount of credit to be injected into an economy in a short time. Credit creation stayed high in the second quarter as well, before gradually being brought down to earth. There are various ways to calculate the total Chinese stimulus effort during all of 2009, but it was certainly huge. One illustrative calculation puts the amount of bank lending above "business as usual," plus special bond financing and fiscal deficit, at a total 20.7% of GDP in 2009.[16] The consolidated government budget swung into a deficit, equal to 2.3% of GDP in 2009, including most of the special bond issuance. Thus, the explosive growth of bank credit provided the bulk of the Chinese stimulus response. It was a monetary response, not primarily fiscal, and it was driven by the state-owned banking system.

By comparison, in the United States, the Federal Reserve Board also dramatically increased its lending, holding US$1.2 trillion more in assets on its balance sheet in mid-April 2009 than a year earlier, an amount equal to over 8% of 2008 GDP of $14.5 trillion. But this was an attempt to offset a collapse in credit extended in other parts of the economy, whereas there was no such collapse in China.[17] The US fiscal stimulus was of comparable magnitude to the expansion in the Federal Reserve Board balance sheet, so that total stimulus response peaked at around 15% of GDP. The Chinese stimulus was larger proportionately than the US stimulus, and it was certainly delivered much more promptly. As a result, by mid-year 2009, there was already unmistakable evidence that

16. GaveKal Dragonomics, "Mother of all stimuli," *China Economic Quarterly* 14: 2 (June 2010), p. 27.
17. Federal Reserve Board data at http://www.federalreserve.gov/releases/h41/Current/

employment had stabilized in China, and that output was beginning to recover. China was arguably the first economy to have recovered from the global financial crisis, and the derived demand for commodity imports was crucial in stabilizing the global economy at the end of the first quarter in 2009.

3. The institutional impact: assessment of GFC response

In order to produce the vigorous stimulus response described in the previous section, Chinese leaders had to engage in a significant process of institutional adaptation. The most immediate example refers to local governments. In fact, local governments in China are not permitted to borrow directly from banks themselves, so they must establish development corporations or other quasi-independent agencies to actually do the work. This process carries obvious moral hazards, and in normal times the central government monitors it fairly closely. In 2008-9, in order to help the localities come up with funding, the central government relaxed its oversight over these development corporations and actively encouraged local governments to expand them. The resulting so-called local government funding or investment "platforms" (*rongzi pingtai*) were allowed to qualify for loans and issue certain kinds of corporate bonds that would count as paid-in capital.[18] These special provisions were designed for projects that were approved by the government as part of the stimulus investment program, but they spread quickly and local government funding vehicles proliferated.

18. This allowed these investment platforms to sidestep capital adequacy requirements, dating back to 1996, which required them to have equity capital equal to 20-35% of total investmenets. Zhang Ping, Head of NDRC, Press Conference at the Second Session of the 11th National People's Congress, March 6, 2009, accessed at http://www.ndrc.gov.cn/xwfb/t20090306_264932.htm; Zhang Guangming, "Siwanyiyuan touzi mianlin nanti; Cuokaihang ruandaikuan youwang chongchu jianghu [4 Trillion Investment faces difficulties; Soft loans from China Development Bank may reappear]," *Zhengquan Shibao,* March 19, 2009, accessed at http://finance.ce.cn/bank/scroll/200903/19/t20090319_14352894.shtml

The Chinese government, empowered by the massive flow of money through the system, soon moved into more assertive forms of industrial policy. At first, this was part of crisis management. In February 2009, "Industrial Revitalization Plans" were issued for ten (mostly) traditional industrial sectors, all struggling at that time with declining orders, excess capacity, and substantial losses.[19] Although justified by crisis conditions, these plans authorized financial support for specific firms, and envisaged desirable market structures for two and three-year time horizons. This represented a newly interventionist spirit in Chinese industrial policy, a spirit that soon spilled over into a plan for "Strategic Emerging Industries." This was a list, ultimately covering 35 industrial sectors, of high technology sectors seen to be emerging in the post-crisis period. Clearly inspired by the fact that governments everywhere stepped up their investment in new energy, environmental, and information technologies, the Chinese government gradually assembled their own aggressive support programs into an overall framework during 2009. Ultimately, the Strategic Emerging Industries plan declared that its objective was to raise the share of a cluster of 35 industrial sectors from under 4% of GDP in 2010 to 8% in 2015 and 15% in 2020. A commonly articulated Chinese perception was that the impending emergence of fundamentally new high-tech industries gave China the opportunity to get in on the ground floor. Without powerful incumbents to lock them out of dynamic and profitable positions, China could "occupy the commanding heights of the new technological revolution." This fueled a willingness to have the government intervene aggressively in important industrial sectors.

These are large and long-term policy decisions, but it is reasonable to link them to the crisis response. In fact, the Chinese Premier Wen Jiabao, in his 2010 Government

---

19. Zhang Ju, "What we can look forward to in the second quarter for the ten sectoral revitalization plans [十大产业振兴计划出齐 二季度带来的憧憬], *Nanfangwang* February 28, 2009, accessed at http://finance.qq.com/a/20090228/000017.htm

Work Report, which is an authoritative official document, summarizes the lessons learned from the global crisis and China's response:

> In the past year, vigorously responding to the global financial crisis,….we came to the following conclusion: While continuing to …. let market forces play their basic role in allocating resources, and stimulate the market's vitality, we must make best use of the socialist system's advantages, which enable us to make decisions efficiently, organize effectively, and concentrate resources to accomplish large undertakings.[20]

Note that this formulation specifically equates the market and the centralized deployment of administrative and political resources. However, as a description of Chinese policy principles, only one part of it is new: the emphasis on the centralized deployment of resources. This is, in fact, the lesson that the Chines leadership had drawn from the crisis response as of early 2010.

What we see from this quote is that the initial institutional and systemic impacts of the GFC response were precisely the opposite of those of the AFC response. Under Zhu Rongji, the AFC response was allowed to continue the pressure on the state sector, and increase the resolve to open, reform, and institutionalize the reformed system. Under Wen Jiabao, the GFC response was allowed to strengthen the state sector, legitimize increased government steerage of the economy, and bring the financial sector back under government tutelage as an instrument of government policy. One piece of evidence for this interpretation is a statement by Huang Mengfu, the head of the All-China Federation of Industry and Commerce. Huang is, by merit of his position, the designated spokesman *to* the Communist Party from the private business sector. He declared in September 2009 that

---

20. Wen Jiabao, "Report on the Work of the Government (2010)," Third Session of the 11th National People's Congress, March 5, 2010, accessed at http://www.npc.gov.cn/englishnpc/Speeches/2010-03/19/content_1564308.htm. The original reads: School of International Relations and Pacific Studies, University of California San Diego。

"in certain regions and sectors, we've observed the phenomenon of the state advancing at the expense of the private sector (*guojin mintui*) . . . we will pay a serious price for this."[21]

In other words, although the stimulus worked, it was costly. At a minimum, it distorted the Chinese economy by halting, and temporarily reversing, the decades-long trend for the state to retreat from the economy, and for private and non-governmental actors to play a greater role. This was harmful not solely or even primarily because the state sector is "inefficient" or "backward," but rather because these actions profoundly disrupt the incentive structure that applies to both private and public actors. As long as the scope of the state sector was basically known and the trend both inside and outside the state sector was toward more profound marketization, individuals were rewarded for maximizing benefits according to market-determined prices and rewards. However, once the scope of the state sector is indeterminate; and administrative interventions are repeatedly re-drawing the boundary between state and private; then individuals must devote a great deal of their attention to anticipating and manipulating those administrative acts. This new environment changes calculations and increases costs even for efficient outcomes: more important, it increases rent-seeking opportunities and produces many more inefficient outcomes.

Thus far, Chinese policy-makers have been heeding Wen Jiabao's lesson, and not Huang Mengfu's lesson. In the years since the GFC response, we have seen increasing reliance on direct government interventions in the economy (sometimes to achieve very desirable goals), in a wide range of policy arenas. Particularly striking are new government initiatives in health insurance and other aspects of health policy; in technology policy; and in housing policy. Obviously such a list does no more than give a

21. "Huang Mengfu: "*Bufen yangye yixian guojin mintui; jiang fuchu shenzhong daijia*" [Some sectors have already experienced the state advancing at the expense of the private sector; we will pay a heavy price], *Diyi caijingbao*, 22 September 2009. Accessed at http://www.umetal.com/html/cnyjsh/newsDetail.jsp?id=1836068.

flavor of recent decision-making, and the reality in each field is complex (See Naughton 2011 for a brief description). But the list should convey the idea that overall policy-making has tilted toward a substantially greater reliance on administrative intervention than may have been the case in the past. In that sense, the evidence is highly consistent with Wen Jiabao's own description of the lessons learned, and raises concern that the lessons learned from the financial crisis might well have been the wrong ones.

Stimulus policies undermined the integrity of the financial system in more direct and immediate ways. First, banks relaxed their concerns about risk and prudential standards and made massive loans to government clients. This represented the sudden abandonment of the difficult process of upgrading banking standards that had been underway since 1997, and which had taken a large leap forward with the bank recapitalization and restructuring accomplished primarily in 2003-6. Bank budget constraints had gradually become "hard" (binding), but now they had suddenly become "soft" again. Over the past fifteen years, banks had been allowed to write off trillions of RMB worth of non-performing loans (NPLs). The stimulus surge of bank lending created not just fears of new NPLs, but more importantly fears that the government could not credibly demand that the banks be responsible for their own profits and losses. Thus, the whole incentive environment of the banking system was weakened. Second, the government, more or less intentionally, expanded the number of financially unsound local government investment corporations, referred to previously. Not for the first time, financially flimsy (and sometimes shady) local government investment corporations proliferated in the Chinese economy. The top bank regulator, Liu Mingkang, reports that at the end of 2009, loans to local funding platforms were 7.38 trillion RMB (up 70% from year-end 2008).[22] A related but somewhat different calculation by Victor Shih comes up

22. Xiao Ping and Zhang Muxia, "Shekeyuan zhuanjia cheng defang zhengfu fuzhai zongliang rengzai kekong fanwei [An expert from the Chinese Academy of Social Sciences says the overall scope of local government indebtedness is still in the controllable range]." *Renmin Ribao*

with an even larger number. 7.38 trillion RMB is a huge sum, equal to about 20% of GDP. While it is obviously possible for the Chinese government to absorb an additional twenty percentage points of GDP worth of debt without threatening its fundamental financial stability, it represents a significant set-back on the road to a healthy, market-compatible financial system.

It can be seen that the vigorous Chinese response to the GFC relied on the most ingrained features of the Chinese political economic system. The responsiveness of local officials to the opportunity to invest; the willingness of actors at all levels to return to "soft budget constraint" conditions; and the lack of real independence of the banking system in the face of renewed politicization: all these propelled the stimulus impulse but also resurrected some of the most serious shortcomings of the pre-reform Chinese economic system. The Chinese stimulus was not a careful technocratic response to perceived crisis, it was a kind of mobilization than opened a Pandora's Box of complex effects. It revealed the deep structure of the Chinese political economy, even as it intensified some of the aspects of the system.

What is surprising is that the response of Chinese leaders to the GFC displayed an almost cavalier lack of regard for the achievements of earlier reforms. The reason why the response to the stimulus policy was extraordinarily rapid and effective is that it was achieved by bringing back to life some of the worst features of the Chinese system. Economic decision-making was driven by a top-down mobilization of the system via Communist Party channels. Its effectiveness relied on unleashing the "expansion drive" in the system, that is, the built-in tendency for political and bureaucratic actors at all levels to claim public resources to invest in their own projects (and careers). Thus, the fact that the system was highly responsive to a top-down call to ramp up investment quickly should

[Overseas Edition], May 21, 2010, accessed at
http://finance.sina.com.cn/g/20100521/06107977696.shtml

not be too surprising, since this is, after all, exactly what the system has been set up to achieve. These systemic defects had never disappeared, but they had been subordinated to the market forces unleashed by earlier reforms. It was astonishing that Chinese leaders were willing to discard so easily the hard-won achievements of earlier reforms.

It is not yet clear how these trends will play out. However, as of 2012, the Chinese economy faces a slow-down, and there are increasing signs of disillusionment with the policy direction charted during the GFC. As the economy slows, all the flaws in the financial institutions that were hidden during the rapid growth phase start to become evident, and also seem to be more difficult to resolve. New leaders coming to power at the end of 2012 will have many motivations to discard the policy initiatives of their predecessors. Moreover, China has moved into the ranks of middle income societies with astonishing speed, creating new demands and new stresses and strains on the system. The legacy of China's vigorous GFC response is still far from clear.

4. From the AFC to the GFC: The ambiguities of success

We have seen that Chinese policy-makers were successful in dealing with the immediate challenge of both the AFC and the GFC. Certainly, China's economic performance was impressive, and neither crisis seemed to slow China's astonishing growth very much. Moreover, both crises have provided material for a narrative of success, one that is to a certain extent picked up and repeated by official Chinese news outlets. Thus, the AFC led China to take effective measures; to fight off speculative attacks on Hong Kong, and to emerge as a responsible power in the Asia region. China's success in confronting the GFC has not only enabled its breath-taking economic growth to continue—thus dramatically increasing its weight in the global economy—it has also given the Chinese leaders an unprecedented sense of self-confidence, combined with a profound disillusionment about the U.S. and liberal economic models. This increased self-confidence is not restricted to the top leadership, either: as Ming Wan points out “to many in China, the country’s stronger performance during the crisis vindicates its choice of development model.”[23]

However, we have also seen that once we dig below the surface, this simple narrative of success is very inadequate. In fact, the 1997-98 AFC *and the Chinese response* caused changes that in many different ways profoundly set the stage for the 2008-9 global crisis, and for the Chinese response. China in the late 1990s was going through a “transition recession,” similar in kind, but much milder than that through which all the post-socialist countries passed.[24] The transition from socialism inevitably leads to a fall in measured output, but different approaches to transition affect the size of the transitional recession. China, by first growing new market-oriented production and building institutions, and only then dissolving the bureaucratic economy had come close to minimizing the transitional recession and converting it into a “growth recession.” But it was impossible to reduce those costs to zero, and China was in the midst of that difficult process when the AFC hit. As a result, the AFC ended up deepening China’s growth recession and contributing to the reform fatigue that grew out of this difficult period. In that sense, it may also be implicated in the backlash to reform that developed slowly during the 2000s.

As we have seen, the initial response to the AFC contributed strongly to a deepening of that reform process. However, it also sets the stage for a subsequent weakening of commitment to that process. Steinfeld (2008, 188) argues that “a twenty-year-old reform agenda, one that since the late 1970s had tentatively and instrumentally employed market mechanisms to sustain socialism, was in the aftermath of the Asian

23. Ming Wan, “The Great Recession and China’s Policy toward Asian Regionalism,” *Asian Survey* 50: 3, p. 532.
24. Kolodko, Grzedgorz W., “Globalization and Catching-up: From Recession to Growth in Transition Economies,” IMF Working Paper WP/00/100, June 2000, accessed at http://www.imf.org/external/pubs/ft/wp/2000/wp00100.pdf

financial crisis peremptorily and unceremoniously ditched. In its place, sweeping marketization—capitalism, in effect—was embraced at considerable political and social risk." Looking back from the perspective of the second decade of the 21st century, it is clear that this conclusion was premature. From 1992—when Deng Xiaoping pulled China out of the post-Tiananmen reaction and kick-started reforms—until November 1999, when China signed off on terms for its membership into the World Trade Organization, an extraordinary series of systematically deepening economic reforms transformed China into what was fundamentally a market economy. In this context, the Asian financial crisis of 1997-98 was a bright punctuation mark, signaling the entry into a climactic stage of reform, in which state-owned enterprises were closed down on a massive scale and unemployment surged temporarily. However, the reform consolidation following the AFC did not extend to a further deepening of the reform process. Instead, once the bank restructuring conceived under Zhu Rongji was completed, reforms slowed dramatically. Indeed, if we adopt a relatively strict definition of reform, as "a change in economic system that lowers barriers and subjects new areas to market competition," there have been no major reform initiatives in the decade since bank restructuring. China has thus fallen short of embracing sweeping marketization, much less capitalism.

While the post-AFC period did not see China stay the course on its marketization agenda, it did hold tight to its concern about external vulnerability. The most fateful decision was to fix the peg of the exchange rate to the US dollar. Maintaining exchange rate stability in the face of devaluation pressure was a decision widely praised in 1998-99. However, Chinese policy-makers then proceeded to hold the peg in place until mid-2005. During that time, China's export competitiveness exploded, on the heels of successful domestic reforms and WTO membership (formally begun in December 2001, with many provisions phasing in over the subsequent 2-3 years). The result was soaring exports, a widening trade surplus, and steady accumulation of foreign exchange reserves (Figures 2 and 3). Not surprisingly, this policy elicited substantial international criticism, not least from the US. While this policy stance certainly responded to China's real and perceived need to contain international economic vulnerability, it did so at substantial cost.

On one side, these policies contributed to domestic economic distortions. We have already argued that the commitment to marketization and reform waned—or was at least temporarily sidelined—after around 2003. In this situation, the decision to maintain a fixed, and undervalued exchange rate, led to a variety of interrelated problems. The close relationship linking a range of economic problems has been argued most cogently recently in Lardy (2012). As China accumulated reserves in the mid-2000s, the tendency for the domestic money supply to expand could only be partially restrained, at great effort, by central bank sterilization. As a result, inflationary pressures steadily built which the monetary authorities were only able to periodically restrain. As Figure 4 shows, cycles of inflationary pressure steadily pushed up the overall price level (after moving out of the deflationary period associated with the AFC itself). Concerned about the financial health of the banking system (only recently rehabilitated), policy-makers responded by keeping caps on deposit interest rates, which increasingly resulted in negative real interest rates for China's savers. "Financial repression" resulted, in which the financial system implicitly taxes the household sector for the benefit of the corporate sector. These policies restrained the growth of household income by directly reducing interest income to China's high-saving households. Moreover, the low interest rates on offer at the banks created incentives to slow the development of capital market alternatives to the banking system, which not only raised financing costs for businesses, but also restricted the saving and investment options of Chinese households. In the absence of forward progress on marketization, imbalances arose that were not subject to the automatic re-equilibration of the market.

On another side, China's post-AFC policies contributed to the global imbalances that were part of the environment out of which the GFC grew. It is not that Chinese policies caused the GFC. There is more than enough blame for the GFC in US macroeconomic policies and regulatory lapses, and there is no need to apportion additional blame to China. However, Chinese policies enabled US policy mistakes, because of the two main channels through which Chinese exchange rate policy influenced the US. First, sustained Chinese government demand for US treasuries (for its official foreign exchange reserves) kept long-term interest rates low. Second, maintaining a fixed RMB kept Chinese export prices low, contributing to lower US prices and restrained US inflation. Both these effects contributed to signals that the US Federal Reserve Board read as indicating that monetary policy in the US was not "too loose." After the AFC, all the East Asian economies began to run long-term trade surpluses and accumulate foreign exchange reserves, and this is part of the economic story that connects the two crises. Asian current account surpluses were the mirror image of US deficits. The willingness of the Asian economies to keep their surpluses in low-yielding US treasuries fed the hubris at the US Federal Reserve Board which believed that there were no bubbles, just an adjustment to a "global savings glut," and thus delayed regulatory and prudent macroeconomic responses until they were too late. (Coulibaly and Millar 2008). China is of course the largest single actor in that story. US policy-makers then maintained a policy stance that, in retrospect, most economists believe to have been excessively expansionary (See Taylor 2009 for one critique). This in turn contributed to inflating the housing bubble, the bursting of which was the proximate cause of the GFC.

There is no unambiguous connection of cause and effect in these relationships. All we can say with confidence is that Chinese policy-making allowed for increasing distortions in both domestic and international economic relationships through the mid-2000s. While Chinese government officials bristled at foreign (and especially American) criticisms of their exchange rate policy, thoughtful Chinese economists also pointed out that fixed and misaligned exchange rates create imbalances that ultimately do damage to the Chinese economy (Yu 2007). In any case, when, due to American mismanagement, the GFC did come, the cautious—some might say excessively cautious—trade and currency policies of China put China in a relatively secure position: Reserves were certainly ample, and domestic financial conditions still reasonably secure. Like other countries that had accumulated reserves during the good times of the 2000s, China weathered the GFC in reasonably good shape.

The final impact of the policy stance that China chose in the wake of the AFC is that it strongly determined the approach of China's policy-makers when they addressed the GFC. By 2008, Chinese policy-makers, led by the Premier Wen Jiabao, had dialed down their commitment to market reforms, and increasingly stressed achievement of social and economic goals through direct government action. Policy reform was underway with respect to health care reform. An activist technology policy had been developed in the wake of the Medium and Long-term Plan for Science and Technology Development, put in effect beginning in 2006. In this context, China's policy-makers very much approached the challenges of the GFC from the standpoint of government planners. They believed in direct government action, and they moved quickly to put government programs in place that would directly support the sectors and households affect by the global crisis. They result was an even higher level of direct government intervention in the economy than had been evident for more than a decade.

Thus, the response to the GFC echoed the response to the AFC in this sense: the initial response intensified the existing policy orientation of the leadership. Zhu Rongji's reformist impulses were extended by the AFC; Wen Jiabao's interventionist tendencies were extended by the GFC. In a sense, this is not surprising, since China really is a large country, with an extraordinarily complex and sometimes tensely bargained out domestic political equilibrium. External events, even rapidly moving and potentially dangerous external events, are filtered through a complex domestic political environment. Leaders such as Zhu Rongji or Wen Jiabao, having achieved political positions that enable them to carry out large scale agendas to which they are personally committed, are not likely to abandon them in the face of external events. Instead, they adapt those agendas to new circumstances, which often involves making that agenda more radical, or extending it into new areas. But by the same token, the radicalization of the agenda creates fertile ground for a subsequent backlash. Policy responses to crises are not necessarily sustained after the first few years.

5. Conclusion: The 2012 legacy

Coming immediately out of the GFC, the Chinese evaluation of their response was overwhelmingly positive. The stimulus program produced tremendous benefits, benefits that were shared between China and the rest of the world. Two years later, policy-makers and the public are paying much more attention to the substantial costs, some of which are only gradually becoming evident. Around the world, most countries are already engaged in unwinding the extraordinary measures taken to cope with the crisis. Fiscal stimulus is being unwound in order to restore confidence in future government finances, especially in Europe. Extraordinary interventions in financial markets are being unwound, especially in the U.S. In one respect, China is very much in line with these trends, as it is proceeding to unwind the extraordinary credit-based stimulus impulse it launched in 2009. But in another sense, China stands out in still embracing the extraordinary expansion in the government role and government intervention adopted during the crisis, while most market economies are re-emphasizing the lines that divide government from the market and committing to a speedy government withdrawal from the market. Of course, all countries are finding this process extraordinarily difficult. But China's task may end up being the most difficult of all, because China confronts a number of intertwined issues.

Consider the issues in terms of structural balance. The long-term quest for structural balance can be seen most clearly through the investment rate. Despite China's oft-stated commitment to a more balanced economy and to reduction of the share of fixed investment in total GDP, the rate of investment in China's economy soared to a globally unprecedented 47% in 2009. Besides being merely ironic, this presents substantial policy challenges, because the task of slowing investment growth and increasing consumption growth while also maintaining economic stability has become even more difficult. In subsequent years, investment has remained an indispensable driver of the economy, and the total investment rate has actually edged up, to an astonishing 49% in 2011. By contrast, some re-balancing has occurred with the reduction in the size of the trade surplus.

Finally, questions of economic structure and development strategy are now in close interaction with questions of the direction of the economic system. The bigger issue with respect to investment, for example, is not the size of investment per se, but rather that the crisis-driven changes to the "rules of the game" have tended to strengthen the very incentives that lead to an inflated investment effort in the first place. By giving government officials and state-owned enterprises control over an even larger volume of resources, and by reducing the accountability of both officials and financial institutions, the changes inevitably soften budget constraints, reduce individual risk, and encourage even larger investments. As a result, although the Chinese government has declared its commitment to an economic rebalancing for more than seven years, such a rebalancing has not occurred. Indeed, the economy is far more unbalanced than it was in 2005, measured by the investment rate. It should be clear after such a time lag that there is a fundamental disconnect between the instruments being applied and the objectives to which they are directed. Yet Chinese policy thus far has stressed the stronger and more authoritative application of the same instruments, rather than a dramatic change of approach.

Both of the global crises, and the responses to them, have defined important moments in the global power shift, and China has been an apparent beneficiary of the shifts both times. But, ironically, those crises and the differing responses to them, also highlight the fact that no one has really been able to define a coherent “Chinese model.” The rather imaginative literature on a supposed “Beijing consensus” demonstrates this quite clearly. For now, Chinese policy-makers appear to be creating a Chinese model by combining a stronger, more authoritative dose of top-down government intervention to their most pressing policy challenges. But this means applying a similar policy-making approach to different policy arenas, and it is unlikely to be very successful, since different approaches are likely to be required in different policy arenas, and the experimentation and pragmatism that many see as part of any Chinese development model almost certainly requires a lighter touch than what we currently see. This momentum—a product of the response to the GFC—appears to be running out of steam as the economy hits the growth slowdown of 2012. It seems likely that a new generation of leaders will re-orient Chinese policy and thereby redefine the meaning of China’s crisis response.

References

Brandt, Loren, and Xiaodong Zhu. 2007. China's banking sector and economic growth. In *China's financial transition at a crossroads*, ed. Charles W. Calomiris, 86-136. New York: Columbia University Press.

Coulibaly, Brahima, and Jonathan N. Millar. 2008. The Asian financial crisis, uphill flow of capital, and global imbalances: Evidence from a micro study. International Finance Discussion Papers 942 (August). Washington, DC: Board of Governors of the Federal Reserve System. http://www.federalreserve.gov/pubs/ifdp/2008/942/ifdp942.pdf.

Eichengreen, Barry. 2006. The next financial crisis. In *Recent financial crises: Analysis, challenges and implications*, ed. Lawrence R. Klein, and Tayyeb Shabbir, 121-33. Cheltenham, UK: Edward Elgar.

Haggard, Stephan. 2008. Democratization, crisis, and the changing social contract in East Asia. In *Crisis as catalyst: Asia's dynamic political economy*, ed. Andrew Macintyre, T. J. Pempel, and John Ravenhill, 93-114. Ithaca, NY: Cornell University Press.

———. forthcoming. Politics in hard times revisited: The 2008-9 financial crisis in emerging markets. In *Politics in the new hard times: The great recession in comparative perspective*, ed. Miles Kahler, and David A. Lake. Ithaca, NY: Cornell University Press.

Jao, Y.C. 2001. *The Asian financial crisis and the ordeal of Hong Kong.* Westport, CT: Quorom Books.

Kanbur, Ravi. 2009. The crisis, economic development thinking, and protecting the poor. Presentation to the World Bank's Executive Board, July 7, 2009. http://www.kanbur.aem.cornell.edu/papers/WorldBankBoardPresentation7July09.pdf.

Lardy, Nicholas. 1998. *China's unfinished economic revolution.* Washington, DC: Brookings Institution.

———. 2012. *Sustaining China's economic growth after the global financial crisis.* Washington, DC: Peterson Institute.

Ma Guonan. 2006. Sharing China's bank restructuring bill. *China & World Economy* 14 (3): 19-36. http://www.bis.org/repofficepubl/apresearch0605ma.pdf.

Naughton, Barry. 2007. *The Chinese economy: Transitions and growth.* Cambridge, Mass: MIT Press.

———. 2009. Understanding the Chinese stimulus package. *China Leadership Monitor* 28 (Spring). http://www.hoover.org/publications/clm/issues.

———. 2011. China's economic policy today: The new state activism. *Eurasian Geography and Economics* 52 (3) (May-June 2011): 313-29.

Park, Donghyun, Kwanho Shin, and Juthathip Jongwanich. 2009. The decline of investment in East Asia since the Asian financial crisis: An overview and empirical examination. ADB Economics Working Paper Series 187 (December). http://www.adb.org/sites/default/files/pub/2009/Economics-WP187.pdf.

Sharma, Shalendra D. 2003. *The Asian financial crisis: Crisis, reform and recovery.* Manchester: Manchester University Press.

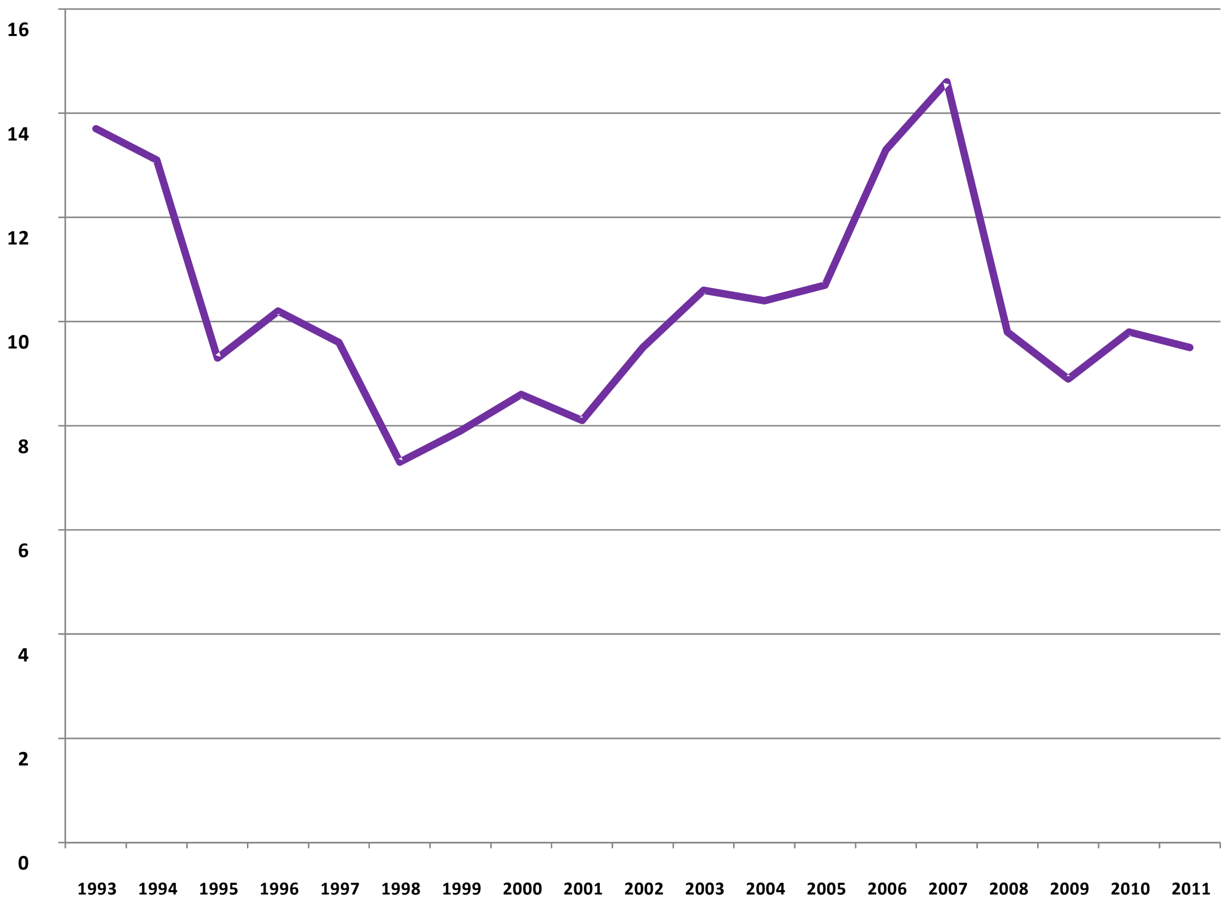
Steinfeld, Edward. 2008. The capitalist embrace: China ten years after the Asian financial crisis. In *Crisis as catalyst: Asia's dynamic political economy*, ed. Andrew Macintyre, T. J. Pempel, and John Ravenhill, 183-205. Ithaca, NY: Cornell University Press.

Taylor, John B. 2009. *Getting off track: How government actions and interventions caused, prolonged, and worsened the financial crisis*. Palo Alto, CA: Hoover Institution Press.

Walter, Carl, and Fraser Howie. 2012. *Red capitalism: The fragile financial foundation of China's extraordinary rise*. Revised ed. New York: Wiley.

Yu, Yongding. 2007. Global imbalances and China. *Australian Economic Review* 40 (1): 3-23.

Figure A1. China annual GDP growth



Source for Figure A1: *China Statistical Abstract 2012,* p. 23.

Abstract (in Japanese)

中国と二つの危機――1997 年から 2009 年まで

要 約

中国は、アジア金融危機（1997-98 年）とグローバル金融危機（2008-09 年）の最悪の衝撃を上手く乗り切ったように見える。中国の指導者は対外的な危機に対して、迅速にそして時には大規模に対応した。しかし、振り返ってみれば、それぞれの危機に対する対応は行き過ぎの面があり、その後に国内での見直しと後退が行われた。本稿は、当面のマクロ経済危機への対応、制度の適応、貿易・為替政策の 3 つの側面から 2 つの危機の共通性と相違について検討する。議論の中では、アジア金融危機への対応の「成功」が、グローバル金融危機に連なるより深い経済問題を生み出す元になったことを明らかにする。そして、グローバル金融危機への対応を通して、政府の官僚と国営企業がより多くのリソースを支配するようになり、また彼らと金融機関の説明責任も減少することになったと論じる。こうした変化が必然的に予算制約を緩め、個々のリスクを下げ、投資を一層促すことになったのである。結果として、現在の中国経済は、国内制度の適応の拙さに由来する問題が蓄積しているが、その不適応は危機への対応と少なからず関係があると言えるだろう。

JICA Research Institute

Working Papers from the same research project

"The Second East Asian Miracle ?: Political Economy of Asian Responses to the 1997/98 and 2008/09 Crises"

JICA-RI Working Paper No. 43

99 Problems (But A Crisis Ain't One) Political Business and External Vulnerability in Island Southeast Asia

Thomas B. Pepinsky

JICA-RI Working Paper No. 44

Unraveling the Enigma of East Asian Economic Resiliency: The Case of Taiwan

Yun-han Chu

JICA-RI Working Paper No. 45

Success as Trap? Crisis Response And Challenges To Economic Upgrading in Export-Oriented Southeast Asia

Richard Doner

JICA-RI Working Paper No. 51

Financial Restructuring after the 1997 Crisis and Impact of the Lehman Shock: Path Dependence of Financial Systems in Korea and Thailand

Yasunobu Okabe