Responding to Global Economic Challenges: A View from China

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The world is again on the brink of a global crisis. Major economies are respectively plagued by different woes: the eurozone is confronted with a free-falling of sovereign debt, leading potentially to a full-fledged financial crisis; the United States is suffering from intractably high unemployment that shows no sign of improvements; and major emerging economies are besieged by unexpected high inflation. Largely due to the economic difficulties, social tensions have increased significantly and unrest has occurred sporadically in many countries.

World leaders have been called to take action to stop the global economy from falling into an abyss. But the challenge is how: launch a grand bailout for the broken coffers of Southern Europe? Expand government spending or conduct an austerity campaign? Carry out another round of quantitative easing in the industrial countries while squeezing the money supply in emerging markets? Unlike the situation immediately after 2008 financial collapse, when it was possible to have globally synchronized policies such as a universal fiscal stimulus and simultaneous liquidity provisions, there is no "one-size-fits-all" solution to address the intricate issues currently facing the major economies.

Problems of the Industrial World

The foremost urgent global problem is the emergence of a full-scale financial crisis in the eurozone. This is coming from the interdependency of sovereign debt woes in Southern European countries and bad assets in European banks. Due to the fact that almost all continental European banks, including German ones, are heavily exposed to toxic peripheral country sovereign debts, sovereign debt troubles and bank insolvency will end up exacerbating each other. This creates a vicious cycle which may doom the entire European financial system and the euro itself.

To save European Union from falling into pieces, the eurozone governments are forced to take collective actions to contain the sovereign debt woes and strengthen sick commercial banks before the situation goes beyond control. But the major obstacle is that the monetary union lacks both fiscal authority and a federal will to employ functional tools to address two interactive systemic risks. In addition, each of the eurozone governments is still struggling to win domestic support for the policy actions needed to address the situation.

Yet, no one can guarantee the success of enlarging the capacity of the European Financial Stability Facility (EFSF), expanding the role of the European Central Bank (ECB) and forming closer fiscal integration. The future of Europe is also shadowed by another recession, thanks largely to austerity policies currently being enforced by peripheral countries and France.

The situation on the other side of the Atlantic is anything but promising. A normal economy would have a strong and sustained rebound after a deep recession clears up the muddle. But this has not happened in the U.S. Two years after the economy started to climb again, the recovery is very weak and temporary. Despite the fact that the U.S. government resorted to an unprecedented stimulus campaign accommodated by the Federal Reserve's quantitative easing, job creation is still stagnant; the current U.S. unemployment rate is still hovering over 9 percent. Public spending, on the other hand, will hit a new high of $3.6 trillion this fiscal year, which makes the U.S. the second most heavily indebted nation in the developed world.

The real danger is that such huge government spending has resulted in little economic growth. This implies that the gap between government spending and revenue is more likely to move toward a diverging track. As the U.S. budget deficit and federal debt are mainly driven by the phenomenal rise of entitlement expenditures, especially in health care, it is very uneasy for the rest world to guess when the welfare status quo in the U.S. will grind to a halt and how the U.S. will unwind its debt burden.

The truth is that the redistribution of wealth needs lots of political support but it is unlikely to raise economic productivity. To absorb unduly high unemployment and reduce unbearable public debt, the U.S. must be on a long-term transition from a mass consumption society toward a creative production economy. However, constrained by political reality, the path of a welfare state is not easily altered.

China's Challenges and Policy Responses

Although China is financially better positioned than the major industrial countries, it has its own challenges.

The first challenge is to cope with rising inflation. Similar to its peers in the developing world, China has been experiencing an increase in prices over recent months. This is caused by both internal and external reasons. For over a decade, the People's Bank of China (PBC) has used yuan to buy dollars and then has sterilized the money supply by selling bonds to retire yuan from circulation to maintain stability in prices and exchange rates. As a result, the PBC's balance sheet is plugged with massive foreign reserves, making it the largest central bank in the world. If the sterilization ceased, a glut of yuan would flood the economy. The grand stimulus starting in 2008 ended the sterilized equilibrium. China's stimulus plan is so heavily debt-fueled that bank lending rose by 21.75 trillion yuan ($3.35 trillion) in 2008-10. This is the monetary driver of rising prices. On the other hand, the Federal Reserve's quantitative easing partly contributes to China's inflation. As trillion-sized extra dollars were injected in the global market, the world commodity prices, including petroleum and agricultural products, have been boosted. As the largest importer of commodities, China is inevitably faced with cost-push inflationary pressure.

The second challenge is to tackle the slowdown of economic growth. This is caused by multiple factors. On the demand side, the gloomy perspective of Europe and the U.S. puts downward pressure on China's growth since they are the most important markets for China's exports, directly accounting for one-third of China's total exports and over a half indirectly. In the meantime, domestic household demand in China lags far behind income expansion, due largely to the fact that income distribution is in favor of government and state sectors. On the supply side, big state companies have easy access to credit with the current financial system, but small and medium-sized enterprises are in a pinch, even though the latter provides the majority of jobs and accounts for half of national products in China. As the matter stands, rising prices coupled with a growth slowdown hints at a real danger of stagflation with Chinese characteristics.

Another woe is the property bubble that has been developing in the past three years when the stimulus campaign was launched. While big firms held too much liquidity, especially monopolistic state companies, they rushed to the real estate sector for unduly high profits. Rich households were zealous of property investments as there were very limited venues to park savings, while middle-income families were panicked to get into the real estate market in fear of rapidly rising property prices.

The fourth challenge is the continuous deterioration of income distribution tilted toward government coffers, big state enterprises and urban riches against the backdrop of rising prices, especially property prices. Meanwhile, disparity between low-income earners and high-income earners has significantly widened.

In addition to these short-term challenges, there are some long-term structural problems that China must address. Some of these include: the continued income disparities between rural and urban areas and among different regions; the reliance on exports and resource-intensive manufacturing as major drivers of economic growth; the relatively slow progress in China's innovative capabilities, and the massive air and water pollution throughout the country. China has been trying to address these problems by changing its overall development model to a more balanced and sustainable path since 2003. However, it is still an uphill battle to try to shift the system to the new development path, particularly in the face of a global economic crisis.

Faced with these challenges, the Chinese government has undertaken a series of policies to combat rising inflation and maintain economic stability.

The most striking one is a tight monetary policy to curb liquidity. Since November of 2010, the PBC has raised the required reserve ratio for commercial banks by nine times, driving the ratio from 17.5 percent up to 21.5 percent, significantly squeezing the available liquidity in the credit market. In addition, the PBC has let the nominal exchange rate of yuan against the dollar appreciate by 4.2 percent since beginning of this year in hopes of partially canceling out imported inflation. The China Banking Regulatory Commission (CBRC) has set up a risk capital requirement for trust companies to oversee Chinese shadow banks for possible credit substitution.

Another strong policy combination is restrictions on residential housing purchases coupled with a big low-income rental housing plan. At the beginning of this year, the Chinese government issued property market regulations to cope with the property bubble by raising the down payment requirement and prohibiting speculative purchases. In the meantime, it has also undertaken a large-scale campaign of constructing 10 million units of low-income rental apartments nationwide this year, and totaling of 36 million units in three years. To accommodate this ambitious plan, the central government is permitting the investment firms of local governments to fund projects by issuing company bonds. The central government is also allowing banks to provide debt financing with preferential rates.

Other visible social programs include a free compulsory education plan for all children, and enlargement of both health care coverage for rural residents and social security for urban low-income earners.

However, some of these measures are double-edged swords. For example, raising the required reserve ratio of banks has an immediate impact on the 40 million small and medium-sized enterprises currently facing a serious credit crunch that is forcing many of them to close or borrow money in the gray market with interest rates two to three times higher than official rates. Most recently, the State Council had to roll out a whole new set of policies specifically designed to support small firms.

On the other hand, traditional tools to tighten credit have become more difficult than ever because financial institutions have many ways of circumventing control and regulations. Furthermore, the conduct of monetary policy is in essence based on direct quota rationing, so that it is more likely to lead to severe rent-seeking by banks.

Compared to proactive monetary policy, fiscal policy is rather inactive and inflexible in responding the looming challenges, even though it may play a more important role given China's strong fiscal position. Certain welfare policies, especially a big campaign for low-income housing, may run the risk of piling up significant bad loans in the banking system as these welfare measures have not been carefully studied and debated.

At the same time, China has also started to promote the development of strategic emerging industries. In all, seven major industry clusters were identified—energy saving and protection of the environment, the next generation of information technology, new materials, alternative energies, clean cars, biotech and high value-added manufacturing—in hopes of increasing their share of China's GDP from 3 to 4 percent to 8 percent by 2015 and to 15 percent by 2020.

Suggestions for Global Cooperative Actions

While China and other countries' efforts may help to ease the problem to a certain extent, it is clear that the world is facing some seriously complex global challenges. An additional round of fiscal stimulus and loose quantitative easing will not help lessen the crisis. On the contrary, they may accelerate its burst and exacerbate the macroeconomic environment afterwards. The following are some possible ways to get out of this economic mess.

The world must work together to contain the immediate financial crisis in Europe in order to prevent the international monetary system from permanent damages caused by either the monetization of troubled sovereign debts or the collapse of the euro system. Meanwhile, it is also urgent to formulate local public polices with global considerations to resume the long path of economic growth in the developed world and to cope with inflation in the developing countries.

1. Fix Europe's Financial Woes

In the context of Europe, the political status quo rules out the replication of the U.S. grand bailout. The International Monetary Fund is an ideal institution to provide external aid. But IMF's European preference is severely constrained by the mismatch of its financial ability and global responsibility. As such, it is necessary to find a creative way to solve the European crisis. An alternative model of cooperation between the European authorities and global market investors can address the current financial woes.

This approach creates a division of labor between the united European governments and allied long-term global investors, including Western private investment firms, like Berkshire Hathaway, and Asian public fund institutions, like China's SAFE and CIC, Singapore's GIC and many others, to strengthen the trembling European financial system. That is, European governments should collectively clear up the sovereign debt mess on the foundation of political compromises and global cash-rich long investors would collaboratively invest in European banks as market-based deals. To facilitate this plan, the European authorities should pursue the following steps in advance:

- enlarge the rescue fund, restructure sovereign debts and promote the Eurobond plan to assure investors;
- adopt the model of a resolution trust company (RTC) to separate bad bank assets from good ones for European banks;
- collectively engage with cash-rich long investors, including Asian and Chinese investors for terms and conditions of involvement;
- enhance transparency of bank balances and off-balances; and
- leave prices and clauses of bank investment negotiated by involved parties on a mutually agreed basis.

2. Restart the U.S. Economic Engine

Obviously, massive government spending alone will not create enough jobs nor will unprecedented quantitative easing. On the other hand, persistent negative externalities caused by these measures loom because together they have driven up commodity prices worldwide and undermined the global trust in the dollar. Keynesian stimulus is not panacea, which has done nothing to mobilize internal sources of growth.

It is time to recall Say's law, another essential economic wisdom, which tells us that supply creates demand itself. The American dream is rooted deeply in the provisions of original innovations and risk-taking entrepreneurship, which come from competitive markets and not almighty government. In this regard, the best approach to reignite the American economic engine is to enact policies that create a business-friendly environment, which cultivates innovation, fosters entrepreneurs and supports capital investment. The following measures should be seriously considered:

- promote small business and American entrepreneurship;
- exit the zero rate policy to reflect the price of capital correctly and lift the glut of easy money;
- cultivate predictable expectations for long-term business investment;
- reform the entitlement system to reduce the fiscal burden;
- restructure the tax system to broaden its base and reward capital investment; and
- open up doors for foreign direct investment in businesses and eliminate structural barricades to such investment.

3. Improve China's Macroeconomic Management

To avoid a possible scenario of stagflation, the Chinese government needs to create a set of policy instruments to achieve the dual goals of macroeconomic management: controlling inflation while maintaining growth at an acceptable pace. The core of these tools is to treat small and medium-sized enterprises fairly in terms of bank lending, explicit taxes, implicit fees and surcharges, and other financial burdens. Keeping these firms afloat in a harsh economic climate is crucially important for employment and growth.

There are many ways to formulate these tools. The first is to refine monetary policy in terms of indirect management and gradually move away from direct quantitative control. If the central bank frees deposit rates and lending rates for banks, it will largely solve the dilemma confronted: the PBC has a high degree of freedom to usher interest rates to ward off inflation, while letting banks have autonomy to select efficient clients and manage risks.

Secondly, it is necessary to form a mix of monetary policy and fiscal policy. To date, fiscal policy is mainly a one-way conduct—a coffer-filling practice regardless of what the macroeconomic environment is. In fact, fiscal policy is able to perform active functions to support monetary policy in achieving its goals. For example, fiscal policy may reduce burdens for small and medium-sized enterprises by simplifying tax practices. Another example is to craft a well-designed income tax code with reasonable deductions for households to replace the prevailing primitive conduct. These would provide incentives and fairness for firms and individuals to pursue honest and hard work.

As for the social programs, especially big ones with long-term effects, the recent bankruptcy lessons of welfare statism in many industrial countries should be kept in mind for policymakers. It is an unsustainable model that is not worthwhile to copy. Even though some programs may win political gains in the short term, the society will eventually pay the cost. The clever way of maintaining sustained harmony and durable stability is to give people more economic freedom while constructing a framework of the rule of law, but not create an almighty government.

Conclusion

World leaders are at a crossroads in deciding where to go. Today's problems need to be addressed by local policies with global implications. Each major nation must take on appropriate policies to solve its own troubles, like debt-fueled spending in the United States or exchange rate management in China. But national governments must do so while keeping in mind the potential global repercussions and backlash from their domestic policies. Meanwhile, the problems also need to be resolved by global cooperation with local solutions. In order to tackle these intricate issues, such as Europe's financial woes and climate change, global cooperation is necessary, but it must be based on local political solutions.

On the other hand, increasing the size of government is not the right answer. Thirty years ago, the world faced big challenges in different forms. The Deng-Thatcher-Reagan revolution was the perfect response—to mobilize millions of people's initiatives to overcome economic and social hardship. This great example is very worthy for newcomers to learn.