

The Role of Macroeconomic Policy in China's High Economic Growth amidst the Global Financial Crisis

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On 22 January 2010, the Chinese State Statistical Bureau announced that the 2009 Chinese economic growth rate remained at 8.7 percent, which fulfilled the 8 percent target preset by the central government at the end of 2008. Many celebrated this achievement, attributing the stimulated economy to government economic policy. This paper analyzes how the macroeconomic policy of the Chinese government contributed to economic growth even under the global financial crisis. The present effects of this policy and its implications on the future are also examined.

Keywords: China's economic growth, Macroeconomic policy, Stimulus package

JEL Classification: E22, E50, E63

I. How China Used Macroeconomic Policy to Respond to the Financial Crisis

Although China was not directly hit by financial crisis and did not experience any financial market difficulties as what happened in Korea (Park and Lee 2009), China felt the shock through slowdown of export in the second half of 2008 and Chinese government shifted the policy measures from decreasing inflation to maintaining growth rate. First, monetary policy was modified, so that beginning September 2008 the People's Bank of China (PBC China' central bank) lowered the reserve

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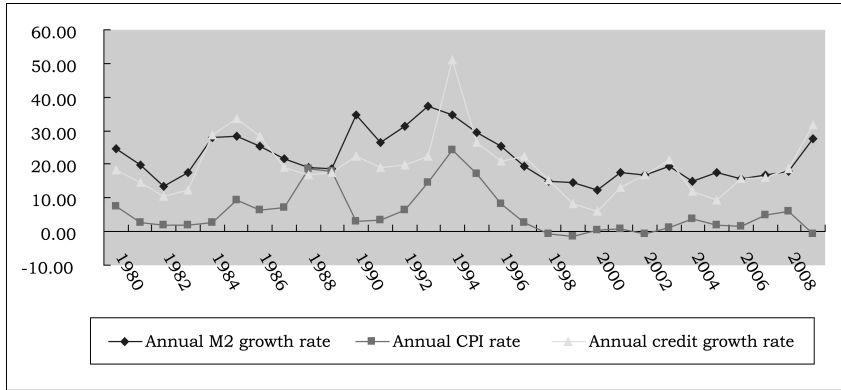
TABLE 1
ADJUSTMENT OF RESERVE RATIOS BY PEOPLE'S BANK OF
CHINA SINCE JANUARY 2008

Date of adjustment	Reserve requirement before adjustment %	Reserve requirement after adjustment %	Difference (Percentage points)
January 25, 2008	14.5	15	0.5
March 18, 2008	15	15.5	0.5
April 25, 2008	15.5	16	0.5
May 20, 2008	16	16.5	0.5
June 7, 2008	16.5	17.5	1
September 25, 2008	Big institutions 17.5	17.5	0
	S/M institutions 17.5	16.5	-1
October 15, 2008	Big institutions 17.5	17	-0.5
	S/M institutions 16.5	16	-0.5
December 5, 2008	Big institutions 17	16	-1
	S/M institutions 16	14	-2
December 25, 2008	Big institutions 16	15.5	-0.5
	S/M institutions 14	13.5	-0.5
January 12, 2010	Big institutions 15.5	16	0.5
	S/M institutions 13.5	13.5	0.0

Source: People's Bank of China, www.pbc.gov.cn.

requirement four times (Table 1). A few days later, the central bank lowered the bank deposit rate by 0.72 percent, going from an annual deposit rate of 4.14 to 3.87 percent. Since then, the deposit rate has been lowered three times to reflect an annual rate of 2.25 percent. On 27 November 2008, the central bank also reduced the annual loan interest rate imposed on financial institutions from 4.68 to 3.60 percent. The rediscount rate was lowered from 4.32 to 2.97 percent. On 23 December 2008, the loan and rediscount rates were again lowered to 3.33 and 1.80 percent, respectively. The expansionary monetary policy quickly affected monetary supply (M_2). The M_2 increased to RMB 47.5 trillion by the end of 2008, a net increase of 17.7 percent compared with the end-2007 monetary supply. In August 2008, the M_2 increase rate was only 15.9 percent, an atypical rate compared with the usual 17-18 percent.

The effect of the expansionary monetary policy became more evident in 2009. Bank lending and monetary supply accelerated every month. By the end of the year, M_2 reached RMB 60.62 trillion, reflecting an increase of 27.68 percent or 9.86 percentage points higher compared



Source: National Bureau of Statistics of China and People's Bank of China.

FIGURE 1
ANNUAL M₂, CREDIT, AND CPI GROWTH RATE IN CHINA
SINCE THE REFORM AND OPENING

with that of 2008, a rare occurrence in China's history. Bank credit also increased to a historically high level as all loans issued by financial institutions increased by 32.99 percent, amounting to a stock of RMB 42.56 trillion. The net loan increase was RMB 10.52 trillion. The additional net loan increase in 2009 compared with that of 2008 was RMB 5.54 trillion. Such a huge increase in loans and monetary supply rarely happens in the history of the country, with comparable expansion witnessed in 1984-86 and 1993-94, all being characterized by very high inflation (Figure 1).

Aside from monetary expansion, a large-scale fiscal expansionary plan was launched by the Chinese central government, from which a stimulus package of RMB 4 trillion was drawn. In the package, although only RMB 1.18 trillion was newly mobilized and remaining RMB 2.82 trillion was prepared, the plan quickly encouraged local governments' initiative of more than RMB 10 trillion similar stimulating spending. Of the RMB 4 trillion package, around 60 percent was allocated in 2009, and the remaining 40 percent would be spent in 2010. Looking at the detailed allotment, more than 80 percent was allocated for infrastructure and 20 percent for technology enhancement, education, medical care, and so on (Table 2). The effect and contribution of infrastructure investment on GDP growth is immediate, hence the huge allocation. This expansionary plan quickly mobilized local governments to allocate

TABLE 2
COMPONENTS OF THE RMB 4 TRILLION CENTRAL GOVERNMENT BUDGET

Area for fiscal spending	Amount allocated (billion RMB)	Ratio out of the total RMB 4 trillion budget (%)
Housing allowance and improvement for poverty-stricken families	400	10.00
Rural infrastructure improvement	370	9.25
Railway, highway, airport, irrigation, power, and other infrastructure constructions	1,500	37.50
Medical care, education, cultural, <i>etc.</i>	150	3.75
Energy conservation, emission reduction, and eco-engineering	210	5.25
Technology innovation and structural adjustment	370	9.25
Reconstruction for disaster areas	1,000	25.00

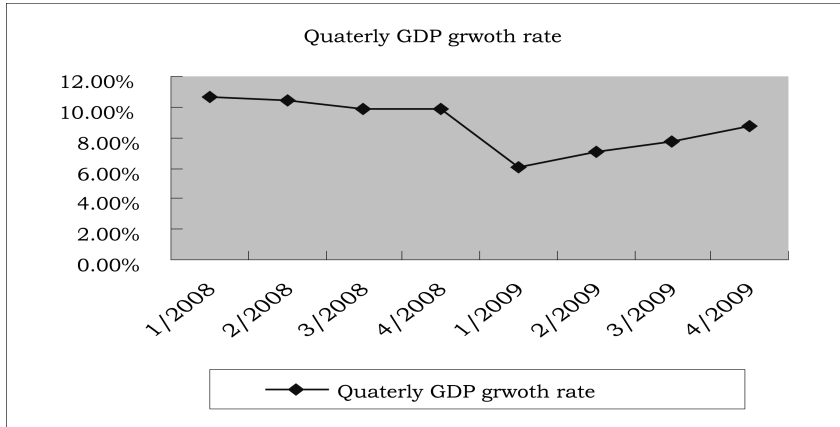
Source: China National Development and Reform Commission: <http://www.sdpc.gov.cn/>.

more than RMB 10 trillion in similar spending.

II. Why the Chinese Stimulus Is More Effective

Both monetary and fiscal expansionary policies effectively raised the GDP growth rate. From the second quarter of 2009, the GDP growth rate in China began growing steadily (Figure 2). For the rest of the world, economic recovery could have taken on a *U* direction, but for China, a true *V* type recovery was observed.

Major countries have also launched similarly huge economic stimulus packages to cope with the financial crisis and the resulting economic downturn. However, most of their strategies were not as effective as those of China. After Bear Stearns collapsed, the U.S. Congress passed a bill allocating \$300 billion to help homeowners with refinancing to save on mortgage loans. Congress launched another \$700 billion to save the market after Lehman Brothers and Merrill Lynch went bankrupt. Later, the U.S. Federal Reserve provided an additional \$800 billion credit, of which \$600 billion was allocated for purchasing Mortgage Backed Securities (MBS) and \$200 billion was provided to



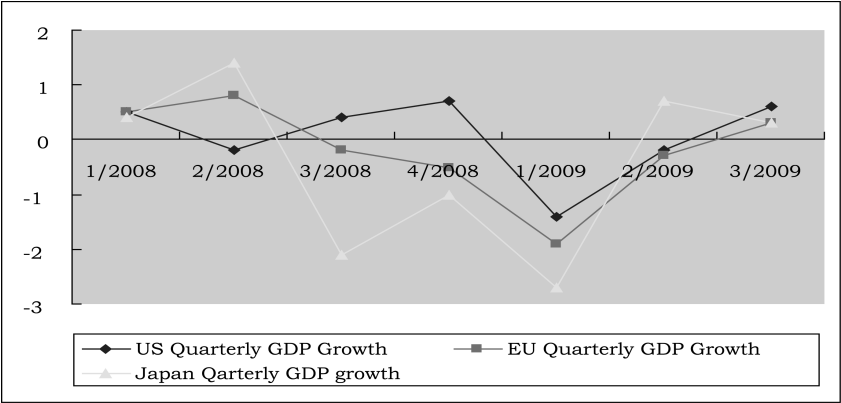
*GDP Quarterly growth rate is the quarter comparison with the same quarter of last year.

Source: National Bureau of Statistics of China.

FIGURE 2
QUARTERLY CHINESE GDP GROWTH RATE*

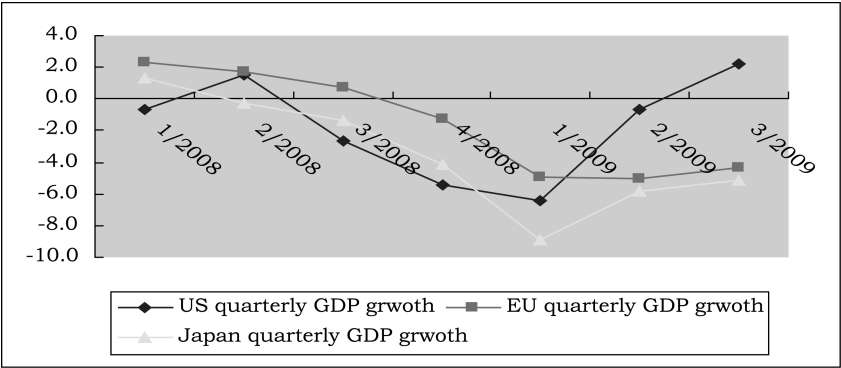
consumers and small and medium sized enterprises (SMEs). After Barack Obama won the presidency, he launched another \$787 billion to stimulate the U.S. economy. The Federal Reserve also lowered the federal fund rate to 0-0.25 percent, which was a new historical low, to reduce credit costs. The Federal Reserve even purchased government bonds directly to inject funding into the monetary base. The U.K. government launched a £400 billion financial rescue package after the Royal Bank of Scotland experienced trouble. Germany also launched a €500 billion rescue plan and a €50 fiscal stimulus package for government investments. The European Central Bank lowered its interest rate to 1 percent, while the Bank of England lowered its rate to 0.5 percent. Meanwhile, the Japanese government launched three stimulus packages, with government spending rising to unprecedented levels. The Japanese stimulus plan reached a total of JPY 62.8 trillion. Nearly every developed country launched a record high stimulus package to save the economy.

Based on a quarter by quarter comparison, most countries reflected a recovered GDP growth rate in the third quarter of 2009. However, compared with the same season last year, the figures were not all positive (Figures 3 and 4). The impact of macroeconomic policy was not as



Source: OECD statistics.

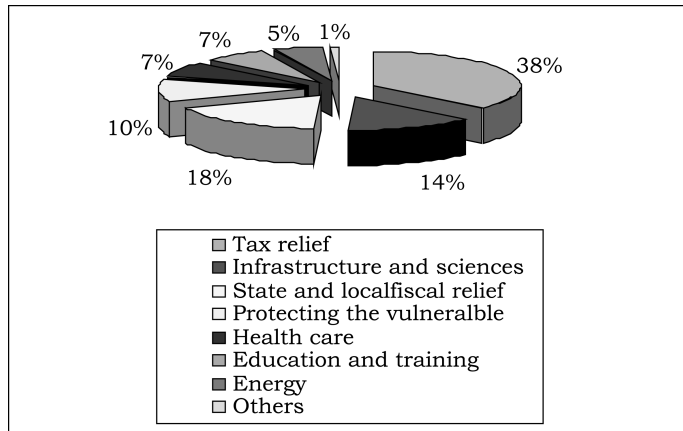
FIGURE 3
THE U.S., EU, AND JAPAN QUARTERLY GDP GROWTH RATE
(COMPARED WITH THE PREVIOUS QUARTER)



* The U.S. figure is the quarterly adjusted annual growth rate, while the EU and Japan figures are the rates compared with the same period last year.
Source: U.S. Bureau of Economic Analysis, Eurostats, and Japanese State Statistics Bureau.

FIGURE 4
THE U.S., EU, AND JAPAN QUARTERLY GDP GROWTH RATE*

impressive compared with the growth of the Chinese economy. Why is the effect of macroeconomic policy more substantial in China than in other countries? Four main factors have been found to be contributory



Source: U.S. Congressional Budget Office (CBO) data.

FIGURE 5

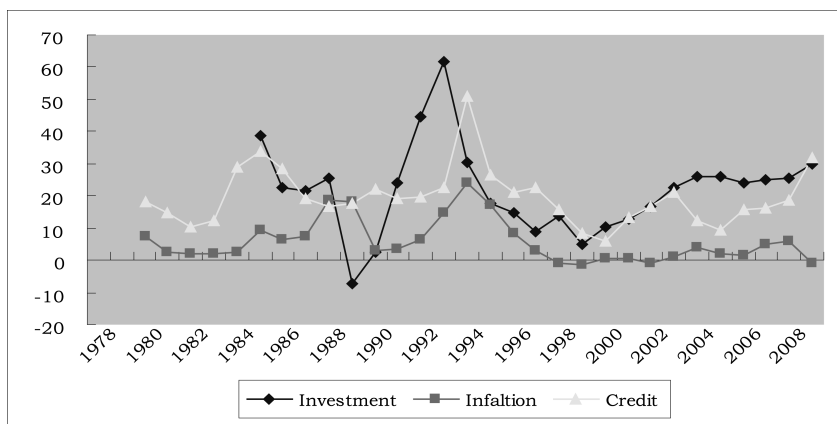
DETAILED BUDGET FOR THE U.S. STIMULUS PACKAGE

to this incidence: the size of fiscal and monetary expansion, growth-oriented economic atmosphere, monetary expansion effectiveness, and economic structure and low development stage.

The RMB 4 trillion central government budget is equivalent to around U.S.\$ 5,800, nearly equal to the fiscal spending of the Obama administration. However, out of the China budget, infrastructure investment accounted for 80 percent, while in the U.S. fiscal spending, less than 20 percent was allocated for infrastructure development (Figure 5). World Bank Chief Economist Justin Yifu Lin also mentioned this point when he spoke to *Wall Street Journal*.¹ Infrastructure investment could have an immediate stimulation impact on GDP growth, while investments in education and R&D could bring forth benefits in the long run.

The growth-oriented atmosphere in China also exerted a considerable influence on GDP growth. In China, incentives for local governments to stimulate economic growth are never lacking. Local governments are accorded merit based largely on their GDP growth rate; hence, pushing the GDP is deeply emphasized in their strategies. When the central government directed policy orientation towards economic growth, local

¹ Bob Davis: Q & A: "World Bank's Lin on Why China Stimulus Is More Effective." *The Wall Street Journal*, October 6, 2009.



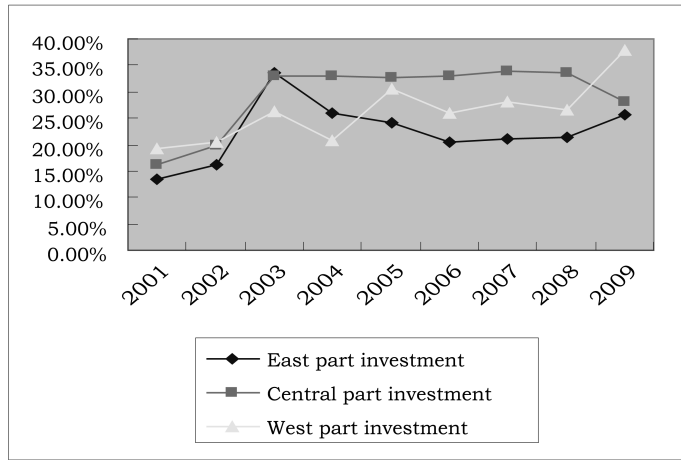
Source: National Bureau of Statistics of China.

FIGURE 6

ANNUAL INVESTMENT, CREDIT, AND INFLATION GROWTH RATES IN CHINA

governments at each level promptly mobilized their resources to expand investments in their regions. Officials queued at the National Development and Reform Commission as certain investment projects required commission approval. All these resulted in a much quicker and more sizeable increase in local government fixed asset investments compared with central government investments. In 2009, the total fixed asset investment was RMB 22.48 trillion, which grew by 30.5 percent compared with that in 2008. However, the fixed asset investment projects of the central government grew by only 18.4 percent at RMB 1.97 trillion during the first 11 months of 2009. Local government spending in the same period grew by 32 percent, amounting to RMB 17.44 trillion. Nearly 78 percent of the fixed asset investments were local government projects. A similar investment volume and growth rate was observed at a smaller scale in 1985 and 1992-94, followed by a high inflation rate in the next two years (Figure 6).

The effectiveness of monetary policy in expanding monetary supply also played an important role. Many scholars discussed ineffectiveness before the financial crisis hit China (Yao 2009), and most of them mentioned the slow economic response to contracting policy (Liao *et al.* 2007; Zhu 2009). When the Chinese central bank lowered the reserve requirement and interest rate, the market reacted swiftly. Banks began to issue new loans, which was a move that changed enterprise and



Source: National Bureau of Statistics of China.

FIGURE 7

ANNUAL FIXED ASSET INVESTMENT IN THE DIFFERENT PARTS OF CHINA

household expectations, encouraging borrowing for investments and real estate purchase. The real estate industry developed rapidly, and the automobile industry experienced a sudden boost with government taxation providing preferential treatment towards energy saving cars. The growth rate of M_1 and M_2 in China increased to approximately 30 percent in 2009. Deflation expectation reversed quickly to inflation. If we look at the U.S. in comparison, although the U.S. Federal Reserve relaxed monetary policy, the banks did not issue more loans. Companies and households were reluctant to expand new credit. This ended up increasing M_1 more quickly than M_2 . By 1 December 2009, the U.S. monetary stock M_1 increased by 13 percent compared with the same day last year, while M_2 increased by only 5.7 percent in the same period. This shows that the deleveraging process has not yet been completed in the U.S. Thus far, companies and households show little confidence in future income and economic growth, making for a conservative investment behavior and consumption. Thus, to date, the U.S. economic recovery is largely based on government fiscal stimulation.

Finally, China is still in the low development stage, and its per capita GDP is only U.S.\$ 3,300. China is not completely industrialized, an environment that usually brings high economic growth. Many new

industrialized economies (NIEs) experienced a similar high growth phase in the past. However, China is such a big country with a huge population, which prolongs its industrialization period. Although some of its coastal urban areas are nearing industrialization, most of China's central and western regions are still gradually catching up with industrialization and urbanization. There is a big room for improvement in infrastructure development, and the Chinese government could use fiscal expenditure to increase investments to maintain its growth rate. Fixed asset investment in the central and western provinces has sped up, while east coastal provinces reflect a slowdown since 2003 (Figure 7).

In 2009, when the central government launched a fiscal stimulus, the western region was accorded the most investment projects, as the infrastructure in the west was comparatively poor. Thus, ladder-like development and the gap between regions enabled China to maintain high growth for a longer period of time.

III. The Cost of Large-Scale Fiscal and Monetary Stimulation

In most developed countries, the biggest cost of large-scale stimulation lies in the growing budget deficit and government debt. The huge fiscal spending of the U.S. has already led to a sizeable federal government budget deficit, which rose to a GDP ratio of 9.9 percent in 2009 from 3.2 percent in 2008. It is expected that the ratio will remain at a high level of 10.6 percent in 2010.² The U.S. federal government's debts rose to \$12.1 trillion and will rise to \$14 trillion in 2010. This will cause increasing distrust from the international community on whether the U.S. is capable of maintaining the stability of the U.S. dollar exchange rate. If this skepticism spreads, the international financial market would become unstable. Another cost is the potential pressure of inflation, although in most countries this is not yet a problem. Expectations on inflation are certainly growing, a situation that may escalate if not properly dealt with. EU member countries and Japan all face deteriorating fiscal deficits and heavy debts. Countries in the Euro Zone are in a more difficult situation owing to the obligations of maintaining favorable budget deficit levels and government debts under the Stability and Growth Pact. These countries are more inclined to exit

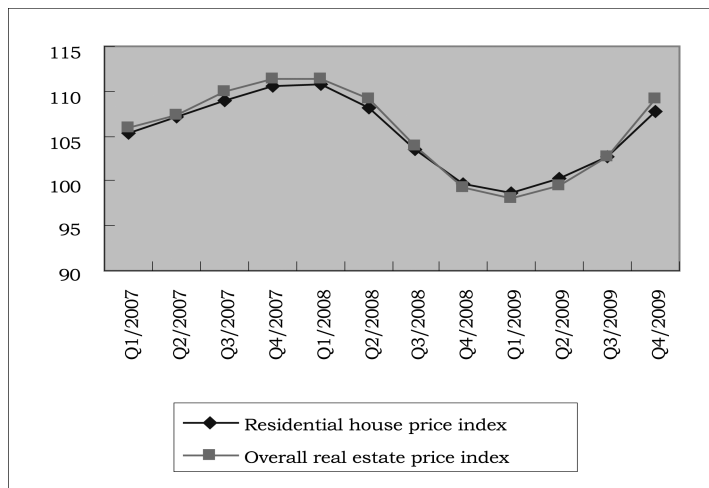
² See Whitehouse Office of Management and Budget: President's Budget FY 2011, <http://www.whitehouse.gov/omb/budget/Overview/>.

the expansionary policy as soon as it is possible for them to do so. This is the background of discussion on the exit of the stimulus among the international society.

The Chinese case is different, as its growth rate is high, and the ability of the government to control economic activities is strong. However, China also paid a huge price in implementing fiscal stimulus and monetary policies.

The most significant consequence is the slowdown of structural adjustment. To maintain the economic growth rate, which is believed to be imperative for maintaining employment security, the central government was compelled to relax its control over industrial structure requirements in their supervision of investment projects. Since November 2009, demand for exports from developed countries dropped, causing China's export growth rate to decline to a negative figure. The contribution of exports to GDP also plunged to a negative rate. Exporting has been the second most important pillar of China's economic development since 2001 after China joined the WTO. Labor-incentive export is also the most important sector for creating jobs. The sharp decline in exports made unemployment an urgent issue for the economic policy. Structural upgrading and adjustment is a must to build a solid foundation for sustainable growth. Conversely, the country must create enough jobs for the laid-off workers of the export sector. The Chinese government had to choose a policy that could first address the most urgent issue unemployment, which provide opportunities for growth to some low-level industries such as iron and steel, glass, cement, and other construction materials. Such a measure could alleviate the effects of investments that could worsen structural imbalance or those that create potentially more serious excess production. The overall excess production in the manufacturing sector worsened, and the efficiency of utilizing resources declined. Economic growth became more dependent on fixed asset investment.

Economists may argue that China did not really experience a recession, as the country maintained a growth rate of over 6 percent. However, it is important for China to grow by more than 8 percent, primarily to create more jobs. Our past experiences dictate that a 1 percent growth could create roughly one million new jobs. Every year up to the present, there will be 8-9 million new graduates who will join the urban work force; hence, an economic growth of under 8 percent could pose grave unemployment problems. Even if China maintains a growth rate above 8 percent, the immigration population and laid-off



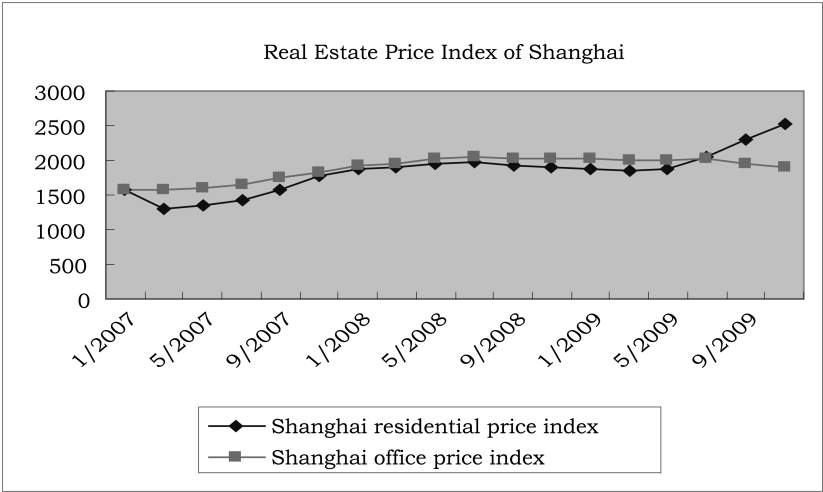
Source: Wind Information Service.

FIGURE 8
REAL ESTATE PRICE INDEX OF CHINA

workers from state-owned enterprises have already created unemployment issues. The growth-oriented economic policy has deeply rooted reasons. When unemployment becomes an urgent problem, structural adjustment targets would follow, although in theory the two can complement each other to achieve stability in the economy.

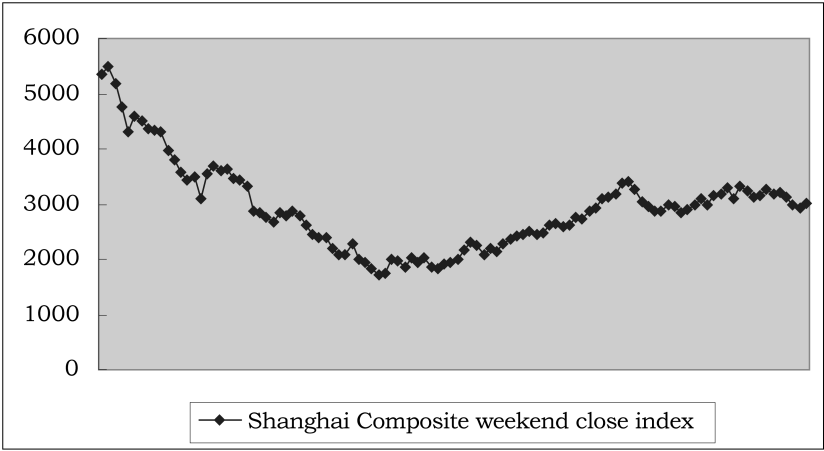
The second repercussion is the asset bubble created by the monetary supply expansion. Low cost credit and easy access to credit increased inflation expectation and investment demand for real estate. Similarly, other financial assets grew fast, resulting in a speedy rise in stock market and real estate prices. In 2009, the overall average real estate price in China increased by 9.1 percent, and residential housing prices grew by 11 percent (Figure 8). In metropolitan cities such as Shanghai, residential housing prices increased by 42.4 percent (Figure 9). Compared with the prices at the end of the first quarter of 2009, the housing price growth rate in Shanghai in the last three quarters jumped to 44.3 percent. This was another record high since the real estate market opened in the early 1990s.

Stock market prices began increasing in March 2009. In only four months, from March to August 2009, the Shanghai Stock Composite Index increased by 75 percent (Figure 10). Amidst fears of potential inflation and



Source: China Real Estate Index System (CREIS): Monthly Report for Shanghai Index.

FIGURE 9
REAL ESTATE PRICE INDEX OF SHANGHAI



Source: <http://Finance.yahoo.com>.

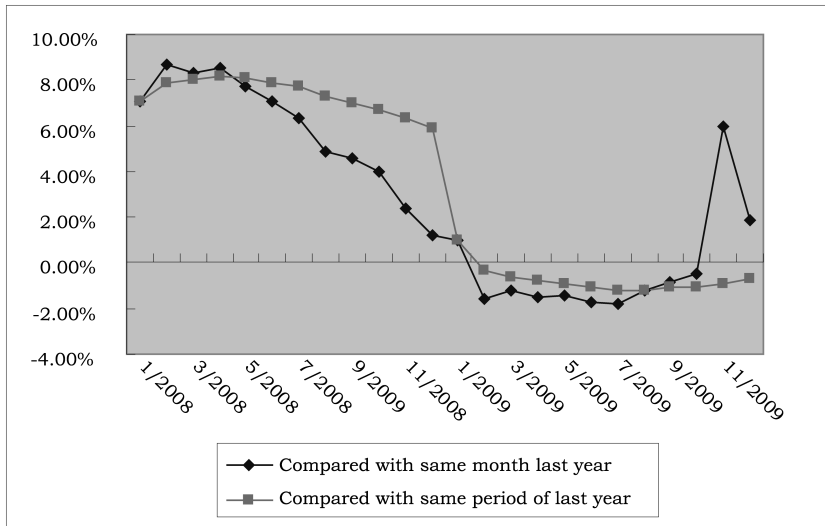
FIGURE 10
SHANGHAI STOCK MARKET PRICE INDEX
(FROM JANUARY 2008 TO JANUARY 2010)

policy that may reverse to inflation fighting measures, the market has continued to fluctuate since August 2009 and will fluctuate further when fiscal stimulus exit strategies begin.

The asset bubble enticed more people to speculate. Many quit their original business activities to invest in real estate or the stock market with the expectation that the bubble would grow bigger before they could withdraw from the market. This is the most negative impact of the asset bubble even the bubble may not burst, as it exceedingly attracted resources into the financial sector while reducing real economy size. As people begin to accept that there is a bubble and that it may burst in the future, they may start to reassess the situation, which will in turn cause money to flow out of the asset market. Eventually, a burst will take place and lead to a financial crisis and economic recession similar to that which is currently happening in the U.S. Even if the bubble does not burst for a while, the inflation impact on commodity prices will accelerate after asset prices jump to a higher level. Thus, in the beginning of 2010, the Chinese government had to take measures to counter the heating up of the real estate market, to which the market reacted sensitively. Real estate prices stopped rising, and the stock market dropped by almost 10 percent during the first month of 2010.

The asset bubble also has another negative impact that is attracting foreign speculative short-term capital inflow. According to Zhang Ming's assessment (Zhang 2010), in the second quarter of 2009 when the asset price started to rise, short-term capital stopped flowing out and was directed back into China. In the first quarter there was a U.S.\$ 45.7 billion capital outflow. In the second quarter, short term capital flew into China was U.S.\$ 87.9 billion. In the third and fourth quarters the inflow figure maintained at U.S.\$ 59.6 and U.S.\$ 48.9 billion respectively. Total short-term capital inflow in 2009 was U.S.\$ 150 billion. Only in December 2009, the short term capital inflow declined to U.S.\$ 5.5 billion. Speculative short-term capital inflow pushes asset prices higher. Inflow will then be withdrawn in the future when risks begin to present themselves. Thus, this situation adds to asset market volatility and increases the risk of sudden asset bubble burst.

Fiscal stimulus also leads to potential inflation. Figure 1 shows that after the rapid M_2 and credit growth, the subsequent one or two years were characterized by high inflation beginning in 1980. Some economists believed that after the late 1990s, the situation might change as the stock market opened a pool for excess liquidity, which could serve as



Source: National Bureau of Statistics of China.

FIGURE 11
MONTHLY CPI FIGURE IN CHINA (2008-2009)

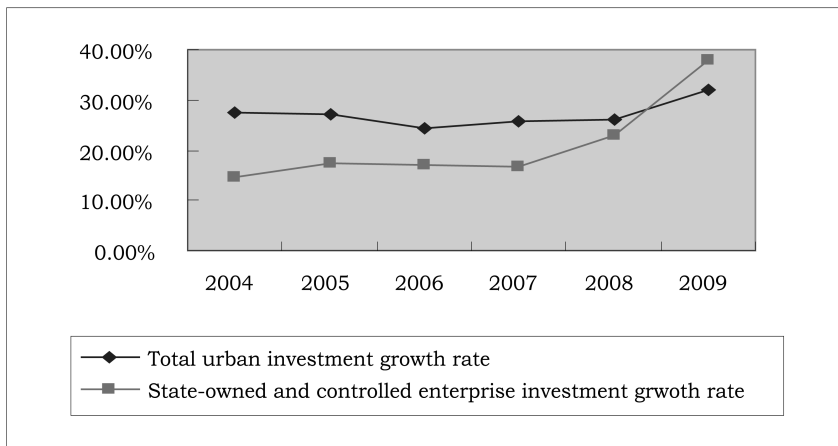
an inflation buffer. To a certain extent, inflation was moderated as the credit and M_2 growth rates in 2003 rose to 20 percent, while inflation rate increased only mildly in 2004. Thus, the economists also believed that the rapid credit and M_2 growth in 2009 was achieved during the deflation period and that there would likely be no high inflation in 2010 if the policy started to turn around. Many economists projected that a controllable inflation rate of below 3 percent in 2010 would occur. However, the policy turn-around poses problems. The banks in China may not be able to reduce loans as quickly as they can respond to the expansionary policy and increased loans once the policy focus shifts to inflation control. Bank managers at each level have an incentive to generate profit to gain bonuses. The only way to make a profit is to lend as frequently as possible considering that the gap between deposit and loan rates is more than 2 percent. Stephen Green, a Shanghai-based economist for Standard Chartered Bank, also noticed this issue. "While China's banking system is remarkably efficient at responding to a crisis and reviving the economy, it just isn't what you need when you want to guide credit down."³ Hence, even if the central government is aware that the inflation may become a problem and

begins to control liquidity, there will be a time lag, and inflation will soar quickly after the huge increase in monetary supply and bank lending. Figure 11 shows the possibility of a quickly rising inflation after November 2009.

Yet another disadvantage of the fiscal stimulation is that although the rapid increase in fixed asset investment produced immediate effects on GDP growth, in the long run this may decrease efficiency in resource allocation and total factor productivity (TFP). The central government did require local governments to ensure the investment projects were studied well before launching in the 2009 stimulation period. The local governments were even requested not to start a totally new project but to complete the planned projects ahead of time. However, in practice, these projects are not insured, and the central government has no capacity to examine them all. Even if all the projects were examined, distortion in government investment mechanisms could lead to low efficiency. The change in total factor productivity (TFP) upon large increase in investments can be demonstrated by the Solow residual. According to this model, given that $Y_t = Z_t F(K_t, L_t, E_t, M_t)$, TFP is $Y_t / F(K_t, L_t, E_t, M_t)$. As K_t increases quickly without Y_t increasing to a parallel level, then, other things being equal, the TFP will be lower than before. Although scholars in China argue about the long-term TEP trend, some believe that TEP in China has been declining since 1992 (Zhang and Shi 2003), while others argue that it has been steadily rising (Xu 2007). The exact contribution of TEP to Chinese GDP growth is not discussed in this paper; what is being pointed out is that high investment growth will lead to low or decreasing TEP unless GDP growth can keep pace with the investment growth rate.

A related problem is the crowding out effect on private investments. From the government's point of view, there is no policy of "state-owned marching forward, non-state owned retreating." The huge amount of government spending and loan issuance helped state-owned enterprises (SOEs) tremendously in terms of obtaining financial resources. At the same time, the small and medium sized non-state owned enterprises (SMEs) experienced more difficulty in acquiring credit. The central government tried to solve this problem and demanded that banks facilitate credit provision to SMEs. Banks responded by setting up SME financial centers in many cities to show their support for the government policy.

³ Refer to Dinny McMahon. "China Pushes to Wean Banks Off Loans." *The Wall Street Journal*, January 27, 2010.



Source: National Bureau of Statistics of China.

FIGURE 12
GROWTH RATE OF FIXED ASSET INVESTMENT BY STATE-OWNED
AND CONTROLLED ENTERPRISE

Local governments at each level also established guarantee companies that specialized in providing guarantees to SMEs as they applied for loans. Until now, however, SMEs continue to experience difficulties in obtaining credit. The crowding out effect, wherein overall state-owned enterprise expansion and non-state owned enterprise contraction in fixed asset investments are observed, did take place after the central government launched the large-scale stimulus package. For example, state-owned or state-controlled enterprise investment grew by 16.7 percent in 2007, lower than the total urban investment growth rate of 25.8 percent for that same year. In 2008, state-owned or state-controlled enterprise investment grew 22.8 percent, while overall urban investment growth rate increased by 26.1 percent. The SOE investment growth rates were all slower than the total growth rate. In 2009, the situation changed, with the SOE investment growth rate rising to 37.8 percent and overall growth rate increasing by 32.1 percent (Figure 12). The same phenomenon occurred in Shanghai. Overall fixed investment in Shanghai grew by 9.2 percent. The state-owned sector's investment grew by 14.10 percent, while non-state owned enterprise investment increased by only 4.8 percent in the same year.

Considering such a high cost from the long-term point of view, the

anti-cyclic macroeconomic policy needs to be discussed further. Keynesian economics taught us how to use macroeconomic policy to deal with the lack of aggregate demand to fill the gap between demand and supply. Thus, whenever the economic growth rate declines to a negative or low level, the government ought to use expansionary monetary and fiscal policy to combat the recession. This is an accepted rule, although economists have already set up many preconditions and presumptions. However, excessive countermeasures would bring high costs. We experienced the negative effects of stagflation in the late 1970s caused by a long period of excessive government policy stimulation. We have recently experienced a severe financial crisis and world economic recession partly caused by the excessive stimulation of monetary expansion by the U.S. Federal Reserve. Therefore, macroeconomic stimulus policy is effective only when resources have not been fully utilized and present only short-term effects. Prolonged economic growth by fiscal and monetary stimulation alone will sooner or later bring about a negative impact, and disequilibrium will occur in the form of either market decline and large-scale insolvency or hyperinflation. The same principle applies to Chinese macroeconomic policy. The negative impact of the stimulus is expected to occur gradually and policy will have to be adjusted in 2010.

IV. The Prospects of the Chinese Economy in the Next Few Years

Owing to certain basic positive factors, Chinese economic growth will still be very high in the next five years mainly because the Chinese economy is still in a take-off stage, and the basic demand for industrialization is huge. China has a ladder-like development structure, with the eastern region as the most developed, the central part developing, and the western area newly developing. This will cause social problems to a certain extent if it does not change constantly. However, it creates the possibility that China will adopt a flying geese development pattern. Industries not suitable in the east could move and shift to the central and western regions. By doing so, China will prolong the competitiveness of manufacturing industries and maintain a longer industry and product life cycle, thus having a longer high economic growth period. This is currently happening in China.

The prospects of further fixed asset investment in the central and

western parts of China are promising. Hence, the investment growth rate would remain at high levels and continue offering significant contributions to overall economic growth.

Apart from the above, the impact of SOEs and further government reforms on economic development is also very positive. The reform and opening is an ongoing ambitious task for the Chinese, ensuring the grand macroperspective of Chinese economic development in the future. Factors such as human resource improvement and enhancements in R&D and technological programs will help China maintain rapid economic growth in the years to come. Although these are beyond the scope of the study, all these positive factors are indicated to show that the basic trend of Chinese economic growth in the future is optimistic and will be very high.

Even under optimistic conditions, in the next year or two, economic development will face challenges categorized into three: decline in investments by local governments, slow private consumption growth, and mild export growth. In 2010-12, an 8-9 percent economic growth could be maintained but higher rates would be difficult to realize.

At present, investment is the biggest contributor to GDP growth and this will not change in the next few years. However, the high growth of up to 30 percent is not sustainable and will create problems. The central government will still have the ability to maintain the same stimulating amount, as it still possesses 40 percent of the RMB 4 trillion stimulus package. However, the local governments will not be able to maintain a more than 30 percent investment growth because they are already heavily in debt, and the monetary policy has begun to tighten. The central government already sent out directives to local governments restricting them from initiating new investment projects, and only ongoing projects should be completed. Thus, the overall investment growth rate will descend to a normal level of 25 percent in 2010. The contribution of investments to GDP will decline, and GDP will have to be increasingly dependent on export and consumption.

If investments drop to 25 percent, investment contribution to GDP will drop from more than 70 percent in 2009 to around 50 percent in 2010. More than one percentage point of GDP growth will be compensated for by either consumption or export. Consumption in China has not been increasing steadily in the past years. In 2009, the real growth rate of consumption of goods was 16.2 percent, only slightly higher than that in 2008. The nominal growth rate of consumption was even lower compared with that in 2008. People expect consump-

tion in 2010 to increase quickly as the government launched many incentives to encourage consumption, especially for rural resident consumption, through subsidies directly from the government. That consumption only changes dramatically when there is a system or institutional change is observed. If no large reform measure on consumption is taken in 2010, a quick rise in consumption will not occur. Short run government subsidies will not have a profound impact on consumption.

In 2009, China's export declined by 16 percent, and its contribution to GDP growth was negative. In 2010, export is expected to grow by about 10 percent. Although the monthly export growth in December 2009 was 17.7 percent compared with the 2008 rate on the same month, there will be a low possibility for 2010 to grow at the same rate. The international market is not recovering as strongly as expected, and consumption in many developed countries has not returned to its previous levels. Protectionism also presents unfavorable effects on China's export. Export in 2010 will recover to normal growth patterns, but its contribution to the Chinese economy will be moderate, most likely at 1-1.5 percent. This amount will only sufficiently compensate for the decrease in investment contribution.

Owing to the increasing inflation pressure, the macroeconomic policy of the Chinese government in 2010 will be to exit gradually from the stimulus. The central bank may raise reserve rates several times and adjust interest rates higher to two or three times in 2010. How will this kind of monetary policy adjustment affect consumption? The implications of this direction require further study. According to theory, monetary tightening will negatively impact consumption, but high inflation will have a stimulating impact on consumption, as depositors will have incentives to buy commodities to escape inflation loss. As discussed above, consumption will more or less increase at a normal rate in real terms, that is, grow by 17-18 percent. Therefore, we can sum up the GDP growth rate in 2010 to be at around 9 percent. However, as some believe, growth rate of up to 10 percent would be very difficult to achieve. With this background, the focus of Chinese macroeconomic policy would have to shift from maintaining growth to promoting economic structural adjustment. Fortunately enough, policy adjustment has already begun, and we shall see the positive effects as asset bubbles have started to contract, and inflation pressure has stopped accumulating.

The biggest problem of the Chinese economy in the long run remains

to be structural upgrading and adjustment. If there is no steady improvement in this regard, Chinese economic efficiency in terms of making full use of its resources will not enhance quickly, and China will remain at the low end of the international division of labor. The existing asset bubble will not be as serious a challenge as many outsiders expect it to be, and it will not burst during a financial crisis. Instead, it will be gradually digested during the next economic growth cycle and, in a worst case scenario, be absorbed by inflation. Should this happen, inflation will replace some of the pressure of RMB appreciation and cause the RMB to appreciate in real terms, while nominal exchange rates will appreciate slowly.

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