

## **CRISIS OR OPPORTUNITIES: CHINA'S RESPONSE TO THE GLOBAL FINANCIAL CRISIS**

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With the international financial crisis, many issues draw attention about China, such as the impacts of the crisis in the country and the crisis-tackling policies adopted by the government. There is also the question if China will continue its economic miracle in the post-crisis period and from what sources will China depend on to sustain its economic growth. In order to answer these questions, the authors firstly explain the growth patterns in the country since the 1960s and its specificities. Then they show the sources of economic slowdown during the present crisis. Thirdly, the economic recovery policies are presented. The authors also explain the opportunities open by the crisis to improve the social protection network in the country. They conclude showing the persisting challenges.

## **CRISE OU OPORTUNIDADE: RESPOSTA DA CHINA À CRISE FINANCEIRA GLOBAL**

Com a crise financeira internacional, surgem diversas questões sobre a China, tais como os impactos da crise no país e as medidas planejadas e adotadas pelo governo para combater seus efeitos. Questiona-se também se a China continuará seu milagre econômico no período pós-crise e de quais fontes dependerá para manter seu crescimento econômico. Para responder a tais questionamentos, os autores explicam inicialmente o padrão de crescimento do país a partir da década de 1960, apresentando as particularidades deste. Em seguida, mostram as fontes de desaceleração da economia durante a crise. Depois, abordam as medidas adotadas de combate à crise. Os autores também explicam as possibilidades abertas pela crise de melhoria da rede de proteção social e concluem apresentando os desafios que ainda persistem.

### **1 INSTITUTE OF POPULATION AND LABOR ECONOMICS, CHINESE ACADEMY OF SOCIAL SCIENCES**

During the course of the global financial crisis, a few issues concerning China have drawn attention of both Chinese and outsiders. Firstly, how the Chinese economy was hit by the current crisis – namely, to what extent have the economic slowdown and social shock been caused by direct impact of the crisis. Secondly, how can China adequately cope with the crisis and ultimately survive disaster and how has its crisis-tackling policy worked so far. Thirdly, will China maintain its economic miracle in the post-crisis period and, if the answer is yes, what sources will China depend on to sustain its economic growth. This essay tries to answer those major concerns by providing narrative and statistical explanations.

## 2 THE GROWTH PATTERN IN CHINA

After the East Asian Miracle in the 1960s and its world-wide recognition in the 1990s, economic growth in China is generally accepted as another miracle of economic development. Although the miracle is far from the end, it has impressed the whole world. It is well known that China has experienced remarkable economic growth during the past three decades. In spite of the economic fluctuation that took place in the late 1990s due to the impacts of the Asian financial crisis and economic restructuring of State Owned Enterprises, and despite the recent shock from the global financial crisis, China has been achieving leading economic growth rates. Since 1978, when China began to implement its economic opening and reform policy, the annual growth rate of real GDP in the three decades has been around 11 percent, and the annual growth rate of real GDP per capita has remained at 10.8 percent. In the new century, China has managed to maintain its striking economic performance even after the high growth rates of the last quarter century.

While fast economic growth has provided successful experiences and lessons, the economic growth pattern of China is characterized by the following weaknesses that are believed to be internal, giving rise to its vulnerability in face of the external crisis. First of all, over-reliance on accumulation of economic growth factors has led China to economic growth driven by heavy investment. Secondly, development in export-oriented sectors is labor-intensive and of low value added. Given the weaknesses in the Chinese labor market, which is characterized by mass employment of migrant workers moving between inland and coastal provinces, shocks to employment are much larger than GDP loss when a crisis occurs. Understanding the characteristics of China's growth pattern is helpful in evaluating the impacts of and the responses to the global financial crisis.

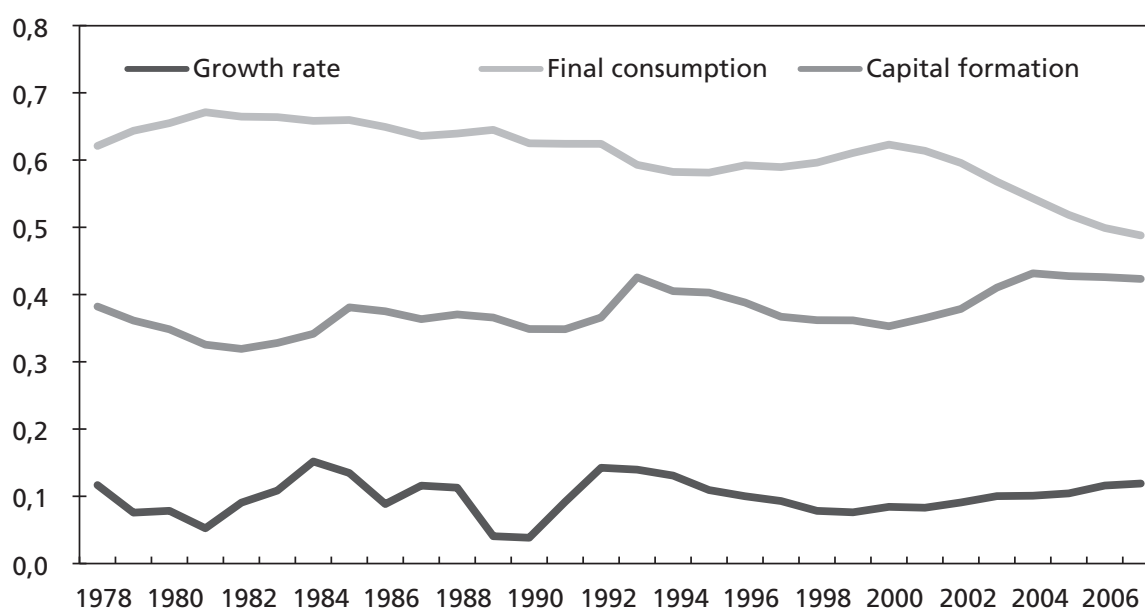
The Chinese economy has been driven by investment rather than consumption. After a slight rise in total factor productivity (TFP) and in its contribution to growth in the early stage of reform, China's TFP performance has been weak since the 1990s (for example Zheng et al., 2004; Kuijjs and Wang, 2005). Thanks to the completion of the demographic transition, the entire period of reform and opening in China has been characterized by an adequate supply of labor force and a high savings rate. This demographic dividend resulted from the fact that the productive population structure emerged through a marketized resource allocation mechanism and participation in the global economy. The favorable population factor has provided a window of opportunities for China's

economic growth and thus, the phenomenon of diminishing return to capital has been deterred (Fang and Wang, 2005). In the meantime, the economic growth in transition China has heavily relied on inputs of production factors rather than on productivity improvement.

It is worth examining the relative contributions of investment and final consumption to economic growth. Picture 1 shows the economic growth rate, savings rate, and share of GDP by final expenditure. The ratio of capital formation to GDP reflects the dependence of growth on investment and the ratio of final consumption mirrors the relative importance of consumption in the economy. The curves reveal the following trend. The investment and economic growth fluctuations match each other, while the relation between final consumption and economic growth is insignificant. The pattern implies that investment has been the most important driving force. In particular, since 2001, a period with fast economic growth, the ratio of final consumption to GDP has been decreasing steadily.

PICTURE 1

**Economic growth rate and share of GDP by final expenditure**



Source: National Bureau of Statistics (2008), *China Statistical Yearbook in 2008*, China Statistical Press.

The relationships may be furthered investigated through a simple regression (Table 1). Using GDP by expenditure data from 1978 to 2007, we regress the growth rate on capital formation ratio and final consumption ratio. The regression outcomes indicate that an additional percentage point increase of capital formation drives the economy to grow 0.64 percentage point, while the impact of the final consumption ratio is statistically insignificant.

TABLE 1  
The impact of investment and consumption on economic growth: 1978-2007

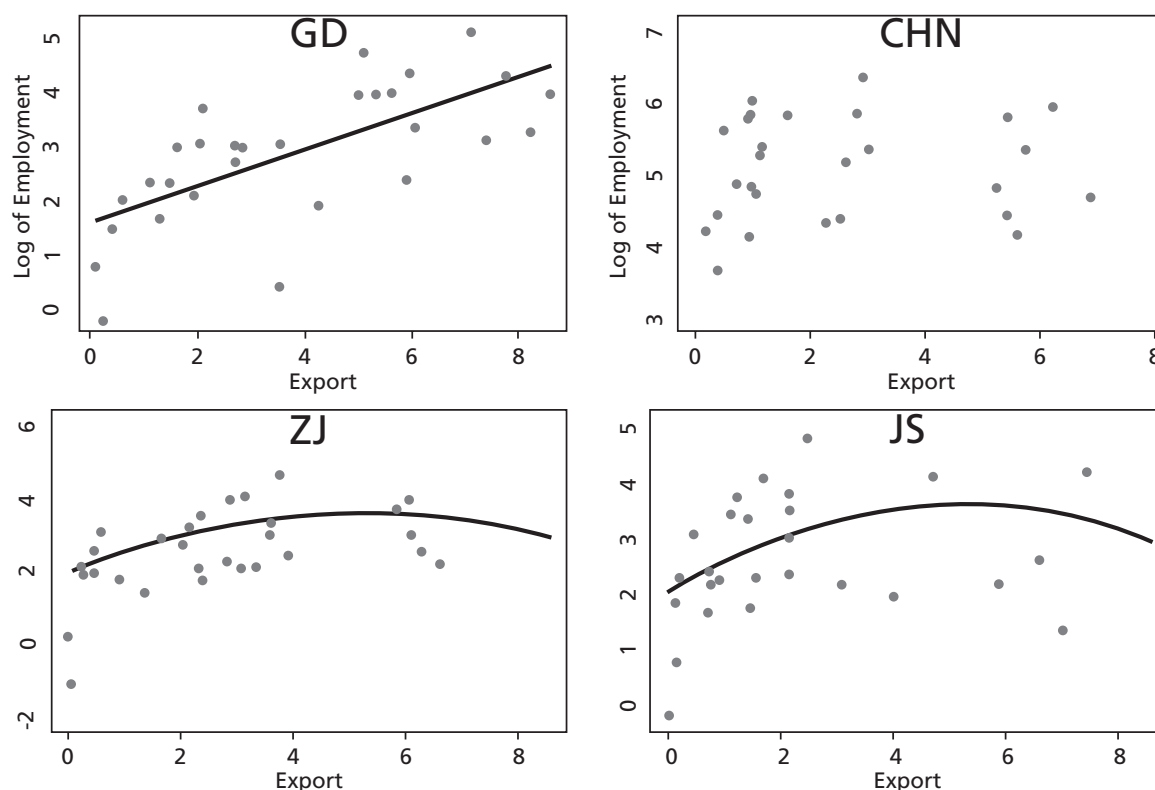
	Coefficient	t	significance
ratio of final consumption to GDP	0.227	1.23	Insignificant
ratio of capital formation to GDP	0.639	2.27	Significant at 5%
R <sup>2</sup> (Adj - R <sup>2</sup> )		0.20 (0.14)	
Number of Observations		30	

As a developing country, it is necessary for China to drive economic growth through intensified investment. However, sustained high investment rates may crowd out the final consumption, and a growth pattern heavily reliant on investment increases economic fluctuation.

The other concern regarding the economic growth pattern is that China also needs to mobilize domestic demand. After the outbreak of the economic crisis, there has been wide discussion on a shift from external demand to domestic demand, which is considered one of the key components of economic restructuring. With globalization, the export-oriented sectors in China have been developing well, and have become a major component of the Chinese labor market. However, the unique institutional setting of household registration, known as the *hukou* system, which prevents migrants from permanently settling down in destination cities where they have found employment, causes mass inflows of labor when the economy booms and mass returns of labor during economic recession.

While migrant workers generally concentrate in coastal areas where the most export-oriented and labor-intensive industries are located, the recent financial crisis may further slow down the migration trend in the near future. In the areas where employment is most concentrated – the Pearl River Delta and the Yangtze River Delta – there is a tendency towards employment increases and export increases (see Picture 2). With the direct shock to the export-oriented sector, the crisis is likely to have serious negative impacts on employment. In addition, most low skilled rural migrant workers work in labor-intensive firms, so the financial tsunami brings with it more shocks to migrant workers. Our conjecture is supported by the widely reported phenomenon of large numbers of migrant workers returning to their hometowns (Sheng, 2009).

PICTURE 2  
Exports and employment in manufacturing



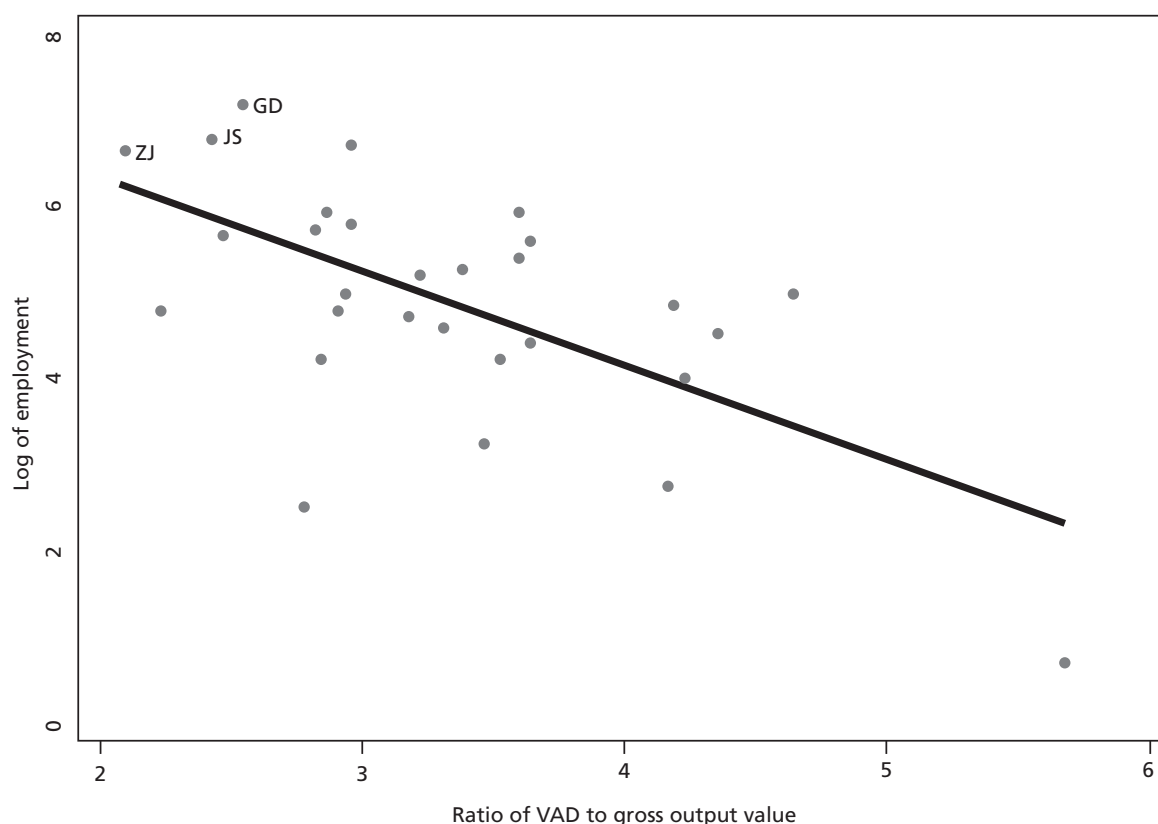
Source: National Bureau of Statistics (NBS) (2007), *Data on Economic Census*, China Statistics Press.

Note: The horizontal axis is the ratio of exported value to total sale value in sub-sectors of manufacturing, and the vertical axis is employment in the sub-sectors. GD, CHN, ZJ, and JS refer to Guangdong, China, Zhejiang, and Jiangsu respectively. Each dot on the scatter plot represents a sub-sector in manufacturing. The picture indicates that in Guangdong, Zhejiang, and Jiangsu, the more export-oriented the sub-sector, the greater the employment concentration.

Given the economic structure of the regions where employment is concentrated, the recent financial crisis could cause bigger losses for employment than for GDP. The fast growing regions, such as Pearl River Delta and Yangtze River Delta, concentrate the most employment in China. These two regions are the first choice of industries that were transferred out of newly industrialized economies. For this historical reason, both the economic and the employment structures are more labor intensive and export-oriented in those areas. Picture 3 shows the relationships between employment intensity and economic intensity by province in 2007. Each dot on the scatter plot represents a province in China. The horizontal axis is the ratio of value added to gross output value in manufacturing, while the vertical axis is the log employment in manufacturing.

PICTURE 3

The relationship between employment and ratio of VAD to GOV

Source: National Bureau of Statistics, *China Statistical Yearbook* (2008), China Statistics Press.

Note: GD, ZJ, and JS refer to Guangdong, Zhejiang, and Jiangsu respectively.

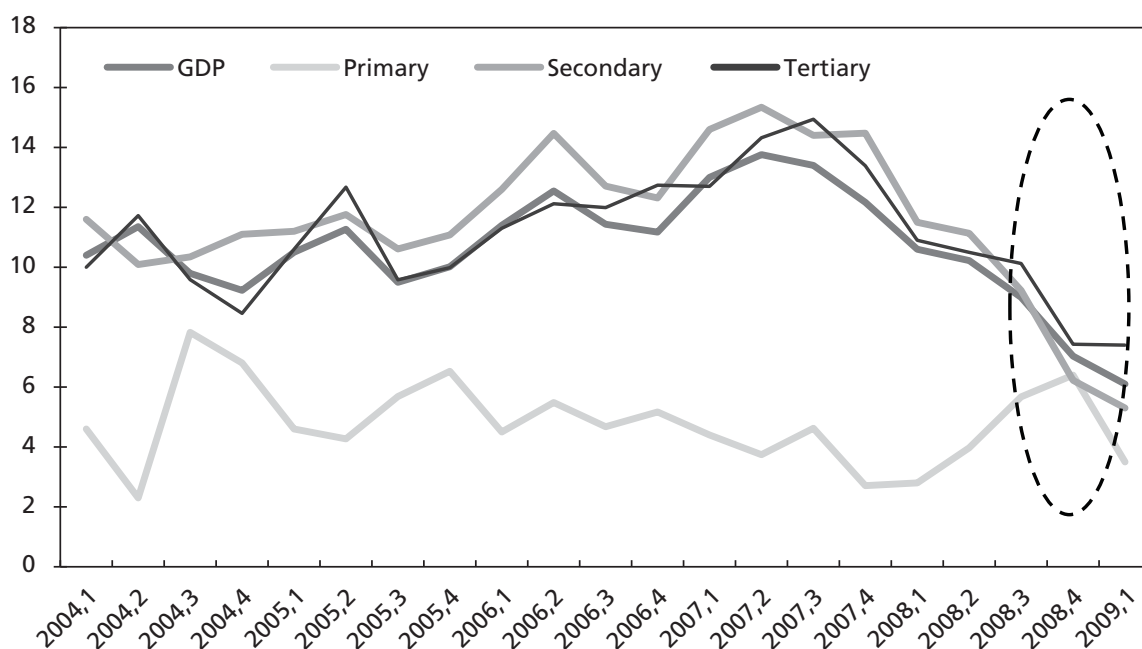
It is evident that provinces with a high VAD to GOV ratio tend to employ fewer workers because we see a clear negative relationship between employment and VAD to GOV ratio. Naturally, when facing the same shock, the economies on the right of the picture may lose more GDP, while those on the left may lose more employment. As marked in the picture, the Pearl River Delta (Guangdong) and Yangtze River Delta (Zhejiang and Jiangsu) are at the very left of the picture, which implies that the employment shock from the crisis will be substantial. According to a survey on migrant workers, the unemployment rate among this group was about 7 percent at the end of 2008 (Sheng, 2009). It goes without saying that coping with the labor market shock, rather than simply stimulating economic growth, should be prioritized.

### 3 THE SOURCES OF ECONOMIC SLOWDOWN: DOMESTIC OR EXTERNAL?

One question we want to answer here is to what extent Chinese economic growth is driven by external demand. To provide the answer, first we should clarify the share of external demand in GDP.

The world economy is plunging in 2009. However, the impact of the financial crisis on the Chinese economy occurs mainly through the second order transmission channel. The slowdown of economic growth in the main economies led to declining external demand for Chinese products, which in turn contributes to the Chinese economic slowdown. Picture 4 shows the quarterly GDP growth rate of the overall economy and by sector. The curves indicate that the Chinese economy maintained a fast growth rate before the fourth quarter of 2008, and the quarterly growth rates, compared to the same period of the previous year, were all above 9 percent. The economy grew 7 percent in the fourth quarter of 2008, then dropped to 6.1 percent in the first quarter of 2009.

PICTURE 4  
Quarterly growth rates by sector



Source: Website of National Bureau of Statistics, [www.stats.gov.cn](http://www.stats.gov.cn).

The curves also show that the secondary industry is the most affected of the three sectors. The slowdown of growth in manufacturing reflects the impact of the crisis on the real economy. Considering that the secondary industry has been the most important pillar of economic growth in China, its contribution to the significant slowdown of GDP growth is understandable. In the fourth quarter of 2008, the growth rate for the secondary sector was 6.2 percent, and 5.3 percent in the first quarter of 2009. It is rare for the secondary sector to grow more slowly than the overall economy in two quarters in a row.

The dramatic slowdown of economic growth has drawn the attention of policy makers, who changed the direction of macro policies from containing inflation to maintaining economic growth at 8 percent. In the next section of this



paper, we are going to discuss the policy instruments used to reach the economic growth target, and their implementation.

In addition to maintaining the economic growth rate above 8 percent, the outbreak of the financial crisis further revealed the structural problem of the Chinese economy. Given the imbalance of the macro economy, policy makers need to examine the following issues. First, as the driving force to economic growth, the desired policy should encourage final consumption, which plays a more active role in long-term economic growth. Second, the recovery policy needs to boost domestic demand and reduce dependence on external demand.

The ratio of total value of import and export is often used to reflect the openness of the economy, and the ratio in China was 0.59 in 2008. At first glance, it is quite a high ratio. However, it indirectly reflects the relationship between international trade and economic growth, and does not measure the proportion of value added of exported goods in GDP. In order to reflect the share of external demand in GDP, the value added of exported goods to GDP needs to be determined.

Unfortunately, the current statistical system in China does not provide the value added of exported goods directly. Based on information about items and value of exported goods by sub-sector and the ratio of value added to gross output by sub-sector, we can estimate the value added of exports in each sub-sector by multiplying value of exports in each sub-sector by ratio of value added to gross output, as shown in Table 1. According to our estimation, the total value added of exported goods accounted for 10.1 percent of GDP in 2007.

TABLE 1  
Value added of exported goods by sub-sector in 2007

	Total value of exports (billion yuan)	Ratio of value added to gross output (%)	Value added (billion yuan)
Food Processing from Agricultural Products	145.73	26.53	38.66
Food Manufacturing	107.47	30.66	32.95
Beverage Manufacturing	6.36	37.06	2.36
Waste Recycling and Disposal	7.7	23.81	1.83
Tobacco Manufacturing	4.9	77.29	3.79
Mining and Processing of Non-Ferrous Metal Ores	181.02	37.88	68.57
Raw Chemical Materials and Chemical Product Manufacturing	392.04	27.39	107.38
Chemical Fiber Manufacturing	202.58	26.32	53.32
Rubber Manufacturing	77.63	27.7	21.5
Manufacture of Leather, Fur, Feather and Related Products	125.58	28.73	36.08



Processing of Timber, Manufacture of Wood, Bamboo, Rattan, Palm and Straw Products,	87.41	29.27	25.59
Manufacture of Paper and Paper Products	70.55	27.56	19.44
Textiles Manufacturing	1272.4	26.23	333.75
Manufacture of Textile Wearing Apparel, Footwear and Caps	234.67	29.8	69.93
Manufacture of Non-metallic Mineral Products	202.74	31.17	63.19
Manufacture of Metal Products	886.61	26.3	233.18
Manufacture of General Purpose Machinery	1754	27.73	486.37
Manufacture of Electrical Machinery and Equipment	2304.3	25.2	580.68
Manufacture of Transport Equipment	421.91	25.69	108.39
Manufacture of Measuring Instruments and Machinery for Cultural Activity and Office Work	312.56	27	84.39
Manufacture of Artwork and Other Manufacturing	529.69	27.09	143.62
Total	9328.3	-	2515.1

Source: National Bureau of Statistics, *China Statistical Yearbook* (2008), China Statistics Press.

Based on a similar calculation and data sources, we can estimate the value added in 2006, and share of economic growth in external demand and domestic demand in 2007. The 2008 data have not been released yet, so the estimate for 2008 is based on more assumptions. Table 2 presents the output. In 2007, the contribution of external demand to economic growth was 12.4 percent (1.51 percentage points), and 10.1 percent in 2008 (0.91 percentage point). It is thus clear that exports only contribute to a very limited extent to economic growth. If the parameter maintains the 2008 level, we may deduce the impacts of declining exports over economic growth in 2009. As noted earlier, exports declined 24.7 percent in the first five months compared to the same period of the previous year, causing a 0.2 to 0.4 percentage point drop of economic growth. Given that a substantial decline of exports has already taken place, the possibility of further decline is lower (as shown in the picture, exports stop declining in the chain index). Therefore, declining exports will not be a major barrier to achieving the goal of 8 percent growth.

TABLE 2  
The contribution of domestic and external demand to economic growth

	2006	2007	2008
GDP (current price)	211923.5	249529.9	300670
Economic growth rate (%)	11.8	12.2	9.0
GDP deflator (%)	-	4.94	10.5

Value added of exports (billion yuan, current price)	2076.1	2515.1	3030.6*
Value added of exports/GDP (%)	0.098	10.08	-
Value added of domestic demand (billion yuan, current price)	19116.25	22437.89	27036.44
Value added of exports (billion yuan, previous year = 100)	-	2396.65	2741.46
Value added of domestic demand (billion yuan, previous year = 100)	-	213811.7	244573.0
Real growth of external demand (%)	-	15.44	9.00
Real growth of domestic demand (%)	-	11.85	9.00
<b>Contribution of External Demand to Economic Growth (percentage point)</b>	<b>-</b>	<b>1.51</b>	<b>0.91</b>
Contribution to Economic Growth from domestic Demand (percentage point)	-	10.69	8.09
Contribution to Economic Growth from domestic Demand (%)	-	87.6	89.9
<b>Contribution to Economic Growth from External Demand (%)</b>	<b>-</b>	<b>12.4</b>	<b>10.1</b>

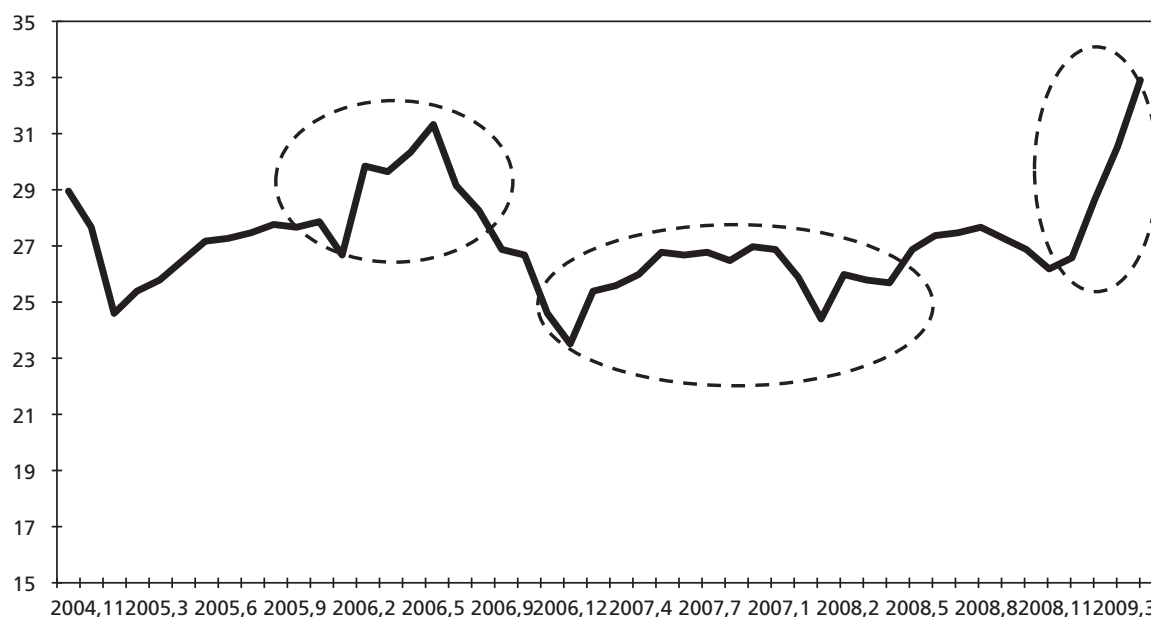
Source: Author's calculation from National Bureau of Statistics, *China Statistical Yearbook* (2008), China Statistics Press.

\* The exported value by item and ratio of value added to gross output in 2008 have not been released yet, so the value added of exports in 2008 is based on Value added of exports /GDP in 2007 multiplied by GDP of 2008.

So how can we explain the slowdown of economic growth since the financial crisis broke out? As noted earlier, investment has been the main driving force for economic growth. It is the slowing down of investment, which is to a large extent a result of tight macroeconomic policies right before the financial crisis hit the real economy, that slowed down economic growth. After the crisis, the monetary policy emphasized loans to private sectors. For instance, in the first half in 2009, loans to households increased steadily and loans to non-financial companies grew rapidly. By the end of June 2009, household loans had increased 23.8 percent over the same period of the previous year. Loans to non-financial companies increased 37 percent, 24.4 percentage points higher than the same period of the previous year.

Picture 5 shows the monthly changes of fixed asset investments since 2004. Before the period of inflation started in early 2007, investment remained at a high level. Since then, tight macro policies implemented to contain price levels have had effects on investment. As shown in Picture 5, the level of fixed asset investment was relatively low. Considering that economic growth usually follows investment, it is reasonable to deduce that the contraction of investment in 2007 led to the economic slowdown, while the outbreak of the financial crisis simply strengthened prudent investment expectations, translating into low economic growth in 2009.

PICTURE 5  
Fixed asset investment in China: 2004-2009



Source: Website of China Economic Information Center, [www.cei.gov.cn](http://www.cei.gov.cn).

It seems appropriate to believe that the stimulus plan that will eventually bring about expansion of investment will help China achieve the target of 8 percent economic growth in 2009. When the stimulus funds reach their destination, the size of fixed asset investment will expand. Monthly growth rates in April and May have already exceeded 30 percent (Picture 5). Since rebound investment is encouraged by the central government, which is quite rare in China, it is expected that the economy will soon peak its investment and recover from the depression.

In addition to economic growth, the follow-up policy needs to address additional issues. First of all, the social impacts of the financial crisis deserve more attention. Although the affected sectors, characterized by labor intensive technology, provide a limited contribution to economic growth, they have a significant impact on employment, in particular migrant workers' employment. The next section describes this impact in detail. Secondly, the follow-up recovery plan should focus more on the structural adjustment of economic growth, fostering the growth of consumption and correcting the imbalanced macro economic structure.

#### 4 ECONOMIC RECOVERY POLICIES

The Chinese government has accumulated experience coping with the outside shock from the Asian Financial Crisis. Since then, policy makers have realized that, in order to reduce the negative impacts of the shock, a timely policy response is crucial in tackling major financial crises. Policy makers have also learned that, in order to effectively reduce the impact of a crisis, in addition to economic policy, social policy plays a key role.

In terms of its scope and magnitude, this financial crisis is much bigger than the Asian Financial Crisis that took place a decade ago. Compared to the situation at that time, the Chinese economy is more integrated with the global economy, which makes the outside shock more significant. Meanwhile, with the rapid economic development of the past decade, Chinese economy is much stronger and the financial system is healthier. Therefore, the Chinese government is capable of responding to the crisis by implementing new economic and social policies.

#### **4.1 Timely adjustment of macro policies**

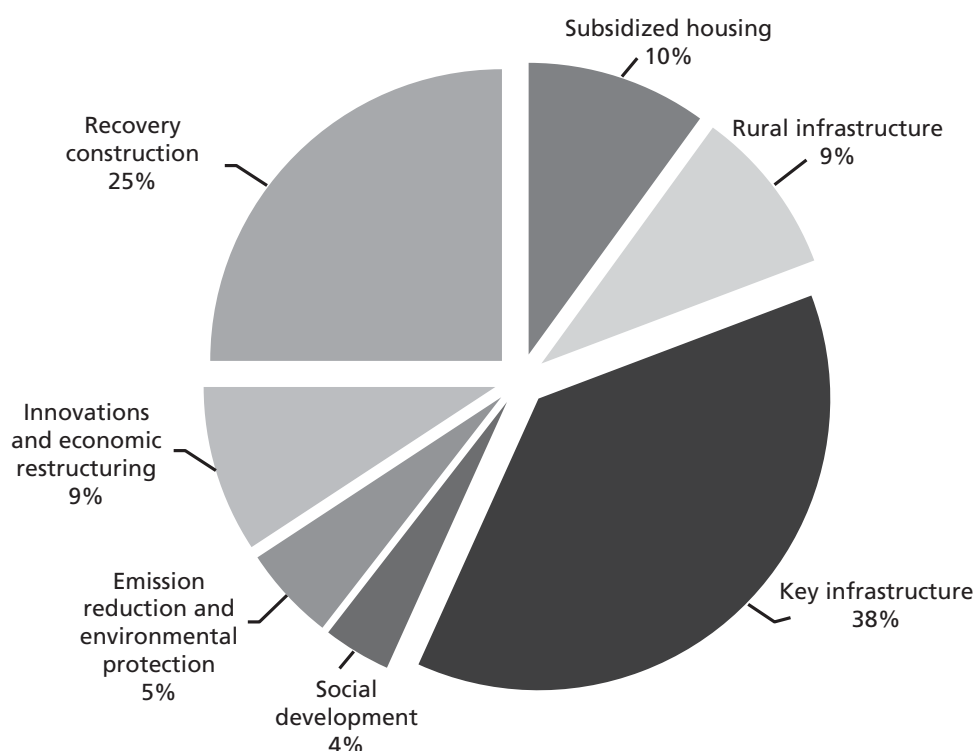
Prior to the global financial crisis, the main aim of the Chinese macroeconomic policy was to contain inflation. Since the fourth quarter of 2006, driven by soaring food prices, China's CPI experienced rapid growth. In the context of the changes in the inflation scenario, the Central Economic Work Conference, which convened at the end of 2007, clearly pointed out that the first priority of macroeconomic management was to "prevent the rapid economic growth from turning into overheating, and to prevent the structural price rise from evolving into full-blown inflation". The direct reflection is the monetary policy. At the end of 2007, in its *China Monetary Policy Report: Fourth Quarter in 2007*, the People's Bank of China clearly proposed to implement a tight monetary policy and restrain the rapid growth of currency and credit in 2008.

The macro policy underwent a sudden turn with the outbreak of the global financial crisis. The goal of macroeconomic management shifted from containing inflation to maintaining economic growth. In *The Chinese Government Work Report of 2009*, the target of maintaining 8 percent economic growth rate was clearly proposed. The main goal of the active fiscal policy and moderately flexible monetary policy is to prevent the economy from slowing down too much. The report discusses the main economic and social policy response provided by the Chinese government after the crisis.

#### **4.2 Fiscal policy: a massive stimulus plan**

The central government announced a 4-trillion-yuan plan to bolster the slowing economy through construction of key infrastructure (38 percent), recovery of earthquake-impacted areas (25 percent), subsidized housing (10 percent), and rural infrastructure (9 percent), investments in innovation and economic restructuring (9 percent), emission reduction and environmental protection (5 percent) and social development (4 percent) (Picture 6). It is apparent that the composition principle of the stimulus package is to combine long-standing bottleneck areas of the economy with priority areas that are intended to stimulate economic growth.

PICTURE 6  
The composition of the stimulus plan



Source: Website of the National Development and Reform Commission (2009), [www.ndrc.gov.cn](http://www.ndrc.gov.cn).

In conclusion, with more employment-friendly investment – namely, allocating investment according to labor-absorbing ability of sectors, scenario 3 can create 74.6 percent more jobs than scenario 1 and 53.1 percent more than scenario 2. It is obvious that investment composition should take into consideration several factors, and any quantitative analysis can only roughly reflect reality. Our simulations, however, intend to show that with or without consideration of job creation, investment decision making can generate a substantial difference in employment absorption. The policy implication is that the central government should use key policy tools to guide the stimulus package to invest in more employment-friendly sectors, regardless of whether the investment is made by central government itself, local governments, or private investors.

### 4.3 A moderately flexible monetary policy

As the financial crisis spread and deepened, the People's Bank of China (PBC) eased the monetary policy and explicitly proposed to carry out a moderately flexible monetary policy. The PBC adjusted the orientation, priority, and intensity of the monetary policy in a timely manner in accordance with the macro economic goal, maintaining stable and relatively rapid economic growth by employing several instruments, including money supply, loans, and interest rates.

The moderately flexible monetary policy evolved from a tight monetary policy that was implemented in the first half of 2008. At that time, in order to prevent rapid economic growth from becoming overheated, and to prevent the structural price rise from turning into entrenched inflation, the PBC adopted a tight monetary policy. After raising the benchmark deposit and lending interest rates on six occasions in 2007, the PBC kept the interest rate policy unchanged in the first half of the year. After the financial crisis, the PBC has been working to ease its monetary policy. This dramatic change demonstrates that the Chinese government attaches great importance to its policy response to the crisis.

The first priority of the moderately flexible monetary policy is to ensure sufficient liquidity within the banking system. In order to achieve this goal, the PBC reduced the intensity of open market operations and raised the level of new loans. According to the *China Monetary Policy Report: First Quarter in 2009* released by the PBC in May, by the end of March 2009, the outstanding broad money M2 posted 53.1 trillion yuan, representing a year-on-year increase of 25.5 percent and an acceleration of 9.3 percentage points in relation to the previous year. The RMB loans increased too, Outstanding RMB loans recorded 35 trillion yuan, up 29.8 percent year on year. In the first quarter of 2009, the new RMB loans increased 4.6 trillion yuan, 3.2 trillion yuan more than the same period of previous year. It is clear that increasing the liquidity of the banking system has been the main policy tool for the Chinese government to cope with the crisis.

The PBC also uses interest rate as leverage to support economic growth. In 2008, RMB lending rates rose before declining. In the first 8 months of 2008, the interest rates of RMB loans increased steadily. In August, the weighted average interest rate of RMB loans issued by financial institutions stood at 8.19 percent, 0.3 percentage point higher than the beginning of the year. Since September 2009, the PBC has lowered the benchmark interest rate five times, which keeps the weighted average interest rate of RMB loans at a low level. In December 2008, the weighted average interest rate of RMB loans issued by financial institutions stood at 6.23 percent, a decline of 1.96 percentage points from the peak in August and 1.66 percentage points lower than in the beginning of the year.

In addition to interest rates, the PBC adjusted the required reserve ratios frequently, according to the macro economic situations. In 2007, the PBC raised required reserve ratios on 6 occasions. In the first half of 2008, three more raises were needed to reduce money supply. After the crisis, the PBC lowered the required reserve ratios on three occasions in the second half of 2008.



#### **4.4 Active labor market policies**

The financial crisis has had significant negative impacts on China's labor market. In order to reduce employment losses, the Chinese government has adopted active labor market policies. Firstly, as we know, medium-sized and small-sized enterprises create mass employment opportunities; however, the ability of these enterprises to resist risks is lower. With the outbreak of the financial crisis, these enterprises have reduced the number of jobs. The governments have taken measures such as reducing taxes and economic burdens to help medium-sized and small-sized enterprises to save employment opportunities and reduce employment losses. Secondly, the Chinese government has also taken many measures, such as providing training to help migrants whose jobs have been seriously affected by the financial crisis and college graduates who find it difficult to get a job.

In 2008, central finance earmarked 3.51 billion yuan to support the development of medium-sized and small-sized enterprises. In September 2008, the Ministry of Human Resources and Social Security and other ministries put forward some measures to support medium-sized and small-sized enterprises, such as more flexible market access conditions, improved administration, more policy support, diversifying financing channels and intensifying training. In November 2008, an executive meeting of the State Council put forward that medium-sized and small-sized enterprises should be given more credit support.

In December 2008, the Ministry of Human Resources and Social Security and other ministries adopted several measures simultaneously to lessen economic burdens and foster a more stable employment situation for enterprises. These measures include: (1) Enterprises with financial difficulties are allowed to delay payment of social security funds; (2) The insurance rates for medical, work injury, unemployment and maternity insurance are allowed temporary cut backs. However, the pension insurance rate cannot be lowered; (3) Unemployment insurance funds can be used to help enterprises with financial difficulties to maintain employment posts; (4) Enterprises with financial difficulties are encouraged to provide on-job training to their employees; (5) Economic compensation problems of enterprises with financial difficulties should be solved appropriately. It has been estimated that the implementation of the first three measures will reduce enterprises' economic burdens by more than 100 billion yuan and more than 10 million employment posts will be maintained.

Youth employment and employment of migrants have been seriously affected by the financial crisis. New labor market entrants, such as college graduates, also face difficulties getting jobs. The Chinese government has taken many measures to help these groups, which include employment service and training, etc.



The Ministry of Human Resources and Social Security and two other ministries jointly issued a Circular on Implementation of Special Vocational/Skills Training Program on January 7, 2009. According to this circular, in 2009 and 2010, training programs will be offered to several groups of people that have been affected by the financial crisis to help them find jobs. These groups include employees of enterprises with financial difficulties, returned rural migrant workers without jobs, unemployed workers, including registered college graduates and unemployed rural migrant workers living in urban areas, and new labor market entrants. Employment services and assistance primarily target college graduates from poor families.

The Central Committee of the Communist Party (CCCCP) issued the No.1 document of the year on February 1, 2009, which includes several measures to promote employment of migrants<sup>1</sup>. Enterprises are encouraged to keep migrant workers' jobs. Enterprises with financial difficulties can adopt flexible employment, elastic working time and on-the-job training to maintain employment posts. Favorable tax/fee/loan policies and other policies for business registration and information consultation target migrants who return home to start their own business. Relevant and practical skill trainings for migrant laborers have been implemented. Enterprises are also required to give migrant workers favorable employment treatment and pay migrants' wages fully and on time. Temporary income support or rural *dibao* are available to migrants who return home without jobs.

## 5 IMPROVING SOCIAL PROTECTION

The financial tsunami has started to affect the Chinese economy and employment. As the rest of the world, China's economic growth will plunge in 2009, although a severe recession is not expected. The export oriented sectors that are also labour intensive are suffering job losses. Unfortunately, China has no real time labour surveys and is unable to report monthly unemployment rates following international standards. Thus, it is hard to assess how severe the impact of the international crisis really is on the Chinese labour market.

But some official messages help to outline the labour market scenario. According to a survey conducted by the National Bureau of Statistics, 70 million migrants returned home before the 2008 Spring Festival. Among those returned migrants, only 12 million, accounting for 17 percent of the total, returned because of factors related to the financial crisis, such as closing of enterprises, layoff, not being able to find jobs and

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1. Each year's No.1 Document of the CCCC addresses major issues and work priorities. For many years, like this year, it has focused on rural development-related issues.

low income. Since the total number of migrants is about 140.4 million, the proportion of migrants who returned home due to factors related to the financial crisis exceeded 8 percent (Sheng, 2009). It goes without saying that coping with the labour market shock should be prioritized, rather than simply stimulating economic growth.

International experiences show that economic crises are usually an important occasion to expand social security coverage and improve social security levels. The economic crisis in the US from 1929 to 1933 induced the establishment of the social US security system. During the Asian financial crisis, China established its social security system in urban areas.

The financial tsunami has had impacts on employment in China, especially employment of migrant workers. However, the social protection system for migrant workers is still very limited. For migrants, expanding social security coverage, boosting urban and rural integration of the social security system and building portable social security between regions are very important strategies for coping with the tsunami. The social protection systems for urban residents and rural population also need improvement, not only with a view to providing better social security to the population, but also stimulating consumption indirectly.

On February 5, 2009, the Ministry of Human Resources and Social Security submitted draft *Regulations on Migrants' Basic Pension System* and *Regulations on the Transfer and Continuity of Basic Pension Relationship for Staff and Workers in Urban Enterprises* to public consultation. According to the *Regulations on Migrants' Basic Pension System*, migrants who have established a labor relationship with their employers in urban areas should participate in the migrants' basic pension system. The *Regulations on the Transfer and Continuity of Basic Pension System for Staff and Workers in Urban Enterprises* provides the basic principles to be followed by staff and workers in urban enterprises when changing their employment across provinces, fund transfers, coverage continuity, determination of retirement place and calculation of fund payment and wage index, etc.

In urban areas, the coverage of the basic medical insurance system for staff and workers of enterprises has been expanding gradually. The basic medical insurance system for urban residents was piloted in 2007 in 79 cities, with the participation of 42.91 million urban residents. In 2008, the number of cities increased to more than 300, and the number of urban residents who participate in this system has also increased significantly.

As regards unemployment insurance, from 1994 to 1998, the contributors remained almost at the same level. Since the issuing of the *Regulations of Unemployment Insurance* in 1999, the number of contributors started to increase rapidly. At the end of 2007, the number reached 116.45 million,

including 11.5 million migrant workers. At the end of 2008, the number of unemployment insurance contributors reached 124 million, of which 15.49 million were migrant workers. While the total number of unemployment insurance contributors increased by 6.5 percent in 2008, the number of migrant worker contributors increased much more, reaching 34.7 percent.

Since early 1990s, the rural pension system has been piloted by various regions. However, unlike the urban pension system that has a mature and nationally universal plan, the rural pension system is at the experimental stage and has not made much progress. The central government has been actively promoting the establishment of a new rural pension program. On September 1, 2009, the State Council issued a document on piloting a new rural pension program, which indicated the formal startup of the system. According to this document, the new rural pension system will be piloted in 10 percent of the country's counties as of 2009. The basic idea is that the fund sources come from personal contributions, additional collective contributions, local and central government subsidies, and social donations, all going into individual accounts. The payment will be made in two parts: individual account accumulation and basic pension provided by government.

In rural areas, after losing the support of collective economy, it was difficult to maintain the original rural cooperative medical system. In October 2002, the Chinese government decided to set up a new rural cooperative medical system gradually all over the country. By the end of 2008, 2729 counties (districts, cities) had established this system, and 815 million rural inhabitants were covered by the system - a participation rate of 91.5 percent - reducing the economic burden of medical treatment for the rural population.

The Minimum Living Guarantee Program (*dibao* program) has become the basic social assistance system in China. Since the financial crisis, both urban and rural *dibao* programs have been developed steadily. By the end of 2008, there were 23.35 million urban *dibao* beneficiaries. The average urban *dibao* standard is 205.3 yuan, and the average monthly urban *dibao* benefit level is 143.7 yuan, increased by 12.6 percent and 39.9 percent respectively compared to 2007. The total expenditure on urban *dibao* was 38.52 billion yuan, a 40.2 percent increase compared to 2007.

At the same time, the rural *dibao* program has been established all over the country. By the end of 2008, there were 43.06 million rural *dibao* beneficiaries, a 20.7 percent increase compared to the previous year. The average rural *dibao* standard is 82.3 yuan, and the average monthly benefit level of rural *dibao* is 50.4

yuan, having increased by 17.6 percent and 29.9 percent respectively compared to the previous year. In 2008, the total expenditure on rural *dibao* was 22.23 billion yuan, a 113.5 percent increase compared to 2007.

The Ministry of Civil Affairs and the Ministry of Finance have jointly stipulated that, as of January 1, 2008, the monthly *dibao* benefit per person should increase by 15 yuan in urban areas and 10 yuan in rural areas. The central government provides some subsidy for urban and rural *dibao* beneficiaries. Local governments provide supplements according to their own financial situations. The non-*dibao* households with extreme financial difficulties can receive temporary assistance.

By January 8, 2009, the Ministry of Civil Affairs and the Ministry of Finance had distributed a one-time subsidy to the urban and rural poor, totaling 9.66 billion yuan and fully funded by the central government. 74 million poor people received the subsidy, including 62.8 million *dibao* beneficiaries, 5.3 million unemployed or *wubao* beneficiaries, and 6.4 million other vulnerable groups. Each urban *dibao* beneficiary received 150 yuan and each rural *dibao* and *wubao* beneficiary received 100 yuan.

Since the financial crisis, the Chinese government has also taken some measures related to compulsory education, which have attracted considerable attention. Since the fall term of 2008, students enrolled in compulsory education at state-run schools are exempted from payment of tuition and miscellaneous fees. Students from urban *dibao* households enrolled in compulsory education are provided with free textbooks. Accommodation and living expenditures of students from households with financial difficulties are subsidized. Migrants' children who meet the local admittance criteria are referred to the closest state-run school and are exempt from payment of tuition and miscellaneous fees.

## 6 CONCLUSIONS AND DISCUSSIONS

### 6.1 General statements on impacts of the crisis

The direct impacts of the financial crisis on China are limited. When the crisis broke out, only a few companies reported asset losses, since the openness of the financial sector has been limited. The actual impact of the crisis on China is mainly through the second order channel. Due to the shrinking of demand in developed countries, the export sector has been heavily affected. Export reduction has resulted in shutdown of firms in coastal areas, the most developed region in China. Considering that most firms are labor intensive, the impact has been greater on the labor market rather than on economic growth per se.

China slowed down the pace of economic growth that it had maintained for decades. In the first quarter of 2009, the quarterly economic growth rate was 6.1 percent, the lowest in the past ten years. Based on the analysis in this report, however, the domestic policy carried out in early 2008, rather than the outside shock, should be blamed for the economic slowdown. In this regard, it seems that the unprecedented economic stimulus plan currently underway will help the Chinese economy back to its normal path. In the first half of 2009, the economic growth rate was 7.1 percent, implying that the growth rate for the second quarter was around 8 percent, which is the target of the economic recovery plan.

The social impacts of the financial crisis deserve more attention. Although the affected sectors, characterized by labor intensive technology, provide a limited contribution to economic growth, they have a significant impact on employment, in particular migrant workers' employment. When the social protection system is imbalanced between urban residents and rural inhabitants, such effects can be even more severe.

## **6.2 Coexistence of challenges and opportunities**

Although the economic slowdown is a challenge for macroeconomic policies in China, it opens a window of opportunity to improve the social protection system, if the social expenditure is appropriately included in the stimulus plan.

In fact, China has already benefited from such adjustment in social policies before. About a decade ago, the Asian Financial Crisis created labor market displacements in urban China. In addition to implementing an active labor market program, a series of social protection reforms was also implemented. Thus, China coped with the Asian financial crisis smoothly.

In the present crisis, the most affected are migrant workers. Unfortunately, migrants and rural inhabitants are not well protected by the current social protection system. In this regard, China can use the economic recovery opportunity to invest in social protection and improve the system for migrants and rural populations. The expansion of the social protection system will not only protect disadvantaged groups from a negative labor market shock, but will ensure their stability in the future. Once the low income population is well protected, their consumption is likely to increase, which is actually positive for the correction of China's imbalanced economic structure.

## **6.3 Issues that require caution**

Some issues are of particular concern, even though the prospect of economic growth in the near future is optimistic. Among them, to correct the imbalanced economic structure is the most pressing.



Firstly, China should reduce its dependence on external demand for economic growth. China is one of the biggest countries in terms of the value of its exports, and external demand has contributed to its economic growth in the past decades and produced foreign exchange surplus. However, the huge foreign exchange surplus is a double-edged sword. On the one hand, it gives China room to deal with the financial crisis. On the other hand, it creates more connections between the Chinese economy and the rest of the world, which increases economic fluctuation factors.

Secondly, China should focus more on increasing final consumption. The analysis in this paper indicates that economic growth in China has been mostly driven by investments rather than final consumption. Policy makers are already aware of the trends and seek to change the pattern by addressing the importance of consumption to economic growth. However, in order to guarantee 8 percent of economic growth, the stimulus plan reinforces the role of investments. In this regard, the achievement of the economic growth target may lead to side effects in the future, making economic structure adjustment more difficult.

Finally, the process of economic recovery should also be a chance to balance the regional economy in China. There seems to be an indication that the flying geese model is going to emerge across provinces. For central and western China, the crisis opens a window of opportunity to catch up with their coastal counterparts. In fact, recently released statistics already showed that economic growth in inland China is becoming stronger. The continuation of labor-intensive industries by inland provinces, however, depends on how the development of those regions matches up to their comparative advantage, which we believe is still labor-intensive industries.

#### **6.4 Prospects for the post-crisis era**

The ongoing global financial crisis reveals the long-standing shortcomings of China's growth pattern. The tasks to change this pattern have been described by international scholars and leaders as rebalancing of economic growth, and by the Chinese government as transitions from export-oriented growth to domestic consumption-oriented growth, from input-driven growth to productivity-driven growth, and from secondary sector-dominated growth to more service-dominated growth. As a potential process of destructive creation - as coined by Schumpeter - this financial crisis can provide opportunities for China to accomplish those transitions.

The 30 years of economic reform and opening have just concluded half of China miracle's story - that is, the central and western provinces of China will continue to grow by catching up with their coastal counterparts. Before and at the time when the global financial crisis hit the real economy of China, there

seems to have been a change in the regional growth pattern of industries – that is, industrial outputs in central and western regions have grown relatively faster than those in the eastern regions. At the same time, as a result of rising labor costs and a sharp drop in export orders, industries in coastal areas seem to lose their role as major drivers of Chinese economic growth.

However, the current changes in the regional pattern of industrial growth, or the industrial relocation trends, are mainly the result of central government's implementation of favorable policies and targeted investment. That created a comparative advantage that defies the industrial structure, which is dominated by heavy industries and inconsistent with the regions' resource endowments. Sustaining rapid economic growth in China requires building a domestic flying geese model so that the central and western regions can maintain the comparative advantage in labor-intensive industries. The urgent challenge for implementation of sound regional development strategies is to transform the government intervention and investment-oriented mode to a comparative advantage-following and market-oriented mode, in order to turn the industrial relocation of industries into an upgrading process of all regions, eastern, central and western, together.



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