CIGI'08: China in the Shifting World Order

Student Session Reports

Session Report: China and Financial Governance

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Introduction

The current global financial system is at a time of crisis; possibly the worst crisis since the Great Depression. Economist Charles P. Kindleberger's analysis of the Great Depression illustrated that during a time of financial crisis, a transition of power often occurs. Historically, the United States has had a central role in global finance; however, with the current turmoil facing the Western banking systems, this may change. China has been instrumental throughout this period of crisis by purchasing US Treasury bills, thereby offering some stability in a global economy that is still quite distant from recovering from its fragile state. The global financial system is at a turning point in terms of governance and China has the potential to pay a key role. The question remains which role will China play?

This session convened by providing an overview on the potential roles that China may embrace under these current times of economic vulnerability. Followed by examining the likelihood of China implementing an exchange rate policy by understanding the current pressures the nations is under.

China: three roles

Although it may be too soon to tell, many observers of the current financial crisis associate the high number of defaulted subprime mortgages that occurred throughout the United States as one of the early triggers to the current situation. Despite the fact that initial impacts of the crisis were first experienced in US, their interconnectedness with the global economy has led to severe repercussions far beyond the US border. China has not escaped this. China as an emerging economy is highly dependent on exports, and consequently, the current situation will have immediate ramifications for its economy. China is currently facing a choice of how to react to this. According to Kindleberger, there are three distinct roles it can assume: 1) destabilizer; 2) stabilizer; or 3) transformative role.

Destabilizer

During the early years of the Great Depression, particularly from 1929-1931, the role of the US in the global economy could be viewed as a destabilizer. Although there still is debate among historians as to the exact cause of the Great Depression, there is a consensus that US economic policy (e.g. protectionism) along with poorly regulated markets exacerbated it. Were China to act in similar ways in today's crisis, the result could be equally devastating. However, it has not opted to do so. Similar to the Asian Financial Crisis of 1997, China has recognized the significance of absorbing the short term shocks of a failing market in order to preserve the long term interests of not only regional markets but also those of the global economy.

Stabilizer

In the current financial crisis, China has used its position in the global economy to act more as a stabilizer than a destabilizer. There are three examples of this. Firstly, China has played a central role in defending the US dollar, despite the fact that this has been extremely costly. According to Baotai Wang of the University of Northern British Columbia, for every 10 percent the US dollar depreciated, China lost the equivalent of 3 percent of their gross domestic product. Secondly, at the onset of the current financial crisis, China had a considerable role in recapitalizing and thus aided in stabilizing Western banks. These investments have also been very costly, as they have not fared so well. Lastly, China has played a role in global macro-economic coordination. China's central bank joined the Federal Reserve, the European Central Bank and the Bank of England in an unprecedented coordinated interest rate cut in early October in a bid to halt the collapse in share prices, the freeze in credit markets and to shore up market confidence.

Thus far China has been able to successfully play the role of a stabilizer, though motivated by self interest. However, how long will it continue to engage in this role? The crisis is moving into a stage where there will be a spill over onto the balance of payments ledger, and the international system will still require support in order to avoid sovereign defaults and currency instability. Consequently, as the crisis continues China will start to experience the effects of the crisis at the domestic level. This begs the question: can the world continue to expect support from China?

Transformer

Despite questions regarding China's ability to continue as a stabilizer, a third possibility for the country is to shift its role from merely being a stabilizer into being a transformer. China can use this opportunity to trigger a new discussion and advocate for reform of the global financial system, possibly even a new Bretton Woods. Premier Wen Jiabao's opening statement at the Asia-Europe meeting can be used as an indication of China's interest in performing this role. The meeting set out an agenda for reforms in the international financial system. Premier Wen called for the establishment of "a fair, just and effective financial system." He further said,

> I deem it important to do three things in this regard: first, increase the say and representation of developing countries in international financial organizations; second, expand the scope of the regulation of the international financial system, with particular emphasis on strengthening the supervision of the major reserve currency countries; and third, establish a reasonable global financial rescue mechanism.

As Kindleberger had indicated during his analysis of the Great Depression, a financial crisis is a time that often results in a transition of power. If China chose to take a central role during this crisis there may be an opportunity for great reforms and re-structuring of the global financial system. However, this is not a given. China may opt to rely on regional arrangements, and its continued support of the International Monetary Fund seems to be contingent on governance reform.

Mounting domestic challenges

China's experiences in the global marketplace have not been free of obstacles. Facing large and sustained trade deficits with China, the US has accused China of manipulating its currency. The crux of the disagreement is whether China has been keeping its exchange rate artificially low, thereby making its goods cheaper. However, even as looser exchange rate policies have allowed the Renminbi to appreciate, the balance of trade has not changed significantly.

Worse than mild altercations with the US is the rising number of issues that are assailing China on the home front. Three decades of unprecedented economic growth has lead to a host of structural and social problems that must be addressed effectively if China is going to continue along its successful path and contribute positively to the global community. While the nominal figure for GDP growth is impressive, there are troubling signs that the economy is no longer expanding at the same rate. This may threaten China's ability to provide jobs for the millions of people that enter the labour market every year. Despite the fact that China's economy is growing very rapidly, in order for there be to a net grain in wealth, the economy must grow at a rate greater than the growth in the labour market.

The picture is further complicated by mounting inflation. The Consumer Price Index, a measure of inflation that monitors the prices of a basket of goods and services, increased by 7 percent between January and September of 2008. Since the spike in commodity prices may be responsible for much of this, it remains to be seen what will happen as prices return to their historical averages.

Rising social inequality

High inflation rates detract from consumers' purchasing power, harming the fledgling domestic consumer market and making it harder for people to escape from poverty. Hundreds of millions have been lifted out of poverty since 1978, but it remains a widespread problem. While Chinese are concerned about poverty, social inequality is worse. Too often, social inequality is a result of rising income inequality. China's score on the Gini index – a statistical representation of income equality, measured on a scale from zero to one (where zero denotes perfect equality) – has been steadily increasing. China's Gini score is now 0.47, compared to 0.16 in 1978. Coming up with effective measures to reverse this trend is therefore one of China's most pressing concerns. The government has not been blind to these developments, and it has introduced policies to counteract the rising inequality. China's new Labour Law, introduced in January, 2008, has empowered employees and represented a major step in the right direction. However, it also caused labour costs to increase, especially for small to medium sized firms.

Retaining stability

Notwithstanding that the new Labour Law may have been a positive development; this is not a good time for firms to face higher expenses. There may be trouble ahead for China's main engine of economic growth, its export industries. The high exposure of the export-oriented provinces to the global market means they are also vulnerable to the current financial crisis. In fact, sixty-seven thousand companies have filed for bankruptcy in the last year in export-oriented provinces, leading to a surge in unemployment. China does not have any official unemployment figures, so the exact scope of the problem is unknown, but the trend is continuing.

Stability is one of the main objectives of the Chinese government: economic, financial, capital market and social stability. It would appear that social stability is judged as the most important of these, but economic stability is an essential prerequisite of social stability. To this end, the Chinese government has assumed a pragmatic approach by limiting uncertainty through cautious monetary policies and incremental changes to the interest rate and reserve ratio. However, it has also abandoned some long-standing policies. In 2005, China unpegged the Renmimbi from the US dollar and moved to a managed floating exchange rate regime. The value of the Renmimbi has since been allowed to float within a narrow band of a basket of currencies. This move has led to diverging opinions within China regarding its exchange rate policies. The Renmimbi has appreciated considerably, making imports cheaper and exports more expensive, and contributing to the scourge of bankruptcies among small to medium sized firms. Not unexpectedly, local authorities that have experienced a collapse in tax revenues as a result, have argued that the value of the Renmimbi is too high.

Conclusion

China has established a central role for itself during this time of crisis. It will be interesting to observe is how that role will change over time. Will China continue to look outward and be a bulwark for the West, or will the challenges they face domestically shift their focus more inward?

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