

The Impact of the Global Financial Crisis on the Chinese economy and China's policy responses¹

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Introduction

The American subprime crisis and the consequent dramatic global slowdown after Lehman Brothers fiasco, the Chinese economy was hit very badly. Following the free fall of the global economy, growth of the Chinese economy fell to 6 percent in the fourth quarter of 2008 from 13 percent in 2007. At the same time, inflationary pressure disappeared suddenly and was replaced by that of deflation.

The Chinese government responded to the impacts of the global economic crisis swiftly. In November 2008, a 4 trillion Yuan stimulus package was introduced. Acted in tandem, the People's Bank of China (PBOC) cut interest deeply, and the growth rate of credits and that of broad money shot up. It seems that the economy started bottoming out as early as in the first quarter of 2009, owing to the stimulus package and the extremely accommodating monetary policy. Since May of 2008, green shoots started burgeoning. However, it is still too early to judge whether the recovery is temporary, or sustainable. To a certain extent, the recovery of growth is achieved at the expense of the worsening of structural problems. It is still too early to answer the question of whether the Chinese economy will be able to come out of the crisis with a more rational structure and embark on a more sustainable growth path.

This paper aims at reconstructing the unfolding of China's growth trajectory before and during the global financial crisis. It examines how the Chinese economy was negatively impacted by the global economic crisis, and the effectiveness of the Chinese government's policy responses to the global financial and economic crisis. Since last September the Chinese government has been facing three major tasks: crisis

¹ Written for the *TWN Research Project on Financial Policies in Asia: Stage Two*

management, structural adjustment and protecting the safety of its foreign exchange reserves. The first section identifies the channels of financial shocks from the global crisis. The second section introduces the Chinese government's policy responses and examines the effectiveness and consequences of these responses. The third section discusses China's structural problems. The fourth section is about policy alternatives that China can choose to participate in the reform of the international monetary system and minimize the possible capital losses on its foreign exchange reserves.

I. The Channels of Financial Shocks from the Global Crisis

There are four major channels via which the global financial crisis impacted on the Chinese economy:

- Direct losses in the America capital market
- Changes in cross-border capital flows
- Reduction in growth of exports
- Foreign exchange reserves safety

1 Direct Loss in the America Capital Market

Before the subprime crisis, China's commercial banks had brought a moderate amount of MBS and CDO. According to the available data, the total direct loss of China's four most important commercial banks was amount to 20 billion US dollar. It seemed that the underdevelopment of China's overseas indirect investment spared China from bigger losses.

However, in August 2008, China once was on the edge, when Fannie Mae and Freddie Mac were on the brink of collapse. If these two mortgage companies had collapsed, China would have lost some 400 billion US dollars in its official foreign exchange reserves. It was really scary. The decision by the US government to place the two companies into conservatorship not only saved the two companies but also spared China a very big disaster. Since then the State Administration of Foreign exchange reserves (SAFE) has started to change its holding of the government agency bonds into the government securities, and from longer-term US government bonds to

shorter term Treasury bills, gradually. However, there are no official data on the change of composition in China's official holdings.

As of June 2008, Chinese commercial banks' holding of Fannie Mae and Freddie Mac bonds and mortgage back bonds guaranteed by Fannie Mae and Freddie Mac amount to 25.3 billion US dollars (Table 1).

There is no comprehensive data available either on the losses on the mortgage related bonds held by China's commercial banks. According to the data available, the direct losses seemed limited. As of August 2008, Bank of China, which was most exposed to subprime crisis among all Chinese commercial banks, had written off 2 billion USD of subprime loan related assets. It was reported that, by the end of 2007, Bank of China's total holdings of subprime loans were 49.9 billion USD. According to a study by Henseng Bank, as of the end of November 2007, Chinese commercial banks' total holding of subprime loan related bonds was 18.2 billion USD. As of January of 2008, the total holding was reduced to 15.9 billion USD. In line with Bank of China's write-off rate (40 percent), roughly speaking, Chinese commercial banks should have written off some 7.68 billion USD losses. Take into consideration the fact that since early 2008, more and more MBS and CDO were turning bad, Chinese commercial banks' losses can be significantly larger. But on the whole and relatively speaking, China's direct losses on MBS and CDO should be limited. This is mainly because China, as a late comer, failed to jump on the bandwagon in time to purchase more MBS and CDO.

On the top of the abovementioned losses, 7 Chinese commercial banks brought 0.76 billion Lehman Brothers bonds. Of course, all these investments have lost.

Table 1. China's purchase of Fannie Mae and Freddie Mac bonds

	Industrial and commercial bank of China	Construction Bank of China	Bank of China	Merchant Bank of China	China Investment Trust Bank	Minsheng Bank	total
Fannie Mae and Freddie Mac related bonds	2.716	3.25	17.286	0.255	1.584	0.227	25.318
Agency Bonds	0.465	2.555	10.637	0.18	0.43	NA	14.24
Bonds Guaranteed by Fannie Mae and Freddie Mac	2.251	0.695	6.649	0.075	1.181	NA	10.851

Sources: Bloomberg and CIIC

China's total foreign exchange reserves amount to 2.1 trillion as of the end of the first quarter of 2009. Among the total foreign exchange reserves, some 1 trillion US dollars are in the form of the US government securities, and the bulk of the securities is short term US treasury bills. At this moment, the book losses on China's foreign exchange reserve holdings are moderate. According to some sources, China has even earned some money from the holdings, because of the appreciation of the US dollar and fall of US government bond yields since the worsening of the crisis. Obviously, the gain on book is temporary. The safety of the value of China's foreign exchange reserves is one of the biggest worries of the Chinese authorities. This issue will be discussed later in more details.

In summary, compared with developed economies and economies in East Europe, China's direct losses in its financial assets as a result of the US subprime crisis was limited and the impact of these losses on the Chinese economy was also limited.

2 The fluctuations of cross-border capital flows

Because China only partially liberalized its capital account, theoretically speaking, cross-border capital can only flow in and out of China via the Channels of

FDI , officially approved foreign borrowing, portfolio investment by qualified foreign institutional investors and qualified domestic institutional investors, respectively. However, there are many loopholes in the controls over cross border capital flows. Among them, are transactions through underground exchange houses (dixia qianzhuang), and under- invoicing of exports and over- invoicing of imports or vice versa.²As a result, despite capital controls, pro-cyclical cross-border capital flows are still a serious threat to China's financial and economic stability.

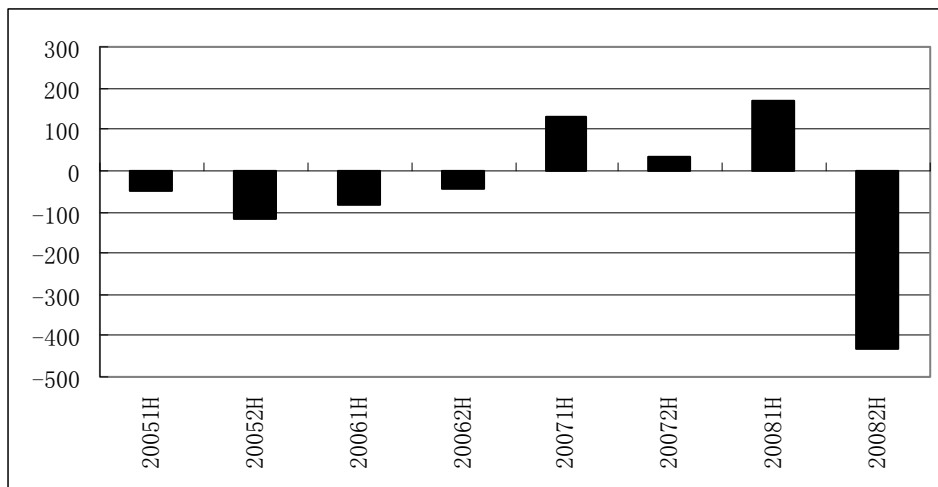
Soon after the breakout of the US subprime crisis, Chinese economists began debating the question of whether international capital would flow in or out of China. Some argued that because of China's relatively strong economic performance, to seek safe heaven, international capital would flow into to China and China should be prepared for a new wave of hot money inflows. Others argued that because of the liquidity shortage, need for capital injection and de-leveraging led credit crunch, unwinding carry-trade, and flight to safe-heaven (the US government securities), international investors would liquidating their holdings in emerging markets, and hence international capital would flow out of China and return to the US and other financial centres of developed countries. The reality turned out that, since early 2008, capital seemed to have been flowing out of China. For example, China's FDI inflow reduced to some 20 billion US dollars in 2008. In contrast, in 2007 FDI inflow was 50 billion US dollars.

Traditionally, there are two ways to measure the magnitude of cross-border speculative capital flows (hot money): one is to check the volume of the errors and omissions in balance of payments; another is to calculate the so-called unexplained capital inflows (or outflows), which is equal to the changes in foreign exchange reserves minus FDI and trade surplus. Of course, these two methods can only provide very rough measures of the magnitude of hot money. But these two measurements still can give a sense of direction.

² Yu Yongding, 2008: The Management of Cross-Border Capital Flows and Macroeconomic Stability in China , TWN Global Economy Series 14, 2008 TWN.

The statistics of error and omission in the balance of payments showed a negative figure of some 40 billion USD in the second half of 2008, compared with a positive figure of near 20 billion USD in the first half of 2008 (Figure 1).

Figure 1. Errors and Omissions in China Balance of Payments
(unit: hundred million USD)



Source: State Administration of Foreign Exchange Reserves.

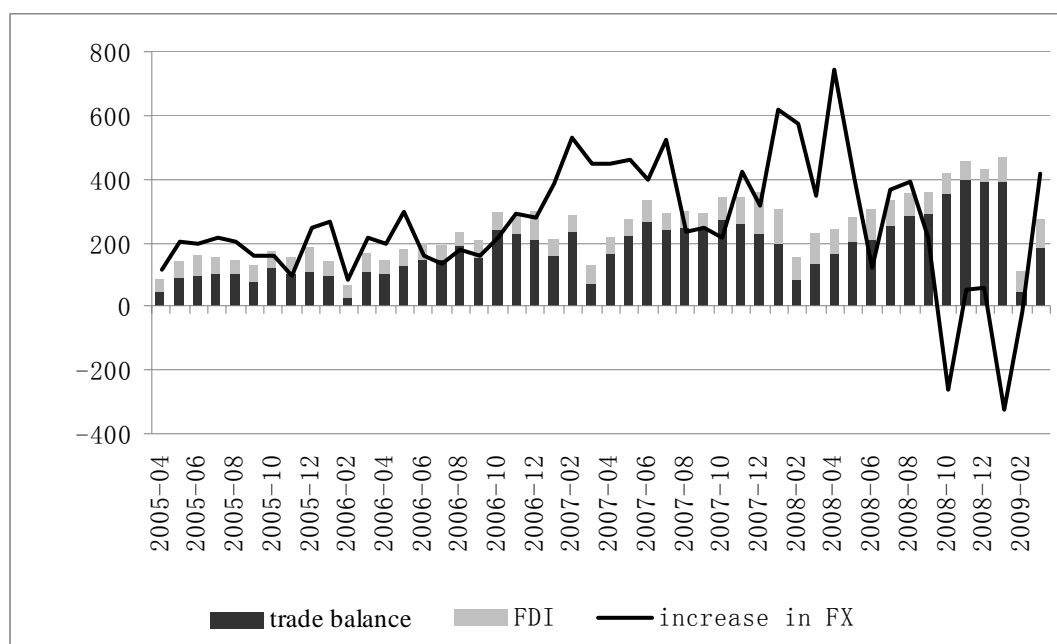
Note: made by Dr Zhang Ming

According to the second measurement, in 2007 and the first half of 2008, there were hot money inflows, and in the second half of 2008, there were hot money outflows (Figure 2). In fact, in 2007 and the first half of 2008 hot money complicated greatly the Chinese monetary authorities' efforts for containing asset bubbles and stabilizing RMB exchange rate.³ However, because of the strong recovery of the Chinese economy and perhaps also due to the improved risk appetite of the international investors in general, hot money started to flow into China again since early 2009 and started to increase strongly since March of 2009. In recent months, China's stock prices rebounded with vengeance and the housing prices have broken the historic record set in 2007 when the asset bubble peaked. The Chinese government

³ Ditto.

is keeping a close eye on the cross-border capital flows and is ready to take action to maintain the stability of China's capital market.

**Figure 2. Short term cross border capital flows as difference between increase in foreign exchange reserves and trade surplus and FDI
(unit: hundred million USD)**



Sources: Ministry of Commerce and State Administration of Foreign Exchange Reserves

Note: made by Dr Zhang Ming

It is worth mentioning that, despite the fact that China like other developing countries has been impacted by pro-cyclical cross-border capital flows, because of China's capital controls and its huge foreign exchange reserves, despite the fluctuations in the short term cross border capital flows, the PBOC's ability to intervene in the foreign exchange market, RMB's exchange rate has been under the effective control of the PBOC. China did not suffer from the roller coaster changes in

the RMB exchange rate. However, China's relative success in avoiding the shocks caused by the sudden surge or sudden stop of international capital flows should be mainly attributed to its insisting in the maintenance of controls over cross-border capital flows rather than its huge foreign exchange reserves. For most developing countries, self-protection may be their most important motivation for accumulating foreign exchange reserves. For China, this is definitely not the main reason.⁴ Finally, it is worth mentioning that despite the fact that capital controls in China are leaky, the controls increase the transaction cost of the movement of speculative capital flows and hence significantly reduce the adverse impacts of the global financial crisis on the macroeconomic stability of the Chinese economy.

It seems that the most serious impact of the global financial crisis on the financial area of the Chinese economy was the difficulty in obtaining trade finance, the adverse impact of which was most acutely felt in the processing trade industry.

3 The impact of the global financial crisis via the trade channel

Compared with other impacts, the far more serious impact of the global financial crisis on the Chinese economy is on trade.

China's fast growth came to a sudden halt in the third quarter of 2008. In the third quarter, China's annualized GDP growth dropped to 9 percent (6.8 in the fourth quarter) from 13 percent in 2007; The growth rate of industrial production fell to 8.2 percent, about half of the rate in the same period of previous year; Growth rates of many important products fell from double digits to negative. The growth rate of exports fell from 20 percent in Oct. to -2.2 percent in Nov.

Statistics shows that the most important cause for the collapse of China's growth in the 3rd quarter of 2008 was attributable to the sudden collapse of the export market, which was in turn caused by the sudden worsening of the US financial crisis since the collapse of the Lehman Brothers. In all China's industries, the most dramatic fall in production happened in the steel industry. The analysis of the causes of the fall

⁴ A detailed discussion can be found in Yu Yongding, 2006: Global Imbalances and China, Paper prepared for Finch Lecture, Melbourne University, 17 October 2006, published in Australia Economic Review, March 2007.

of steel production sheds lights on the causes of the fall of the Chinese economy in general in a crystal clear way (table 2).

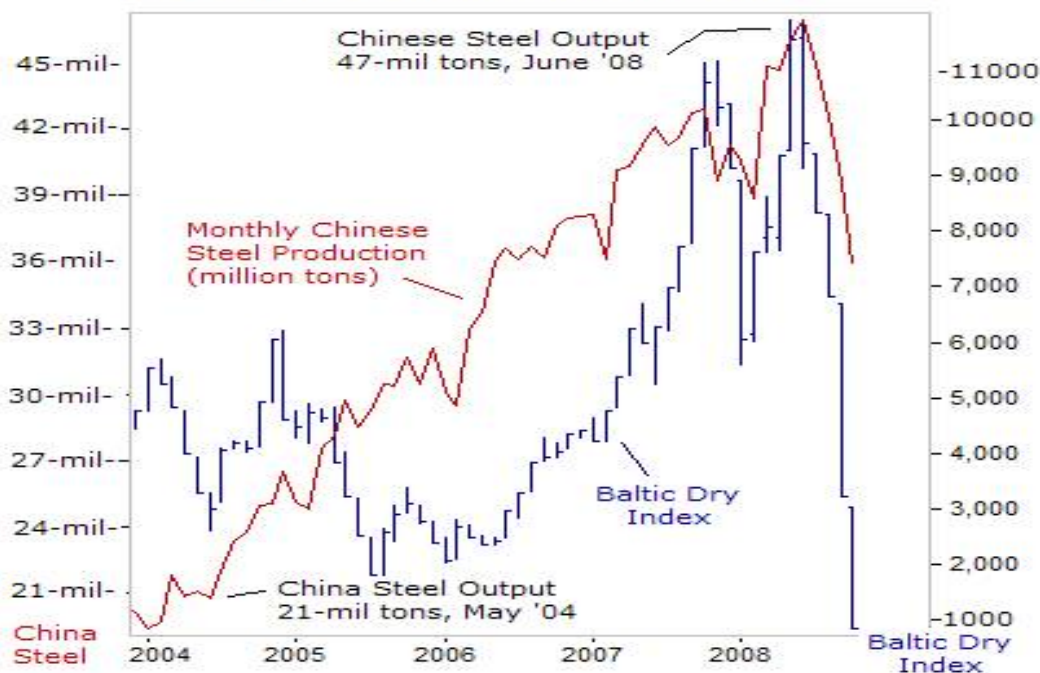
Table 2. Direct impacts of fall in foreign demand on steel production

types	Output, Aug	Output, Sep	Reduction in Sep	The fall
exports	7.6769milT	6.67mil T	-1mil T	-13.12%
Total output	47.8 mil T	45.9 mil T	-1.9 mil T	-3.93%
Exports/total output	16.06%	14.53%	53.58%	—

Source: Xue Qiyuan, based on various sources

It can be seen that the drop in steel exports directly accounted for 54 % of the total decrease in steel productions in Sep. 2008, and the fall of exports in turn was a direct result of the fall of global economy (Figure 3)

Figure 3 Market Signals of Sharp Downturn in Global Economy



Source: Seeking Alpha: Can Central Bankers Prevent a Great Depression? <http://seekingalpha.com/article/106770>, 2008 Nov 19 09:23 AM

Besides direct impact, indirect impact of fall in demand of steel-related exporting industries on steel production was also very great. On the whole, the fall of external demand can explain more than 60 percent of the fall of steel production.

In summary, the dramatic fall of export demand since the third quarter of 2008 is the single most important cause of China's slowdown. The slowdown in fixed asset investment was the second important contributing factor. The fall of fixed asset investment on growth in turn can be attributed to the slowdown in real estate investment--as a result of monetary tightening over the past several years, the fall of export-related investment, the worsening of expectations, and financial losses made in speculations in financial markets by big state-owned enterprises as a result of the burst of asset bubbles and the collapse of commodity prices. Anecdotal evidences show that the speculative losses by those enterprises were huge, but difficult to substantiate. The third important cause for the slowdown of the economy is the large inventory adjustment. Until the middle of 2008, many Chinese enterprises were still expecting further rise in prices and engaged in large scale hoarding activities. The unwinding of the inventory worsened greatly the fall of China's growth. Lastly, the wealth effect of the burst asset bubbles also played certain role in slowing growth of consumption.

II. China's main policy responses to the global slowdown

When the global slowdown has become apparent, the government shifted its policy direction quickly and forcefully. In November 2008, the government started to implement a very large stimulus package. At the same time the PBOC also ushered in expansionary monetary policy.

1. Expansionary fiscal policy

In November 2008, the government introduced a **4 trillion Yuan** (\$580 billion) stimulus package for 2009 and 2010. In 2008, China's GDP was 29 trillion.

The package accounted for 14 percent of GDP in 2008. Besides the increase in expenditures, the government also considered possible tax reductions, which included VAT reform, Business tax cut and raising the threshold of individual income taxes. According to National Development and Reform Commission (NDRC), assuming that the fiscal multiplier in China is 2-3, the package can create about one percentage point increase in GDP in each year for 2009 and 2010. On top of the central government's stimulus package, provincial governments were encouraged to raise money to launch their own complimentary stimulus package. The total amount of planned stimulus packages announced by local governments totaled at 18 trillion Yuan.

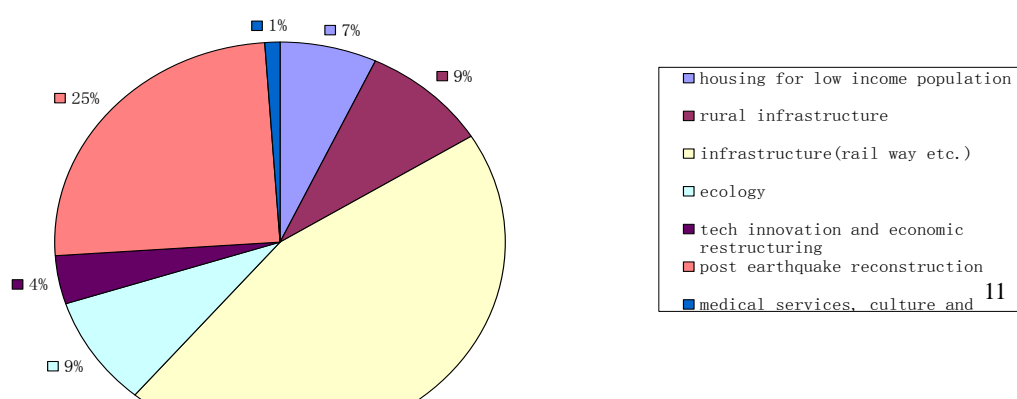
The structure of the 4 trillion stimulus package is summarized by the following table (table 3 and figure 4).

Table 3. the Breakdown of 4 trillion Yuan Stimulus Package (Unit billion Yuan)

Construction of houses for low income urban households	280
Increased spending on rural infrastructure and boosting rural incomes	370
Expenditures in transportation network construction	1800
Increased investment on medical service, culture and education	40
Increased spending on ecology protection	350
Technical innovation and economic restructuring	160
Sichuan post-earthquake reconstruction	1000
<i>total</i>	4000

Source: NDRC.

Figure 4. The Structure of China's Stimulus Package



Source: NDRC

It is easy to see that most of the money has been and will be spent on infrastructures such as railway, high way and so on, followed by earthquake rebuilding. Sources of financing of the stimulus package were designed as follows:

- Central government financing one-quarter of the 4 trillion Yuan package, in forms of direct grants and interest rate subsidies. In the case of central government-sponsored project, NDRC-MoF may inject all of the registered capital.
- Government bonds will be issued to cover the budget deficit.
- Central government will issued bonds on behalf local governments to fill the short fall in financing local projects
- Banks loans will be important sources of funds, especially for local governments.

In March of 2009, People's Congress approved the government's new budget for 2009. According to this budget, in 2009, the total government (central plus local) revenue would be 6.623 trillion Yuan, up 8.0 percent from 2008, among which, revenue of the central government should reach 3.586 trillion Yuan, an increase of 9.8 percent over 2008. Total government expenditure (central plus local) would be 7.635 trillion Yuan, up 22.1 percent, among which, expenditure of the central government would be 4.3865 trillion Yuan, an increase of 848.501 billion Yuan, up 24 percent. In 2009, the total government deficit would be 950 billion Yuan (\$139 billion), the highest in six decades, compared with 111 billion Yuan in 2008. Central government's deficit will be at 750 billion Yuan, 570 billion Yuan more than last year. The state council will allow local governments to issue 200 billion Yuan worth of government bonds through the ministry of finance. The expected budget

deficit/GDP ratio will be about 3% of GDP, compared with the budget deficit/GDP ratio of 0.4 percent in 2008.

There is no detailed information available on how the budget for 2009 was amalgamated with the 4 trillion Yuan stimulus package. However, attention should be paid to some key figures provided by the Ministry of Finance in a related report on central government's 2009 budget:

- 908 billion Yuan in public spending, an increase of 487.5 billion Yuan, an increase of 54 percent over 2008.
- 123.08 billion Yuan for direct subsidies to agricultural production and trade, an increase of 19.4 percent over 2008.
- 220.833 billion Yuan for subsistence allowances for both urban and rural families.
- 103.341 billion Yuan for subsidizing rural residents' purchase of home appliances and vehicles and increase reserves of important materials such as grain, petroleum, nonferrous metals and specialty steel products.
- 716.14 billion Yuan, an increase of 120.59 billion Yuan or 20.2 percent, to assist agriculture, rural areas and farmers.
- 728.463 billion Yuan for items directly related to the people's wellbeing such as education, medical and health care, the social safety net, and so on, an increase of 29.4 percent over 2008
- 146.103 billion Yuan for science and technology, an increase of 25.6 percent over 2008.⁵
- 500 billion Yuan reductions in Taxes and fees, which partially will be the result of VAT restructuring, increase in tax rebate, and exemptions. On the whole the government plans to withdrawn or suspend 100 administrative charges by 2009.

According to the MOF, as of May 31 2009, China allocated 562 billion Yuan (82.3 billion U.S. dollars) for public works projects, completing 61.9 percent of its central budget for 2009. Among them, more than a half of the allocated funds went to rural development and prominent infrastructure construction. The breakdown is as follows.

⁵ Source: Xinhua News Agency: Key figures from Chinese Finance Ministry's 2009 draft budget report, March 05, 2009.

163.5 billion Yuan went toward infrastructure projects such as railway, highway, airports and harbour construction.

138.1 billion Yuan was put into projects to enhance rural infrastructure and improve living standard in the countryside through the construction of irrigation facilities, power grids and paved roads.

Other spending included

- 84.8 billion Yuan for reconstruction in areas hit by the May 12 earthquake last year
- 44.2 billion Yuan for education, medical care and cultural development
- 42.7 billion Yuan for low-income housing project
- 41.2 billion Yuan for industrial upgrades
- 27.8 billion Yuan for environmental protection and energy saving
- 19.7 billion Yuan for public service facility buildings.⁶

It can be seen that the single most important element in China's stimulus plan is public work. This policy can work but that it could be an antithesis to the structure readjustment. China's investment rate was already too high in all measurements. The investment growth rate hit an annual growth rate of 32.9 percent y/y in the first five months of 2009, which will lead to an even higher investment rate. The excessively high investment rate in turn will in the long-run lead either to more serious overcapacity or lower efficiency reflected in an even higher capital-output ratio, which was already very high in China. Of course, the Chinese government knows very well that the Chinese economy has been suffering from overcapacity and this is the very reason why the government-financed investment is concentrated in infrastructure construction rather than in building new factories. However, there are three problems with this approach. First, China's infrastructures are far ahead of other developing countries. Though more infrastructures are needed, waste in the infrastructure construction is ubiquitous, due to the scale and hasty implementation of the investment. The future returns of this round of big infrastructure push are worrying. Second, it seems that far more resources should be used in providing public goods and building a decent social safety network. However, this is easier said than

⁶ Xinhua News Agency, 2009-06-04 20:52:35.

done. Lack of incentives for the local governments to support this endeavour is one of the most important constraints. Third, public spending should be conducive for the private investment and helpful for the development of small and middle sized enterprises. Unfortunately, it seems that private investors and especially small and middle sized enterprises have failed to get much benefit from this spending binge. On the contrary, many local governments are squeezing small and middle sized enterprises increasingly harder to compensate the reduction in their fiscal revenues resulted from the slowdown of economic growth.

Another important feature of China's stimulus plan is the large amount of tax rebate for exports. The amount of rebates was planned to be 670 billion Yuan, accounting for some 15 percent of the total central government expenditure. It was recently rumoured that to provide exporting enterprises more incentives, the amount of tax rebates will reach 800 billion Yuan for the year of 2009. This policy is very problematic. Although, because of the policy, some exporting enterprises can survive or linger on for a while, the negative impact of the policy on resource allocation and rationalization of the economic structure is equally obvious.

In contrast to many developing countries, which do not have adequate fiscal and financial resources, for China, it is not only affordable but also the sustainable to carry out a very expansionary fiscal policy. Over the past decade, China's budget deficit over GDP ratio was very low. In 2007, China ran a budget surplus. As a result, China's debt balance over GDP ratio was just 18 percent at the end of 2008. Even after having adopted the expansionary fiscal policy, by the end of 2009, China's debt balance over GDP ratio should still be lower than 20 percent. Therefore, there is plentiful policy room for the government to manoeuvre.

However, complacency is dangerous. If self-sustained demand cannot be created or revived in a few years' time, the policy space can be used up quickly. Low or even negative returns on the government financed investment projects, in turn will produce increasingly high pressure on the government budget in the future. Nonperforming loan ratio definitely will increase in coming years. The quality of the growth and sustainability of the growth have been compromised by the over-zealot government-led, especially local government-led, investment drive.

2. Expansionary Monetary Policy

Table 4. Credit and Monetary Expansion

Billion Yuan, %	May	April	March	February	January
Growth of M1	18.7	17.5	17.0	10.9	6.7
Growth of M2	25.7	26.0	25.5	20.5	18.8
Credit	664.5	591.8	1890	1070	1620
Growth of credits	30.6	29.7	29.8	24.2	21.3

Source: People's Bank of China.

Up to May 2009, the increase in bank credits was 5.77 trillion Yuan, higher than the official target of 5 trillion Yuan for the entire year of 2009. In contrast, the annual increases in bank credits in 2006 and 2007 were 3.18 trillion Yuan and 3.63 trillion Yuan, respectively. The increase in bank credits in the first quarter was surprisingly high, and the same was true of the growth rate of broad money M2. The gap between the growth rate of M2 and nominal GDP has broken the historical record (Table 4).

The most important cause of the rapid increase in credits and money supply is attributable to PBOC's expansionary monetary policy. Previously, corresponding to the rapid increase in liquidity caused by PBOC intervention in the exchange market, which was aimed at offsetting the appreciation pressure on the RMB created by persistent trade surplus (and capital account surplus), the PBOC sold large amount of central bank bills to mop up the excess liquidity. Since the fourth quarter of 2008, the PBOC has almost stopped selling more bills. As a result, the liquidity has inundated the inter-bank money market and even once made the interest rates in the inter-bank market lower than interests on deposits with commercial banks with same terms of maturity, which was described in China's banking circles as "flour being more expensive than bread".

China's financial conditions are very different from those in America and Europe in the global financial crisis. China just completed overhauls its banking system by writing off nonperforming loans and large scale of capital injection. Its banking system was relatively safe and sound when the Western banking system was on the edge. As a result, there was no credit crunch, and the monetary multiplier in

China has not fallen as dramatically as in the United States. Therefore, the dramatic increase in liquidity in the inter-bank money market has been duly translated into rapid increase in bank credits and broad money.

In my view, although monetary policy should be more accommodating, when a large stimulus fiscal package had been adopted, China's monetary policy in the first quarter of 2009 was too loose. The rapid expansion of credits and money supply was, to a certain extent, the result of non-market interferences. There are no sound economic rationales for supporting such a dramatic expansion. If commercial banks had been allowed to make decisions that are purely based on economic considerations, growth of credits and money supply would not have grown so fast. And there would have been fewer needs to worry about the possibilities of rising nonperforming loan ratio, worsening of economic structure and resurging of assets bubbles in the future. Actually, anecdotal evidence shows that large chunk of excess liquidity has entered stock markets and real estate markets. Assets bubbles are returning with vengeance. The huge gap between the growth rate of M2 and nominal GDP implies very large inflation pressure for the future. Taking into consideration the fact that China has a M2/GDP ratio of nearly 180 percent of GDP, highest in the world, the consequences of a loose monetary policy is very scary indeed.

Since the beginning, I have had no a shred of doubt about China's ability to achieve a growth rate of 8 percent in 2009. The confidence is based on the following facts:

- Strong fiscal position
- Vast domestic market
- Strong external position

As a result, the scope for using stimulating package by the government is very great. Literately, China will be able to spend its way out economic slowdown. In fact, at present, in the Chinese economy "green shoots" can be seen everywhere. It is possible that the Chinese economy has bottomed out since the end of fourth quarter of 2008.

According to the most recent government announcement, industrial production rose 8.9 percent in May from a year earlier, higher than April's 7.3 per cent growth. Retail sales increased 15.2 per cent after a 14.8 per cent rise the previous month. The

growth rate of fixed asset investment was 32 percent. The PMI index has been kept above 50 three months in a row. Housing prices have started to rise in many important cities and The Shanghai Composite index are approaching 2,700 from the low of 1,600 in late 2008. The bad news is that exports in May fell 26.4% from a year earlier, which shows that despite trade promotion policies such as the increase in tax rebate, the recovery of exports is something which cannot be decided by exporting countries themselves alone.

Despite the strong showing, worries about sustainability of the recovery are still lingering. The Chinese government is facing with a dual tasks of crisis management and structural adjustment. While we can say that the crisis management has been successful, the same is difficult to say about structural adjustment. To achieve a sustainable growth and improve the welfare of the nation, growth should not be achieved at the expenses of structure adjustment. China's structure problems include

- High external dependency
- High investment rate
- Pollution
- Energy efficiency
- Income distribution gap between different social group and between rural and urban areas
- Insufficiency in the provision of social goods (social safety net, medic-care, education, etc.)

If China fails to tackle these structural problems, growth is likely of double-dip and W shape. In order to deal with structural problems, China should push for more reforms. Actually, the current crisis also means good opportunity for the speeding up of reforms. Some key areas of reform include

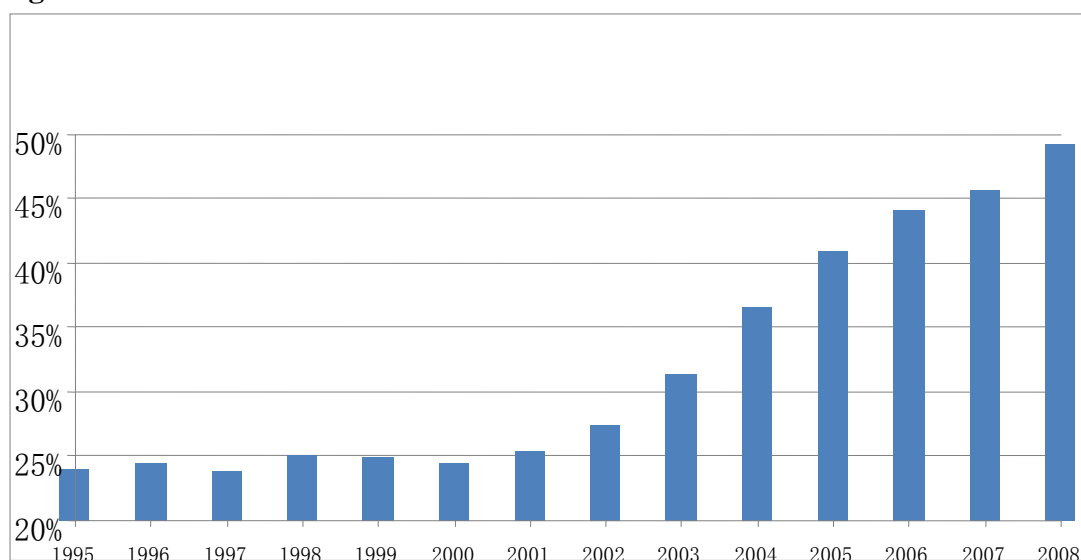
- Liberalize the restriction to the entry into Medic-care, sanitation, education, finance, communication and transportation. Rules of fair competition should be applied to these areas. Anti-monopoly laws should be formulated and enforced in natural monopoly industries;
- Liberalize price controls over energy, water, electricity and allow market demand and supply to determine the prices of these products;
- Further liberalize control on interest rates and establish a more flexible

exchange rate regime, and capital controls can be further liberalized side by side with internationalization of the Renminbi (China's currency);

- Low efficient enterprises and polluting enterprises should be allowed to go bankrupt, while the government should take more responsibilities for providing compensation for the employees of the enterprises;
- Strong policy should be taken to narrow the income gaps between the rich and poor, between urban and rural areas, and between regions;
- Provision of public goods such as social safety net, medical cares and free education should be speeded up.

After the global financial crisis, some of what we are doing is undoing what we have done to rebalance the economy. For example, as a result of the fiscal stimulus package, China's investment rate has become even higher (Figure 4), which means that in the future, China will face even more serious overcapacity. In the pre-crisis period, growth in exports absorbed a large proportion of overcapacity. In the future, if the growth rate household consumption fails to increase significantly, FAI will have to bear even more burden to absorb the overcapacity, or the capital-output ratio has to increase dramatically. If this happens, the growth miracle of China will come to a sudden end.

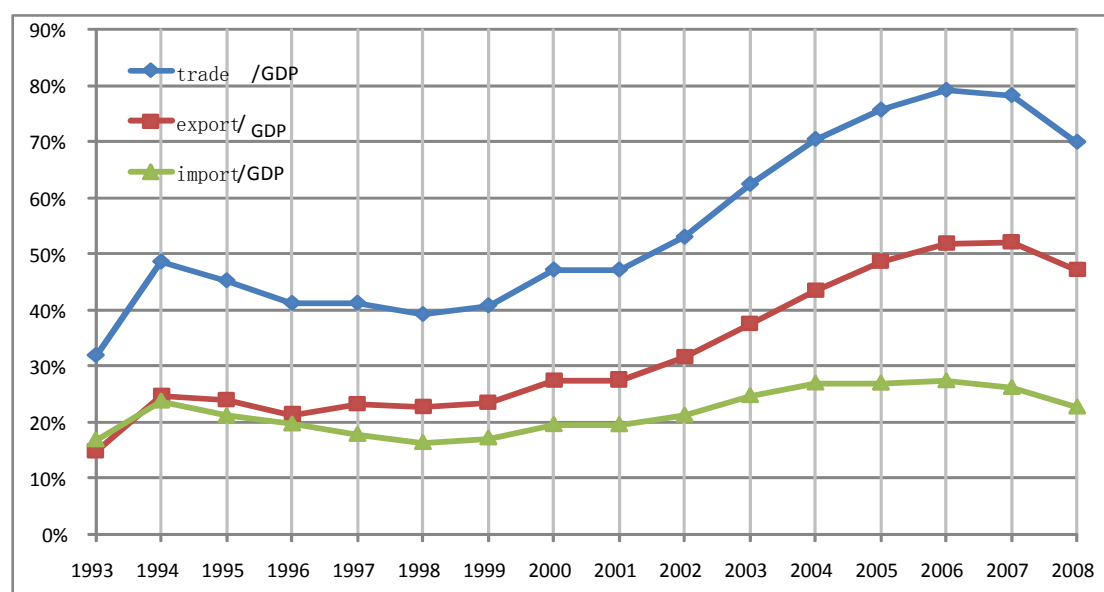
Figure 4. China's investment Rates



Sources: Zhongjing Net date bank.

The implementation of the investment and export- driven growth strategy over the past three decades has remade China's economic structure correspondingly. China's investment rate has been significantly higher even than those of Japan and Korea when they were in the periods of high growth. China's trade over GDP ratio is also much higher than all major open economies in the world. In contrast to America's less than 20 percent, in 2000s, China trade over GDP ratio has been above 60 percent and rising (Figure 5). Since 2006, as a result of the government's policy of rebalancing, China's dependency on external markets has started to fall. Now as a result of the global financial crisis, the share of China's trade in GDP will fall further. However, this does not mean that China's dependence on external demand has been declined structurally.

Figure 5. China's Dependency on External Demand (constant prices, RMB)



Source: Wu Haiying, based on Statistical Year Book of China, various issues.

In short, while I am not at all worried about China's ability to achieve a growth rate of 8 percent for 2009, I am worried about middle and long term structural problems and hence the sustainability of China's growth. Anecdotal evidences show that low efficiency and wasteful behaviours in investment projects as part of the stimulus package are prevalent. Asset bubbles aided by excess liquidity are begun to resurge. It seems that while the Chinese economy now is experiencing a V shape

rebound, its structural problems are worsening on the whole. This development is very very worrying indeed.

IV. How to safeguard the value of China's foreign exchange reserves

1. The dollar trap

The current global financial and economic crises were triggered by the burst of US asset bubbles. Global imbalances are a necessary condition for the formation of the US asset bubble. Without continuous foreign capital inflows into the US capital market, meaning without countries like China, Japan and the oil exporting countries continuously running current account surpluses against the US, the Fed would not be able to maintain the low interest rate policy and the long-term yield curve would not be able to stay flat for so long. To blame China for the US subprime crisis is ridiculous. However, as I wrote in an a paper in 2006, “(the correction) of global imbalances not only depends on whether American can reduce its current account deficits but also on how the rest of the world, including China, will respond to the further worsening of US current account deficit. Consensus has been reaching that the twin surpluses are neither desirable nor sustainable for China. Therefore, China will take actions to correct its imbalances. China's future correction undoubtedly will have important impact on the global imbalances.”⁷ Unfortunately, China failed to do more for the correction of the imbalances for its own interests in the subsequent years.

The global financial crisis and the US government's responses to the crisis have added a new dimension to the issue of rebalancing of the Chinese economy. China's twin surpluses are not just a matter of misallocation of resources but also a matter of capital losses. As pointed out by some observers, all policy options aimed at safeguarding for the People's Bank of China (PBOC) are unattractive. If the PBOC does nothing and simply hold on to the dollars, the losses will increase. If it buys more to prop up the dollar, it will only have a bigger version of the same problem in the future. If, on the contrary, the PBOC diversifies into other currencies, they will drive down the dollar faster and create greater losses.

⁷ Yu Yongding, 2006: Global Imbalances and China, Paper prepared for Finch Lecture, Melbourne University, 17 October 2006.

What can China do to safeguard the value of its hard earned foreign exchange reserves? To correct the misallocation of resources embedded in the persistent twin surpluses and to reduce the possible capital losses of China's foreign exchange reserves, China should exploit all available channels to rebalance its international balance payments. The rebalancing problems facing China can be divided into two categories: flow problem and stock problem. Put aside the problem of safeguard the value of its existing foreign exchange reserves (stock) for the time being, an important fact is that China's foreign exchange reserves are still increasing at an annual rate of some 200 billion US dollar, compared with 400 billion US dollar in the pre-crisis period. Therefore, the more urgent task for the Chinese government is to reduce the increase in foreign exchange reserves. Only after China's foreign exchange reserves stop increasing, can China shift its attention to the existing stock of foreign exchange reserves. To achieve this objective, the most obvious channel is to run a more or less balanced current account or even a current account deficit, which in turn requires the deepening of structural adjustment to eliminate the savings-consumption gap, the reform of exchange rate formation regime to minimize government intervention in the foreign exchange market, and the elimination of export promotion policy which creates price distortion.

As regard with flow problem, there are two things China should do. First, China should reduce its twin surpluses by earnestly implementing the policy measures which have been already agreed upon on paper by government officials and the public. Among the policies, the key, of course, is to stimulate domestic demand, especially domestic consumption. The global financial crisis may already have produced some effects on the reduction of twin surpluses, which may or may not make the US government happier, because the reduction of China's twin surpluses automatically translate into less demand for US treasuries from China, which is badly needed by the US government. Because twin surplus has become structural, China will not be able to reduce twin surpluses, especially trade surplus in a short period of time.⁸ Therefore, a key problem China has to tackle with head on is to translate China's twin surpluses into assets other than US treasuries. There are many avenues available for this objective.

⁸ Due to constraint of space, this paper will not discuss the issue of how to reduce capital account surplus.

First, China should promote ((actually have promoted) outbound FDI in developing countries. China has powerful ability of infrastructure construction. For many developing countries, lack of infrastructures is the most important bottleneck for economic development. The potential returns on investment in roads, railways, and so on in developing countries in Africa, Latin America and some parts of Asia should be relatively high.

Second, China should continue to acquire more strategic resources and increase its reserves of strategic materials gradually.

Third, China should be more actively engaged in M&A activities in the developed world.

Fourth, China can be bolder in portfolio investment. Besides the US treasuries, holdings of other types of assets and assets denominated in currencies other than the US dollar should be increased.

Fifth, China should increase lending to international organizations such as IMF. However, China's claims should be denominated in SDR or Reminbi. Similarly, China should seek to increase its contributions to the regional financial architecture based on Chiang Mai Initiative.

Sixth, China should encourage foreign governments and corporations to issue Reminbi denominated bonds (Panda Bonds). China can also encourage commercial banks to extend Reminbi denominated loans to foreign borrowers. Reminbi Funds thus raised by foreign entities can be used to buy dollars from Chinese entities.

Seventh, the People's Bank of China should try to increase its currency swaps with foreign central bank.

Eighth, China should increase its aid to poorest developing countries in the world.

But what China can do about its stock of foreign exchange reserves, which is mainly in the form of US government securities is a more serious challenge. In the next 4 years, the Obama government is going to sell 3.8 trillion (dollars) bonds. China cannot help but to wonder if there is enough demand for these bonds. In fact, this 3.8 trillion dollar bonds are based on very optimistic assumptions on the US recovery. The true figure can turn out to be much big. On the other hand, with economic recession, whether US households will have the ability to digest the huge bond issuance is questionable. Currently Federal Reserve is implementing very expansive monetary policy, and the excessive reserve has increased from 3 billion to something like 800 billion. The quality of the asset side of the balance sheet of the Fed is like junk bond funds. At this moment of crisis, perhaps the policy is OK. But when the US economy turns around, risk appetite increases, and people stop hoarding money, inflation can be very serious in the US. China knows neither what the balance of demand for and supply of the US government securities, nor what the Fed's exit strategy will be. The US government tries to assure China that their foreign exchange reserve is safe and US dollar will remain strong. But the US government and the Fed fail to provide China with any details of how US policy responses to the global financial crisis will not lead to serious capital losses to China's foreign exchange reserves. Nobody knows whether US government, when being desperate, can reject the temptation to inflate away its debt burden. Devil is in the details. Empty words of good will not soothe China's nerve. China is worried and this worry is legitimate. The US government must address China's concern in an earnest manner.

What can China do about its foreign exchange reserve stock? The basic principle should be diversification. This action should have been taken long time ago. Remember, since 2004, Japan stop further accumulation of foreign exchange reserves by stop intervention in the foreign exchange market. In contrast, in the roughly the same period of time, China more than doubled its foreign exchange reserves, and surpassed Japan to become the unenviable largest holders of US government securities. Even in the second half of 2008, when the prices of US securities were rising, China failed to utilize the opportunity to diversify. If China diversified at the time, it could have succeeded in diversification without drag down the prices of US government securities. Instead China increased its holding of US treasuries. However,

despite the missed opportunities, China still can do something about the stock of its holdings of foreign exchange reserves.

First, China can buy more TIPS and the US government should also take initiatives to provide more TIPS like financial instruments and allow China to convert some of its holdings of US government securities into similar but safer assets.

Second, China should be allowed to convert part of its foreign exchange reserves into SDR denominated assets. For example, the possibility of reintroducing substitution account should be considered.

Third, China should not rule out the possibility of selling its holdings of US securities to make the composition of its foreign exchange reserves mimics that of SDR. The US government must realize that this is China's legitimate right. In order to avoid bigger losses, China may have to bear some losses due to the sale of the securities. Of course, China should do so with utmost care and with close cooperation with US authorities.

Fourth, if the US government cannot safeguard the value of China's holding of US government securities, the US government should compensate China in one way or another. The US should not use the pretext that nothing can be done to interfere market mechanism. The US government was not hesitant when it decided to protect the money market fund market when the funds were facing the danger of "breaking the buck". Some economists have proposed so-called "grand bargain". This is a proposal worth exploitation between the two governments.

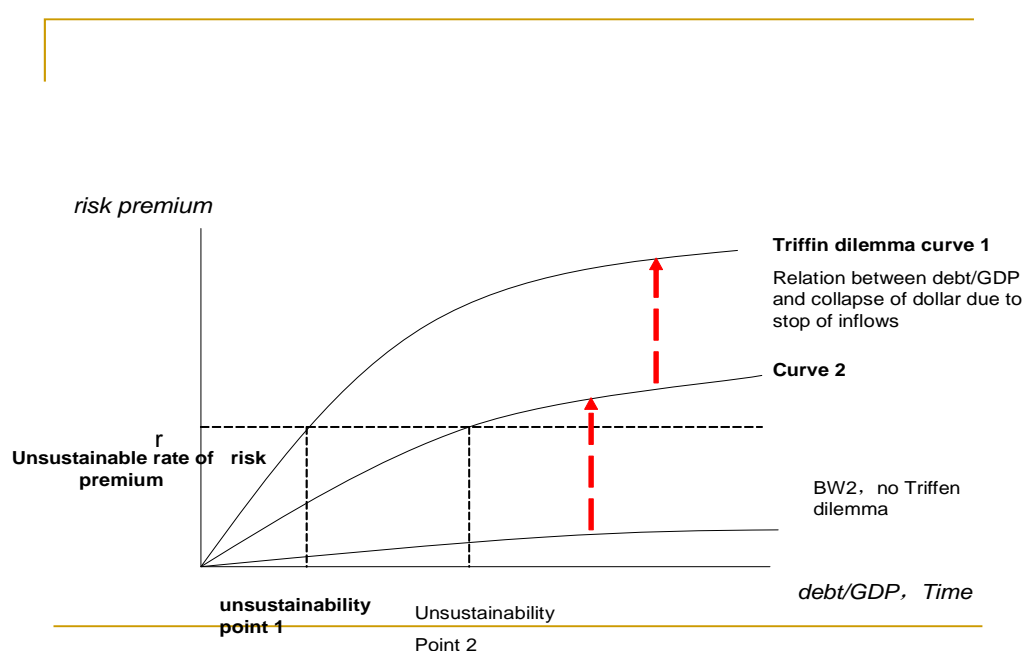
V. The Reform of the International Monetary System

1. The relationship between global imbalances and global financial crisis

There is no denying that China has fallen into a dollar trap and indeed this is mostly China's own making. However, there should be no denying either that the current international monetary system should also share its blames. The fundamental flaw of the system is that the US dollar-a national currency serves as the dominant

international reserve currency. Because America's obligations are denominated in US dollar, there are no disciplines being imposed on the US monetary authorities. On the other hand, for most countries, China in particular, their claims are denominated in the US dollar and hence there is no way for their to ensure the value of their assets will not be eroded by US policy. Though a dollar crisis failed to materialize in the way as feared by many economists before the global financial crisis, the fundamental problem has not changes. On top of the accumulation of foreign debt, the financial crisis further damaged the creditability of the US dollar. The strong dollar is temporary. If America fails to rebalance its economy, a dollar crisis will happen and happen sooner rather later. The figure 6 shows that when foreign investors have confidence in the US financial market, despite the accumulation of foreign debts by the US, dollar crisis will happen at the unsustainable point 2 (tolerable debt/GDP ratio is relatively high). After foreign investors' confidence in the market has been dented by the financial crisis, for a given debt/GDP ratio, they will demand a higher risk premium and hence a dollar crisis will happen at a lower debt/GDP ratio. As shown in the figure 6, the upward shift of Triffin dilemma curve caused by the weakening in the US capital market will bring forward a dollar crisis. To prevent the recurrence of the global financial crisis, and pre-empt a dollar crisis, the reform of the international monetary system is indispensable necessary.

Figure 6 Relationship between global imbalances and the US financial crisis



According to the UN commission report on the reform of international monetary and financial system, the current international monetary system is flawed with three major problems: deflationary tendency, instability and inequality.⁹ China's view of the current international monetary system is not identical to those to the UN commission but the two share many common opinions.

2. The creation of an international reserve currency

Ahead of the G20 Summit in April, Zhou Xiaochuan, Governor of the People's Bank of China, released an essay titled "Reform of the International Monetary System."¹⁰

Zhou called for the "re-establishment of a new and widely accepted reserve currency with a stable valuation" to replace the U.S. dollar - a credit-based national currency. The central bank governor noted that the International Monetary Fund's Special Drawing Right (SDR) should be given special consideration.

As pointed out by the UN commission report (2009), there are three fundamental problems with the current international monetary system, which are closely related with the fact that a national currency, the US dollar, is used as the dominant international reserve currency.

First, the system has deflationary tendency. Under the current system, non-reserve currency countries have to accumulate foreign exchange reserves and the burden of adjustment is on the current account deficit countries, which implies that global purchasing power is withdrawn from the global market.

Second, the system is unequal. Developing countries, which have accumulated foreign exchange reserves, have to borrow with high interests from rich countries or scarify the opportunities to invest domestically in exchange for low yield US government securities. In contrast, the rich countries are able to use cheap capitals from developing countries to live beyond the means.

⁹ The UN commission on the reform of the international monetary system and financial system, to be published.

¹⁰ Zhou Xiaochuan: Reform of the International Monetary System. Website of PBOC, Submit Date:2009-3-23 17:35:0

Third, the system is unstable. The dollar as a unchallenged reserve currency enables the United States to print money to finance its external debts. As a result, when the foreign debt/GDP ratio reaches at a certain level, foreign holders of dollar assets will lose confidence in the US dollar, which can lead to collapse of the dollar and upheaval in the international monetary system. As has been shown, the current global financial crisis is at least partially attributed to the inherent instability of the current international monetary system. Therefore, the current international monetary system should be reformed. The key to the reform is to decommission the US dollar as a dominant reserve currency.

According to UN commission's suggestion, "(o)ne institutional way of establishing a new global reserve system is simply a broadening of existing SDR arrangements, making their issuance automatic and regular. Doing so could be viewed simply as completing the process that was begun in the 1960s, when SDRs were created. The simplest version... is an annual issuance equivalent to the estimated additional demand for foreign exchange reserves due to the growth of the world economy. But they could be issued in a counter-cyclical fashion, therefore concentrating the issuance during crisis periods. "(UN commission report, 2009).

The UN commission specifically suggests a few possible approaches. One approach is that countries would agree to exchange their own currencies for the new currency –say International Currency Certificates (ICC), which could be SDRs—and vice-versa in much the same way as IMF quotas are made up today (except that developing countries would only contribute their own national currencies). This proposal would be equivalent to a system of worldwide “swaps” among central banks. The global currency would thus be fully backed by a basket of the currencies of all members.

Another approach is that the international agency in charge of creating global reserves would simply issue the global currency, allocating ICC to the member countries, much as the IMF Special Drawing Rights are issued today. There would be no “backing” for the global currency, except the commitment of central banks to accept it in exchange for their own currencies. This is what would give the ICC (or SDRs) the character of an international reserve currency, the same way acceptance by citizens of payments in a national currency gives it the character of the domestic

money. If the global currency is considered a deposit in the IMF or the Global Reserve Bank, and the institution in charge of managing the system is allowed to lend to member countries or buy their government bonds, then those investments would be the “backing” of the global currency just as domestic moneys are “backed” today by the assets of national central banks (the government bonds in their hands and their lending to private sector financial institutions).

Some economists criticize the UN commission proposals as unrealistic. The main argument against using the SDR as a global reserve currency is that SDR is not a currency but a unit of account. SDRs can be used to settle accounts with governments and the IMF itself but not for other purposes. They cannot be used to intervene in foreign exchange markets. More generally they cannot be used in transactions with market participants. This means that the SDR is not an attractive form of reserves (Eichengreen, 2009).

On 10 July 2009, the Executive Board of the International Monetary Fund (IMF) has backed the allocation of SDR equivalent to US\$250 billion, as was requested in the US\$1.1 trillion package agreed at the G-20 London Summit. According to news reports,

- The SDRs allocated will count toward members’ reserve assets.
- Acting as a low cost liquidity buffer for low-income countries and emerging markets, which will reduce developing countries’ need for accumulation of US government securities for the purposes of self-protection and liquidity.
- Some members may choose to sell part or all of their allocation to other members in exchange for hard currency, while other members may choose to buy more SDRs as a means of reallocating their reserves.

The Executive Board decision shows that SDRs is allocated to fulfil the traditional objectives of foreign exchange reserves. Despite the fact that they cannot be used in transactions with (private) market participants, as long as SDRs can be used to settle accounts with governments and the IMF, SDRs can be used to intervene in foreign exchange markets and hence the increase in allocation of SDRs can lead to

the reduction in the accumulation of US government securities as foreign exchange reserves. The decision actually has suggested the direction of how to enhance of the role of SDR in the reform of the international monetary system.

It seems that the use of the SDR as an international reserve currency (not international currency) is not conditional on private demand for SDRs. Bergstein even went as far as to say that “the absence of a private SDR market that would permit instantaneous liquidation is in fact a virtue of the scheme, because it reduces the risk of systemic instability, and irrelevant in any event for the massive dollar holders that would still have huge amounts of fully liquid assets after making deposits at the account.”¹¹ As a reserve currency, the SDR would be used only when central banks are intervening in the foreign exchange market. Therefore, the key is whether other *central banks* are willing to accept the SDR in exchange for their own currencies (or accept it as an international fiduciary currency). If it is the case, the need for the accumulation of US government bonds and dollar deposits disappears. When a currency is attacked, the central bank of the country under attack can withdraw SDRs from its SDR account with the IMF and use the SDRs to buy US dollars from the Federal Reserves. As a result, in the balance sheet of the country’s Central Bank, both assets (SDRs) and liabilities (commercial banks’ reserves with the Central Bank) will decrease in equal amount. The opposite is true of the balance sheet of Federal Reserves. There is no change in either country’s net asset or liability. This arrangement is equivalent to a centralized and controlled currency swaps among central banks. It is also a way of multilateralization of current account imbalances.

It seems that this arrangement cannot prevent the US from running current account deficit by printing IOUs. But the arrangement will take away a very important incentive for financing US current account deficit from the rest of the world. If there is no country that wishes to run current account surplus in order to accumulate foreign exchange reserves against the United States, then the latter will not be able to run current account deficit persistently. As a result, a sort of constraint still can be placed on the US authorities.

¹¹ Bergsten, C. Fred : *Objections Do Not Invalidate Substitution Account Benefits*, Letter to the editor in the *Financial Times* in response to letter by International Monetary Fund (IMF) historian James M. Boughton December 28, 2007

If a country has already accumulated an excessive amount of foreign exchange reserves, the most important question is not whether the central bank can use the SDR to intervene in the foreign exchange market, but that whether the SDR can be used as a safe store of value. It seems that an international reserves currency in the form of the SDR allows the country with excess foreign exchange reserves to convert its dollar assets into SDRs so as to diversify away the exchange rate risks. Here comes the idea of substitution account. As pointed out by Bergstein (Bergstein,2009), the more immediate threat to international financial stability that China and perhaps other monetary authorities, together holding more than \$5 trillion, will lose confidence in the US currency due to the prospects for huge and sustained budget deficits as well as the financial weaknesses that triggered the crisis itself could be significantly reduced by creating the substitution account that was actively negotiated in the IMF in the late 1970s and for which detailed blueprints were developed. Instead of converting unwanted dollars through the market, official holders would deposit them in a separate IMF account for SDR. Their new asset would be liquid and pay a market rate of return. It would provide the desired diversification because the SDR is denominated in a basket of currencies comprising 44 per cent dollars, 34 per cent euros and 11 per cent each yen and sterling. The Substitution Account simply replaces one asset with another for a limited group of countries and has no net effect on the global money supply or any other economic variable. The idea of the substitution account shows that the SDR not only can be used by central banks to intervene in foreign exchange markets, but also can replace the US dollar as a more stable store of value.¹²

Indeed, there are some questions about the SDR as a reserve currency need to be worked out. The one is who will bear the exchange rate risk. A change in the dollar/SDR exchange rate would create losses and gains for the IMF. A sustained decline in the dollar against other currencies that make up the SDR will imply losses

¹² According to Bergstein, substitution account “failed only because the sharp rise in the dollar that followed the Federal Reserve’s monetary tightening of 1979–80 obviated much of its rationale and over disagreement between Europe and the United States on how to make up for any nominal losses that the account might suffer as a result of further depreciation of dollars that had been consolidated.” **How to Solve the Problem of the Dollar** by C. Fred Bergsten, Peterson Institute for International Economics Op-ed in the *Financial Times* December 11, 2007.

(Akyuz 2009).¹³ In my view, the use of the SDR as international reserve currency and the substitution account are two related but different issues. If the international society decided to replay the US dollar by the SDR or “Bancor”, the cost of the transformation should be borne by the whole international society. Who have been holding what is not an important issue. However, if the substitution account is created to allow countries such as China to convert dollar assets into SDR denominated assets held by the IMF, then there is indeed a question of who will bear the exchange rate risk. In the PBOC’s balance sheet, dollar assets become SDR deposits with the IMF. In the IMF balance sheet, in the liability side, there is an increase in SDR deposits; in the asset side, there is increase in the US government securities (of course, denominated in US dollar). It is obvious that if China’s dollar assets (US government securities) are converted into SDR deposits with the IMF, China will reduce its exchange rate risk and the US will be able to avoid a dollar crisis caused by the dumping of dollar assets by China and other major dollar reserve holding countries. If the dollar fails to devalue as expected, with or without the substitution account, nothing serious will happen. If the dollar devalues significantly as expected, it is likely that the IMF’s asset losses will be significant. This means that the rest of the member countries of the IMF will have to share the losses that originally would have been borne by China and other reserve holding countries. However, it is worth emphasizing that, if happens, a dollar crisis will be devastating, and will hurt seriously everybody not merely China. With a substitution account, the likelihood of such a dramatic fall of the dollar will be reduced significantly. Hence all members of the IMF will benefit, even if they have to share some losses. There is no denying that China as well as the US will be the biggest beneficiaries of the substitution account and hence they need to do something to compensate the other member countries. The specific way of compensation can work out beforehand. Bergstein is even more optimistic. According to him, if the substitution account “had been set up in 1980 when previously considered, would have made huge profits for its first five years that would have kept it whole for at least two decades.”¹⁴

3. The reform of the IFI governance

¹³ Akyuz, Yilmaz 2009: Policy Response to the Global Financial Crisis: Key Issues for Developing Countries. South Centre, 13 May 2009

¹⁴ Bergstein, C. Fred 2007: How to Solve the Problem of the Dollar Op-ed in *Financial Time* December 11 2007.

To create a global reserve currency or even to create a substitution account is conditional on the reform of the governance of the international monetary and financial system. It seems that at current stage, the reform of the IFI governance, especially the IMF government is an easier and less controversial issue. The following are some reforms the IMF should begin to implement.

Firstly, the IMF should re-examine its traditional policies, and move away further from free market ideology. Over the past decade, many policy prescriptions underlying dogmatism provided by the IMF have been proven wrong. Diversity of ideas and pragmatic approaches should be encouraged within the international financial institutions.

Secondly, the governance of the international financial institutions should be reformed. To make IMF decision-making power more inclusive and equitable, there are at least five things should be done. Number one, the basic votes should be further increased, so that the share of basic votes in the total votes can be increased. Number two, the quota formula should be reformed to reflect economic reality. In line with the distribution of quotas, in the current IMF voting framework, China, India and many emerging economies are under-represented. This arrangement is totally unacceptable. For China, I guess, to increase quotas of developing countries is one of the most essential reforms that IMF needs to take at this stage. Number three, double-majority voting should be applied to a broader set of decisions to compensate for voting imbalances. Double majority voting (shares and chairs) should be extended to the selection of the Managing Director and the chair of the IMFC, as well as for key policy decisions. Number four consideration should be given to eliminate effective veto powers over decisions to amend the Articles of Agreement. Number five, selection of Fund and Bank senior managers should be based on merit and should ensure broad representation of all member countries. The selection process should be made more transparent.

Thirdly, to strengthen the role of the international financial institutions, their financial resources should be increased. For IMF, there are two major channels for increasing financial resources: one is to increase the quotas and another is to borrow more. The current quota formulation cannot reflect the shift of the balance of power

between developed and developing countries. To increase financial resources as well as to improve governance, the quotas of developing countries should be increased as soon as possible. With regard to the increase in financial resources, China will be more than happy to make more contributions to the IMF, and the preferable form of the contribution for China is to buy SDR denominated IMF bonds. China has already officially expressed its desire to invest in bonds denominated in SDR, as a way to increase the resources of the IMF. The G20 meeting in London announced a US\$1.1 trillion package to help member countries to overcome difficulties brought by the global crisis. On 10 July, IMF board has backed the allocation of SDR equivalent to US\$250 billion, as was agreed at the G-20 London Summit. This increase in allocation of SDR is a very positive step forward towards the strengthening of roles of the international financial institutions. To the London package, China's contribution is US\$ 50 billion. China could have contributed more. However, to obtain the support of the public in China, I shall emphasize, more fundamental reforms of the IMF, such as increase China's quota are indispensable.

Fourthly, as argued by UN commission led by Stiglitz, to strengthen the role and improve the governance of the international financial institutions, to involve the UN and other UN organizations is important. "Neither the Group 7 nor the Group 20 represents a sufficiently inclusive global steering group for addressing global systemic challenges. While the G-20 is more broadly based, there is still no representation of the remaining 172 countries. The shape of any future governance format must ensure inclusiveness and adequate representation of developing countries. It is therefore important to strengthen international institutions, especially the United Nations, the body which is most universal, legitimate and accountable to the people of the world. This inclusive response will require the participation and the involvement of the entire international community. As UN commission suggested, "there should be consideration of a new Global Financial Authority to co-ordinate financial regulation in general and establish global rules in certain areas, such as with regards to money laundering and tax secrecy. The current proposal to re-establish the Financial Stability Forum with a wider membership as the Financial Stability Board (FSB) is a step with potential.

Concluding Remarks

Currently, China is faced with three major challenges: arrest the fall of the growth rate and increase in unemployment; continue to carry out structural reform and to safeguard the value of its exchange reserves. So far the Chinese government has successfully arrested the fall of the economy. There are few economists in China who have doubt about the possibility for the economy to achieve a growth rate of 8 percent for 2009. On the front of structural reform, success is not so obviously. Though there are some progresses, but on the whole, the structural issues seem to be worsening. As for the safeguard the safety of the value of China's huge foreign exchange reserves, it seems that it is too late for China to take any initiative. However, better late than nothing.

More fundamentally, China's task is to change its growth model or paradigm of export led and investment led strategy. Over the past three decades, owing to the gradual reform and opening up to the outside, the Chinese economy has maintained an average annual growth rate of GDP as high as 9.8%. Now China has become the third largest economy, the second largest trading nation and the largest foreign exchange reserve holding country in the world. China's growth is truly a epoch making miracle.

Now as the global financial and economic crisis is still unfolding, the growth strategy and economic policy of the Chinese government are put under test. It seems that the Chinese government has been very successful in responding to the global slowdown in a very swift and determined fashion. As a result, the Chinese economy has been bottoming out. However, the seriousness of the impact of the global crisis on the Chinese economy shows that China needs to speed up its structural reform and adjust its once very successful strategy and policies in a timely way. Otherwise, the Chinese economy may lose its growth momentum in the near future.

To deal with one of the root causes of the global financial crisis, the reform of the international monetary system is high on the agenda. While actively engaging in this front, China has more initiatives to take in the areas of regional financial cooperation and the internationalization of the RMB. The latter two issues are equally important as China's involvement in the reform of the international monetary system, but they will be dealt with in other occasions.

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