

CHINA'S GROWTH RECESSION & POLICY RESPONSE

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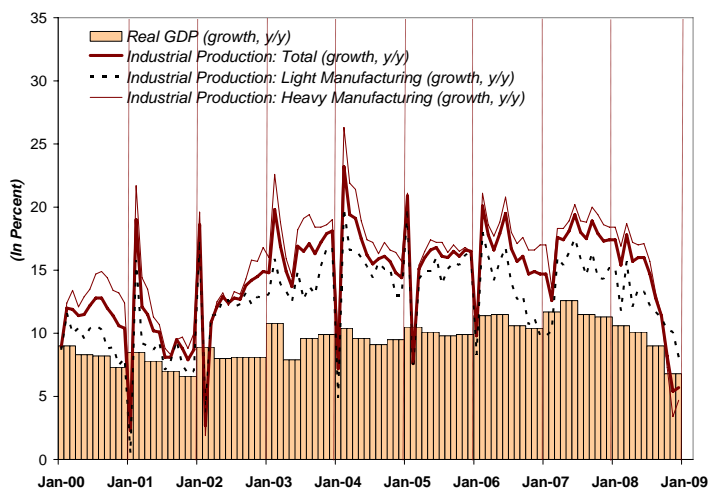
Global demand for manufactured goods has fallen in the wake of the world-wide financial crisis and ensuing G-7 consumption slowdown. This drop in demand has pushed China's economy to the brink of a "growth recession" –conventionally defined as a period of weak economic growth and rising unemployment. To combat this, China's government has utilized a combination of policy tools aimed at:

- **Fiscal:** Promoting domestic investment through public infrastructure development;
- **Monetary:** Loosening credit, particularly to state-owned enterprises; and
- **Other:** Extending export rebates and incentivizing real estate transactions.

There are several indications of an economic slowdown in China (see figures below). Recent reports of labor market penetration problems and plant closings in thousands of textile, apparel, hardware, and electronics firms, suggest that urban unemployment may rise above last official estimates of 4.2%.¹

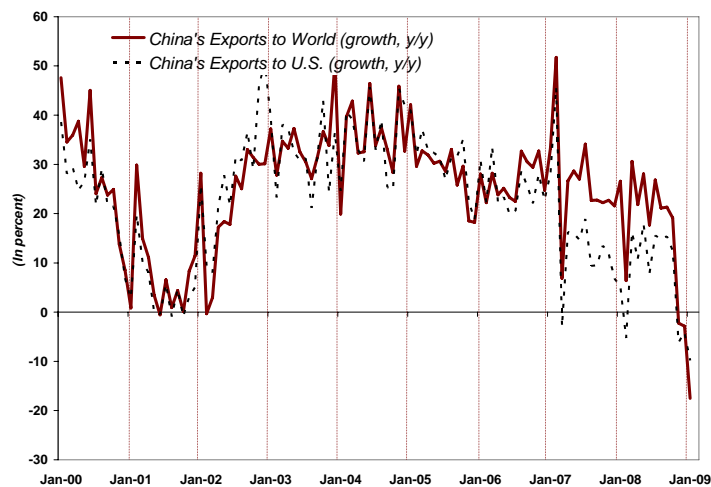
CHINA'S GDP & PRODUCTION GROWTH HAVE FALLEN

Industrial production, led by heavy manufacturing (e.g. steel), decelerated precipitously in 2008Q4. This marked the first time since such data became available in 1995 that production was limited to single digit growth during pre-holiday seasons.



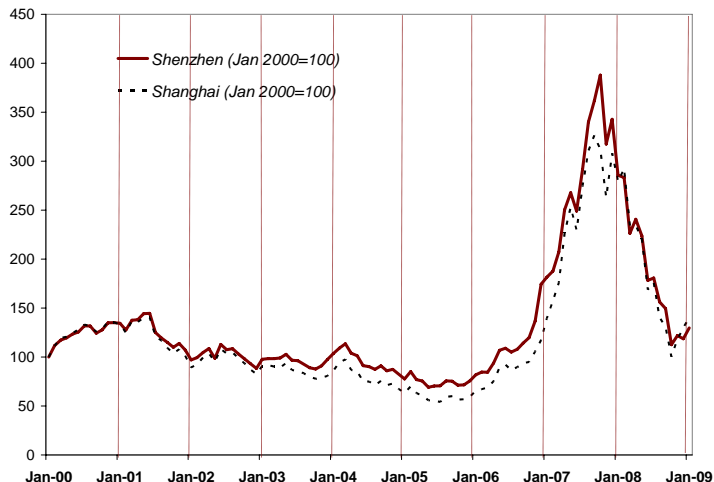
CHINA'S EXPORTS HAVE DECELERATED

Chinese exports exhibited 2-3% negative growth in November and December '08, marking the 1st time since the Southeast Asian crisis that a decline occurred in the fourth quarter. China's January '09 total and U.S. export fall of 18% and 10%, respectively, was notably more precipitous.



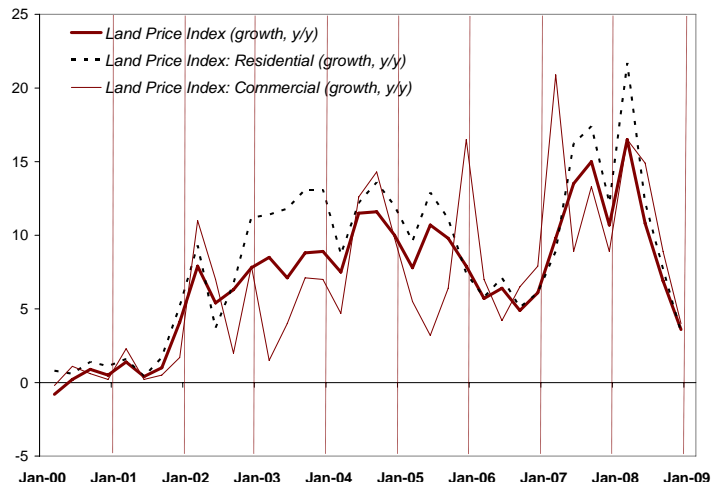
CHINA'S STOCK MARKET BOOM HAS FIZZLED

The 2008 fall in China's major stock market indices was attributable to a correction of its 2007 bubble and deteriorating global financial conditions.



CHINA'S REAL ESTATE PRICES HAVE DECELERATED

After 2008Q1, China's nascent housing market has undergone the most precipitous real estate price drop in recent years, led by residential sales.



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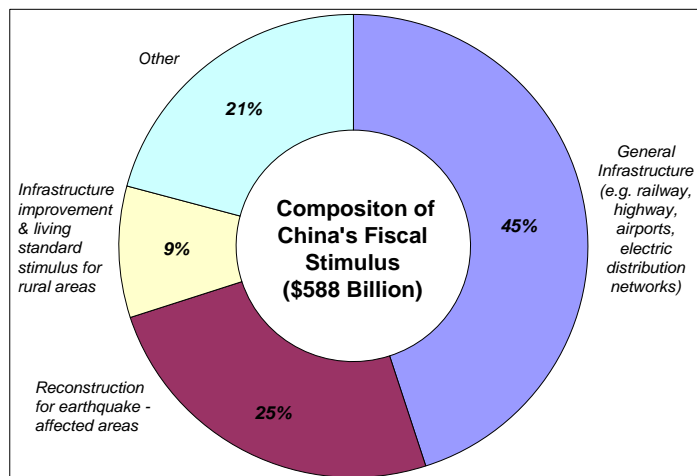
An Immediate Change of Course is Unlikely: First, Chinese energy consumption trends, considered a harbinger of industrial activity, have not rebounded. Second, import demand from the United States, China’s largest trade partner, has remained weak. Third, China’s intermediary product processing imports from other Asian countries, such as Malaysia and Taiwan, dropped precipitously in 2008Q4, inhibiting China’s capability to re-export processed electronics and related products.

II. IMPLICATIONS:

Implications	Rationale
1. Narrowing of U.S.-China trade deficit	United States' export growth to China is likely to decelerate soon, given falling Chinese demand for semiconductors and other processing trade inputs, and given tightening Chinese regulations on soybean imports from the United States. Nevertheless, reductions in United States import growth from China for manufactured goods, clothing, toys, and other products should more than offset that slowdown, and reduce the United States' bilateral trade deficit with its third largest trading partner.
2. Rise in Chinese domestic consumption	China's export-oriented policies have incentivized local firms to continue manufacturing products for exportation to Hong Kong, knowing that those products will eventually re-enter China. Because of this and rising inventory levels, Chinese consumers are purchasing higher-quality products that were originally intended for foreign consumption -without commensurate price increases. This may establish expectations for purchasing higher quality goods and support increases in future consumption levels.
3. Renminbi stabilization	China is likely to support a stable renminbi-dollar exchange rate in the short term, thereby easing its longer term effort of managing a renminbi-dollar appreciation (initiated in July 2005). Although an outright depreciation would help support sluggish export growth, China's government suggested as early as November 2008 that it would exercise other policy options (e.g. export tax rebates).
4. Social Unrest	Anecdotal evidence has surfaced regarding wide-spread protests associated with recently unemployed manufacturing workers in such industries as electronics, toys, and clothing.

III. GOVERNMENT REACTION:

- **Increased fiscal expenditures.** Part of China’s \$588 billion (~15% of China’s GDP) fiscal stimulus package of October 2008 was considered new spending -nearly half targeted rail construction, highway, airport, and electric distribution network construction projects. A new fiscal stimulus is in the works, and provincial governments are responding in kind.



- **Loosened credit.** China’s 216 basis points drop in interest rates since September 2008 – 100 basis points in November alone– marks the beginning of aggressive monetary policy action by China’s government. Lower lending rates mostly benefit state-owned enterprises, which still employ approximately a third of the urban workforce, and which typically maintain close ties with state-controlled lending institutions.

- **Supporting exports.** China raised its export tax rebates in November for the second time this year. The latest measure, significantly more comprehensive than the last, increases rebates on some 3,486 labor-intensive exported items, which constitute approximately 25% of China’s 2007 exports. These include rebates on textiles, apparel, and toys. China also plans to temporarily eliminate export taxes, and provide financial support to certain high-tech and agricultural industries.

- **Incentivizing real estate sales.** Several big city governments have decreased property taxes for new homeowners and simplified the process for attaining housing certification for migrants to urban areas.

Sources: CEIC, China’s National Development & Reform Commission (NDRC) Ministry of Human Resources & Social Security (MOHRSS), The Economist, Financial Times, Global Insight, USITC’s Dataweb, The Wall Street Journal, and World Trade Atlas

¹ China’s unemployment data underestimate actual levels, as the estimate excludes migrant workers, rural employees, or those laid-off by state-owned enterprises.

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