

Global Imbalance, Financial crisis and China's Economic Recovery

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ABSTRACT

This paper examines the inherent relationship between the global imbalance and financial crisis from historical review and literature survey. This paper sets up a two-country model featured by monetary hegemony showing that the financial crisis of 2008 is interrelated with the United States' expansionary monetary policy and the hegemony of U.S. dollar. This paper then analyses the impact of crisis and the policy responses, focusing on the preconditions for China's economic recovery. Through international comparison, we argue that one of the Great Depression's lessons is the exorbitant government intervention in some areas and the necessary condition for China's recovery is economic flexibility, namely, resilient market mechanisms.

Key words: Global imbalance; Financial crisis; Economic flexibility; Economic recovery

The US subprime mortgage crisis that broke out in the summer of 2007 has escalated into a global financial crisis. Both developed economies at the epicenter and emerging economies at the peripheral have suffered from its huge impact, and the spillover effect is still taking its toll on the real economy. As the most serious one since the Great Depression, the current financial crisis is adjusting the global growth cycle that was still robust over the past few years, plunging the whole world into an inevitable recession.

What is the real cause of this crisis, how big is its impact, and how to get out of it? This is a question that most academic researches and policy authorities are trying to answer. This paper attempts to examine this issue from a unique perspective. Specifically, Part I discusses the internal correlation between imbalances and crisis, creating a two-country model of imbalances and crisis from the perspective of currency hegemony. Part II deals with the crisis's impact and policy reactions. Part III explores the decisive factors for economic recovery through international comparison. Part IV puts forward conclusions and policy recommendations.

I. Global imbalance and the financial crisis

Opinions on the cause of the current global financial crisis, though varied, generally fall into two groups: the first view holds that this financial crisis is different from previous ones, in that it is caused by special factors like financial sophistication. The other view stresses that financial crises are essentially triggered by the same causes, with striking similarities in their phenomena and transmission mechanisms. We agree with the second view for two reasons. First, the current crisis is a precise replica of the classic syllogism: credit expands - bubbles burst - default gets out of control. Second, it is equally wrong to blame this crisis on financial sophistication as to blame the "tulip mania" on tulips.

With this view in mind, we closely examined both long and near-term reference points. On the near term, we studied previous global imbalances; on the long term, we anatomized the dollar-dominated international monetary system since the establishment of Bretton Woods System. Global imbalances are nothing new, and have repeatedly haunted the global economy well before the World War II. As review of the imbalances thereafter shows, first, given its unique role in the world economy, the United States has always played a key role in previous imbalances. Second, after the collapse of the Bretton Woods System, world economic operations have undergone major transformations, with the US current account repeatedly in severe deficits. Lastly, the US expansive monetary and fiscal policies are often precursors of global imbalances.

As for global imbalances, numerous studies have been devoted to this subject since the dawn of the new century. Proceeding from traditional views, some research primarily focuses on the potential impact of US current account deficits and external debts on the US dollar exchange rate,

worrying about steep dollar depreciations that may potentially drag the world economy into chaos. Judging from reality, asset price bubbles caused by global excess liquidity should be a bigger concern, as a crisis may be triggered once asset bubbles burst, rather than the dollar plummets.

Other research proposes inspiring new opinions set at a broader perspective. For instance, the popular view of “Bretton Woods II” holds that as a new peripheral, Asia’s fixed exchange rate region has reconstructed the US-centered Bretton Woods System, in which peripheral countries adopt an export-oriented strategy through exchange rate undervaluation, capital control and export of sovereign capital. In this case, the US current account deficits are hallmarks of a successful international monetary system, which is perfectly sound and sustainable. However, the view of “hard asset crunch” holds that only developed economies like the US, Japan and the EU are able to provide safe and liquid reserve instruments, while emerging economies lack such a capability. Therefore, the slower the growth of Europe and Japan, the less capable other countries are in providing financial assets, the greater US current account deficits, and the lower global interest rate levels.

Despite such insights, little attention was paid to the US dollar hegemony and the dollar’s role in global imbalances and financial crises. McKinnon (2005) blamed global imbalances on the international dollar standard. For historical reasons, international merchandise trade and capital flow are priced in the US dollar, making the United States “the only country that affords huge indebtedness in its own currency and immune from the risks that other countries whose debts are denominated in foreign currencies usually face”. In this context, what the US international borrowings face are soft constraints that finally led to its low savings rate. That’s why it is more precise to say that the US faces soft constraints of international borrowings than to say that the US is capable of providing hard assets due to the dollar’s unique status.

Based on the model of Caballero et al (2008), we introduced currency through Cambridge Equation and introduced exchange rate through purchasing power parity (PPP) to create a two-country model on imbalances and crises from the perspective of currency hegemony. This model primarily focuses on global imbalances under the condition of “central countries” in the international monetary system. As peripheral countries hold the currencies of central countries, when the issuance of money exceeds a certain limit, causing global liquidity and actual interest rate to go beyond stable conditions of economic growth, two extreme conditions of high interest rate and low interest rate will occur. High interest rate will harm the real economy, and excess liquidity may cause inflation and thus “stagflation”. Under low interest rate, asset prices may deviate from the real economy and form asset price bubbles.

Three conclusions can be drawn from the model: 1) when a sovereign country’s currency becomes an international standard, the country must maintain current account deficits to inject liquidity into the global economy, which means that the country earns seigniorage from the rest

of the world; 2) given the dual properties of their currencies, central countries will exert tremendous impacts on global asset market through monetary policies, and when the amount of money issued by a central country exceeds a certain limit, it will create tremendous risks for the global economy; 3) the expansionary monetary policies of peripheral countries have a smaller impact on the global economy, but will bring huge risks to their own economies once the policies are overdone.

Combining the model with reality, we hold that the expansionary fiscal and monetary policies of the US are the fundamental causes of this round of global imbalances. The unique role of the dollar, or the dollar hegemony, has played a key role in this process. The US dollar standard has two connotations: first, the United States has the responsibility and obligation to provide liquidity to the global economy to meet its needs. This requires the US to have a certain degree of deficits in its international balance of payments. Second, the US can leverage its unique influence on the global economy to serve its own interest through ways including seigniorage. Intertwined with domestic and foreign policies, such conflicting rights and responsibilities have pushed the US macroeconomic policies into a dilemma. Accommodating domestic targets would expose the global economy to huge risks. This is why “supranational currency” is being called for so strongly.

II. Crisis impacts and policy responses

Although it is no more than a year since the subprime mortgage crisis has evolved into a global financial crisis, it is by no means a simple transformation. Globalization has made the economic relations among various countries closer. It has stimulated global economic growth through massive flows of goods and factors, and also synchronized the economic cycles of various countries, giving rise to systemic risks of the global economy.

1. Impact of the subprime mortgage crisis in the context of synchronized business cycles

The world is experiencing a synchronized economic cycle unprecedented since the World War II. Both developed and emerging economies have been hit hard by the crisis, and no one is immune from its repercussions. As our research indicates (see Table 1), before China’s entry to the WTO (1996Q1: 2001Q4, common factors could only explain for 3% of China’s GDP. After China’s entry to the WTO (2002Q1: 2008Q3), the role of common factors had dramatically changed. Half of China’s quarterly GDP fluctuations could be explained in light of the impact of random common factors. Obviously, international economic factors have a significant impact on China. The coefficients in Table 2 provide further evidence on the correlation between common factors and China’s GDP. Before China’s entry to the WTO, the correlation coefficient was -0.049,

and after the entry, the figure became 0.76, which matches the degree of correlation of the US, Japan and the EU. Following this correlation, if the subprime crisis is taken as a global common factor, it must have a tremendous impact on China.

Table 1: Impact of common and special factors on GDP(Y), consumption (C) and investment (I)

		Variance contribution of common factors (%)		Variance contribution of special factors (%)	
		1996Q1: 2001Q4	2002Q1: 2008Q3	1996Q1: 2001Q4	2002Q1: 2008Q3
US	Y	50.8	43.5	49.2	56.5
	C	45.6	36.0	54.4	64.0
	I	48.6	27.1	51.4	72.9
Japan	Y	5.1	62.2	94.9	37.8
	C	5.8	21.9	94.2	78.1
	I	3.3	53.0	96.7	47.0
China	Y	3.0	50.5	97.0	49.5
	C	3.2	1.0	96.8	99.0
	I	1.3	8.0	98.7	92.0
EU	Y	24.6	67.4	75.4	32.6
	C	22.5	62.0	77.5	38.0
	I	42.7	60.4	57.3	39.6

Source: Taskforce of Macroeconomic Research Department, Institute of Economics, CASS (2009)

Table 2: Correlation coefficient of variables and common factors

	Y		C		I	
	1996Q1: 2001Q4	2002Q1: 2008Q3	1996Q1: 2001Q4	2002Q1: 2008Q3	1996Q1: 2001Q4	2002Q1: 2008Q3
US	0.879	0.70	0.825	0.63	0.858	0.55
Japan	0.160	0.84	-0.207	0.50	0.001	0.78
China	-0.049	0.76	0.073	-0.08	-0.047	0.29
EU	0.595	0.88	0.560	0.84	0.795	0.83

Source: taskforce of Macroeconomic Research Office, Institute of Economics, CASS (2009)

2. China's policy responses

China's economic downturn is triggered by both external shocks and its own structural adjustment (ZHANG Xiaojing, 2008; LIU Shucheng, 2009). Hence, China's policy reactions should not only aim at resolving the crisis but also accommodate mid and long-term

restructuring. Overall, China's policy reactions fall into the stages below:

(1) First half of 2008: the policies to fight overheating and inflation began to be adjusted to prevent a possible economic downturn. But the crisis's severity was not well understood. When inflation intensified, the balance still shifted to preventing it. Similarly, international opinions also considered that inflationary risks were greater than downward risks.

(2) Second half of 2008: the central authorities noticed the crisis's severity, and in response to the export and economic slowdown in the coastal regions, adjusted the priority of macro-regulation to "maintain steady and rapid economic growth and prevent excessive price rise". The adjustment was also complemented with well-guided fiscal, tax and financial measures.

(3) Mid-September, 2008: The bankruptcy of Lehman Brothers was a turning point for the worse. Policies swerved: tightening policies were replaced with proactive fiscal policies and moderately relaxed monetary policies. Specifically, China's export tax rebate was raised on three occasions, lending and deposit interest rates were lowered on five occasions, deposit reserve ratio was lowered on four occasions, personal income tax on savings interest was temporarily exempted, the stamp tax of securities transactions was lowered, housing transactions tax was reduced, and SME credit support was strengthened.

(4) Before the end of 2008, the central authorities took major steps to stimulate domestic consumption and adopted a four-trillion yuan stimulus package.

(5) Early 2009, the industrial adjustment and rejuvenation plan was adopted. The four-trillion yuan stimulus package primarily focuses on infrastructure and welfare programs, with little effect on industries. Moreover, the package has not taken into account mid and long-term industrial adjustment. It is in this context that the adjustment and rejuvenation program was launched with the central objective of adjustment, such as to curb excess capacity, adjust industrial layout, improve technical levels, increase concentration, enhance international competitiveness, conserve energy and protect the environment. These efforts are supply-side adjustments, but will also create new demand.

(6) Technical innovation. Future competitiveness still depends on scientific and technology strengths. It is easy for businesses to make profits during economic booms, but they tend to neglect R&D and innovation as well. But in times of crisis, the importance of innovation comes to the spotlight. Only through embarking on innovation can China's economy develop into a higher level after the crisis. Both the four-trillion yuan package and the industrial adjustment and rejuvenation program have special commitments to technical innovation.

(7) Improve social security. This is the very purpose of economic growth. Social security is even more important during a crisis like the current one.

In general, China's policy reactions include measures to expand domestic consumption, increase employment and ensure people's well-being, and went through the following stages

with different priorities: adjustment of policy directions, four-trillion yuan investment package, industrial rejuvenation program, innovation and social security. The reactions first aimed at immediate problems and later focused on mid and long-term considerations, social security and scientific development.

III. Conditions for China’s economic recovery: international comparison

In general, an economy’s recovery depends on its initial conditions, development stages and its flexibility. The following paragraphs will examine China’s advantages (or weaknesses) in these aspects from the perspective of international comparisons.

1. Initial conditions

Initial conditions refer to the basic situation of an economy when a crisis occurs, including the indicators like fiscal, financial and international balance of payments, which may drastically change under the impact of a crisis. We identified through international comparison that China’s initial conditions have the following features: high savings rate, low proportion of bad loans, sound fiscal system, and limited exposure to external risks.

(1) High savings rate

As Table 3 shows, China’s savings rate in 2006 was 54%, ranking first among the BRIC countries and higher than the world average of 22% by more than 1.5 times. High savings rate means that China has abundant capital and compared with other economies that heavily depend on overseas financing, has a great room for maneuver in coping with crises.

**Table 3 Comparison of BRIC countries and world average savings rate
(Share of total savings to GNI, %)**

	1970	1980	1990	2000	2001	2002	2003	2004	2005	2006
China	27	33	40	37	38	41	44	47	51	54
Brazil	19	18	19	14	14	15	16	19	17	18
India	15	17	22	26	26	27	29	32	33	34
Russia	..	..	30	37	33	29	30	31	32	31
World average	25	23	22	22	21	20	20	21	21	22

Source: World bank, World Development Indicators (WDI) database.

(2) Low proportion of bad loans

Non-performing loans have been dwindling over the years. According to the development indicators of the World Bank, the NPL rate in China's banking sector was still 30% in 2001, but declined to 7% in 2007. According to the latest statistics released by China Banking Regulatory Commission (CBRC): by the end of February 2009, the NPL rate of China's financial institutions was 4.5%, and the figure for China's commercial banks was only 2.2%. This is evidence to the soundness of China's banking system.

(3) Sound fiscal position

By the end of 2008, the balance of China's national debt accounted for about 20% of GDP. In 2007, this proportion was 71% for the US, 67% for the euro zone, and 163% for Japan. In 2008, the proportion of China's fiscal deficits accounted for less than 1% of GDP. In 2009, although there was an increase of 950 billion yuan in China's fiscal deficits, the proportion to GDP was still less than 3%.

(4) Limited exposure to external risks

As Table 4 shows, according to the crisis risk evaluation of large economies (mainly evaluation of exposure to external risks), China's overall risks are the lowest, as shown by indicators such as current account, short-term foreign debts, bank savings and lending.

Table 4: Assessment of crisis risk of large emerging economies

Economy	Current account/GDP (Expected value of 2009)(%)	Short-term external debts/Foreign exchange reserve (Expected value of 2009)(%)	Bank loans/deposits	Overall risk ranking
South Africa	-10.6	81	1.09	17
Hungarian	-4.3	79	1.30	16
Poland	-8.0	38	1.03	14
South Korea	1.3	102	1.30	14
Mexico	-2.5	39	0.93	12
Pakistan	-7.8	27	0.99	12
Brazil	-1.5	22	1.36	10
Turkey	-2.3	70	0.83	10
Russia	1.5	28	1.51	9
Argentina	0.2	63	0.74	8
Venezuela	0.8	58	0.75	7

Indonesia	1.2	88	0.62	6
Thailand	0.3	17	0.88	5
India	-2.4	9	0.74	4
Taiwan, China	7.9	26	0.87	3
Malaysia	11.3	15	0.72	2
China	5.2	7	0.68	1

Source: HSBC; Economist Research Division.

The advantage of China's initial conditions provides a great room for expansionary fiscal and monetary policies. In the face of crisis, it is tempting for all economies to expand fiscal spending and loosen monetary policies. But due to the limitations of initial conditions, it is not an achievable goal for all economies. For instance, Latin American countries have low saving rates and limited fiscal surplus, which makes them depend on overseas financing. After the outbreak of the financial crisis, the exit of foreign capital has pushed up financing costs, and in the face of difficulties in overseas financing, the government has to be prudent in fiscal expansion. In addition, considering currency devaluation and capital outflow caused by monetary expansion, the room for expansionary monetary policies is also limited.

2. Development stage

China is in the stage of accelerating industrialization and urbanization, which have created tremendous demand for industrial upgrade, infrastructure construction, real estate, automobile, and services. Therein lies the potential for China's domestic consumption. China's unique advantages are unmatched by mature market economies and even among the BRIC countries.

In terms of urbanization (Table 5), China and India are in the process of acceleration and still have great potentials. ZHANG Ping (2009) calculated China's urban development curve and concluded that China's urbanization still has a long-lasting driving effect. Russia and Brazil are already urbanized and there is little room for further progress. In terms of urbanization, (see Table 6), China has the highest degree of urbanization, but its industrial upgrade still provides a tremendous demand in the making. In fact, the industrial adjustment and rejuvenation program mentioned before aims to both adjust supply side and create massive new demand.

Table 5: Comparison of urbanization levels (%)

	1960	1970	1980	1990	2000	2001	2002	2003	2004	2005	2006	2007
China	16	17	20	27	36	37	38	39	39	40	41	42
Brazil	45	56	67	75	81	82	82	83	84	84	85	85
India	18	20	23	26	28	28	28	28	28	29	29	29
Russia	54	62	70	73	73	73	73	73	73	73	73	73
World Average	33	36	39	43	47	47	47	48	48	49	49	50

Source: World bank WDI database.

Table 6: Proportion of industrial added value to GDP (%)

	1960	1970	1980	1990	2000	2001	2002	2003	2004	2005	2006	2007
China	45	40	49	42	46	45	45	46	46	48	48	..
Brazil	37	38	44	39	28	27	27	28	30	30	31	31
India	20	21	25	27	26	25	26	26	28	29	29	29
Russia	..	..	..	48	38	36	34	34	35	39	38	39
World Average	..	..	37	33	29	28	28	28	27	28	..	..

Source: World bank WDI database.

3. Economic flexibility

Economic flexibility refers to an economy's capability to respond to the external environment or shocks. Changes in economic environment will lead to relative price movements, which is an important signal to the market: a flexible economy will respond to these signals and restore potential output levels at the fastest pace and lowest cost. "Fastest" and "lowest cost" are the ideal conditions of a recovery and also serve as a guideline for it: first, the recovery must be fast. The longer the recession is, the greater the losses. Second, recovery carries a price. According to some popular views, as long as the government increases input, it can achieve rapid growth. But if this comes at the cost of greater economic imbalances and scientific development, the potential losses may be even greater. We cannot determine the speed and cost of recovery without measuring economic flexibility.

Government initiative plays a particularly important role in a crisis. The effectiveness of this role depends on an economy's flexibility. Economic flexibility is particularly important to whether government investment and policies will achieve a sustainable leverage effect. In addition, given the uncertainties of future domestic and international situations, an economy's flexibility will determine whether an economy will make correct and positive responses to the

new changes. Compared to the initial conditions and development stage mentioned before, economic flexibility can better reflect its institutional characteristics.

Economic flexibility includes the following aspects: flexibility of macroeconomic policies, smooth flows of goods and labor, elimination of trade access restrictions, as well as free pricing mechanisms.

From a macroeconomic policy point of view, with changing domestic and international situations in the second half of 2007, China's policy adjustments have been frequent, reflecting a high degree of flexibility. However, how to make the right decisions and timely yet accurate policy reactions depends on scientific and democratic decision-making. This deserves our special attention in improving macro-regulation system.

In terms of the flow of goods and labor, China has yet to build a perfectly unified domestic market of goods and services. Local protectionism still stands in the way of commodities distribution; while China's *hukou* system and labor market divide still impede labor flow. This is not what a mature economy should be like.

As for market access, with the advances in reform, private firms are allowed to enter an increasing number of industries, but state monopoly in sectors like finance and telecoms still exist. How to break monopoly to allow in more private capital as drivers of the economy remains a pressing task.

In terms of pricing mechanism, more than 90% prices are determined by the market. However, the government still controls the pricing of resources and production factors. Moreover, interest rate and exchange rate should be further liberalized.

There are no universal indicators to assess an economy's flexibility. However, economic freedom can be of some reference value. As Table 7 shows, China's overall score is 53.2, ranking 132nd among 179 economies, which is far lower than the medium figure. It shows that China's economic flexibility is lacking. Given the differences in indicator selection and calculation methods, this result cannot reflect the level of China's market-oriented economy. But as a reference, particularly through individual indicators, it can help us identify possible gaps and guide further reform.

Among the ten individual indicators, only two are above the average value. One is government size, and the other is labor freedom. As for the indicator of government size, the less government spending, the higher the score is. China has a high indicator "government size" due to limited private spending, rather than heavy government intervention. In developed economies, private spending accounts for a high share of GDP, while the "government size" indicator is much lower (like the UK, France and the US). As for labor freedom, even among the BRIC countries, China has no distinct advantage and ranks lower than India and Brazil, slightly higher than Russia, but far higher than countries like European countries such as France and Finland. In general, China's market freedom needs to further improve on many fronts.

Table 7: International comparison of economic freedom (2009)

	Total	Corporate Freedom	Trade Freedom	Fiscal Freedom	Government Size	Monetary Freedom	Investment Freedom	Financial Freedom	Property Rights	Free from Corruption	Labor Freedom
Russia	50.8	54.0	60.8	78.9	70.6	65.5	30	40	25	23	60.0
China	53.2	51.6	71.4	70.6	88.9	72.9	30	30	20	35	61.8
India	54.4	54.4	51	73.8	77.8	69.3	30	40	50	35	62.3
Brazil	56.7	54.4	71.6	65.8	50.3	77.2	50	50	50	35	62.7
France	63.3	87.4	80.8	50.9	14.5	71.7	60	70	70	73	54.5
Japan	72.8	85.8	82	67.5	61.1	93.6	60	50	70	75	82.5
Finland	74.5	95.1	85.8	64.3	28.6	87.4	70	80	95	94	44.8
UK	79.0	89.8	85.8	61.0	40.3	80.4	90	90	90	84	78.5
US	80.7	91.9	86.8	67.5	59.6	84	80	80	90	72	95.1
HK	90.0	92.7	95	93.4	93.1	86.2	90	90	90	83	86.3
World Average		64.3	73.2	74.9	65	74	48.8	49.1	44	40.3	61.3

Source: The Heritage Foundation, 2009 INDEX of Economic Freedom.

In economic recession, the flexibility of labor market is even more important. For instance, in an economic downturn, formal employment may experience negative growth, but the growth of informal employment and flexible employment will accelerate to compensate for the losses of formal employment and support the normal growth of total employment (CAI Fang, 2009). According to the statistics of the General Administration of Customs, March 2009, the export of China's highly competitive labor-intensive goods increased to different extents on a yearly and quarterly basis. Although this has to do with a series of stimulus policies like export tax rebate, it reflects the flexibility and adaptability of China's labor-intensive industries, which must have to do with the flexibility of China's labor market. From this perspective, the "labor freedom" indicator measured by conventional foundations cannot fully describe the important hallmarks of China's labor market.

Through contemplations about this crisis, people have come to realize that the omnipotence of free market is an illusion. But this does not mean that the central role of market in resource allocation should be negated. During the Great Depression, over-intervention of the government actually prolonged the crisis. For instance, trade protectionism, raising tariffs, limiting labor flow (the US restricted immigration), restricting domestic competition, preventing wage declines, etc. These measures ignored the importance of economic flexibility. According to research (Cole and Ohanian, 2004), the labor and industrial policies of the New Deal (including Hoover's and Roosevelt's) should be responsible for sectoral high wage, distorted labor market, depressed

employment, consumption and investment. These policies may explain for 60% of the weak recovery of the US economy (or prolonged recession). Relative to stable levels, these New Deal policies have caused output, consumption and investment to decline by thirteen percentage points. Moreover, it was the elimination of these policies that led to the strong recovery in the 1940s.

In all, China's initial conditions and development stage are conducive to economic recovery, but its economic flexibility must be enhanced through reform. For China to get out of this crisis early, government-led stimulus and domestic consumption enhancement are not enough. Private investment and market mechanisms are critically important as well.

IV. Conclusions and policy recommendations

Our analyses above have produced the following results:

1. Global imbalance are the root cause of this sub-prime crisis, and the solution to imbalances is the key to avoiding such crises in future. Imbalance, crisis and US dollar hegemony are closely related to each other. Therefore, reforming the international monetary system is of crucial importance. At least, the "exorbitant privilege" of the US dollar should be curbed. Since it is too costly to wait for a financial crisis to do so, we need to preemptively check the US dollar hegemony through reforming international monetary system and improving global governance structure.

2. Given the interconnectedness and interactions of various economies, a country cannot cope with a global crisis single-handedly. It has to depend on positive changes in the external environment and international coordination. In the era of globalization, the theory of "decoupling" can hardly hold any ground, and the periodical fluctuations of various economies are increasingly synchronized. To get out of this crisis, China also needs a positive external environment, and therefore should closely watch the changes in international situations and properly respond. In addition, global interdependence has dramatized the need for international cooperation, and we need to draw on the tragic lessons of the beggar-thy-neighbor policies such as trade protectionism.

3. Full flexibility of economies is essential to China's economic recovery. China has certain advantages in terms of policy reactions and conditions for recovery, however, it is more important to enhance economic flexibility, make government-led investments more effective and policy effect more sustainable. The lesson of the Great Depression is that government over-intervention had worsened and prolonged the depression. A balance must be struck between government and the market: on the one hand, we cannot believe in market fundamentalism; on the other hand, we cannot negate the value of market by misinterpreting

socialism as a savior of the Wall Street. Actually, market mechanisms are essential to enhancing economic flexibility. In China, how to bring into full play the role of the market in resource allocation remains an arduous task. Reform and opening-up over the past thirty years have paved the way for establishing a socialist market economic system, but market-oriented reform still needs to be advanced to tackle the crisis through reform. Priorities include:

(1) Break labor market divide to allow for more flexibility. In particular, the household registration (*hukou*) system should be phased out for freer flows of urban and rural labor; expand access to informal employment; prevent local protectionism during a crisis (including a ban on non-local workers); wages should be determined through consultations, rather than stiffly fixed to a high level.

(2) Break various barriers to facilitate the flow of goods and services. With the need to expand consumption and maintain growth rate, some local governments have introduced “buy local” regulations, which impede the formation of a unified domestic market. It is also unfavorable to expanding domestic consumption. Meanwhile, the fragmented trade system also prevents export-oriented goods from being sold in the domestic market. When the external environment worsens, integrating domestic and international trade is an important means in reducing external dependence and promoting domestic consumption.

(3) Relax control and increase the enthusiasm of private investment. During a crisis, a key problem is flagging social investment and it has to be stimulated through various stimulus policies like loosening restrictions on various sectors. For instance, the recently released reform program in 2009 calls for “more research on the entry of private capital into sectors like petroleum, railway, electric power, telecommunications, municipal facilities and so on, with a view to promoting private investment”. This is an important measure.

(4) Press ahead energy price reform that aims at mid and long-term scientific development. Arbitrary price control will harm the efficiency of resource allocation. Hence, we must advance the reform of resource prices to make them reflect market supply and demand relations, resource scarcity and environmental losses, so as to use resources more efficiently, conserve energy and protect the environment for scientific development on a mid and long-term basis. Given current low prices of international bulk commodities, it is high time to reform resource prices.

(5) Increase exchange rate flexibility and make currency policy the frontline against external shocks. In the Great Depression, those countries that abandoned the gold standard the earliest and adopted independent monetary policies for monetary expansion were also the first to escape the crisis. As China’s economy increasingly integrates into global arena, it is increasingly vulnerable to external shocks. In this context, independent monetary policies can be the frontline against external risks. But if exchange rate lacks flexibility, an independent monetary policy will be meaningless. Therefore, we need to approach the importance to enhance exchange rate flexibility from a longer term strategic perspective.

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