



# China and the Global Financial Crisis: Implications for the United States

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June 3, 2009

**Congressional Research Service**

7-5700

[www.crs.gov](http://www.crs.gov)

RS22984

## Summary

Over the past several years, China has enjoyed one of the world's fastest growing economies and has been a major contributor to world economic growth. However, the current global financial crisis threatens to significantly slow China's economy. Several Chinese industries, particularly the export sector, have been hit hard by crisis, and millions of workers have reportedly been laid off. This situation is of great concern to the Chinese government, which views rapid economic growth as critical to maintaining social stability. China is a major economic power and holds huge amounts of foreign exchange reserves, and thus its policies could have a major impact on the global economy. For example, the Chinese government in November 2008 announced plans to implement a \$586 billion package to help stimulate the domestic economy. If successful, this plan could also boost Chinese demand for imports. In addition, in an effort to help stabilize the U.S. economy, China might boost its holdings of U.S. Treasury securities, which would help fund the Federal Government's borrowing needs to purchase troubled U.S. assets and to finance economic stimulus packages. However, some U.S. policymakers have expressed concerns over the potential political and economic implications of China's large and growing holdings of U.S. Government debt securities. This report will be updated as events warrant.

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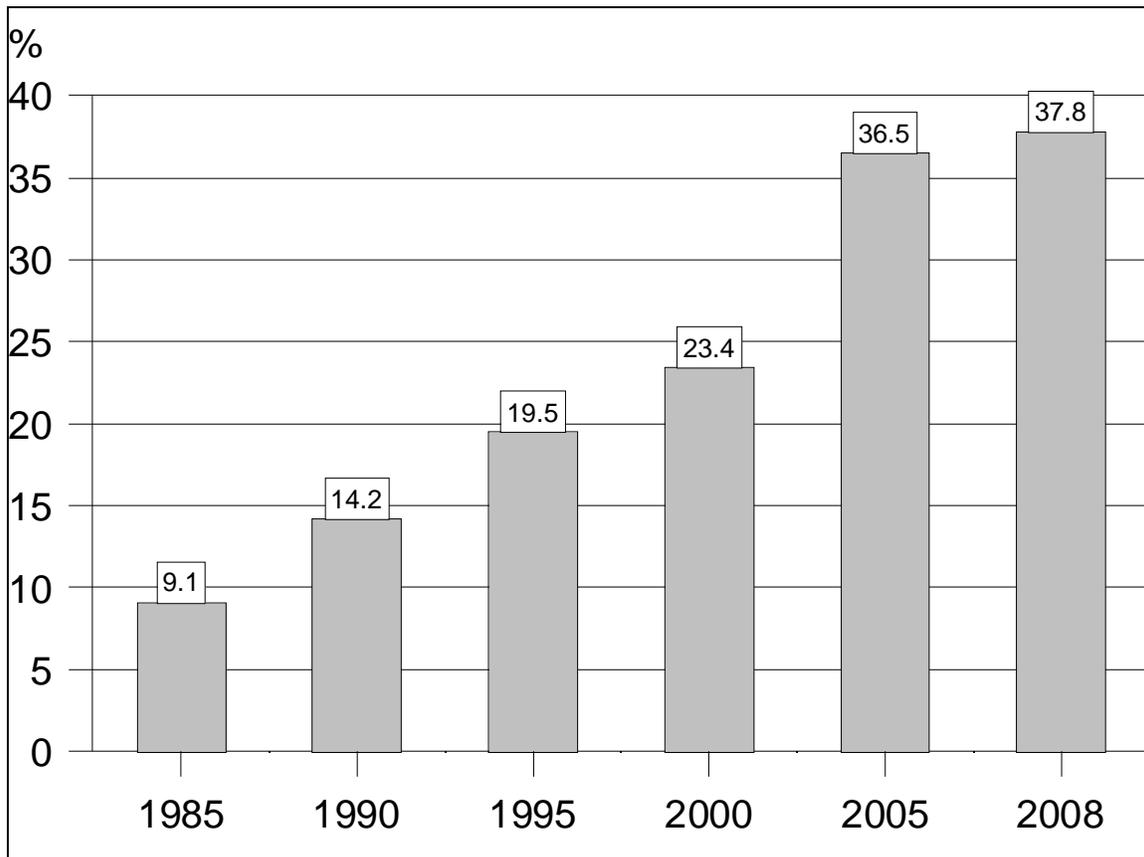
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## China's Stake in the Current Crisis

China's economy is heavily dependent on global trade and investment flows. In 2007, China overtook the United States to become the world's second largest merchandise exporter after the European Union (EU). China's net exports (exports minus imports) contributed to one-third of its GDP growth in 2007. China's exports of goods and services as a share of GDP rose from 9.1% in 1985 to 37.8% in 2008 (see **Figure 1**). The Chinese government estimates that the foreign trade sector employs more than 80 million people, of which 28 million work in foreign-invested enterprises.<sup>1</sup> Foreign direct investment (FDI) flows to China have been a major factor behind its productivity gains and rapid economic growth. FDI flows to China in 2007 totaled \$75 billion, making it the largest FDI recipient among developing countries and the third largest overall, after the EU and the United States. The current global economic slowdown (especially among its major export markets—the United States, the EU, and Japan) is having a significant negative impact on China's export sector and industries that depend on FDI flows.

**Figure 1. Chinese Exports of Goods and Services as a Percent of GDP: 1985-2008**



Source: Economist Intelligence Unit.

<sup>1</sup> *Invest in China*, September 10, 2007.

The Chinese economy has slowed sharply in recent months. China's 4<sup>th</sup> real GDP growth (year-on-year basis) was 6.8%, and its 1<sup>st</sup> quarter 2009 growth (year-on-year basis) was 6.1% (reportedly, the slowest quarterly growth in 10 years). Some analysts contend annual economic growth of less than 8% could lead to social unrest in China, given that an estimated 20 million people seek jobs every year (including migrant workers that move to urban centers and high school and college graduates).<sup>2</sup> According to the International Monetary Fund (IMF), China was the single most important contributor to world economic growth in 2007.<sup>3</sup> Thus, a Chinese economic slowdown (or recovery) could also have significant global implications.

## **China's Exposure to the Global Financial Crisis**

The extent of China's exposure to the current global financial crisis, in particular from the fallout of the U.S. sub-prime mortgage problem, is unclear.<sup>4</sup> On the one hand, China places numerous restrictions on capital flows, particularly outflows, in part so that it can maintain its managed float currency policy.<sup>5</sup> These restrictions limit the ability of Chinese citizens and many firms to invest their savings overseas, compelling them to invest those savings domestically, (such as in banks, the stock markets, real estate, and business ventures), although some Chinese attempt to shift funds overseas illegally. Thus, the exposure of Chinese private sector firms and individual Chinese investors to sub-prime U.S. mortgages is likely to be small.

Moreover, Chinese government entities, such as the State Administration of Foreign Exchange, the China Investment Corporation (a \$200 billion sovereign wealth fund created in 2007),<sup>6</sup> state banks, and state-owned enterprises, may have been more exposed to troubled U.S. mortgage securities. Chinese government entities account for the lion's share of China's (legal) capital outflows, much of which derives from China's large and growing foreign exchange reserves. These reserves rose from \$403 billion in 2003 (year end) to \$1.95 trillion as of December 2008.<sup>7</sup> In order to earn interest on these holdings, the Chinese government invests in overseas assets. A large portion of China's reserves are believed to be invested in U.S. securities, such as long-term (LT) Treasury debt (used to finance the federal deficit), LT U.S. agency debt (such as Freddie Mac and Fannie Mae mortgage-backed securities), LT U.S. corporate debt, LT U.S. equities, and short-term (ST) debt.<sup>8</sup> The Treasury Department estimates that, as of June 2008, China's holdings of U.S. securities totaled \$1,205 billion (up from \$922 billion in June 2007), making it the 2<sup>nd</sup>

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<sup>2</sup> According to *Xinhua Net* (March 9, 2008), China's Labor and Social Security Minister Tian Chengping warned that the employment situation in China in 2008 was expected to be "very severe."

<sup>3</sup> *IMF Survey Magazine: What the Numbers Show*, October 17, 2007.

<sup>4</sup> Some analysts contend that China's policy of keeping the value of its currency low against the dollar and large purchases of U.S. debt may have been a contributing cause to the current global financial crisis.

<sup>5</sup> China's central bank manages its currency (the renminbi or yuan) against a basket of major currencies (largely the U.S. dollar) by heavily intervening in international currency markets to maintain targeted exchange rates. See CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte.

<sup>6</sup> For an overview of the China Investment Corporation, see CRS Report RL34337, *China's Sovereign Wealth Fund*, by Michael F. Martin.

<sup>7</sup> China's large and growing reserves are largely the result of China's currency policy (which requires the government to intervene in currency markets to prevent the renminbi from appreciating), large levels of FDI, and large trade surpluses.

<sup>8</sup> ST debt includes Treasury, agency, corporate, and equity debt with less than one year maturity.

largest foreign holder of such securities (after Japan).<sup>9</sup> Of this total, \$527 billion were in LT U.S. agency securities,<sup>10</sup> \$522 billion were in LT Treasury securities, \$100 billion in LT equities, \$26 billion in LT corporate securities, and \$30 billion in ST debt.

If China held troubled sub-prime mortgage backed securities, they would likely be included in the corporate securities category and certain U.S. equities (which include investment company share funds, such as open-end funds, closed-end funds, money market mutual funds, and hedge funds) which may have been invested in real estate. However, these were a relatively small share of China's total U.S. securities holdings.<sup>11</sup> China's holdings of Fannie Mae and Freddie Mac securities (though not their stock) were likely to have been more substantial, but less risky (compared to other mortgage-backed securities), especially after these two institutions were placed in conservatorship by the Federal Government in September 2008 and thus have government backing.

The Chinese government generally does not release detailed information on the holdings of its financial entities, although some of its banks have reported on their level of exposure to sub-prime U.S. mortgages.<sup>12</sup> Such entities have generally reported that their exposure to troubled sub-prime U.S. mortgages has been minor relative to their total investments, that they have liquidated such assets and/or have written off losses, and that they (the banks) continue to earn high profit margins.<sup>13</sup> For example, the Bank of China (one of China's largest state-owned commercial banks) reported in March 2008 that its investment in asset-backed securities supported by U.S. sub-prime mortgages totaled \$10.6 billion in 2006 (accounting for 3.5% of its investment securities portfolio). In October 2008, it reported that it had reduced holdings of such securities to \$3.3 billion (1.4% of its total securities investments) by the end of September 2008, while its holdings of debt securities issued or backed by Freddie Mac and Fannie Mae were at \$10 billion. *Fitch Ratings* service reported that the Bank of China's exposure to U.S. sub-prime-related investments was the largest among Asian financial institutions, and that further losses from these investments were likely, but went on to state that the Bank of China would be able to absorb any related losses "without undue strain."<sup>14</sup>

However, China's economy has not been immune to effects of the global financial crisis, given its heavy reliance on trade and foreign direct investment (FDI) for its economic growth. Numerous sectors have been hard hit.<sup>15</sup> To illustrate:

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<sup>9</sup> Although the Chinese government does not make public the dollar composition of its foreign exchange holdings, many analysts estimate this level to be around 70%. Based on this estimate, China's holdings of such securities may have risen to about \$1.4 trillion through the end of 2008, and it is likely that China surpassed Japan by the end of 2008 as the largest foreign holder of U.S. securities.

<sup>10</sup> China was the largest foreign holder of U.S. agency debt, accounting for 36% of total as of June 2008.

<sup>11</sup> According to the Treasury Department, China was not among the top 10 global investors of U.S. corporate mortgage-backed securities.

<sup>12</sup> *Financial Times*, September 11, 2008.

<sup>13</sup> According to *Caijing.com*, Chinese banks held \$670 million worth of bonds issued by U.S. investment bank Lehman Brothers when it went bankrupt in September 2008.

<sup>14</sup> *Fitch Ratings*, Press Release, January 24, 2008.

<sup>15</sup> China's economy was already slowing down before the global financial crisis hit. This was in large part the result of government efforts to slow the rate of inflation. China's real GDP growth fell from 13% in 2007 to 9% in 2008. The global financial crisis has sharply diminished economic growth. Thus, the Chinese government has abandoned its anti-inflation policies and instead has sought to stimulate the economy.

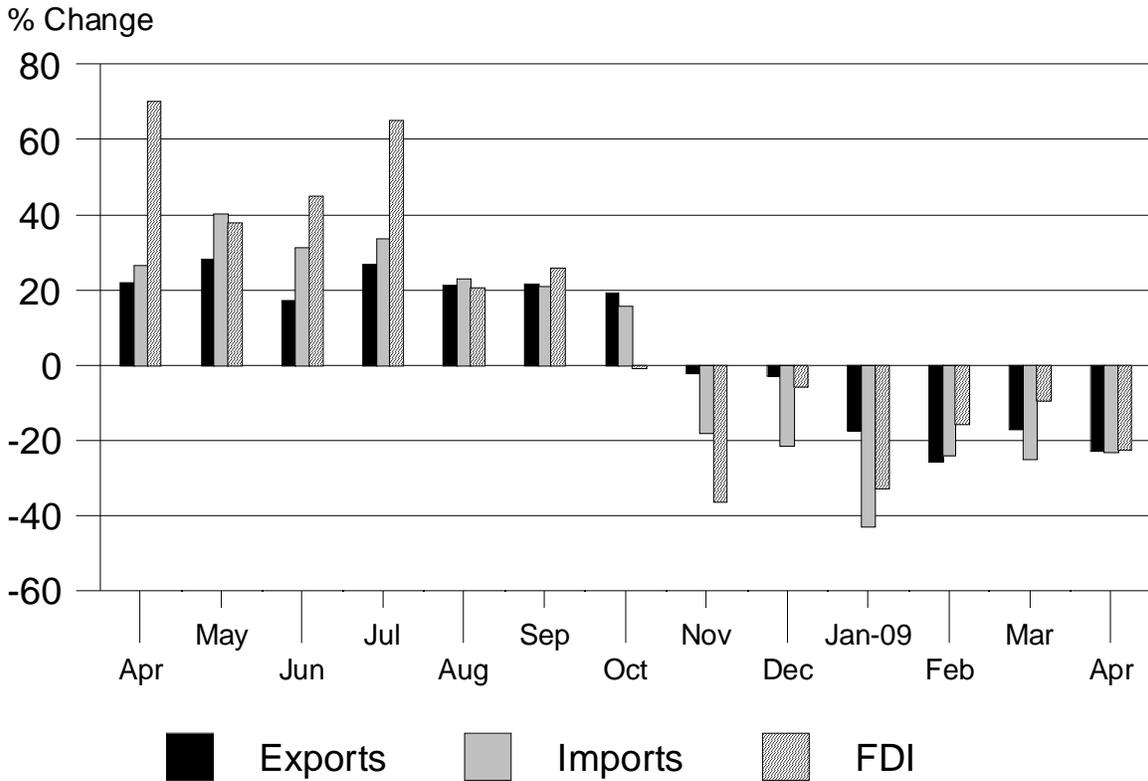
- The real estate market in several Chinese cities has exhibited signs of a bubble that is bursting, including a slowdown in construction, falling prices and growing levels of unoccupied buildings. This has increased pressure on the banks to lower interest rates further to stabilize the market.
- The value of China's main stock market index, the Shanghai Stock Exchange Composite Index, lost nearly two-thirds of its value from December 31, 2007, to December 31, 2008.
- China's trade and FDI have plummeted over the past six months or so (see **Figure 2**). For example, China's exports and imports in February 2009 were down 25.7% and 24.1%, respectively on a year-on-year basis; the decline in exports was the biggest monthly decline ever recorded. The level of FDI flows to China has declined in each of the past seven months (November 2008-April 2009) on a year-on-year basis. FDI flows to China in April 2009 were down 22.5%, compared to April 2008 when FDI surged by 70.2%
- The Chinese government in January 2009 estimated that 20 million migrant workers alone had lost their jobs in 2008 because of the global economic slowdown.
- For the first four months of 2009, industrial output rose by 5.5% year-on-year, well below 12.9% growth rate in 2008.
- *Global Insight*, an international forecasting firm, estimates that China's real GDP growth will slow to 6.6% in 2009 (compared to growth rates of 13% in 2007 and 9% in 2008).<sup>16</sup> Some analysts contend annual economic growth of less than 8% could lead to social unrest, given that every year there are 20 million new job seekers in China.<sup>17</sup>

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<sup>16</sup> Global Insight, *China*, May 29, 2009.

<sup>17</sup> According to *Xinhua Net* (March 9, 2008), China's Labor and Social Security Minister Tian Chengping warned that the employment situation in China in 2008 was expected to be "very severe," noting that towns and cities would be able to provide only 12 million new jobs.

**Figure 2. Changes in China's Monthly Trade and FDI Inflows: April 2008-April 2009**  
year-on-year basis



Source: Global Insight and China's Customs Administration.

## China's Response to the Crisis

China has taken a number of steps to respond to the global financial crisis. On September 27, 2008, Chinese Premier Wen Jiabao reportedly stated that “what we can do now is to maintain the steady and fast growth of the national economy, and ensure that no major fluctuations will happen. That will be our greatest contribution to the world economy under the current circumstances.”<sup>18</sup> In addition to cutting interest rates and boosting bank lending, China has implemented a number of policies to stimulate and rebalance the economy, increase consumer spending, restructure and subsidize certain industries, and boost incomes for farmers and rural poor.

### China's Stimulus Program

On November 9, 2008, the Chinese government announced it would implement a two-year 4 trillion yuan (\$586 billion) stimulus package (equivalent to 13.3% of China's 2008 GDP), largely

<sup>18</sup> *Chinaview*, September 27, 2008.

dedicated to infrastructure projects.<sup>19</sup> The package would finance public transport infrastructure (including railways, highways, airports, and ports) affordable housing, rural infrastructure (including irrigation, drinking water, electricity, and transport), environmental projects, technological innovation, health and education, and rebuilding areas hit by disasters (such as areas that were hit by the May 12, 2008 earthquake, primarily in Sichuan province).<sup>20</sup> China's stimulus, if fully implemented, would likely constitute one of the largest economic stimulus packages (both in spending levels and as a percent of GDP) that have been announced by the world's major economies to date, although it is unclear to what extent the stimulus package represents new spending versus projects that were already in the works before the economic downturn hit China.<sup>21</sup> **Table 1** provides a breakdown of the stimulus program spending priorities.

**Table 1. China's November 2008 Domestic Stimulus Package**

	In Chinese Yuan (billions)	In U.S. Dollars (billions)	As a Percent of Total Stimulus Package	As a Percent of China's 2008 GDP
Transport infrastructure investment	1,500	220	37.5	5.0
Post-earthquake reconstruction	1,000	146	25.0	3.3
Public housing	400	59	10.0	1.3
Rural infrastructure	370	54	9.3	1.2
Research and development and structural change	370	54	9.3	1.2
Environmental development	210	31	5.3	0.7
Healthcare and education	150	22	3.8	0.5
Totals	4,000	586	100.0	13.3

**Source:** Global Insight

**Notes:** Ranked according to planned spending levels.

The Chinese stimulus program includes steps the government intends to take to assist 10 pillar industries (i.e., industries deemed by the government to be vital to China's economic growth) to promote their long-term competitiveness. These industries include autos, steel, shipbuilding, textiles, machinery, electronics and information, light industry (such as consumer products), petrochemicals, non-ferrous metals, and logistics. Government support policies for the 10

<sup>19</sup> China's currency is officially called the renmibi (RMB) and is denominated in units of yuan. Both terms are used to describe China's currency.

<sup>20</sup> Shortly after the central government announced its stimulus package, numerous local government officials announced their own stimulus package. Thus, the total level of China's economic stimulus could be much higher than the official 4 trillion yuan (\$586 billion) figure.

<sup>21</sup> In dollar terms, China's stimulus would be larger than the combined stimulus packages of Japan and the European Union, but smaller than levels announced by the United States. See CRS Report RL34742, *The Global Financial Crisis: Analysis and Policy Implications*, coordinated by Dick K. Nanto.

industries are expected to include tax cuts and incentives (including export tax rebates), industry subsidies and subsidies to consumers to purchase certain products (such as consumer goods and autos), fiscal support, directives to banks to provide financing, direct funds to support technology upgrades and the development of domestic brands, government procurement policies, the extension of export credits, and funding to help firms invest overseas.<sup>22</sup>

On April 7, 2009, the Chinese government announced plans to spend \$124 billion over the next three years to create a universal health care system.<sup>23</sup> The plan would attempt to extend basic coverage to most of the population by 2011, and would invest in public hospitals and training for village and community doctors. A number of efforts have been made to boost rural incomes and spending levels and to narrow the gap in living standards between rural and urban citizens (as well as between coastal and western regions of the country). For example, since February 2009, an estimated 900 million Chinese rural residents have been eligible to receive a 13% rebate for purchase of home appliances. Public housing projects, education, and infrastructure projects are largely targeted to rural areas. The government has also announced plans to boost agricultural subsidies to farmers. China has taken a number of steps to respond to the global financial crisis.

## **Has China's Economy Bottomed Out?**

Chinese officials contend that their economic policy efforts are beginning to produce results. For example, in 2009 (through June 3 15, 2009) the Shanghai Stock Exchange Composite Index has risen by 45%. Industrial output rose by 7.3% in April 2009 on a year-on-year basis (it was up 8.3% in March 2009). In addition, retail sales in April 2009 were up 14.8% while investment in real estate was up 6.4% (year-on-year). However, China's trade and FDI flows continue to show sharp declines. Many analysts contend that China's large-scale bank lending and infrastructure spending projects have helped boost the domestic economy, but warn that these can not be maintained indefinitely. Many Chinese analysts have raised concerns that the large level of borrowing by local governments and state-owned enterprises will lead to a rise in non-performing loans on the balance sheets of China's major banks and could undermine efforts to reform the banking system. Others are concerned over the long term effects of expanded local government debt.<sup>24</sup> China's long-term economic growth prospects will likely depend on the ability of the government to rebalance the economy by promoting greater domestic consumption.

## **China's Potential Role and Implications for the United States**

Analysts debate what role China might play in responding to the global financial crisis, given its huge foreign exchange reserves but its relative reluctance to become a major player in global economic affairs and its tendency to be cautious with its reserves. Some have speculated that

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<sup>22</sup> On May 18, 2009, China's State Council, announced plans to create 3 million new jobs in light industry over the next three years by providing financial support to small and medium-sized light industry firms with "good development potential."

<sup>23</sup> It is not yet clear whether this is part of the November 2008 stimulus package or constitutes new spending commitments,

<sup>24</sup> The central government has indicated that it will fund 1.2 million yuan out of the 4 million yuan stimulus package; local governments are expected to fund the rest.

China may, in order to help stabilize its most important trading partner (the United States), boost purchases of U.S. securities (especially Treasury securities) in order to help fund the hundreds of billions of dollars that are expected to be spent by the U.S. government to purchase troubled assets and stimulate the economy.<sup>25</sup> Additionally, China might try to shore up the U.S. economy by buying U.S. stocks. On September 21, 2008, the White House indicated that President Bush had called President Hu about the financial crisis and steps the Administration was planning to take. An unnamed Chinese trade official was reported as stating that “the purpose of that call was to ask for China’s help to deal with this financial crisis by urging China to hold even more U.S. Treasury bonds and U.S. assets.” The official was further quoted as saying that China recognized that it “has a stake” in the health of the U.S. economy, both as a major market for Chinese exports and in terms of preserving the value of U.S.-based assets held by China” and that a stabilized U.S. economy was in China’s own interest.<sup>26</sup> During her first visit to China in February 2009, Secretary of State Clinton urged China to continue to buy U.S. Treasury securities. Some contend that taking an active role to help the United States (and other troubled economies) would boost China’s image as a positive contributor to world economic stability, similar to what occurred during the 1997-1998 Asian financial crisis when it offered financial aid to Thailand and pledged not to devalue its currency.

On the other hand, there are a number of reasons why China might be reluctant to significantly increase its investments of U.S. assets. One concern could be whether increased Chinese investments in the U.S. economy would produce long-term economic benefits for China. Some Chinese investments in U.S. financial companies have fared poorly, and Chinese officials could be reluctant to put additional money into investments that were deemed to be too risky.<sup>27</sup> Secondly, a sharp economic downturn of the Chinese economy would likely increase pressure to invest money at home, rather than overseas. Many analysts (including some in China) have questioned the wisdom of China’s policy of investing a large volume of foreign exchange reserves in U.S. government securities (which offer a relatively low rate of return) when China has such huge development needs at home.<sup>28</sup> China’s holdings of U.S. securities at the end of 2008 are estimated to be roughly equivalent to over \$1,000 per person in China, a significant figure for a country with a per capita GDP of about \$3,190 (2008).<sup>29</sup> On March 13, 2009, Wen Jiabao at a news conference stated that he was “a little bit worried” about the safety of Chinese assets in the United States<sup>30</sup> On March 24, 2009, the governor of the People’s Bank of China, Zhou Xiaochuan, published a paper calling for the replacing the U.S. dollar as the international

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<sup>25</sup> According to the Treasury Department, China overtook Japan in September 2008 as the largest foreign holder of U.S. Treasury securities. As of January 2009, China’s holdings totaled \$740 billion, accounting for 24.1% of total foreign holdings of U.S. Treasury securities. China accounted for more than one-third of total new purchases of these securities by foreign investors from January 2008 to January 2009.

<sup>26</sup> *Inside U.S. Trade, China Trade Extra*, September 24, 2008.

<sup>27</sup> For example, in June 2007, China’s sovereign wealth fund bought \$3 billion worth of shares from Blackstone LP (a U.S. private equity firm) at \$31 each, but the value of those shares fell to \$7.3 as of April 1, 2009.

<sup>28</sup> China could use some of these reserves to purchase foreign imports, such as food, equipment, raw materials, consumer goods, etc. However, a significant sell-off of U.S. assets could destabilize the value of China’s remaining U.S. assets and could weaken its ability to maintain its exchange rate goals. A similar result would occur if the government sold off its dollar holdings in China to obtain renminbi to be used to stimulate the domestic economy—it would cause the value of the renminbi to depreciate against the dollar, which could decrease exports.

<sup>29</sup> As long as the Chinese government continues to intervene in currency markets to keep the value of the renminbi low against the dollar, and continues to experience large trade surpluses, it will have relatively few options for dealing with additional foreign exchange reserves, other than to keep buying U.S. assets.

<sup>30</sup> Xinhua News Agency, March 13, 2009.

reserve currency with a new global system controlled by the International Monetary Fund.<sup>31</sup> Many analysts (including some in China) have questioned the wisdom of China's policy of investing a large level of foreign exchange reserves in U.S. government securities, which offer a relatively low rate of return when China has such huge development needs at home.

While additional large-scale Chinese purchases of U.S. securities might provide short-term benefits to the U.S. economy and may be welcomed by some policymakers, they could also raise a number of issues and concerns. Some U.S. policymakers have expressed concern that China might try to use its large holdings of U.S. securities as leverage against U.S. policies it opposes. For example, various Chinese government officials reportedly suggested on a number of occasions in the past that China could dump (or threaten to dump) a large share of its holdings in order to counter U.S. pressure (such as threats of trade sanctions) on various trade issues (such as China's currency policy). In exchange for new purchases of U.S. debt, China would likely want U.S. policymakers to lower expectations that China will move more rapidly to reform its financial sector and/or allow its currency to appreciate more substantially against the dollar.<sup>32</sup> Some analysts have suggested that China could choose to utilize its reserves to buy stakes in various distressed U.S. industries. However, this could also raise concerns in the United States that China was being allowed to buy equity or ownership in U.S. firms at rock bottom prices, that technology and intellectual property from acquired firms could be transferred to Chinese business entities (boosting their competitiveness vis-a-vis U.S. firms), and that becoming a large stakeholder in major U.S. companies would give the Chinese government enormous new political influence in the United States.<sup>33</sup> U.S. policymakers in the past have sometimes opposed attempts by Chinese firms to acquire shares or ownership of U.S. firms.<sup>34</sup>

While attending the G-20 summit in London on the global financial crisis on April 1, 2009, President Obama and President Hu met separately to discuss a number of issues. The two sides agreed "to work together to resolutely support global trade and investment flows" and to "resist protectionism."<sup>35</sup>

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<sup>31</sup> *Financial Times*, "China calls for new reserve currency," March 24, 2009.

<sup>32</sup> China's currency has appreciated by about 19% to the dollar since reforms were made in July 2005, but many U.S. policymakers contend that it remains significantly undervalued.

<sup>33</sup> Most Chinese firms that have been allowed to invest overseas are state-owned enterprises.

<sup>34</sup> For example, efforts by a Chinese state-owned oil company (CNOOC) in 2005 to purchase a U.S. energy company (Unocal) was widely opposed in Congress and eventually led the Chinese company to drop its bid. In 2007 a Chinese firm (Huawei) attempted to buy a stake in a U.S. technology company (3Com), but dropped its bid after a number of national security concerns were raised in a review by the U.S. Committee on Foreign Investment in the United States.

<sup>35</sup> White House Pres Release, April 1, 2009.

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