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IMPACT AND RESPONSE TO THE FINANCIAL CRISIS: COMPARING THE EU AND CHINA POLICIES

This article, in a comparative approach, assesses the impact of governments' policies both in the EU and in China to handle the impact of the international financial crisis.
Europe, recovered quickly from the crisis, but it continues to experience low overall macro-economic performance, with noticeable variations among the EU's 27 member-nations and the 17 Eurozone members. Debt levels and unemployment rates remain relatively high, and European authorities are forced to look for a balance between fighting inflation by raising interest rates and supporting demand, which necessitates a more permissive policy. The collateral impact of the financial crisis on Europe resulted in a currency crisis that endangered the euro and was caused by Maastricht mechanisms for convergence and stability that regulate the functioning of the Economic and Monetary Union (EMU).
China quickly returned to a high growth rate that was fueled by the implementation of vast expansionist policies by the national and provincial governments. After a brief recession, the Chinese economy very rapidly resumed its high performance levels in terms of GDP growth, trade balance, and currency reserves. The Chinese economy's recovery from raises questions about its ability to change its growth model by abandoning a model based on promoting exports and on heavy investments in infrastructures, particularly in economic sectors that are not always productive, a strategy that creates a drain on households, whose savings finance the current growth model.
JEL: P11, P21, P52

The financial crisis spread quickly to the European Union and China following the sub-prime crisis in the United States and the ensuing bankruptcy of several large investment firms. In order to limit the "tsunami" triggered by the crisis, governments quickly implemented large-scale measures to minimize the shock to their economies and spur the recovery of growth rates.

Governments' reactions included increases in public spending and a blend of fiscal measures and credit expansion to support stimulus packages with the strongest growth potential to stimulate demand. Measures also included financing large public infrastructure projects and injecting liquidity to save banking systems. These

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Keynesian-inspired programs had a dual purpose: In the short term, they were intended to immediately influence demand, and in the medium term, to create structural modifications. They were implemented with a limited time-frame—from two to three years depending on the country—based on the hypothesis of fast positive effects on growth, which turned out to be the case in most of the economies involved.

This chapter assesses the state of affairs after the crisis, asking how large economic sub-sectors have behaved, and measuring the extent of growth recovery, particularly in China and Europe.

Europe, like other large market-based economies, recovered quickly from the crisis, but it continues to experience low overall macro-economic performance, with noticeable variations among the EU's 27 member-nations and the 17 Eurozone members. Debt levels and unemployment rates remain relatively high, and European authorities are forced to look for a balance between fighting inflation by raising interest rates and supporting demand, which necessitates a more permissive policy. The collateral impact of the financial crisis on Europe resulted in a currency crisis that endangered the euro and was caused by Maastricht mechanisms for convergence and stability that regulate the functioning of the Economic and Monetary Union (EMU). Public and private deficits caused growth in the sovereign debt of several "Southern" EU member-states that were subsequently labeled with the dubious acronym PIGS (Portugal, Ireland, Greece and Spain). These events fueled debates about the future of the euro and led EMU member-governments to implement a new kind of bail-out instrument whose beneficiaries to date are Greece and Ireland. The effects of the crisis on European financial and monetary mechanisms have led the European leadership to reconsider EU methods of governance and to explore more proactive policies for stimulating growth.

China quickly returned to a high growth rate that was fueled by the implementation of vast expansionist policies by the national and provincial governments. After a brief recession, the Chinese economy very rapidly resumed its high performance levels in terms of GDP growth, trade balance, and currency reserves. In addition, China currently plays a central role in regional development, having recently out-performed Japan in terms of GDP. The weak performance of the United States and the growth of its public debt are currently pushing China to play a more active role in international financial and currency markets. Its purchase in mid-2010 of Greek and Spanish treasury bonds, which has amounted to 420 millions € (*China Daily* 2010), is part of an undeniable geopolitical turn that also includes increasing control of direct investments in other European assets. China is thus enacting a diversification strategy in terms of its financial holdings, while fueling debates about the question of the yuan's appreciation (currently tied to the US dollar), its internationalization, and its possible utilization as an international currency. The creation of the G20 is an acknowledgement of the growing role of emerging economies, most importantly China, which continues to seem hesitant to become involved in constructing a new international financial architecture.

On the other hand, the Chinese economy's recovery from the crisis raises questions about its ability to change its growth model by abandoning a model based on promoting exports and on heavy investments in infrastructures, particularly in economic sectors that are not always productive, a strategy that creates a drain on households, whose savings finance the current growth model.

The following section examines the current situation from three perspectives. Part 1 summarizes the stimulus plans adopted by the EU and their economic impact. Part 2 evaluates the performance of these measures and demonstrates how economic recovery has led to a monetary crisis and problems with EU mechanisms of convergence and stability. Part 3 analyzes the Chinese strategy for stabilizing and re-launching its economy, describing the problems that it has faced.

The Impact of the Sub-prime Crisis on the European Economy

The EU-27 was rapidly impacted by the spread of the sub-prime crisis as it became apparent that numerous European investment banks had accumulated toxic loans by issuing and buying risky equities. The crisis exerted immediate affects on GDP growth rates, inflation, unemployment, industrial production, and external trade with the rest of the world, while also causing contraction in trade within the Eurozone. GDP growth rates in the Eurozone rapidly dropped from an average of nearly 2% in the first semester of 2008 to almost -10% in the first semester of 2009, while rates of fixed capital investment dropped sharply from 4% to -15% during the same period. Inflation rose by at least two percentage points from 2% to 4%, while unemployment rose throughout the EU to an average of 10% of the working-age population. The contraction of internal EU-27 trade proved particularly sensitive due to the high degree of integration and sub-contracting relationships among the EU-15 nations and the new member-states.

The *EU Recovery Plan* was a blend of short-term and structural measures. In terms of contributions from the different member-states, it is essentially a patchwork in which each government allocates its contribution as a function of its national interests, yielding a final plan that resembles a puzzle in which each piece is inter-locked with the others.

Rapid investments consistent with priorities defined in the Lisbon Agenda[2] were emphasized. Investment provided targeted assistance to a number of areas, including business creation, the development of a favorable business environment, research and innovation, and a smart economy. The plan's more long-term aspects centered on the development of infrastructure and energy conservation.

The European plan had three short-term objectives: 1) Aiding employment through fiscal reduction, particularly among SMEs (Small and Medium-sized Enterprises)

[2] In March 2000, the EU Heads of States and Governments agreed to make the EU "the most competitive and dynamic knowledge-driven economy by 2010". Although some progress was made on innovating Europe's economy, there has been growing concern that the reform process was not going fast enough and that the ambitious targets would not be reached.

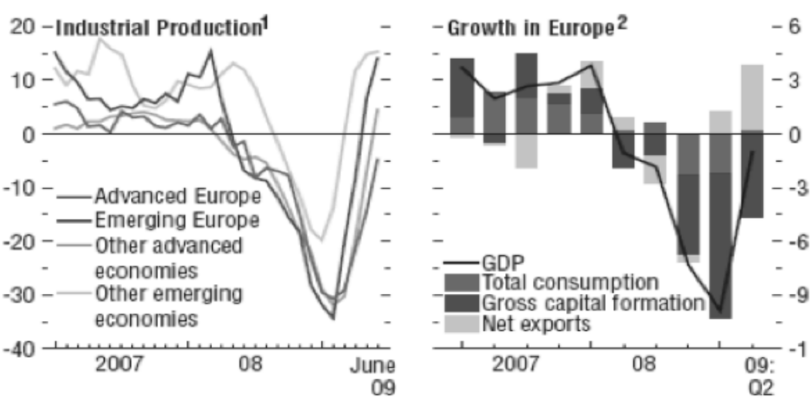
and employer labor costs in order to stimulate employment; 2) Injecting cash into the financial system in order to reinforce the banks and provide them with the means to support business investment; and 3) The choice of instruments and the implementation schedule differed between EU countries, some choosing rapid commitment (year 1 versus year 2) in terms of fiscal incentives and increases in public expenditures while others favored spreading interventions over a longer period. The sums allocated varied on average between 1.5 and 2% of national GDP. The consensus among EU countries and other large economies, as well as international organizations like the IMF and OECD, was that the bail-out program should be temporary, coherent, and targeted.

Nearly every G20 member-nation (itself an organizational outcome of the crisis), and particularly the G7, applied a cluster of fiscal reforms whose rates and other features varied from country to country and whose costs amounted on average to approximately 1.5% of world GDP. The economic policies that were applied described a V-curve, with a rapid decline in production followed by sustained recovery. In most cases, the curve tended to follow the V-shape of a square root: . This curve reflects a rapid recovery followed by weak growth, with the exception of China and several other Asian economies. Some forecasters predict another drop (a W curve) in the event that financial stabilization was not sustainably reinforced and public deficits were not rapidly reduced.

The implementation of stimulus packages in Europe resulted in a rapid counter-cyclical effect following the first year, with growth rates quickly recovering to near-pre-crisis levels, which was also true of other large regions. The impact on public deficits and employment has proven more durable, while average unemployment rates of 10 % across the EU-27 and 9.6% in the Eurozone vary significantly among individual countries. For example, unemployment is lower in Germany and its neighbors and higher in the South, reaching 20% in Spain. Average unemployment rates are similar over-all to those in the United States.

Figure 1

The Impact of Initial Measures



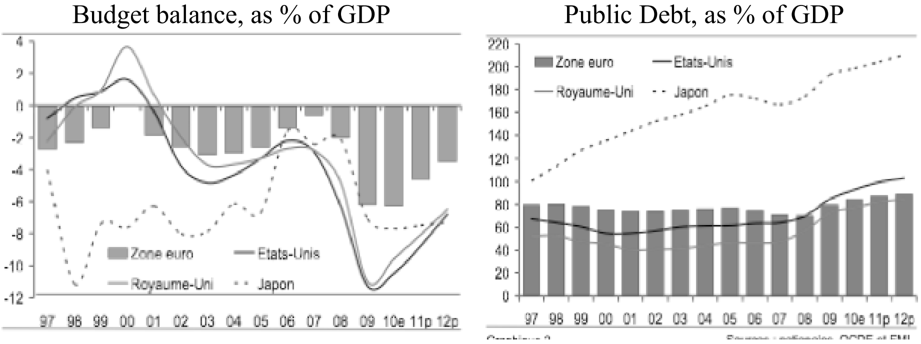
Source: IMF (2009).

European countries committed themselves to rapidly reducing public deficits and to returning to Maastricht criteria that prescribe a 3% budget deficit and 60% debt with respect to GDP. The level of imbalances weighs heavily on future growth, deflation is a constant risk, and a new or double recession could occur if recovery is hampered by the governments' limited room of maneuver. This danger is considerable if these economies do not commit to strict deficit reduction programs and to prolonging the number of workers' active work-years. Both of these commitments were summarized in the "Competitiveness Pact" submitted by the German Chancellor and the French President in February 2011. The cumulative imbalances and "soft" constraints on budgets that banks and other financial institutions were allowed to enjoy, particularly in Ireland and Spain, are the cause of these countries' sovereign debt crises and of the resulting pressure on the common currency.

Figure 2

Budget Balance and Public Debt in the Eurozone, the US, the UK and Japan

Budget balance, as % of GDP | Public Debt, as % of GDP



Source: Arvisenet (2011)

NB: Zone Euro: Eurozone; Etats-Unis: United States; Royaume Uni: United Kingdom; Japon: Japan.

From Financial Crisis to Monetary Crisis: The Destabilization of the Euro

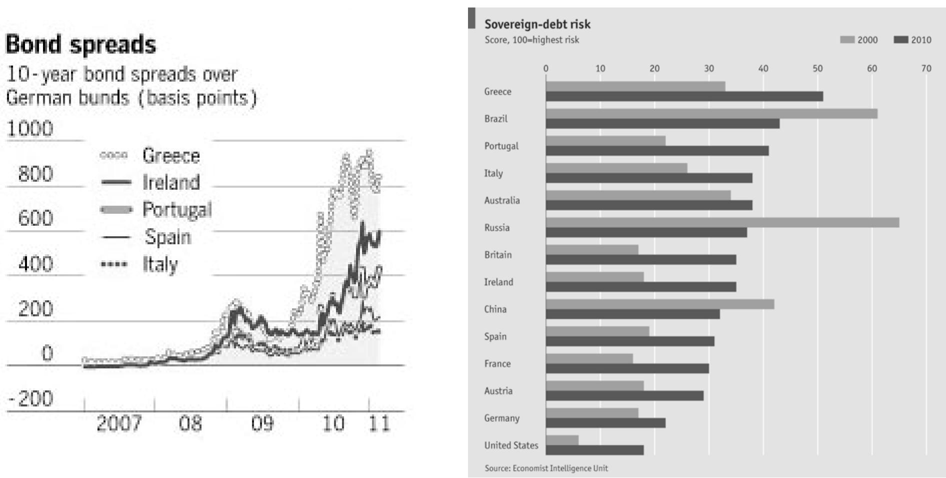
The bail-out of the European banking system had immediate undesirable effects on the European financial and monetary system. The stimulus packages, by introducing liquidity *through* increases in public deficits, enabled the banks to be refloated in order to encourage them to finance the recovery. Paradoxically, however, this in turn gave the power to the financial markets to appreciate the risks represented by the various financial instruments, particularly government bonds issued by member-states (fig. 3). Ten-year government bonds (sovereign debts) issued by the different countries showed important spreads that imperiled the European monetary system, which had been praised during the crisis. For European leaders and the officials of the Council of Europe, the European Commission, and the European Central Bank (ECB), the monetary system had ensured the resiliency of the European economy at the time of the crisis.

The origins of the European monetary crisis are to be found in the founding principle of the European Economic and Monetary Union by the Maastricht Treaty (1992), which entailed the abandonment of monetary sovereignty by signatory nations. Because of a lack of fiscal federalism and the powerful reluctance of the governments to make provisions for assisting national economies in crisis through fund transfers, no bail-out mechanism was included in the treaty's provisions. Indebted countries hold debts that are not in their national currency, meaning that they can no longer devalue their currency in order to recover competitive margins. The principles of convergence and deficit control (of the budget and public deficits) and communitarian discipline were judged to be sufficient to constrain the budgetary policy options of the different governments. One positive impact of the system for some countries—with negative effects for the over-all mechanism, however—was that the euro-based debts of Eurozone members had low initial costs, which in certain countries led to ill-advised allocation of resources and later to speculative bubbles, for example in Spain's construction industry. This unfortunate side-effect spread throughout the financial system and soon led to an increase in borrowing costs on Euro bond markets. Despite reluctance, particularly Germany's, the most heavily affected countries ultimately received EU aid to help service their debt in exchange for very strict austerity measures.

In addition to stability and convergence mechanisms that the larger member-states intend to enforce, the European leadership adopted several other measures designed to maintain the coherence of the Economic and Monetary Union and to sustain the euro's value on currency markets, while also reinforcing discipline within the Eurozone.

Figure 3

Bond Spreads and Sovereign Debt Risks



Sources: Financial Times (2011), The Economist (2011).

This raises the question of whether we are moving towards a long-term imbalance, i.e., the rise of Northern European countries – the German zone (Pettis 2010) –

further strengthened by the adoption of the Competitiveness Pact and the first step towards implementation of a European economic government.

Since the summer 2011, the thinking of the EU leadership has been currently focused on three issues:

1) Defining a competitiveness pact that would unite EU economies by concentrating on the reforms needed to control salaries, make the labor market more flexible, control the explosion in public expenditures and reform retirement systems. The fiscal aspect of the proposal envisions the implementation of a European formula for calculating taxes on businesses. (This represents an effort to combat the fiscal dumping practices of some Eurozone countries, including Ireland).

2) Reinforcing the European Financial Stability Fund (EFSF), a mechanism allowing governments to draw on the fund to help in times of difficulty. These resources, amounting to 750 bn €, will come from several sources, among them the EFSF, which will have a borrowing limit of 440 bn €. This will be replaced in 2013 by the European Stability Facility, which will control funds of up to 500 bn €.

3) Constituting a "true federal shock" to which Eurozone countries would have to respond by considering the creation of a single common economic policy, by narrowing the gap between each country's fiscal policy.

Nonetheless, as this book goes to print, the Greek mess has not been solved and the rescue plan appears difficult to implement. Some Eurozone members are still reluctant to implement it (Finland), the trade off between German domestic interests and its leading exporter role in the EU being not settled yet. There are also other reasons for this lack of agreement: the fear that other countries will not be able to default (Italy, Spain). The new European Stability Facility has not enough funding to intervene on different fronts. Last, many countries, first Germany, are still opposed to the creation of a European bond market. Many institutions and financial questions are at stake, among them the bail out question which is not officially recognized in the European Treaties and the undercapitalization of European banks as highlighted in an August 2011 IMF statement.

Chinese Fiscal Measures

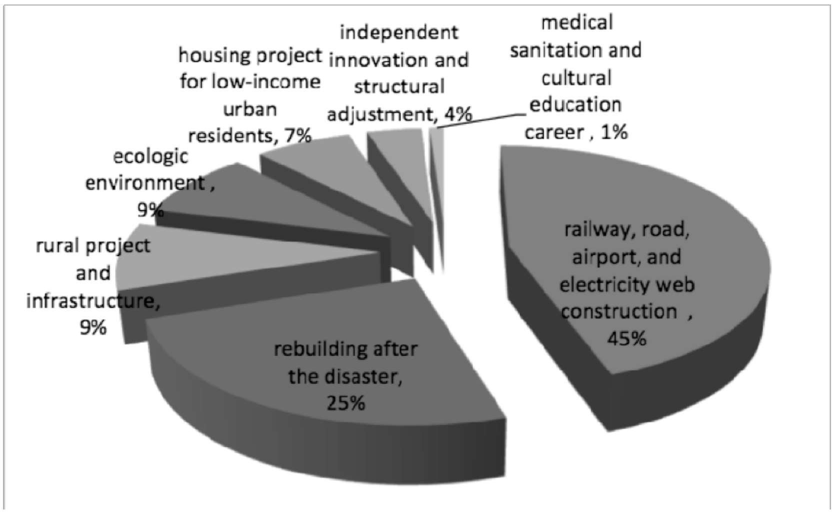
Asian economies have been affected by the crisis as well but have exhibited greater resiliency than Europe. The adoption of counter-cyclical policies enabled them to lessen the impact of the crisis and to recover more quickly, posting higher GDP growth rates than either the United States or Europe. As in other regions, however, the crisis did result in slowed growth and decreased exports.

The economic policy implemented by China eased the return to rapid, healthy growth. Its recovery from the crisis does raise questions, however, concerning the change in the growth model towards an emphasis on internal demand and the appreciation of the yuan.

In 2008, the Chinese economy entered into a slowdown, recording a drop in exports towards developed markets (which represent 40% of exports) due to weakened demand and implementation of protectionist policies. External trade began to decline rapidly in 2009, affecting employment rates in traditional exporting regions. The GDP growth rate dropped from 11.4 in 2007 to 8.7% in 2009, and China saw a decrease in its foreign financial investments due to losses in the value of United States bonds and the devaluation of the US dollar. Domestically, because Chinese banks were spared the effects of the crisis, their profits even grew during the crisis. This is because the banking industry's exposure to fluctuations in the global economy is limited by the fact that their capital accounts are administrated, which has the effect of blocking capital in- and out-flows. The required reserve ratio is far higher than in the large developed market economies, particularly the United States, a reflection of the risk aversion of Chinese banks.

Figure 4

The Distribution by Sector of Chinese Fiscal Stimulus of 4 trillion yuans



Source: National Development and Reform Commission (2009).

The anti-crisis measures taken by China were concentrated in 6 major areas:

1) The reinforcement of macroeconomic regulation in order to stimulate the economy through the adoption of proactive fiscal policies and a relatively loose monetary policy. Public expenditures beginning in 2009 were distributed to the provinces, social development, research and development, energy and environmental savings, large infrastructure projects, and aid to zones affected by earthquakes (Sichuan).

2) The encouragement of exports and the stimulation of domestic demand,

particularly by lowering taxes on real estate transactions, increasing assistance to small and medium-sized businesses, and reducing prices of durable goods purchases by farmers.

3) A generous credit policy. Chinese banks made loans amounting to 31% of GDP in 2009. The government loosened limits on the growth of credit by relaxing measures limiting real-estate purchases and by reducing interest rates and required cash reserves. This policy had immediate effects on housing purchases and the automobile sector.

4) Maintaining the stability of exchange rates by pegging the yuan (RMB) to the dollar after having allowed it to regularly appreciate against the dollar since 2005.

5) Promoting structural adjustment of the Chinese economy by distributing more resources to agriculture and rural areas, limiting the over-capacities of the steel industry and redundant electrical generating plants, and by encouraging the development of clean energy, information technologies, and high-speed rail service.

6) Reducing the impact of the crisis on society by allowing businesses to delay payment of social security and taxes, by developing training and laborer recycling programs for those who lost their jobs, extending social security benefits in rural areas, constructing rent-controlled housing for low-income citizens, and improving the medical system.

In summary, the Chinese recovery program allocated significant resources that favored industrial infrastructure and transportation development by massively supporting demand in the housing and automotive sectors. The program also had a geographical dimension, with centrally defined objectives that were duplicated at the provincial level. There was a multiplying effect for industries both upstream and downstream of the production cycle in numerous sectors of the economy. The program was coherent in its conception and envisioned as long-term, with the result that its effects were felt in numerous sectors. At the same time, it represented a response to the relative decline of foreign trade due to the temporary contraction of external demand. Ultimately, inflation was contained, at least at the outset, due to the existence of over-capacities that exerted an anti-inflationary effect.

The mechanisms for resource allocation did lead to a number of distortions. State-owned companies were favored, which led to an increase in their available resources and to forms of renationalization because state-owned firms were able to take over lower-performing private firms. Easy access to credit created a lever effect that enabled property-owning households to undertake loans for the purchase of additional property. On the other hand, access to easy credit was more difficult for small and medium-sized businesses, which confronted banks' hesitation to extend loans. Finally, despite the apparent coherence of the recovery program, portions of the sums allocated to it were not spent or were allocated to projects that had little impact in terms of supporting economic activity.

The recovery was rapidly visible in terms of GDP growth—the strongest of the region's economies—as well as the growth of foreign currency reserves and the resumption of exports. For a number of Chinese specialists, the crisis was attributable to unregulated American capitalism, but it was nevertheless revealing for Chinese leaders in terms of the robustness of growth and the reliability and durability of their economic model which has experienced undeniable success for the past thirty years. The mercantilist model led by exports has facilitated the accumulation of the reserves that have served to finance the international expansion of the Chinese economy (Brunet & Guichard 2011). But this model could reach its limits if the contraction of growth both in the US and in Europe continues in the coming years. Could the crisis have been a blessing in disguise for the Chinese economy? Yes, if the Chinese government can handle and master carefully the move towards a domestic-led growth model.

Figure 5 illustrates three things: the rapid recovery of Asian economies, the spread in terms of performance between the principal economies and economic sub-regions, and the strong resiliency of the Chinese economy as it responded to the crisis. This resiliency can be attributed to the effectiveness of the measures adopted and implemented by the Chinese government.

Exiting the crisis confronted the Chinese economy with new problems, including inflationist pressures, the development of financial bubbles (for example, in the housing sector), but also the need to move to another economic model. The scarcity of industrial jobs has led to rapid salary increases, particularly in industries located in regions that export low value-added products. In addition, China has found itself facing pressure from its partners, who have demanded a rapid appreciation of the yuan against the dollar and the euro.

Figure 5

The Asian Recovery

	Real GDP			
	2007	2008	2009	2010
Emerging Asia[3]	**9.8**	**6.8**	**3.3**	**5.3**
China	13.0	9.0	6.5	7.5
South Asia[4]	**8.7**	**7.0**	**4.3**	**5.3**
India	9.3	7.3	4.5	5.6
Pakistan	6.0	6.0	2.5	3.5
Bangladesh	6.3	5.6	5.0	5.4
ASEAN–5	**6.3**	**4.9**	**0.0**	**2.3**
Indonesia	6.3	6.1	2.5	3.5
Thailand	4.9	2.6	–3.0	1.0
Philippines	7.2	4.6	0.0	1.0
Malaysia	6.3	4.6	–3.5	1.3
Vietnam	8.5	6.2	3.3	4.0
Newly industrialized Asian economies	**5.7**	**1.5**	**–5.6**	**0.8**
Korea	5.1	2.2	–4.0	1.5
Taiwan Province of China	5.7	0.1	–7.5	0.0
Hong Kong SAR	6.4	2.5	–4.5	0.5
Singapore	7.8	1.1	–10.0	–0.1

Source: IMF (2011).

At the domestic level, the crisis raised the issue of adopting a different growth model based on internal demand, an issue often avoided by Chinese leaders, at least before Wen Jiabao's March 2011 governmental report. For the Chinese government, changing model implies investing heavily in infrastructures and social services (such as education, retirement, and health) in order to permit Chinese households to reduce their savings rates. In tandem with these measures, it implies reforming the domestic financial system so that available resources can be more efficiently and rationally channeled.

At the international level, one crucial issue relates to China's active participation in refashioning the international financial architecture along three important lines: the diversification of financial institutions in China, the international role of the yuan, and China's active participation in the G20 and the reform of the international monetary system.

Conclusion: Many Problems Persist After the Crises

The European and Chinese economies exited the crisis with a number of problems related to macro-economic performance, consolidating Europe's coordination and convergence mechanisms, controlling inflation, managing financial surpluses, redistributing wealth, and reallocating resources in China in a context of economic growth that remains plagued by uncertainty.

The adage says that the European construction has survived through a succession of crises in negotiating often durable compromises that serve as the basis for future developments. The 2008 financial crisis undeniably illustrates this claim. The mechanism on which the functioning of the Eurozone is based was especially affected, highlighting the limits of mechanisms for aid and internal transfer. The difficulties encountered by the GIPS (a more elegant acronym for the countries at the periphery of the Eurozone) have created powerful turbulence in the Eurozone and cast doubt on the medium-term viability of the euro. Discussions surrounding the euro are less pessimistic today because of the slight economic recovery, particularly in Spain whose public accounts have been heavily degraded.

Four important questions remain concerning Europe's medium-term future:

1) The ability of countries that have been forced to default (Greece, Ireland, and soon Portugal) to implement austerity plans, on condition of receiving direct support via the new EU mechanisms and indirect support from other countries within the Eurozone, including lightening or even forgiving debt.

2) The balance that Germany is able to find between, on the one hand, strengthening the banking system and, on the other hand, defending the euro, an objective that suggests that Germany is transferring resources to the indebted countries ("Germany will pay").

3) The ability of Eurozone countries to agree on the contents and implementation of

the Competitiveness Pact.

4) The policy of fighting inflation and the negative effects on European exports of a too-strong rise in the euro against the US dollar.

The recent support (end of September 2011) from the Bundestag to the German Chancellor and the EU leaders to rescue Greece has created a more favorable climate to reduce and curb down the pressure of financial markets on the euro. It has allowed stock markets to regain confidence. Nonetheless, as specialists point out, there are still three main issues to addressed:

- Eurozone banks have to be recapitalized;

- Greece's debt has to be managed in a way which doesn't spread to other countries in difficulties;

- Enough funding has to be made available in order to finance Spain and Italy.

Will the European stabilization fund be able to provide enough funding to buy Euro bonds to defuse the crisis? We will see in the coming months.

The Chinese economy's problems are of a completely different order. On the macro-economic level, the Chinese government restarted growth thanks to a package of measures implemented to protect the economy from the crisis. Domestic investment and consumption contribute to a significant extent to GDP growth. In the short-term, the government needs to control inflation, increase interest rates, and limit the formation of speculative bubbles, particularly in the housing market.

More fundamentally, the Chinese government is going to confront a change in a growth model based on household under-consumption, which represented only 35% of GDP during the last decade, and on an excessive savings rate; household savings subsidized the boom in investment and contributed to dubious loans. Moving towards a more balanced growth means abandoning this highly successful model, reducing investment, especially useless investments, that are supported by household savings. It is difficult to modify a model that is profitable, and it may take some time to manage the transition to a growth model based on consumption and more rational distribution of investment risk takes time.

Yet, the European and Chinese governments face choices that are not independent from each other, nor from the American political economy. Today, the EU and the US are facing a double dip. Growth, after a short recovery has not resumed and is still facing difficulties in handling employment, supporting investment and domestic demand. The financial mess has not been definitively settled up, particularly in Europe (with the exception of the UK). The banking system has not been deeply restructured; the banking industry is trying to escape government and supranational regulations. Strong adjustment policies in Europe (higher interest rates, wage controls, credit squeeze) have a negative effect both on the demand and supply sides.

Competitiveness through labor costs reduction is an issue, but it should not lead to an economic depression. A mix of stabilization policies and managed demand should be implemented in order to help supporting growth. Structural reforms of both the fiscal system (more federalism) and banking system (European wide system) should accompany the launching of new macro-policies oriented toward a sustainable growth.

How China is concerned? Macro-stabilization is an important issue in order to secure China's exports: the EU is China's first economic partner. Secondly, the future of the Euro matters for China as the financial authorities are willing to diversify their huge monetary reserves in US dollars. But China should adopt a cautious attitude concerning buying more risky financial assets (sovereign debts from the most indebted Eurozone countries) and rather look for acquiring more tangible and rewarding assets (corporations) in order to increase their market shares, their access to technology and brands (Volvo). The present Eurozone crisis should also push the thinking of Chinese leaders on the desirability, feasibility and implementation of a new international monetary system.

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