

Viewpoint: Linda Yueh

China and the Global Financial Crisis

Biographies: [Linda Yueh](#)

Introduction

Dr Linda Yueh is an economist and commentator on global economic and business issues. She is a fellow in economics at the University of Oxford, a visiting professor at the London Business School, and an associate of the Centre for Economic Performance at the London School of Economics and Political Science. Previously, she worked as a corporate lawyer internationally, based in New York, Hong Kong and Beijing. Recent books include *Macroeconomics* (co-authored with Graeme Chamberlin) and *Globalisation and Economic Growth in China* (co-edited with Yang Yao). Forthcoming books include *The Law and Economics of Globalisation: New Challenges for a World in Flux* (editor) and *The Future of Asian Trade and Growth: Economic Development with the Emergence of China* (editor). Dr Yueh is editor of the Economic Development and Growth book series published by World Scientific Publishing, and serves as an adviser to the World Economic Forum in Davos, Switzerland, and the UK government. She is a frequent commentator for the media, including the BBC, CNBC, CNN and the *Guardian*.

The Financial Crisis

Although it is certainly true that excessive risk-taking by financiers and inadequate regulatory supervision are to blame for the global financial crisis, international macroeconomic forces should not be overlooked as a contributing factor. This is particularly the case as any lasting resolution must address the causes of the most significant global economic crisis in recent memory.

The economic crisis of 2008 has its roots in the last recession. Ever since the US central bank used loose monetary policy to stave off a technical recession in 2001, after the dot-com bubble burst, low interest rates in developed economies became the norm as economic growth continued to be strong. Cutting interest rates to stimulate the economy during a downturn is the usual use of monetary policy, but the extent of globalization in a fundamentally changed global economy of the 2000s altered its effects.

The mispriced risk, which was at the heart of the US subprime mortgage crisis, is a result of low interest rates and excess liquidity. Credit was cheap and plentiful, which is peculiar in a country with a low rate of saving as well as a high level of consumer debt and highly leveraged firms. Normally, with a savings deficit, borrowing would be more expensive given the low supply of funds.

The liquidity did not cause inflation. This is due to globalization and the global appetite for US debt, which kept down prices and the cost of borrowing. The US Federal Reserve then missed the signal that money was too cheap and lenders continued to seek borrowers, even if they were sub-prime ones.

This strong demand for US treasuries stemmed from the trade surpluses in the Middle East (due to oil exports) and China and elsewhere in Asia (due to cheap manufactured goods). When combined with a high savings rate, particularly in Asia, large foreign exchange reserve holdings accumulated in their coffers. As a result of the fixed exchange rates operated by these countries, purchases of US treasuries were necessary even if the American interest rate, and therefore returns, were low.

Chinese Strategy

This fixed exchange rate regime also forestalled a quick re-balancing of the global economy. For instance, when China, recorded trade a surplus reaching some 14% of GDP in 2007, the currency should have experienced irresistible pressure to appreciate. By so doing, goods purchased from China would have been more expensive for American consumers who would then buy less, thereby reducing the US trade deficit and concurrently causing the Chinese trade surplus to fall.

This, however, did not happen, as the Chinese intervened to manage their currency and used measures to raise reserve requirements in the banking sector to manage the large increase in liquidity in the economy.

This was not entirely successful, as inflows continued to come in and China experienced the prospect of an over-heating economy when investment, particularly in fixed assets and construction, grew rapidly and led to the prospect of an asset bubble.

Exchange rates are not the only reason for such economic movements. Demand for the US dollar, which has the status of being a reserve currency, does not depend purely on supply and demand caused by trade balance and capital movements. If that were the case, then the US 'twin deficits' (budget and trade) would have become unsustainable long before the crisis. Indeed, the US external deficit, which reflects consumption based on borrowing from abroad, was a phenomenon in the 1980s, well before China's significant opening to the world economy after 1992.

It is not unusual for China or other developing countries to want a stable and competitive currency as their economy grows. Nevertheless, the so-called global imbalances seen in 2008 saw the West, which had low savings, importing savings from the (Far and Middle) East. Also the appetite for US dollars kept liquidity high and cheap (as well as interest rates low) in the United States.

The Development of a Global Crisis

The financial crisis followed, as financiers created ever more sophisticated instruments and sold them around the world. To resolve the situation, there will need to be a rebalance in the global economy. This should be done gradually; liquidity from China and emerging economies is needed to help the West to deal with the credit crunch. This liquidity would alleviate some of the necessary belt-tightening experienced by Western consumers and help deflate the asset bubbles that have been building up in emerging economies. It would also help stabilize the rich countries, home to most of the world's consumers upon whom most emerging economies depend for export growth.

Some sovereign wealth funds have already helped to re-capitalize Wall Street and European banks, for example Singapore's investments in Citigroup and UBS. And, imagine what would have happened if China's sovereign wealth fund had bought Lehman Brothers. Buying well-priced but illiquid companies is not new, as was seen in the rise of merger and acquisition activity in the aftermath of the Asian financial crisis.

However, the political reaction to sovereign wealth funds strongly suggests that private and commercial firms investing in the West would be more feasible. But China only allowed commercial outward foreign direct investment in the past five years and, even then, it was tightly controlled.

From the perspective of developed countries, it is a small economic step to take direct capital investments from emerging economies through sovereign wealth funds, but a large one politically. Alternatively, commercial capital outflows from Asia would allow a re-balancing without much of the political backlash. However, doing so would also erode capital controls in countries such as China, which will make a fixed exchange rate harder to maintain. This is not a position that China is ready to take nor, it appears, is the Middle East.

However, it should be in the interest of emerging economies to allow greater flexibility in their exchange rates to protect themselves against a currency-led financial crisis, especially considering that a floating currency appreciates/depreciates to absorb external shocks while a fixed exchange rate can be attacked by speculators.

Also, countries such as India and Vietnam had experienced double digit inflation as a result of their low exchange rates, making imports more expensive and investment cheap, factors that can lead to economic overheating and an eventual crash. Moreover, with China and India leading global economic growth, as the developed economies fall into recession, those looking for capital returns are likely to contribute to potential future market bubbles (particularly housing) in these countries, which could cause the next financial crisis.

Also, Western governments will have to borrow to fund the rescue packages and fiscal stimulus measures to fight the recession. These government bonds are likely to be bought by governments from emerging economies, with high levels of savings, such as China. Therefore, rather counter-intuitively, although global imbalances led to this crisis, these imbalances (whereby liquidity flows from East to West) should be maintained for some time longer so that Asian savings can help fuel Western recovery and gradually achieving a rebalanced global economy.

Reducing liquidity at a time when the West is drawing upon it to fund rescue efforts will likely lead to a long and painful period of austerity. The recovery of the Western economies and their markets is in the global interest, particularly China's as the world's second largest trader.

China has played a notable, albeit an indirect role, in the global financial crisis. Its actions, along with other major emerging economies, can also help to resolve it. Doing so is not just geared at aiding a US-led crisis, but to restore a global economic and financial stability that has brought real prosperity to China and much of the developing world over the past decade.

More Info

Books:

- Dollar, David. "Asian century or multi-polar century?" In Natalia Dinello and Wang Shaoguang (eds). *China, India and Beyond: Drivers and Limitations of Development*. Cheltenham, UK: Edward Elgar, 2009.
- Wolf, Martin. *Fixing Global Finance*. New Haven, CT: Yale University Press, 2008.
- Yueh, Linda. "Perspectives on China's economic growth: Prospects and wider impact." In Natalia Dinello and Wang Shaoguang (eds). *China, India and Beyond: Drivers and Limitations of Development*. Cheltenham, UK: Edward Elgar, 2009.

Article:

- Bean, Charles. "Some lessons for monetary policy from the recent financial turmoil." Speech at Conference on Globalisation, Inflation and Monetary Policy, Istanbul, Turkey, November 22, 2008.

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