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# China and the United States' Recovery from the Global Financial Crisis

## Abstract

Faced with the global financial crisis, which has a large impact on the world's economy, China and the United States took different actions to pull the economy out of it, based on the fairly different financial, fiscal, and even political systems they have. This thesis focuses on the comparison of the financial and fiscal systems and trade structures between the two different countries, and how these have impact on their stimulus packages, thus influencing the economic recovery as a whole.

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Yufei Wang

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## ABSTRACT

Faced with the global financial crisis, which has a large impact on the world's economy, China and the United States took different actions to pull the economy out of it, based on the fairly different financial, fiscal, and even political systems they have. This thesis focuses on the comparison of the financial and fiscal systems and trade structures between the two different countries, and how these have impact on their stimulus packages, thus influencing the economic recovery as a whole.

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## **Chapter I. Financial and Fiscal Systems**

### **Centralized Financial Setting in China**

China's Financial System is comparatively centralized and simple, in which the People's Bank of China (PBOC) plays a dominant role.

Under the leadership of the State Council of People's Republic of China<sup>1</sup>, the People's Bank of China acts as the central bank in China's financial system. The PBOC was established on December 1st, 1948 based on the consolidation of the former Huabei Bank, Beihai Bank and Xibei Farmer Bank, and was appointed as the central bank of China by the State Council in September 1983, whose main responsibilities involve formulating and implementing monetary policy as a governor, preventing and resolving financial risks for the national financial system, and safeguarding financial stability to better promote the economic growth in the country.<sup>2</sup>

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<sup>1</sup> Details of State Council of People's Republic of China are available at: <http://www.gov.cn/english/links/statecouncil.htm>

<sup>2</sup> More information are available on PBOC's website. <http://www.pbc.gov.cn/>

According to the Law of the People's Republic of China on the People's Bank of China<sup>3</sup>, the PBOC performs three major functions: the service function, the regulatory function and the supervising function. First of all, as the bank of both the government and other banks, the PBOC provides financial intermediation, allocation of settlement, agency services and other financial services to the government, commercial banks and other financial institutions. Besides formulating and implementing monetary policy, issuing Renminbi and administering its circulation are also within the scope of PBOC's responsibilities. Moreover, the PBOC conducts financial statistics, surveys, analysis and forecasts on policy recommendation for the government, and also participates in international financial activities in the capacity of the central bank on behalf of the government. In regard to the regulatory functions, the PBOC is in charge of regulating and controlling money supply and credit scale to achieve the expected monetary and macroeconomic policy objectives, by adjusting the deposit reserve ration and the discount rate, issuing and enforcing relevant orders and regulations, regulating inter-bank lending market and inter-bank bond market, administering foreign exchange and regulating inter-bank foreign exchange market, regulating gold market, holding and managing official foreign exchange and gold reserves to keep the national currency of foreign exchange

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<sup>3</sup> The Law of the People's Republic of China on the People's Bank of China was adopted at the Third Session of the Eighth National People's Congress on March 18, 1995, promulgated by Order No. 46 of the President of the People's Republic of China on March 18, 1995, and amended in accordance with the Decision on Amending the Law of the People's Republic of China on the People's Bank of China adopted at the 6th Meeting of the Standing Committee of the Tenth National People's Congress on December 27, 2003.

rates relatively stable, managing the State treasury and maintaining normal operation of the payment and settlement system. More importantly, the PBOC takes responsibilities of supervising the financial system in China.

Although the China Banking Regulatory Commission (CBRC)<sup>4</sup>, the China Securities Regulatory Commission (CSRC)<sup>5</sup> and the China Insurance Regulatory Commission (CIRC)<sup>6</sup> are established one after another to facilitate the PBOC to better regulate the financial system, acting as the highest authorities in the financial system, the PBOC still performs the supervising function, like guiding and organizing the anti-money laundering work of the financial sector and monitoring relevant fund flows, to maintain financial stability and the integrity of organizational systems. The China Banking Regulatory Commission was established on April 28th, 2003 to facilitate the PBOC to achieve the legitimacy and stableness of the banking system by regulating and supervising banks, asset-management companies, trust and investment corporations and other deposit-taking financial institutions. The CBRC's main responsibilities include, setting up and revising supervisory rules and regulations, governing the banking institutions by authorizing the establishment, changes, termination and business scope; conducting surveillance of banking institutions on their daily behaviors and imposing sanctions for non-compliance; providing informational performance reports for the entire banking industry and proposals on the resolution for those struggling deposit-taking institutions in consultation with relevant regulatory authorities; supervising the boards of the major state-owned

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<sup>4</sup> Source: <http://www.cbrc.gov.cn/english/home/jsp/index.jsp>

<sup>5</sup> Source: [http://www.csrc.gov.cn/pub/csrc\\_en/](http://www.csrc.gov.cn/pub/csrc_en/)

<sup>6</sup> Source: <http://www.circ.gov.cn/web/site45/>



banking institutions by examining their financial activities and the credibility of major shareholders; and assuming other responsibilities delegated by the State Council. The CBRC also has the authority in China's financial system to closely cooperate with the PBOC to maintain a sound banking system in China. In fact, both CBRC and the PBOC possess the penalizing power over the commercial banks on violation of laws. To strengthen the centralized market regulatory system for further development of the securities market, the State Council established the State Council Securities Commission (SCSC) and the China Securities Regulatory Commission (CSRC) in October 1992, which were merged as one ministerial unit, the China Securities Regulatory Commission in April 1998, which plays the key role in supervising and governing the securities and futures market in China. Authorized by the State Council, the CSRC functions as a direct leader in securities and futures market supervisory bodies, watching over securities and futures business, stock and futures exchange markets, a variety of institutions in the securities and futures business; formulating policies, laws, and plans for the securities market; and also directing and adjusting the market operations to enhance their capabilities of resisting to, and healthily coping with financial crisis. In the same year, another ministerial financial institution, the China Insurance Regulatory Commission was established in accordance with the functions of administrative management of insurance markets authorized by the State Council and relevant laws, rules and regulations to maintain the legal and stable operation of related markets. Through drawing up development strategies and plans for the insurance industry and assuming supervisory responsibilities in the light of relevant rules and regulations, it creates and keeps a healthy

environment for all the insurance corporations. Through examining and approving the setup, merge, split, change and dissolving of institutions involved in the insurance industry, it maintains the steady development of China's insurance system. The CIRC also has supervisory power over the qualifications of the staff in insurance institutions and insurance schemes following laws. By overseeing the organizational forms and business operations of all Chinese insurance companies, it takes charge from the State Council to punish any unfair competition and illegal conduct of related institutions. Certainly, providing risk appraisals and forecasts, monitoring the daily operations and trades, compiling statistic data and statements to the national insurance system are all in the range of CIRC's duties. As the central authority of China's financial system, the PBOC directly reports to the State Council about its decisions concerning the annual money supply, interest rates, exchange rates and other important issues specified by the State Council for approval before they are put into effect. The PBOC is also obliged to submit work reports to the Standing Committee of the National People's Congress on the conduct of monetary policies and performance of the financial industry. Moreover, the top management of the PBOC is composed of the governor and a certain number of deputy governors. The governor of the PBOC is appointed into or removed from office by the President of the People's Republic of China.

Although China's banking market has been partly open to the private and foreign capitals, the four large-scale state-owned commercial banks ('Big Four') still possess a sizable share in China's banking industry. These are the Bank of China (BC)<sup>7</sup>, Industrial

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<sup>7</sup> More information refers to: <http://www.boc.cn/en/>

and Commercial Bank of China (ICBC)<sup>8</sup>, China Construction Bank(CCB)<sup>9</sup> and Agricultural Bank of China (ABC)<sup>10</sup>. In practice, the ‘Big Four’ embraces an extensive business network throughout the country in both urban and rural areas, and shows vigorous global presence. Meanwhile, a couple of joint-stock commercial banks alongside the state-owned banks also play irreplaceable roles in developing a market-oriented banking system. Among those, the leading ones include: Bank of Communications<sup>11</sup>, China Citic Bank<sup>12</sup>, China Everbright Bank<sup>13</sup>, Guangdong Development Bank<sup>14</sup>, China Merchants Bank<sup>15</sup>, China Minsheng Banking Corp. Ltd.<sup>16</sup> and etc. Moreover, China Development Bank<sup>17</sup>, The Export-Import Bank of China<sup>18</sup> and Agricultural Development Bank of China<sup>19</sup> are regarded as policy banks, who directly subordinate to the State Council, are incredible facilitators for the government and the central bank to carry out the macro economic functions mainly by sharing the burden of the policy loans. With the domestic banking market’s opening to foreign competitors,

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<sup>8</sup> More information refers to: <http://www.icbc.com.cn/icbc/sy/>

<sup>9</sup> More information refers to: <http://www.ccb.com/en/home/index.html>

<sup>10</sup> More information refers to: <http://www.abchina.com/en/>

<sup>11</sup> Homepage: <http://www.bankcomm.com/BankCommSite/en/index.jsp>

<sup>12</sup> Homepage: [http://bank.ecitic.com/investorrelation/index\\_en.html](http://bank.ecitic.com/investorrelation/index_en.html)

<sup>13</sup> Homepage: <http://www.cebbank.com/Channel/90969>

<sup>14</sup> Homepage: <http://www.gdb.com.cn/EN/index.html>

<sup>15</sup> Homepage: <http://english.cmbchina.com/>

<sup>16</sup> Homepage: [http://www.cmbc.com.cn/index\\_en.shtml](http://www.cmbc.com.cn/index_en.shtml)

<sup>17</sup> Homepage: <http://www.cdb.com.cn/english/index.asp>

<sup>18</sup> Homepage: <http://english.eximbank.gov.cn/>

<sup>19</sup> Homepage: <http://www.adbc.com.cn/en/index.aspx>

more and more international banks entered China's financial market by not only establishing branches and subsidiaries, but also actively participating in Chinese banks' shareholding reforms. Since the end of 2006<sup>20</sup>, foreign banking institutions have been enjoying full access to the banking market in China. There are rural and urban credit cooperatives, trust and investment corporations, domestic and joint ventures leasing companies, finance companies and insurance companies actively acting as the non-banking institutions. Credit cooperatives function as banks although they are relatively small. These institutions finance their loan portfolios with deposits taking in from individuals and collectives. While trust and investment corporations are owned by governments and banks, which raise funds through deposits, loans from enterprises, other financial institutions and government departments, and bonds in the domestic and foreign securities markets. Then, these funds are channelled to the approved investment. As for the leasing and finance companies, some of them are domestically owned, while others are joint ventures with foreign financial institutions including international banks. Last but not least, the insurance industry has recently been growing dramatically in terms of numbers and the importance. With constant increases in rate of return on investment, this industry is regaining a foothold in the financial system in China.

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<sup>20</sup> More information concerning China and the WTO is available at [http://www.wto.org/english/thewto\\_e/countries\\_e/china\\_e.htm](http://www.wto.org/english/thewto_e/countries_e/china_e.htm).

## **Federal Reserve System in the United States**

The Federal Reserve System of U.S.<sup>21</sup> is a quasi-government agency, established by Congress in 1913, whose primary responsibility is to stabilize the economy. Theoretically, the Fed does not rely on Congress for funding, which makes it almost exempt from political process as long as its operations are within politically acceptable bounds of the president and Congress. The original purpose of creating the Fed is mainly for providing commercial banks credits to avoid insolvency and bankruptcy in exceptional circumstances, which is considered “the lender of last resort” function. However, the Fed has been assumed broader responsibilities since the Great Depression. Namely, it is delegated to attain an efficient and competitive financial system, and a healthy and stable economy by regulating and supervising the operation of the entire financial system.

To decentralize policy-making authority, the nation was divided into 12 districts, each with one Reserve Bank. Among those, New York, Chicago and San Francisco are the largest three across the country. Lending funds to depository institutions, furnishing currency, collecting and clearing checks and transferring funds for depository institutions and handling U.S. government debt and the cash balance are all on the task lists of these Federal Reserve Banks. There are nine directors, six of who are elected by almost 3,000 Member Commercial Banks while the other three are appointed by the Board of Governors, to elect the presidents and other officers for the twelve Federal Reserve Banks. The Fed is governed by the Board of Governors, whose seven members are

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<sup>21</sup> More information refers to: <http://www.federalreserveonline.org/>.

nominated by the president with the advice and consent of the U.S. Senate for a 14-year term. Meanwhile, the board chair performs a 4-year term as the chief spokesperson for the Fed. The Board of Governors is performing the following roles: (1) Setting reserve requirements and approving discount rates as one part of monetary policy; (2) Supervising and regulating member banks and bank holding companies; (3) Establishing and administering protective regulations in consumer finance; and (4) Overseeing Federal Reserve Banks. The Federal Open Market Committee (FOMC) is the principal policy-making body to direct open market operations by formulating monetary policy and overseeing its implementation, which includes seven members of the Board of Governors plus the president of the New York Fed and presidents of four other Reserve Banks.

The Fed chiefly serves four functions: (1) Formulating and implementing monetary policy; (2) Supervising and regulating the financial system; (3) Facilitating the payments mechanism; (4) Operating as the fiscal agent for government. Primarily, the Fed tries to achieve the steady growth in the economy with little inflation in a long term, and to minimize fluctuations in a short term by influencing costs and accessibility of funds in the financial system. The Fed directly affects depository institutions' capability to extend credit, the money supply in the country, and therefore interest rates, while it also influences the spending, producing, borrowing, lending, pricing, and hiring decisions throughout the entire economy. In the second place, the Fed supervises structures and performances of banking institutions by formulating specific rules to promote the safety, soundness, fairness and efficiency of the banking system. In unexpected cases such as banks' failures, the Fed, along with other relevant government agencies, mainly the

Federal Deposit Insurance Corporation, usually put joint efforts in preserving the public's confidence in the financial system foremost by taking exceptional measures like finding a merger partner for the failing institution or even removing the bank's management. Thirdly, the Fed is committed to facilitating the transfer of funds by providing currencies, coins and clearing checks, developing and maintaining a safe and efficient payment mechanism, which is crucial to the success of the financial system. Last but not least, the Fed acts as the fiscal agent of the U.S. government by furnishing the banking services. To be specific, the Fed maintains the Treasury's transactions account, clears Treasury checks, issues and redeems government securities, and deals with foreign governments and foreign central banks on behalf of the U.S. government.

Three policy tools are to a large extent used by the Fed in accomplishing its goals. Open market operations are regarded as the most significant monetary policy tools at the Fed's disposal, which are carried out by the Federal Reserve Bank of New York under the guidance and direction of FOMC, involving buying or selling U.S. government securities by the Fed. Such operations directly affect depository institutions' accessibility to reserves, which governs their ability to make loans and to extend credit in another word. Therefore, the change of reserves through open market operations affects the money supply and credit extension in the economy eventually. Moreover, the Fed also operates a lending facility named the discount window to provide depository institutions funds to borrow if they are ever short of needed and warranted reserve assets. In practice, there are primary, secondary and seasonal credit programs established in January 2003 for discount

window borrowing<sup>22</sup>, however, it is the primary credit rate that is often taken as the discount rate nowadays. More specifically, the rate charged for exceptionally short-term loans, mostly overnight made to depository institutions that are in a fairly good financial condition is the primary credit rate, which fluctuates in response to the change of other short-term rates. While the secondary credit rate refers to the rate of short-term loans to those with financial difficulties, thus is currently set one-half percent higher than the foregoing one. And, seasonal credit is extended to a number of agricultural or seasonal resort communities in need of seasonal funding, which is in value an average of various market rates. Theoretically, since the change of discount rate has a direct effect on the cost of borrowing funds from the Fed, the volume of borrowing would thus be expected to fluctuate correspondingly given other factors. Practically, the Fed only serves as a lender of last resort and lends for extension to depository institutions in exceptional circumstances where it is imperative. The last instrument in the Fed's hand is the reserve requirements, which refers to a certain proportion of checkable deposit liabilities depository institutions are required to hold. For instance, if the Fed is aimed at encouraging lending and investment of depository institutions, it will lower the required reserve ratio thus releasing more funds in the financial system. However, rather than frequently adjusting the reserve requirements, the Fed takes open market operations as the key instrument to implement monetary policy.

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<sup>22</sup> "The restructuring of the discount window at the beginning of 2003, including repositioning the discount rate from below the FOMC's target rate to above the target rate, was designed to improve the window's operation as a mechanism for implementing monetary policy and as a backup source of funds for individual depository institutions."



After the large-scale collapse in financial industry during the Great Depression, the Glass-Steagall Act of 1933 was enacted, that established interest rate ceilings that could be paid to depositors, separated investment and commercial banking, and created the Federal Deposit Insurance Corporation (FDIC). There is a dual banking system in U.S., allowing banks to choose their regulators between the federal government and state governments. More specifically, banks belong to the Fed and subscribe to FDIC deposit insurance are federally chartered banks, called national banks. The state-chartered banks can, if they want, belong to the Fed and/or subscribe to FDIC insurance. As a matter of fact, nearly all banks subscribe to FDIC insurance although only about twenty-five percent have federal charters and belong to the Fed, which tend to be much larger and possess more assets and branches.

### **China's Fiscal Policy**

China's fiscal system can also be basically characterized as centralization, which is practically on account of China's political structure-Communism. Although China has mainly been through three stages of fiscal reforms, they are essentially considered continuous oscillations between centralization and decentralization. Specifically, before 1978, the Chinese central government, to a fairly large extent, was in charge of making decisions in the fiscal system. Thus rigid arrangements and central plans were playing a dominant role in China's fiscal system during that period. During the long period of the highly centralized fiscal setting, the central Ministry of Finance took over most of the fiscal decisions and arrangements with the highest authority in the fiscal system. In fact,

the most conspicuous characteristic of the fiscal system then was “centralized revenue collection and centralized fiscal transfers”(tongshou tongzhi)<sup>23</sup>, which means, the central government was in control of all taxes collected as well as the income distribution. Importantly, China was fairly unitary during the first couple decades right after the founding of the country. And people are relatively conservative and obedient to the central government. Therefore, the distinctly centralized fiscal arrangement did work pretty well in collecting taxes and profits from each province especially at the early stage of this period with the historical background. Although it can hardly be regarded as economically efficient to allocate resources, distribute production and even decide on the consumption according to central policies, the whole unbelievably centralized fiscal system did accumulate a substantial amount of capitals for the preliminary development of a number of fundamental industries. Actually, from the perspective of the income distribution within the realm of the whole nation and the overall sustainable economic growth, the efficiency of a highly centralized operation stands out. While the decentralized governments concern more about the present efficiency of capitals and resources, the central authority may stand at a better position to plan on improving the efficiency in a longer run. In another word, the central government is capable of achieving a sustainable growth through mobilizing capitals across the country with a comparatively fair income distributing arrangement in that context. Otherwise, merely focusing on the short-term development within a relatively narrow scene is very likely to cause inefficient allocation of resources and thus leading to the market failure by local

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<sup>23</sup> J Vivian Zhang, “Guest Editor’s Introduction”, *Chinese Law and Government*, 2004

authorities. While the highly centralized fiscal system did very well in accumulating capitals for the country, it was not efficient enough since the local fiscal revenue and the local fiscal expenditure were disconnected. Fortunately, the Chinese government realized the inefficiency in 1978<sup>24</sup>, so it initiated reforms on the existing centralized fiscal system in order to help the devastated economy to revive. By linking the local revenue to their expenditure within different arrangements, the local incentive was largely enhanced and the entrepreneurial vigor was greatly released since provinces gained substantial autonomy within the budgetary control. The efficiency of the system was therefore significantly improved. However, China's fiscal system was stuck in an awkward position between the completely centralized planning and the perfectly decentralized management. Inevitably, conflicts over fiscal resources among individual provinces and the divergence between central and local preferences greatly arose, which brought about more negative externalities caused by local irresponsible activities. Meanwhile, the informational asymmetry and costly monitoring weakened the central authority's macro control over the national fiscal system, while fostered the regionalism, which went against the requirements of development of the market economy with Chinese features. As a result, a new round of centralization of the fiscal system was carried out in 1994.

Based on the principle of linking fiscal responsibility with fiscal power, the newly implemented tax sharing system strengthened the central fiscal control over the national economy, increased the transparency and predictability of the fiscal system, and was

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<sup>24</sup> The downfall of Gang of Four and the effects of Cultural Revolution marked 1978 for economic revolutions in China.

considered as a remarkable step towards the rationalization and institutionalization of China's economic and political system. Three categories of taxes were stipulated: central taxes, local taxes, and taxes shared between the central and local governments. Central taxes were taxes related to national interests and necessary for the management of the nation. Local taxes included business tax, profits turned in by local-owned enterprises, personal income tax, urban land using tax, fixed assets investment adjustment tax, urban maintenance and construction tax, house property tax, vehicle and vessel usage tax, stamp tax, butchery tax, husbandry tax, tax on special agriculture, tax on use of arable land, tax on contracts, tax on heritage and gift, land value increment tax, and payment from the use of state-owned land. While the central-local shared taxes included value added tax, resource tax, and tax on security exchanges. Equally important, two sets of taxation bureaus were set up to segregate the collection of central and local taxes, which to a great extent strengthened the monitoring of tax collection against the informational asymmetry problems. Since the tax bureaus at local levels were set up by the central government therefore operated independently of local tax bureaus and local governments, the central controlling power over local money was essentially enhanced. Moreover, the new tax system established a mechanism of fiscal transfer between the central and provincial governments. Not only because it increased fiscal revenue for the central government by transferring former local taxes to central taxes, but also in that a new transitional transferring scheme was settled down to maintain and to facilitate the local government's income level other than the tax return to locality under the new tax sharing

system. In addition, the central authority also put a lot of efforts in encouraging local fiscal growth in a variety of political arrangements.

In practice, the tax sharing system was proven to be more suitable to the development of the market economy in China with the following conspicuous advantages. The foremost one is, the central fiscal revenue was substantially increased with the implement of the tax sharing system, and thus the central fiscal authority reinforced its capability of controlling the national economic and political system. Secondly, the tax sharing system was regarded as an institutionalized system, under which, the transaction cost was lowered and the transparency and predictability was increased. Because there was a well specified law and regulation scheme for fiscal revenues, expenditures and transfers as well as a well organized tax collection mechanism. What is more, the regionalized protectionism was successfully broken down in view of the fact that local government didn't necessarily receive more revenue from developing and protecting locally owned enterprises if they were inefficiently run under the new tax regime, where the free-trade theories can be borrowed to make better explanations on the benefits. More specifically, the central or local fiscal revenue under the old fiscal contract system was determined purely by the ownership of enterprises. Therefore, local governments held the strong motivation to encourage local protectionism by implementing biased policies against non-native rivals and offering preferential treatment to local companies, which inevitably distorted the market and seriously hurt the efficiency of free competition. Nevertheless, the tax sharing fiscal system, under which the standardized taxes are put into effect, largely separates the local fiscal revenue from

the ownership of enterprises, if not thoroughly. By promoting free competition in markets and encouraging enterprises to sharpen their competitiveness, local governments improved their balance sheet from the better performance of all enterprises on a whole. Admittedly, the current fiscal system has its drawbacks. For instance, there are poorly regulated extra-budgetary organizations existing; the grassroots levels of the sub-provincial fiscal government may suffer debt crises a lot. Nevertheless, the tax sharing system works fairly well currently.

Influenced by the global financial crisis, the GDP growth unfortunately fell dramatically starting from 2008. To cope with the situation, the Chinese government launched a series of stimulating programs including the stimulus package, which turned out to be successful in stabilizing and reviving the economy. Based on the fact that China has very low budget deficit over the past several years, the Chinese government holds a satisfactory position to supplement the decreased export demand with expansionary fiscal policies. At the same time, the People's Bank of China adopted an expansionary monetary policy to support the expansionary fiscal policy. Owing to the fact that China's financial system is vertically supervised, and also because financial institutions are strictly monitored to operate within separate industries, it is easier for the government to control the situation. More importantly, China's financial market is far from fully-matured compared with those in the United States and Europe, which makes it relatively isolated from those markets, it helps the government in a large degree. Overall, China's performance during the global financial crisis was considered comparatively well.

## **Fiscal Policies in the United States**

In the United States, a number of government institutions are jointly responsible for making fiscal policies. It is the Treasury Department<sup>25</sup> that often develops proposals regarding taxes, which are sent to Congress for examination, amendment or rejection. In reality, Congress examines and amends or rejects the received proposals in committees, with the House Ways and Means Committee<sup>26</sup> and the Senate Finance Committee<sup>27</sup> designated for tax matters. Noticeably, special interests and nonpartisan private representatives have the opportunity to testify on matters important to them as well. The committees take the responsibility of making amendments and reporting bills to Congress on a whole. The House and the Senate then vote respectively before a conference committee rewrites the different versions and reports a compromise measure to both houses for approval. Last, the president accepts or vetoes the legislation. In recent decades, the Executive Office of the President has been playing a more and more significant role in president's decisions considering a great deal of what the president ends up promoting comes from it. However, a large number of political appointees have been put in the White House, which created a multitude of information filters between civil servants and the president since the second half of the 20th century. In the meantime, the head of the president's National Economic Council (NEC)<sup>28</sup>, the former Economic Coordinating Council in the White House has become progressively powerful

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<sup>25</sup> Homepage: <http://www.treasury.gov/Pages/default.aspx>

<sup>26</sup> Homepage: <http://waysandmeans.house.gov/>

<sup>27</sup> Homepage: <http://finance.senate.gov/>

<sup>28</sup> Homepage: <http://www.whitehouse.gov/administration/eop/nec/>

on account of his or her key position in coordinating economic policies from all departments of the executive branches. When it comes to the implementation of tax policies, the Secretary of Treasury is considered the president's lead person, to a certain extent because the Internal Revenue Service (IRS)<sup>29</sup> falls under the Treasury. Before the large-scale growth in staffing of the White House, the Treasury actually possesses considerable influence on president's economic and tax policies, which has unfortunately been undermined because it is increasingly difficult for the Treasury to emanate a rough idea from a political conversation in the White House. In addition, there is a group of nonpolitical appointees mainly composed of economists, lawyers, and a couple accountants reside in the Treasury's Office of Tax Policy (OTP), actively engaging in the development of tax policies, who extensively represent the public interests. Along with the IRS, they write regulations on implementing laws that have already been passed.

According to statistics, federal taxes have remained fundamentally constant given the size of the economy for most of the post-World War II era, climbed to the highest levels in World War II followed with a mild drop in the 1960s. However, after hitting a historical highest level in 2000, taxes slumped to the lowest point since 1950, and then rose modestly afterward. Among the major shifts, increases in Social Security taxes and reductions in corporate tax payments were playing the leading roles. In practice, most growth in tax payments during the postwar period came from the state and local rather than the federal tax increases. Specifically, in the postwar period through 1980, the taxes were essentially raised to support the national defense spending, the expansion of the

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<sup>29</sup> Homepage: <http://www.irs.gov/>



Social Security programs, and building of national highway systems. Early in 1981, President Ronald Reagan proposed two simple but substantial tax reductions to embrace his claim against big government, each of which took partial advantage of a reaction against the impact of inflation on individual tax rates and on the taxation of depreciable capital income. As a matter of fact, he did achieve success in reducing tax rates, accelerating depreciation allowances and increasing defense expenditures. Nevertheless, neither Congress nor the administration initially reduced other expenditures, which made it almost impossible for the fiscal budget to meet the ends. Consequently, political forces were split into a couple groups, among which, some proclaimed the need for further tax cuts while others worked to cut the deficit. Importantly, the president left the public with the impression that he opposed to all taxes, though he eventually accepted many increases. On October 22, 1986, President Reagan signed into law the most sweeping change in the income tax, the Tax Reform Act of 1986 (PL 99-514) in American history. In fact, the Treasury Department released the blueprint in November 1984 and a revised version was put forward by the administration in May 1985. Five months later, the House Ways and Means Committee produced its draft. The Senate Finance Committee approved a separate measure in May the following year. Finally, a conference committee produced a report thrashing out the differences through August, which the House voted on and the Senate cleared in September. When it comes to George H. W. Bush's administration, the administrative spending was raised to higher levels while he avoided tax increases, which led to larger deficit problem at the end of 1980s. Bill Clinton claimed a moderate government by truly throwing a \$500 billion deficit-reduction package in 1990.

Moreover, he was keenly concerned about the size of new programs and proposals in order to stick to his lower budget goals although he turned out failing to essentially cut taxes for the middle-class as asserted in his campaign. As the 21st century began, President George W. Bush basically continuously favored higher spending on medicare and education coupled with sizable tax cuts during his compassionate conservative first governing term. At the beginning of his second term, President Bush embarked on two major domestic initiatives affecting taxes: the Social Security reform and rewriting the tax code, both of which ended up in failures. What is more, the power shift to the Democrats in both houses during the mid-term election dramatically jeopardized his commitment to the 2001 tax cuts. Partially because of the abandon of the fiscal discipline rules on legislators' habits and their almost sole operation on the giveaway side of the budget, increasing expenditures, the fiscal deficit had become extremely high by the time Bush's second term rolled around. As for President Barack Obama's fiscal policy, more details will be discussed especially concerning the stimulus package in the following paragraphs.

## **Conclusion**

The differences between the financial and fiscal systems of China and the United States can be better presented with both political institutional set-ups and economic contexts taken into consideration. Since the Communist Party of China is the only party in power in China's political system, it turns out to be much easier for the Chinese centralized authority to influence the economic system, while the competition between

the Democratic Party and the Republican Party of the United States makes it more difficult for the comparatively decentralized politics to have direct impact on the economic development in the U.S. More specifically, the complicated settings of the election mechanism of the U.S. have unfortunately slowed down the decision-making process of the political system. What is more, Chinese governments are more capable of making decisions in a longer term view, because they possess more political power and retain more secure political positions, which allows them carrying out those policies even with less popularity in an immediate run. However, with the risk of being voted out of the office, the American authorities always have to be extremely sensitive to all citizens' needs. Even worse, in order to satisfy ordinary people, a wealth of programs are actually designed according to what governors think people want rather than in line with ways to benefit the whole economy.

Noticeably, the American-styled federalism is evolved from a highly decentralized political arrangement, in which lower-level governments possess primary authority in some matters. Admittedly, the national government's primacy in setting domestic policy has been gradually secured since the beginning of the past century. The political influence of the central authority, however is still much less compared with that of the Chinese central government on local governments, which contributes to explaining the less efficient and less effective action taken by the U.S. central government for the recovery from the financial crisis.

Furthermore, in entrepreneurs' vocabulary, profit is always the one that plays the most significant role in the decision-making process. As strongly argued by the

neoclassical economists, industrial markets should not be excessively intervened into by the government. To achieve the partial equilibrium of the market, each individual in the market is supposed to act freely in order to fulfill his profitable goals. However, as the leading authorities of a country, governments on the other hand are responsible for facilitating the construction of public goods and supervising externalities of each move of the industrial world to better achieve the national goals on a whole. Especially in the event of the financial crisis, governments tend to make more industrial policies to speed up the recovery of the economy. As a result, more controversies arose between political parties and the market participants.

Due to the different stages of development and the dissimilar political settings of China and the United States, the economies are influenced in completely different ways. As a developing country, China has just experienced, and, to a certain degree, is still experiencing the development of some infant industries. In other words, the domestic market has not yet been fully mature, which makes political intervention more acceptable for individuals in the market. Nevertheless, the fairly developed industrial market in the United States leaves it more challenging for the authorities to justify the necessity of political arrangements. Specifically when it comes to industries that are currently not competitive enough in a free market such as energy, solar, wind and military, support from governments is decisive in the sense of cultivating sustainable development of the country and ensuring the overall security of the nation, which grants those industries more time and a better economic environment to mature. When it comes to the financial and fiscal mechanisms of both countries, the Chinese central banking authority is

apparently endowed with more direct linkages with other parts of the whole system not only because of the stronger political influence, but also on account of the large number of state-owned banking institutions and other corporations in the economic context. Moreover, the Chinese authority possess more dominance over capitals floating in domestic market by imposing strict restrictions on investments of foreign capital. As for the U.S., more private venture capitals are available in the market to accelerate the growth of certain industries, where the flourish of the Silicon Valley is a sparkling example. All in all, being faced with the financial crisis, it takes the American government much more time to take effective action correspondingly than the Chinese government does.

## **Chapter II. Recovery from the Financial Crisis**

### **Background and the impact on the United States and China**

The financial crisis has been wreaking havoc in the economic markets across the world, especially in the United States since August 2007. It is essentially a crisis of credit, which was provoked by a housing bubble in the U.S. economy and aggravated by the financial recklessness in the financial system. Originally, the easy monetary policies and the historically low interest rate offered by the Federal Reserve successfully encouraged the financial institutions to borrow more money with an increased leverage to strengthen the economy, which nevertheless, nurtured the crisis of credits to a certain degree. Meanwhile, a multitude of financial innovations in the financial market disturbed the efficient operation of the financial system, which masked the risks for a relatively long period of time. Influenced by the monetary policies and general surpluses from Japan, China and the Mideast, cheap credits flooded in the United States, which stirred up the innovations of investment products from financial institutions. Also, for almost three decades, the government sponsored enterprise Fannie Mae and Freddie Mac well performed as a support for the government adding their guarantee to "Mortgage-Backed Securities" to ensure their marketability. By identifying prime borrowers with credit scores above a certain limit, the government sponsored enterprise gave out loans correspondingly with principals under a certain dollar threshold. However, along with purely private lenders, they took on up to five trillion US dollar housing exposure with

minimal capital to cover the risk by securitizing sub-prime mortgages, which failed to follow their risk management procedures, and packaging them into "Collateralized Debt Obligations", and then dividing them into three different classes to different investors with different tolerances for risk. Motivated by profits, the credit rating agencies were easily convinced to assign different ratings accordingly. What is worse, regulations and supervisors in the financial system failed to restrain excessive risk taking. Therefore, even when the loans were too risky, the lenders still did not care because they could easily package them into mortgage-backed securities and sell them on to investors who only had asymmetrical information thus heavily relied on the evaluations of rating agencies, which was proved not reliable. Innovative investment product such as the "Adjustable Rate Mortgages" allowing low teaser rates, no down payments, and even the postponement of part of the interest made more and more households, who did not qualify for purchasing houses, or larger houses become eligible to apply for loans, the asset prices rocketed. That is to say, driven by large profits, financial institutions' greed and arrogance, rating agencies' lack of due diligence, and the investors' bubble mentality jointly broke the safety net of the securitization chain. As a result, the increased default led to plummeted asset prices and market-wide bankruptcies.

The most direct impact of the global financial crisis on China is that the benefits and security of the 20,000 trillion US dollars foreign reserves and foreign investment were significantly threatened, including foreign exchange reserves, sovereign funds, certain foreign investments of commercial banks and some Qualified Domestic Institutional

Investors<sup>30</sup>. More specifically, the prices of stocks and bonds in foreign markets plummeted during the financial crisis, which leads to an approximately 20 percent Capital Loss in the whole foreign investment. What is more, the bankruptcies and credit crisis of a number of giant foreign enterprises such as the Lehman Brothers and AIG made those investments substantially shrink. Meanwhile, the potential decrease in the value of Treasury Bonds in the United States, the depreciations of EURO and some other currencies brought about by the global financial crisis in our trade partner countries endangered China's foreign exchange reserves as well. With the national-wide economic recession triggered by the financial crisis in the United States, the domestic consumption was badly impacted, which resulted in a plummet in demand for products from China. In the same vein, the exports to most other developed regions such as the Europe and Australia shrank at the same time. Furthermore, while the exchange rate of Chinese Yuan to US Dollar is gradually rising, those of currencies in other developing countries, neighbors of China like Korea and India decrease on the other hand. Therefore, China's foreign trades were further hurt. Last but not the least, the not yet fully mature financial market in China, which is nowadays closely related to the international financial markets, was unfavorably influenced by the crisis of credits from the global economic and financial markets.

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<sup>30</sup> Refers to the data provided by National Bureau of Statistics of China 2009.



## **Stimulus Packages of the United States and China**

While the Federal Reserve had been cutting interest rates to zero in hope of stimulating the economy, an aggressive fiscal stimulus package, which refers to a temporary infusion of expenditures into the economy by the federal government to raise demand and spur the growth, was agreed to be the best option in such a depressing scenario, where the economy rapidly contracted and the unemployment rate jumped to a 25-year peak. Although some economists think the government debt would use up savings that would otherwise go to investment, most people believe the negative effects would be limited on account of an already stagnating investment.

Accordingly, the American Recovery and Reinvestment Act (ARRA), an economic stimulus package was enacted by the 111th United States Congress in February 2009, following other economic recovery legislation passed in the final year of the Bush presidency including the Economic Stimulus Act of 2008 and the Emergency Economic Stabilization Act of 2008 which created the Troubled Assets Relief Program (TARP). The stimulus was intended to cushion the drop in demand and the subsequent decline in consumer and business confidence, household wealth, and access to credit; To preserve and even create jobs, to spur economic activity and to invest in long-term growth; To alleviate suffering for those most impacted by the recession; And to foster unprecedented levels of accountability and transparency in government spending during the recession.

The economic stimulus package is nominally worth \$787 billion in total, among which about \$499 billion, is devoted to Keynesian-style government spending measures including: increasing domestic spending on infrastructure, education and health care,

research on renewable energy as well as other forms of direct spending excluding transfers by \$224 billion; And making another \$275 billion available for federal contracts, grants and loans. As for the remaining \$288 billion, it took the form of federal tax cuts and benefits, and other social welfare provisions for millions of working families and businesses, such as adjustment of the Alternative Minimum Tax (AMT), business tax incentives, state fiscal relief and aid to those most directly hurt by the recession. Statistically, until the end of December 2009, \$263.3 billion of the original \$787 billion, or roughly one-third of the total, has gone to American households and businesses in the form of tax reductions. An additional \$149.7 billion has been obligated for projects and activities, which will generate economic activities as well because recipients are certain that funds are available once they make expenditures.

Notably, a couple priorities are laid out by President Barack Obama for the country to quickly spur the economic growth and effectively preserve and create jobs in the near term<sup>31</sup>: bolstering small business growth, providing emergency aid to people and places, advancing the energy efficiency of homes, and then expanding investments in transportation and communications infrastructure. Based on the fact that the whole country is suffering from a rampant, double-digit unemployment, the exceptionally high multiplier of investing in infrastructure to create jobs attracts a wealth of attention. It is said, every \$1 billion in federal funds invested in infrastructure creates over 47,000 jobs and \$6.2 billion in economic activity. What is more, investing in infrastructure is also an approach, which is capable of accomplishing both short-term and long-run goals. In other

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<sup>31</sup> According to President's Budget Proposal for 2011.

words, further developing in infrastructure is a very smart strategy that addresses both the long-term objectives for a sustainably growing economy for the future, and the current need to create job opportunities as well.

The issue of infrastructure construction is truly front and center. On one hand, it is significant for the country to remain competitive faced with challenges of rebuilding the economy in an era of fiscal restraint. From the more creative approach, it is one of the best ways to get the investment out of the door as quickly as possible. Because jobs are desperately needed at the moment, given the severity and the depth of the crisis the economy is going through.

The ARRA, to a certain extent, targets at infrastructure development and enhancement. Accordingly, 43 percent, roughly \$335 billion of the total stimulus, in terms of investment priorities is assigned to the main drivers of metropolitan and national prosperity, consisting of innovation, human capital, and infrastructure. Specifically, the Act plans to invest in the domestic renewable energy industry and the weatherizing of 75 percent of federal buildings, as well as more than one million private homes around the country. Moreover, construction and repair of roads and bridges, scientific researches and the expansion of broadband and wireless service are also included as projects that the Recovery Act will fund. While a large amount of projects in ARRA are emphasized more immediately on jump-starting the economy, others, especially those involving infrastructure improvements, are expected to contribute to economic growth for a longer term. Admittedly, some criticism arose about the fact that the legislation gives a full year to merely sign a contract to begin spending half the money, and another year to sign a

contract to spend the second half, making the infrastructure spending too slow, not able to create jobs right away. Additionally, some people are concerned that the enormous overcapacity in the non-residential construction sector may bring about large-scale defaults on relevant loans thus causing banks to suffer another big hit.

The American economy is essentially a network of metropolitan economies, which embrace a fairly large portion of the economic activities. Namely, there are 366 metro areas in the United States, which house 83 percent of the population, and where 88 percent of the GDP is generated. The 100 largest metropolitan areas harbor two-thirds of the population and generate 75 percent of the GDP<sup>32</sup>. Therefore, it is worthwhile for the federal government to make efforts to closely connect the macro growth to the metro development in decision-making to bolster job creations. In practice, the federal government's support on investment in the next generation of infrastructure is playing a critical role for the metros to rebuilt an American economy which is "more export-oriented and less consumption-oriented, more environmentally oriented and less fossil-energy-oriented, more bio- and software-engineering-oriented and less financial-engineering-oriented, more middle-class-oriented and less oriented to income growth that disproportionately favors a very small share of the population", according to Larry Summers (2009). Notably, a sustainable low carbon economy is expected to be constructed through various instruments and market mechanisms under the guidance of government policies; And a clean energy economy needs the collaborative efforts from

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<sup>32</sup> Robert Puentes, "Budeget 2011: Investing in Infrastructure", *The Brookings Institution*, Feb. 04, 2010

scientists, researchers and investors to unleash innovations. Although there is only a relatively small \$1.5 billion program (TIGER Grants)<sup>33</sup> designed to fund competitive grants that support nationally, regionally, or metro-significant projects that may facilitate linking transportation, housing, energy and environmental concerns, it encourages the confidence in building the next generation of transportation infrastructure. And funding for the Transportation Investment-Generating Economic Recovery (TIGER) discretion grants, which is originally devised for the ARRA and uses job creation as a key metric for evaluating applications is expected to increase by the Congress. When it comes to spurring innovation, the budget requests an additional \$5 billion to expand ARRA's Advanced Energy Manufacturing Tax Credit; another \$300 million for the Advanced Research Projects Agency- Energy beyond the \$400 million it received as stimulus; and another \$144 million for smart grid research.

As for the \$5 billion set aside in the ARRA for the U.S. secretary of education, it mainly focuses on four objectives: achieving equity in teacher distribution, improving collection and use of data, enhancing standards and assessment, and supporting struggling schools. As explained by John Irons from the Economic Policy Institute, "We can't ask our kids to be the engine of future economic growth if we put them into schools that are below standard."<sup>34</sup>

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<sup>33</sup> Robert Puentes, "TIGER's Tale and Lessons for Stimulus Spending", *The Brookings Institution*, Feb. 22, 2010

<sup>34</sup> Strobe Talbott, Bruce Katz, John Irons, "Infrastructure Investments, Economic Growth And Jobs", The Bernard L. Schwartz Forum on U.S. Competitiveness, *The Brookings Institution*, October, 2009

The reactions to the stimulus have been divergent since the implementation of the ARRA. A group of people those are comparatively confident about the fiscal stimulus package in raising hope, increasing consumption and therefore restoring the economy, is called the “Animal Spiritualists”<sup>35</sup>. It is believed by this school that, evaluating the impact of counter-cyclical macroeconomic policy is inherently difficult because we do not observe what would have happened to the economy in the absence of policy. In addition, although the real GDP is still far below its previous peak level and millions of Americans are out of work, no economy can be switched from dramatic decline to vigorous growth anyway. Moreover, the current recession follows an anemic recovery from the perspective of the business cycle. It is said, from 2001 to the end of 2007, every economic indicator except for corporate profits hit the weakest performance since World War II. Meanwhile, the percentage of the adults employed did not grow at all even during the expansion phase of the cycle (from Nov. 2001 to Dec. 2007) for the first time in history, which did large damage to working and middle-class households. In their eyes, the ARRA of 2009 is the boldest counter-cyclical fiscal expansion in American history, which has played a key role in the turnaround of the economy that has been occurring. Indeed, real GDP began rising in the third quarter of 2009 in large part because of the tax cuts and spending increases, and job losses in the fourth quarter were only one-tenth their size in the first quarter. It is estimated the stimulus has preserved or created 1.6 million to 1.8 million jobs at the end of the first quarter in 2010, and will generate as many as 2.5

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<sup>35</sup> Philip I. Levy, “Obama’s Pyrrhic Victory on the Stimulus Package”, *American Enterprise Institution*, Feb. 13, 2009

million jobs ultimately. Although the speed of rolling out the stimulus package is questioned by a lot of people, they still believe that the political and fiscal system, which slows down the decision process, actually effectively helped to block a certain amount of undesirable projects.

Another group holds a much more pessimistic view on the impact of the stimulus package. In general, people in this category fundamentally believe the \$787 billion stimulus package is far from adequate to be able to quickly pull the economy out of the deep recession, disregarding the inefficiency of the package itself. They claim the stimulus package should be larger because the economic problem was enormous; more diversified because it is not clear exactly what would work, and reasonably prolonged because the economy seemed to be weakened for several years. As they expect, the coming recovery for employment will take much longer time to reach the pre-recession level and the upcoming economic growth will take the L-shaped or W-shaped instead of a V-shaped pattern to recover. More specifically, with a nearly zero percent interest rate, the room left for monetary policy instruments to stimulate the seriously weakened economy is limited. Thus the \$787 billion stimulus funding was mainly divided into two parts, among which, approximately \$499 billion was allocated to be used as Keynesian-style government spending. While another major part took the form of tax relief. In order to have an instant and evident stimulus effect on the economy, it is agreed by most economists that the federal funds need to be spent as fast as it could be and have the amount of money injected into the economy as soon as possible in the most effective fashion. However, it is extremely difficult for the governments to spend the substantial

amount of money in a fairly short period of time, especially when a multitude of decisions need to be made cautiously, and a great deal of projects need to be planned and carried out. In practice, the Obama Administration only managed to put less than one third of the fiscal stimulus funding into effect before 2010, which was supposed to be the best timing to pull the U.S. economy back onto the track. While the excessive reliance on infrastructural projects, which usually take a relatively longer cycle to be put into effect, makes the stimulus package seem even smaller. What is more, given the fact that the U.S. economy is incredibly enormous, the stimulus amount, which is only half one percent of American one year's GDP, can hardly have a significant positive influence on the depressed domestic economy even if the money could be injected into the economy immediately. Meanwhile, more challenges lie on the tax-relief side because the downturn of the economy, especially the disappointing job markets made people pessimistic about the future thus hurting their expectations of the income. As a result, although the governments pushed very hard to encourage spending by cutting taxes, most individuals and households were just keeping saving more and more instead of stimulating consumption as the governments had expected to offset their lost confidence in their economic life in the future. All in all, to make the giant economy turn around speedily, a much more sizable stimulus spending is imperative. What is more, there are also another group of politicians and economists who believe that increases in government spending are bad for the economy by an means, mainly because the deficits will be accumulated thus hurting the government's ability to support economic behaviors, which makes it more difficult to get higher stimulus spending.



<b>Components of ARRA</b>				
	Total Amount	Share Disbursed by End of Fiscal Year		
	(\$billions)	2009	2010	2011
Discretionary spending(Highways, mass transit, energy efficiency, broadband, education, state aid)	308	11%	47%	72%
Entitlements(Food stamps, unemployment compensation, health IT, Medicaid matching rate, refundable tax credits)	267	32%	73%	91%
Revenues (Personal tax credits, business, energy, infrastructure)	212	31%	116%	119%
<b>Total</b>	<b>787</b>	<b>24%</b>	<b>74%</b>	<b>91%</b>

Source: Data from [www.Recovery.gov](http://www.Recovery.gov)

What is even worse, businesses are showing increasing reluctance to hire workers back in the current economy despite of the multiplied spending from the government and a variety of increased favorable terms and conditions to encourage employment. Statistics released by the Department of Labor revealed the serious problem in job markets. The increase of prolonged unemployment, companied by the expanded reliance on just-in-time employment practices like part-time jobs rather than full-time jobs indicates that job

creation will be moderately slow in the coming recovery. There is little doubt that businesses are lacking the ability for new recruitment, however, it is also the case that more and more businesses are attracted by the benefits of outsourcing production to cheaper labor forces overseas instead of investing in the domestic labor market. Hence, recommendations are made for the government to foster dynamism in the economy by triggering promising industries in which a large number of jobs are expected to be created and to build employability skills for the unemployed.

Consistent with the conservative approach to new recruitment, more and more companies hold a general reluctance for new investment either. Being uneasy about cash flows and being faced with the global price competition, companies are greatly abating excessive assets and cutting back on nonessential investment, which is not only an effect, but also a cause of the moderate economic growth and economic uncertainty. With equipment investment, non-residential construction, residential construction, and consumption all contracting rapidly, and net exports remaining flat, the private sector offers little hope of a turnaround any time soon. Moreover, people in this group have further explained their pessimism with the three constraints the weak economy is still hampered by: deflationary pressure on asset prices, an ongoing struggle in households to balance household budgets and the fragility in financial system. That is another reason that well explains the necessity for a deeper stimulus.

While the stimulus package is obviously winning some economic credits, a couple aspects are questioned mainly concerning the efficiency, effectiveness and the sustainability. Two factors spell out the comparatively slow implementation of the

stimulus. While most spending is going to discretionary projects, which take plenty of time and lots of coordination, the regulatory processes of government are actually purposefully designed to encourage a very prudent and anything but an untidy decision making process, which collaboratively hurt the goal of jump-starting the economy to a certain degree. When talking about the ineffectiveness of the government spending, two other problems are pointed out. Ideally, the part of the stimulus package that provides fiscal relief to state and municipal governments is supposed to offset the reductions in state taxes below where they would have been without the stimulus. However, in the circumstance that a large number of people lost their jobs precipitately, the state tax revenues therefore plummet, which caused terrible shapes of local governments' fiscal budget balance sheets while they are actually faced with the strict restrictions from the constitution of not running too high a deficit. As a result, the local government has to cut the fiscal spending unfortunately, which is why more than half the stimulus package turns out to be in the form of tax reductions rather than government spending. Economists like Bruce Bartlett considered it a huge mistake in the economic sense, which plays a tremendously negative role in spurring the economic growth<sup>36</sup>. A very similar situation would be 'the Fed's passive shrinkage of the money supply in the early 1930s', owing to a much lower multiplier for tax cuts than government spending as shown on the following table. And that is exactly how the influence of the central stimulus package was strongly counteracted by the local and municipal governments' actions. On the other hand, there are a handful of rational taxpayers, who clearly recognize the short-term tax

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<sup>36</sup> Bruce Bartlett, "Do Tax Cuts Starve the Beast?", *The Fiscal Times*, July 14, 2010

cuts must eventually be offset by future tax increases, thus they disregard the impact of the stimulus tax cuts on their current disposable incomes in reality. What is more, a group of people has been paying down debts with the money gained from tax cuts rather than actually spending them. Also, the lost confidence in the economy plays an irreplaceable role in the rise of the saving rate as mentioned above.

ARRA spending and impact on GDP	Multiplier	Amount(Billion \$)			Contribution to GDP (Billion \$)		
		1Q	2Q	3Q	1Q	2Q	3Q
Direct spending	1.6	0.0	5.2	9.2	0.0	8.3	14.7
Aid to states	1.4	8.6	22.6	21.0	12.0	31.6	29.4
Transfers to individuals	1.7	1.3	31.0	18.0	2.1	51.2	29.7
Business tax cuts	0.4	0.0	18.0	22.0	0.0	7.2	8.8
Individual tax cuts	1.3	0.0	8.8	10.5	0.0	11.0	13.1
Total		9.9	85.6	80.7	14.2	109.3	95.7
% of GDP		0.3%	2.4%	2.3%	0.4%	3.1%	2.7%

Source: Data from Recovery.gov, multipliers from Zandi (2009).

Moreover, the President was criticized for the lack of a groundwork for tax reform and fiscal sustainability. Admittedly, deficit reduction was definitely not the right goal in such a weak economy. However, the President is expected to signal the will and the ability to exert fiscal discipline as the economy recovers. It is worried that the proceeding increase in national debt would not only impose a greater burden on future taxpayers, but would also run the risk of raising the long-term rate of interest. To sustain a long-run growth of the economy, it is suggested to work on a more balanced trade pattern by depreciating the dollar. Theoretically, the foreign world will make effort automatically to prevent the dollar depreciating too far because they would be threatened by U.S.

competition while a falling dollar is regarded a necessary development on the path to recovery of the economy.

According to the Congressional Budget Office's study, the most appealing recommendation to improve the stimulus plan turns out to be putting more efforts on unemployment insurance, which not only provides a vital safety net to the unemployed, but also serves as a priceless stimulus by putting money back into the economy. In the view of the fact that the unemployed desperately need the money, they are thus most likely to spend it right away. Although some critics contend that unemployment insurance weakens people's incentive to look for work, it can significantly improve social welfare by providing a relatively strong safety net in the regard of health and even mortality. Importantly, a high fraction of the unemployed people who can not enjoy a sufficient benefits will end up dropping out of the labor force permanently in order to live on Social Security disability without paying taxes anymore. Therefore, expanding the unemployment insurance is the fiscally responsible choice with those outcomes taken into consideration. By the same token, increasing the amount of paid time off per worker, in the forms of paid family leave, paid sick days, paid vacation days or a shorter workweek suggested by Dean Baker<sup>37</sup>, is believed to be an effective mechanism of both boosting demand and greatly expanding work opportunities at every level of GDP.

Coincidentally or not, China was in a fairly good position when the global financial crisis hit its market, which made satisfactory preparations for both the fiscal and

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<sup>37</sup> Eileen Appelbaum, Dean Baker And John Schmitt, "The Need for an Economic Stimulus Package", *The Brookings Institution*, January 2008

monetary authorities to carry out stimulus plans. First of all, the mammoth amount of trade surpluses over years built up a huge foreign currency reserve for China, while a government budget surplus had been accumulated for several years in a row. Meanwhile, monetary policies had been raising interest rates to curb the excessive growth and overflowing credit. Therefore, lowering interest rates, expanding government spending, freeing up credit, encouraging investments and cheering consumers to spend more are all smoothly incorporated in the Chinese Government's stimulus package, which is globally regarded as a remarkably forceful, dynamic and effective commitment to solving the financial problems.

China's rapid implementation in rolling out the stimulus package, which consists of sizable-scale stimulus programs in propelling economic expansion, turns out to be extraordinarily impressive to the whole world mainly because of its highly centralized economic and political institutional settings and the special development stage the country is in. Noticeably, it is not only because of the ample liquidity China's banks possess, but also on account of the exceptional efficiency of the Chinese authorities to ease up on credit, which makes Chinese Government stand out from the rest of the world. In fact, most of the leading banks and enterprises in China are still controlled by the state despite of almost three decades of quasi-capitalism, which grants the Chinese Government a phenomenal influence over the economy compared with other governments. According to the stimulus package, all projects applying for the stimulus funding need to be approved by the central government of China, and will be distributed and implemented at the lower-level authorities. In practice, the National Development

and Reform Commission (NDRC)<sup>38</sup>, China's key economic planning organization, a provincial government or municipality typically solicits such project proposals and applications, which are then reviewed by the NDRC and other relevant ministries, such as Ministry of Transportation<sup>39</sup>, Ministry of Commerce<sup>40</sup>, etc., according to the potential of the project on stimulating economic growth, as well as the applicant's capability of raising adequate funds in other complimentary ways to ensure the implement of the proposed project. As a matter of fact, in order to achieve an impressive economic and thus political performance, the provincial governments took the initiatives to seeking loans and funding their local development projects. Although China's local governments are banned from issuing debt, securing bank loans or using government assets as collateral for loans by China's Budget Law, they have actually set up a wide variety of financing vehicles to accomplish their goals. What is more, a fairly proactive fiscal policy is part of China's stimulus package as well, which encourages state-owned banks to loosen credit and lend more freely predominantly to state-owned enterprises, some domestic private enterprises and provincial investment vehicles by counteracting the credit frozen effect from the global financial market. As a result, China's economic market is immediately flooded with loans once the central government make orders while the Obama Administration is struggling to get American banks to lend given issues such as anti-government ideology. The special arrangement of state intervention, market power and dictatorship in China is regarded as a better catalyst than most other developed

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<sup>38</sup> Refers to <http://en.ndrc.gov.cn/>

<sup>39</sup> Refers to <http://www.mto.gov.on.ca>

<sup>40</sup> Refers to <http://www.mofcom.gov.cn/>

countries in government spending and loan boosting. According to the China Banking Regulatory Commission, led by state-owned banks, domestic banks ended up extending a total of approximately 9.6 trillion yuan, doubling the target in loans to support the stimulating economic development. It is also reported by the National Audit Office that around nine percent of local governments' new debts in 2009 were involved in the investment in the central government's 4 trillion yuan stimulus package projects.

Following the Keynesian idea that, when the economy itself appears relatively weak, it is time for the government to start spending more through short-term investments to stimulate the economic growth, the Chinese government in practice adopted both a proactive fiscal policy and appropriately accommodative monetary policy to stimulate the economy when the global financial crisis bore down on China.

China's stimulus package sets a goal of adding one percentage point to the country's gross domestic product by building infrastructure, cutting business taxes and encouraging banks to lend money, all in a bid to invigorate the investments and boost the spending power of its own consumers instead of relying on exports. According to the Chinese government, its fiscal policy embraces the 4 trillion yuan (\$586 billion) stimulus plan, one-quarter of which turned out being paid by the central government while the rest was either borrowed by lower-level governments from state banks or supported by state-owned enterprises, which would be impossible to achieve in the United States given the relatively loose financial relations. And half of the stimulating investment funding planned to be spent on basic infrastructure; 500 billion yuan (\$74 billion) would be used to offset the tax cuts from the value-added tax reform; While some other would be



allocated to increase export rebates. At the end of 2009, a considerable proportion of the loans, which is worth almost 2.79 trillion yuan of debt were used to finance transportation and other infrastructure facilities according to the National Audit Office. In addition, 10 key sectors, including the steel, auto, textile, machinery, electronics and shipbuilding industries were principally targeted in a separate industrial developing plan. What is more, improving the living standards by further developing social security programs for both urban and rural poor was comprised in China's stimulus plan as well.

Based on the fact that China had just launched a large-scale urbanization across the country when the global financial crisis occurred, the economy was in need of numerous investments in infrastructure; Construction is the industry in the economy that slowed down the most thus calling for support. Millions of jobs could be created in infrastructure construction. And, China survived from the Asian financial crisis, which took place in 1998 with a quick payoff after it poured money into infrastructure. Infrastructure construction is inevitably singled out to play a significant role in the stimulus plan to lift the country out of the doldrums. As funding for railways, airports, metro systems and power plants is substantially increased to local governments, financial institutions and large state-owned enterprises, the steel-makers, cement producers and construction companies are witnessing sales soar even amid the crisis. It is said that China will have a \$200 billion budget on railways in the next two years, and plans to build 44,000 miles of new roads and 100 new airports in the next decade, while two out of the world's three largest ports are in China, Shanghai and Hong Kong respectively. Meanwhile, new technologies such as solar, wind and battery technology also have caught the Chinese

Government's attention for the future growth. Not surprisingly, automobile sales surged following a cut in taxes on smaller vehicles that took effect at the beginning of 2009. As for manufacturing, the value-added industrial output was reported to be in a continuous expansion, in spite of the decline in exports, by the National Bureau of Statistics at the end of the same year.

With a shrinking export market, it is imperative for the Chinese government to construct consumer confidence by improving people's living standards and strengthening the social safety net through offering better social security programs in education, health care to support domestic consumer spending thus reducing Chinese economy's heavy reliance on exports. In practice, \$125 billion was in the budget to build hospitals, to broaden medical insurance coverage, as well as to expand its pension program. Since China embraces an exceptionally high rate of savings, there exists plenty of room for the government to unleash potential capabilities in consumer spending. As long as the government could successfully boost consumer confidence through the improvement of social welfare benefits. Comparatively, the government in the United States is faced with a rather different situation, where consumers do not possess a decent amount of savings and even struggle with the overflow of house debts. In the meantime, the central government of China has loosened the restrictions on foreign investments to a certain extent, which has contributed to providing jobs and introducing new technology and management practices into Chinese market.

Joseph Stiglitz, one of the optimists once commented on China's stimulus package, "Now they have the fastest trains in the world. When completed, that will leave them in a

position for faster growth.”<sup>41</sup> Admittedly, while China’s stimulus package has accomplished prominent economic growth, there are a couple negative influences brought by the stimulus package as well.

For both infrastructure construction and the social security systems, which China has invested heavily on, an appreciable amount of follow-up funding is necessary for lasting development. However, it might be dangerous from the perspectives of both the government’s debt and inflation, especially in the housing market, if credits are continuously poured into the economy in a large amount. Importantly, China has to make sure the scale of the debts it takes on is controllable, which means the burden of the debt can be taken in by a lasting economic growth in the future. Another concern on the huge amount of debt from state-owned enterprises arises in this economy particularly because of the special settings where they play an irreplaceable role in the economic development. Namely, the lack of competition from free market economy and the inefficiency of the highly centrally controlled system put the quality of the debts in risk as well. As for the property prices, China had been implementing tightening policies to stabilize the increased housing prices since 2007, caused by both the capital withdrawal from the real economy as a result of industrial overcapacity in 2004 and a massive capital inflow in response to the renminbi exchange rate reform in 2005. However, the monetary policies and fiscal measures to mitigate housing prices were unfortunately put to a quick end by the unexpected financial crisis in 2008, leaving the Chinese housing market already fragile by itself. The matter was actually worsened by the abundant internal monetary

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<sup>41</sup> Joseph Stiglitz, Nathan Gardels, “Time for a Second Stimulus”, *NPQ* Spring 2010

oversupply for the stimulus purpose to offset the negative effect of the global financial crisis. Unfortunately, while the national economic growth was indeed fueled by the historically large amount of money spared by the governments, the housing market began experiencing a price rocket as well. Depending on the fact that how gigantic an amount of stimulus funding was spent within such a short period, it is worth suspecting that a certain portion of the money has already been spilled in stocks and real estate markets for speculation rather than investments in infrastructure and social welfare benefits to bring about a lasting economic recovery. What makes the situation even more dangerous is the exceptional economic recovery successfully triggered by China's stimulus package in the Chinese market is inevitably attracting the considerable amount of speculative foreign capitals flowing into the domestic economy, especially the housing market, which intensifies the pressure on the demand side. The international inflow of 'hot money' merely focusing on speculative opportunities will consequently endanger China's economy by creating bubbles in the asset market.

As a matter of fact, China has been witnessing volatile movements of prices in housing market caused by excessive speculative booms since 2003. Especially recently, a new periodically rocketing price trend can be effortlessly observed from the chart below. In general, China's housing market can be better understood if we approach it from both the supply and the demand sides.



Source: National Bureau of Statistics of China

The most distinct feature in China's housing market is that the supply is not naturally responsive to the demand in the market, which completely violates the theoretical roles in an ideal economic world. To explain the distorted situation in China's economy, the following three perspectives stand out. First of all, still being strongly influenced by the Chinese characteristic socialism regime, the rights of the country's land development are predominantly within the control of local and municipal government, who plays the role as a 'visible hand' in the market by setting up regulations and dictations, however, has yet to act as a mature manager of the economy. That is to say, the land in China is not considered a normal commodity whose price is decided by the joint efforts from both the supply and the demand. Because except from the governments, nearly no one possesses any rights to decide on the usage and development of it. At the same time, China is experiencing a deeper marketization up to the present time, which leaves Chinese government comparatively inexperienced in efficiently operating the asset market.

Secondly, the real estate management is in the form of a streaming layer model, in which, hundreds of authorizations from dozens of government organizations are usually requested for a single project. Namely, to get the approval of using or developing a certain piece of land, a company on average needs to deal with no less than 10 different government organizations individually before any practical action is ever taken. The costs of supply are therefore elevated significantly, a considerable part of which does not even involve the development and the supply itself. As a matter of fact, the special procedures widely-existed in the Chinese asset market in turn to a great extent contribute to breeding the bribe and corruption problems of government officials, which considerably hampered the effectiveness of the market as well. Moreover, GDP is taken as an important factor in assessing the performance of local government, which turned out to predominantly encourage the local officials to blindly push up land prices over transactions simply aiming at raising the GDP, as the transaction of land is counted in summing up GDP in China. As a result, the distorted pricing system of land, which for the most part is influenced by China's special political setting, lays an unfavorable foundation for dragging the housing price back on track thus helping to mitigate the housing bubble in the asset market.

Meanwhile, the demand for housing in China is dramatically overheated compared with other parts of the world. As well known, most Chinese households are substantially influenced by the conservative Chinese culture and traditions that, basically the life goal is to save money as much as possible through hard working. Therefore the majority of Chinese people live an insanely busy life by working indigently to make money and then

to save as much as they can without hesitation. It is always encouraged in Chinese culture to live a frugal life while enjoyment is normally discouraged. Moreover, the social security welfare is still comparatively poor compared with those in the developed countries, which further strengthens Chinese people's belief in keeping a tremendous amount of savings for safety and for retirement. Also, the idea of 'Respect the old and cherish the young' in Chinese culture fosters a distinctive habit of Chinese people to save for the younger generations' education, marriage and even houses no matter how old they are as long as the parents are capable of, which in practice supports the remarkably high saving rate. Furthermore, with an exceptionally large amount of savings held in their hands, Chinese households and individuals do not have as diversified investment instruments as those in other advanced countries do. Actually, neither the financial market nor the financial institutions has been fully developed yet, the scarcity of investment opportunities in Chinese market aggravates the saving instead of investing plight. Without a variety of investing opportunities, the housing market stands out acting as a prominent investing option for millions of Chinese households and individual, most of who are not well educated about the financial world, especially when the central bank of China set a relatively low interest rate, making the traditional saving fashion lose its glory. In the same vein, when it comes to investment for business, a great deal of funding from investors, another group of people with the ample possess of capital resources is pushed into the real estate market rather than other industries on account of the unsatisfactory investing environment in China, which is to a certain degree unfair, lacking transparency and yet to be better regulated to attract more investment. According

to statistics, the private investment for business in China is 20% less as a share of GDP than that in a developed country. Furthermore, inflow of foreign capitals for speculation are disturbing China's housing market by overheating the demand on a whole.

All in all, it is the characteristics of both the supply and demand aspects in China's asset market that determine an oversupplied monetary and fiscal policies in China is fairly likely to endanger the safety of the housing market. And the speculative bubble in China's housing market would inevitably threaten the stability of the whole society, a set of measures have been accordingly taken by the government including raising sales tax on real estate transactions, proposing to impose an annual property tax on certain residential housing and implicit restrictions on the lending for housing purchases banks and other financial institutions make to rein the madly growing property price.

The second concern about the package is regarding the non-performing loans in the banking system because, to a great extent, banks are politically manipulated by the central government to bolster the stimulus plan. However, China's comparatively immature banking system can not afford the burden of a huge amount of loans if the world economy does not recover soon enough. When smaller banks exceedingly exposed to loans to small and medium-size firms are considered at risk, state-owned banks mainly carrying infrastructure loans also cannot be exempt from being hit in a surge of non-performing loans. In response to pressure from the government to free up credit with the hope to spur the growth, Chinese bank lending was pushed to increase rapidly, which implies the possibility of loosening lending standards in the banking system. Moreover, under the GDP-oriented mechanism for government performance evaluation, local



governments initiated the flood of ambitious spending proposals not limited in infrastructure to pursue a higher GDP growth locally. Given the speed at which the loans are being issued, it is reasonable to question the quality of the projects financed and the discipline of the financing.

Not only in the housing market, the substantial amount of stimulus funding poured into China's economy in such a short period of time actually causes over investment and over capacity in automobiles, steel, semiconductors, cement and aluminum sectors as well, where the factories were left saddled with excess capacity of production because of the weakened internal and external consumption demand. As China has been playing a significant role in acting as a well-known world's factory, the production capability in a couple of major industries has already been satisfying the world's need for a relatively long time, where more spending on environment protection will help to healthily balance the economy. Obviously, the export-oriented industries have been performing a more and more irreplaceable role in China's economy. However, heavily influenced by the global financial crisis, demand from a number of principal foreign markets, as well as the domestic market has been exceptionally plummeting, which has seriously hurt the Chinese economy especially those export-oriented sectors. To offset the negative effect from the financial crisis on the economy, the Chinese government has taken a sizable stimulus package into effect to fuel the slowed-down economic growth. Local and municipal governments on all levels, following the central government's policy, have taken joint effort to increase investment in various projects in a certain areas such as infrastructure and transportations. Inherent in China's political system, local governor's

political performance is always taken as being reflected by the local GDP, which leads to a fiercely blind competition in applying for the stimulus funding to invest in the encouraged industries among all provincial authorities. Noticeably, the local deficits are thus enlarged because of the increasing investment, which eventually results in a heavier burden on the local residents. Meanwhile, the flooding investment in new projects not only hurts the potential investment from the enterprises, which would in turn benefit China's further marketization, but also impedes local government's capability of offering social welfare thus encourage consumption. Moreover, most of the newly invested projects require a even larger amount of following-up funding to ensure the sustainable development, which puts fairly high pressure on the local governments and as a consequence would do harm on speeding household's consumption to the same token. Faced with a tremendously weakened external demand, quite a few industries in the economy have been seriously challenged. The emerging increased investment is definitely putting more pressure on the existed over-capacity in the certain industries without a strengthened domestic consumption trend. On the contrary, when it comes to the U.S. economy, American households are on a whole comparatively willing to hold more debt for their consumption. It is partially because of a completely different culture and tradition. And also, China helped to keep the interest rates low by holding the dollars and Treasury bills to a certain degree turns out to be supporting American consumption relying on the inexpensive debt in the meantime. That being the case, American should probably start consuming less with the credit cards while Chinese, on the other hand are encouraged to do so.

As for the difficulties of supervising the effectiveness and efficiency of spending across the local government level, potential wasteful spending and rising corruption certainly exist specifically with an expansion in government-sponsored investment. It is said that some local governments are even involved in retiring their older debts with the stimulus money, which heavily damaged the effectiveness of the macro stimulus plan. Several terms have been set up to regulate local governments' action. For instance, local governments are not permitted to use stimulus funds to build office buildings for their own use or to support industries that run afoul of environmental codes.

As talked above, it is doubtful in a large scale that the stimulus policy responses of the U.S. government were in general "too late and far too small"<sup>42</sup> to have enough impact on the downturning economy. Specifically, the economic crisis brought the unemployment rate in the U.S. to historical high double digits, and the numbers of unemployed, discouraged, and involuntary part-time workers rocketed in 2008 and 2009. Unfortunately, employment in virtually all occupational classes had kept falling while nearly all alternative measures of labor underutilization had sharply risen. Moreover, men in the central working age group (25 to 54 years) ended up losing most jobs in quantity. Relatively less educated workers were more adversely affected by the poor labor market conditions. More people accepted part-time jobs because of economic reasons and long-term employment plummeted. At the same time, China's labor market seemed to have turned in a better report by not losing a lot of jobs despite the substantial hit from the

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<sup>42</sup> Dean Baker, "The Housing Crash Recession and the Case for a Third Stimulus", *Brookings Institution Press*, March 2009

external markets. Although the U.S. government took action in stimulating the economy at the beginning of 2009, the national job market disappointedly does not show any explicit evidence of robust recovery in the short term. Admittedly, the unemployment rate did statistically fall under double digits in 2010. According to a host of economists, the real unemployment rates, including people who are pathetically forced to accept part-time jobs because they have to cover the living expenses, and those who reluctantly turn to permanent disability welfare thus being driven out of the labor force forever are in fact much higher than the nominal ones. On the other hand, China's stimulus package seems to have a fairly positive influence on expanding the work opportunities especially in the infrastructure industry, which to a certain degree made up to the loss mainly in exporting-orientated industries as shown from the following statistics.

<b>U.S. Unemployment Rate (% , 16 years and over)</b>												
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2010	9.7	9.7	9.7	9.9	9.7							
2009	7.7	8.2	8.6	8.9	9.4	9.5	9.4	9.7	9.8	10.1	10.0	10.0
2008	5.0	4.8	5.1	5.0	5.4	5.5	5.8	6.1	6.2	6.6	6.9	7.4
2007	4.6	4.5	4.4	4.5	4.4	4.6	4.6	4.6	4.7	4.7	4.7	5.0

Source: U.S. Bureau of Labor Statistics

<b>China Unemployment Rate (% of Labor Force)</b>				
Year	Q 1	Q2	Q3	Q4
2010	4.2			
2009	4.3	4.3	4.3	4.3
2008	4.0	4.0	4.0	4.2
2007	4.1	4.1	4.0	4.0

Source: National Bureau of Statistics of China

Satisfactorily, the real GDP of the U.S. is steadily climbing up from the third quarter of 2009, based on the Bureau of Economic Analysis, which principally demonstrated contributions from personal consumption expenditures, defense expenditures, private inventory liquidation, exports primarily in equipment and software, and nonresidential fixed investment. As indicated in the table below, the 3.2% annualized pace was slower than the 5.6% in the fourth quarter 2009, the slight trend of growth nevertheless seems to be agreed by both economic optimists and pessimists to be between 1.5%-2.0% and 3.0%-3.5% this year. What is more, a less aggressive fiscal spending level has been recognized by both groups as the stimulus package runs its course. Notwithstanding, the drag from nonresidential structures is cheerfully lessening, and the personal consumption expenditures and business investment may jointly support the economic growth. Meanwhile, although net export of U.S. does not play as significant a role as rest of the world's in economic growth, the fact that the U.S. dollar is fall against the other major currencies claims a promising increase in exports.

When it comes to China, the government's stimulus package was proven to be more effective in the economic system. First of all, when the authorities decided to focus on infrastructure, a large amount of loans are directed to state-owned corporations by the brute force of the government to be invested in building everything from high-speed rail networks, new highways to bridges across the country. What is more, the different stage of development actually sets a better tone for the stimulus package in China to work. Because a lot of economic behaviors can be created by the new constructions while

rebuilding and renovating has very limited effect on expanding the economy. In the same vein, some other sectors easily benefited from the government's aggressive spending as well. Noticeably, the stimulus spending from the government had been slowed down last year (2010) to a certain extent. However, the effect was almost offset by the increased investment in real estate and the growth of personal consumption expenditures based on the pleasant job market performance. All the foregoing factors pretty much explained the continuously high-speed growth of China's socialistic market economy after the global financial crisis. However, government's deficits have experienced an abrupt increase since 2008, and even reached an historical high level as a consequence of a great deal of stimulus spending.

<b>U.S. GDP Growth Rate (Annual GDP growth adjusted by inflation)</b>					
Year	Q 1	Q 2	Q 3	Q 4	Average
2010	3.20				3.00
2009	-6.40	-0.70	2.20	5.60	0.18
2008	-0.70	1.50	-2.70	-5.40	-1.83
2007	1.20	3.20	3.60	2.10	2.53

Source: U.S. Bureau of Economic Analysis

<b>China GDP Growth Rate (Annual GDP growth adjusted by inflation)</b>					
Year	Q 1	Q 2	Q 3	Q 4	Average
2010	11.90				11.90
2009	6.20	7.90	9.10	10.70	8.48
2008	10.60	10.10	9.00	6.80	9.13
2007	13.00	12.60	11.50	11.20	12.08

Source: National Bureau of Statistics of China

<b>U.S. Government Budget (Billion \$, Deficit (-) or Surplus)</b>					
Year	Revenues	Budget	Social Security	Total	Debt Held by the Public
2009	2,105	-1,551	137	-1,414	7,544
2008	2,524	-642	186	-459	5,803
2007	2,568	-342	187	-161	5,035

Source: U.S. Congressional Budget Office

<b>China Government Budget (Billion \$)</b>		
Year	Revenues	Budget
2010	850	
2009	750	750
2008	180	180

Source: Ministry of Finance People's Republic of China

When we talk about the U.S. Consumer Price Index, the Fed anticipated that a subdued inflation would remain over the next several years, which is helpful to the economic recovery. Alongside the high praise of the superb performance of China's stimulus package, worries about the country arose that the economy may be overheating. Since Chinese state-controlled enterprises dominate the economy and enjoy plenty of advantages of political arrangements, a large amount of money from the stimulus package were sent to those companies especially in the infrastructure and energy sectors, which satisfactorily generated high-speed recovery of the economy within a fairly short period of time. Nevertheless, to sustain the growth rate thus providing enough job opportunities for the large population entering the labor force each year, further tapping the domestic market and releasing more tightly regulated sector are imperative. Obviously, the two-

digit GDP growth rate in the first quarter 2010, continually soaring growth rates in the 12-Month based Consumer Price Index from the beginning of 2010, together with the accelerating rise in real estate prices fuels the fears the economy may overheat.

U.S. CPI 12-Month Percent Changes (Not Seasonally Adjusted)												
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2010	2.6	2.1	2.3	2.2	2.0							
2009	0.0	0.2	-0.4	-0.7	-1.3	-1.4	-2.1	-1.5	-1.3	-0.2	1.8	2.7
2008	4.3	4.0	4.0	3.9	4.2	5.0	5.6	5.4	4.9	3.7	1.1	0.1
2007	2.1	2.4	2.8	2.6	2.7	2.7	2.4	2.0	2.8	3.5	4.3	4.1

Source: U.S. Bureau of Labor Statistics

China CPI 12-Month Percent Changes												
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2010	1.5	2.7	2.4	2.8	3.1							
2009	1.0	-1.6	-1.2	-1.5	-1.4	-1.7	-1.8	-1.2	-0.8	-0.5	0.6	1.9
2008	7.1	8.7	8.3	8.5	7.7	7.1	6.3	4.9	4.6	4.0	2.4	1.2
2007	2.2	2.7	3.3	3.0	3.4	4.4	5.6	6.5	6.2	6.5	6.9	6.5

Source: National Bureau of Statistics of China



### **Chapter III. Trade**

As one of the world's largest exporters and importers, China now is playing a significant role in changing the landscape of the international trade around the world. However, in recent years, China has become a major target for antidumping action especially by United States on account of its huge trade deficit with China. From the point of view of the United States, there are a number of factors which to a relatively large degree explained the situation: government subsidies and preferences for some domestic infant industries; failure to reach international labor standards by well protecting labor rights; intellectual property rights and environment involving concerns and some other invisible barriers for some American exports entering China's market, which jointly contribute to the huge trade deficits between the two countries. Since it is claimed that, the devaluation of the currency would gain a country international competitiveness thus improving the trade balance, more and more tensions are put onto China of exchange rate manipulation with the enlarged trade imbalance. In practice, the Chinese yuan had been basically fixed and inconvertible, which was restrictively controlled by the government for a fairly long time. Not surprisingly, China announced the action of adopting a "flexible" exchange rate for the yuan in June, 2010 under the pressure of US and other countries. Nevertheless, it has also been argued it is China's immature financial system that brings about the huge account surplus China currently have pretty much as we have been talking about in the foregoing section. Namely, private

savings in China do not have a variety of options for investing on account of its dysfunctional financial system, which fails to intermediate the growing savings into effective investments, thus leading to an extraordinarily high saving rate. Therefore, to expand state expenditure on infrastructure and health programs, for instance, and to increase consumption by reducing investment are commonly encouraged for China's economy. Paradoxically, without adequate domestic capital accumulation, the expansion of output capacity can not be achieved, which sets the limit for consumption eventually. Accordingly, stimulating consumption should only be to the extent of reducing the trade surplus rather than at the expense of domestic capital accumulation through building up a modern financial system, where more sophisticated investment products could be furnished and more discrimination against private investors would be diminished. What is more, a slowdown in investment will also hurt China's capability of technological innovating and upgrading. On the other hand, instead of merely putting pressure on the appreciation of Chinese currencies, by reinforcing social safety nets, upgrading labor's skills and strengthening the competencies in production, the United States would be able to improve not only its own trade balance, but also the global welfare gained from free trade. In the same vein, a stronger social safety net and an advanced unemployment insurance will help the consumers to gain confidence in spending thus accelerating the stimulus to the economy as well.

With the deeper engagement of both the United States and China in mutual trade, the debate over trade imbalance between them is correspondingly heating up. Statistically,

the trade deficit with China amounted to nearly \$227 billion in 2009<sup>43</sup>, which is almost two-thirds of the overall US trade deficit of \$365 billion and about 1.6 percent of US GDP. Accordingly, China held around \$284 billion surplus in the same year, a fairly large portion of which is invested in US Treasury bond markets as the stock of foreign exchange reserves. At the end of 2009, China's total stock of foreign exchange reserves reached \$2.4 trillion, which accounts for about two-thirds of its gross foreign assets<sup>44</sup>. Therefore, pressure increasingly fell on China's currency especially from the United States, which claims the Chinese currency yuan is undervalued. More specifically, the US trade deficit would be considerably reduced and the employment would be increased by appreciating yuan thus raising prices of Chinese exports. However, the relative value of the yuan to the dollar rose by 20 percent between 2005 and 2008, while the US trade deficit with China actually increased 33 percent during the same time frame<sup>45</sup>, which indicates the value of the yuan is not, or at least not the main driver of the US trade deficit with China. Meanwhile, with the concern of financial instability through speculative capital inflow, asset bubbles and nominal shocks to the export sectors, Chinese government decided to make more effort on building a more modernized market economy through structural and institutional transformation to increase Chinese consumption and make domestic investment more efficient instead. Given the mutual dependence through cross-border investment, consumption markets and debt financing

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<sup>43</sup> Dick K. Nanto, J. Michael Donnelly, "U.S. International Trade: Trends and Forecasts", *Congressional Research Service*, Oct. 15, 2010

<sup>44</sup> According to the data from National Bureau of Statistics of China.

<sup>45</sup> Mark Wu, "China's Currency Is Not Our Problem", *The New York Times*, Jan. 17, 2011

between the United States and China, a stable yuan to dollar exchange rate benefits both countries in a long run.

Although President Obama announced a new goal to double exports over the next five years in July 2010, it is not easy for the US to improve the trade balance with China in practice, which is disadvantageous to the economy's recovery in the United States. The predominant factor is China's comparatively low unit labor cost, where labor is the most significant component of most goods exported to the US from China. In another word, lower unit labor cost differentials play an important role in explaining China's net export advantage because United States exporters face a intensely tough price competition with relatively higher production costs. Admittedly, much more industries have been involved in import sectors from china during the past decades, and US workers are still around five times as productive as their Chinese counterparts, average wages in the US is still about 10 and even 20 times higher than those paid to Chinese workers not merely in lower end of the wage scale<sup>46</sup>.

As a matter of fact, the unit labor cost is the money wage divided by labor productivity<sup>47</sup>. Comparatively, the money wages in the United States are so much higher than those in China because of multiple factors, such as average living standards, sizes of the population and its growth and etc. Meanwhile, the labor productivity is mainly determined by efficiency of production, which is directly related to technology, education and etc. Seeing that the two countries are completely in different stages of development,

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<sup>46</sup> Refers to data from National Bureau of Statistics of China.

<sup>47</sup> Tracy Mott, "Wage, Mark-up, and Productivity Competition in International Trade from A Kaleckian Perspective", June 2011

the United States is far more advanced in both technical innovations and management, while the similar industries in China are highly challenged in terms of increasing productivity. As shown below, the average money wages for workers in manufacturing in China is roughly around 4% to 10% of the American workers in similar industries when the productivity differences range from 8% to 16% given the fact that technology and information are easy to be transferred. When the differences between the money wage levels in the United States and China are bigger than the differences of productivity for the two countries, the unit labor costs in the United States turn out to be so much higher than those in China especially in industries such as manufacturing, which play the dominant roles in the imbalanced international trade pattern. Therefore, if money wages for Chinese labor force rise, the upgraded labor skills and the improved productivity in China will surely relieve the pressure from the American labor force through international trade while the bilateral trade plays a more active role in improving the welfare of people in both countries.

<b>Weekly earnings of production and non-supervisory workers (Dollars)</b>						
	2000	2004	2005	2006	2007	
<b>United States</b>	579.22	580.84	578.19	584.04	589.72	
	Source: The State of Working America 2008-10					
<b>Monthly average money wage in Manufacturing (Dollars)</b>						
	2000	2004	2005	2006	2007	2008
<b>China</b>	88.07	141.30	159.74	188.33	228.99	292.17
	Source: International Labor Organization Database					

	<b>GDP per person employed(US \$) (Constant 1999 US \$ at Purchasing Power Parity)</b>					
<b>United States</b>	57909	61919	62655	63207	63783	65489
<b>China</b>	4660	7048	7710	8536	9574	10378
Source:World Bank Database						

	<b>Productivity(US \$/hr) (Constant 1999 US \$ at Purchasing Power Parity)</b>					
	2000	2004	2005	2006	2007	2008
<b>United States</b>	29.0	31.0	31.3	31.6	31.9	32.7
<b>China</b>	2.3	3.5	3.9	4.3	4.8	5.2

Calculated according to the data above: Productivity= GDP per person employed/Hours  
(Assuming 8\*5\*50 hours per employ per year)

	<b>Unit Labor Cost (Dollars)</b>					
	2000	2004	2005	2006	2007	2008
<b>United States</b>	20.0	18.7	18.5	18.5	18.5	
<b>China</b>	9.6	10.1	10.2	10.9	11.9	14.0

Unit Labor Cost = Money Wages/ Productivity

In the past few years, the average money wage in China has witnessed a rise, especially in state-owned enterprises in major provinces including Beijing and Shenzhen. However, given the dramatically increased general price level, a real wage increase is doubtful. Theoretically, foreign trade will raise wages of unskilled workers relative to those of skilled workers in an economy that is relatively well endowed with unskilled labor and specialize in producing unskilled labor intensive products for exports, while the wage levels of unskilled workers in another economy endowed with skilled labor will be lowered comparatively. More specifically, as Chinese labor-intensive products take up larger share in the global market, the price of factor used intensively in the production process of export sector, which is the wages of unskilled workers are supposed to be

driven up correspondingly. While the domestic demand for skilled labor may be reduced to a certain degree. Meanwhile, the competition in labor-intensive industries from China weakened the competency of those sectors in the United States, which leads to a downturn in unskilled workers wage levels. In the past decade, the wages of unskilled labor force in China, especially those of state-owned enterprises have increased to some degree, which minimized wage disparities between skill-intensive and labor-intensive industries. Admittedly, the average wage of the state-owned enterprises lagged markedly behind that of private, jointly-owned enterprises throughout the 1990s. However, since the substantially large number of state-owned enterprises assume significant political responsibilities of maintaining low unemployment and ensuring social stability in China's central planned economy, the increased wage levels are supposed to stimulate consumption in a certain way. Theoretically, the rising money wages would raise both unit labor costs and price levels, which would affect the trade balance and the real wages. The rising real wages would raise consumers' purchasing power thus stimulating consumption. However, If increases in money wages only raise the price level, real wages will not rise. So, one hopes that increases in money wages in China will not be completely accompanied by higher prices, so that consumption will increase. Since the increase in money wage tends to be in non-exporting industries and the money wage data is mainly only for manufacturing wages, it is difficult at this point to get the changes in real wage in China. When it comes to the regional imbalances, the Southeastern and Bohai regions, coastal areas where the metropolises such as Beijing, Shanghai, Guangzhou and Shenzhen are located, have the highest average wages throughout the

country because of their advantageous locations for trade and superior political arrangements, which plays an unfavorable part in fueling consumption<sup>48</sup>. Moreover, the diverging trend in wage levels across industries is also intensely evident. Average wages for skill-intensive sectors such as financial, scientific researches and services enjoy much higher wages than labor-intensive industries of manufacturing, construction and basic services chiefly because of the potentially large pool of unskilled working force in China, which is supposedly to be eased to a certain degree by international trade with advanced countries such as the United States. Unsatisfactorily, under the influence of the global financial crisis, export-oriented manufacturing and construction related industries witnessed a comparatively large portion of unemployment while the layoffs among high skilled urban workers have been rather limited, which further hurt the consumption in the economy because the majority working force are still unskilled. Noticeable, with the rapid industrialization, parts of China's job market started experiencing a labor shortage alongside the acceleration of wage increases, which in turn contributed to the increase as a result. In fact, the one-child policy<sup>49</sup> has dramatically slowed down the population growth especially in rural area. To support continuing industrialized development, the surplus in rural labor market is almost depleted and roughly three-quarters of the urban districts have no more young labor remaining to transfer from agriculture into other

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<sup>48</sup> In China, there is geographic imbalance in population. The eastern coastal part holds the majority.

<sup>49</sup> The One-Child Policy is applied by the Chinese government to control the rapid growth in population within the special circumstance the country has. It refers to that one family can only give birth to no more than one child.



industries. That is to say, to achieve a longer sustainable prosperity, it is imperative for China's economy to speed up on technical innovations and improvements thus adjusting the trade pattern and industrial arrangement gradually to skill-intensive as well with the increasing capital accumulation, fiercer labor market competition, expansion of Foreign Direct Investment inflow, ongoing export growth and state-sector restructuring. Promisingly, with more attention paid onto education, China is also expecting a robust supply of university graduates, who possess fairly advanced knowledge and sophisticated technological skills, to contribute to the further prosperity of the economy. At the same time, with more and more agreements being drawn concerning Chinese market's huge potential for development, an increasing amount of professionals are attracted from overseas will bolster the transition likewise.

At the same time, the lack of a social safety net and the failures to reach the international labor standards in China leads to lower costs of labor in a short run in spite of the hidden social liabilities in a long run. Furthermore, more and more firms from the United States and other developed countries start building export-oriented production bases in China to take advantage of China's large supply of low-wage and poorly protected workforce, the huge domestic market, as well as the factor price distortion primarily caused by local governments' preferential offering to attract foreign investment, weak labor rights and weak environmental protection laws, which has also deepened China's trade imbalance. Noticeably, the transnational enterprises contribute to improving the competitiveness of China's export sectors by spreading advanced technological and management knowledge and building up more efficient operations, which lays a further

barrier for China's import. All in all, the explosion of foreign direct investment by those transnational enterprises China has witnessed, together with China's comparatively protectionist trade policies, is playing a remarkable role in increasing the US trade deficit with China. For that reason, the competitiveness of American goods overseas is severely challenged and job-creation in the United States during the recovery of the global financial crisis is exceptionally difficult.

When it comes to China's GDP growth, one of the most distinct features is that consumption, especially private consumption has not been a key driver of economic growth, while investment, government spending and net exports have respectively played a relatively important role. It is well known that higher wages are closely correlated with higher private consumption according to the World Bank. To better create employment and to further increase wages and productivity require more efficient investment in China, which is promising to be achieved by structural and institutional transformation mentioned earlier in China's state-owned enterprise system, together with providing a more satisfying investment environment especially for sectors with large domestic consumption potential. What is more, the comparatively poorer social safety net in China is to a large extent responsible for the relatively lower consumption. Especially during the financial crisis, Chinese people tend to save more for precautionary purposes. As a matter of fact, most Chinese workers must rely on their own resources to pay for health care and retirement. With the cultural and traditional influence, they try their best to save for next generation's education and even marriage and housing. That is exactly why private consumption is highly difficult to be stimulated.

**Conclusion:**

Given the fact that the political system in China is the socialism with Chinese characteristics, it is relatively easier for China's ruling Communist Party to plan on and carry out political and economic arrangements. While a completely different political setting in the United States makes it much more difficult for the U.S. administrators to command neither spending nor lending even in their domestic economic market because of the decentralized federalism. However, the effects of the different political and regulatory systems are that each of them plays a special role in impeding progress or blocking undesirable cases. Also, since the two countries are experiencing different stages of development, the governments are playing very different roles in each economy. While the Chinese government is applying heavy intervention into the market and putting a fairly amount of protection over their infant industries, the government in the United States relies more on the market to adjust itself. Moreover, the different levels of development influence the two countries' ability to spend on infrastructure and therefore the effects on stimulating the economic relationships and behaviors. Meanwhile, the differences between the financial and fiscal mechanisms of these two countries, to a large degree explained the effectiveness of the stimulus packages. Because the influence the Chinese government has over the whole banking system and the special economic context through state-owned institutions and enterprises are unmatched.

In terms of achieving the desired public private mix in investment, the Chinese governments are challenged with too much public and private investment given issues such as bad debts of State Owned Enterprises, which still dominate the internal market in China. Give the highly centralized economic and political settings, it is fairly easy for the stimulus plan to be supported by the central government, lower-level governments, banks and state-owned enterprises in a large scale. However, the internal market has been seeing an overcapacity in a number of industries, which potentially could be eased by more spending on environmental protection and more efforts on raising labor standards especially in manufacturing. On the other hand, the United States is faced with the problem of not enough public and private investment in a relatively more advanced development stage in the economy with anti-government ideology. The stimulus was intended to cushion the drop in demand and the subsequent decline in business confidence, and to spur economic activity and thus to stimulate the already stagnating investment. Nevertheless, with a decentralized economic and political settings and an advanced development stage, there are more efforts the government needs to make to push the investment to the next level.

When it comes to consumption, Chinese consumers are highly encouraged to adjust their saving-consumption pattern while Americans are recommended to be more careful when they take on debts especially house debts to help both of the countries to build healthier economic environment. If the government in China could play a more active role in encouraging customers' consumption, reducing their concerns about social security net and directing the traditional ideology of saving more towards spending, it is

very promising for the the internal markets to drive not only the economy of China, but also for the whole world. As for consumers in the United States, it is necessary to be more cautious in terms of taking on debts to avoid potential financial crisis in the future. Moreover, the easier it is to run the economy, the more watchful the central government should be because a slight mistake in the decision could easily lead to a national-wide disaster throughout the whole country. For the Chinese government specifically, the ongoing house bubble and the large-scale overcapacity in a variety of industries their economy is experiencing are certainly threatening their economic development, which are all rooted in their over conduct on the export-orientated perspective. As for the United States, although the way the central government leads and influences the economy is utterly different, taking more actions to gradually decrease the economy's reliance on the national-wide household debt without hurting the consumption is imperative.

As both China and the United States are performing the significant roles in the world's economy, an active cooperation with a joint effort would not only benefit the two countries, but also the whole world's welfare. If China could dedicate in increasing their domestic consumption, diversifying the product mix to decrease exports to the United States, and the United States for the moment could encourage investment and reduce their household debt, it would be much more promising for these two countries to stay on the same page to overcome the global recession from the financial crisis and present a more prosperous worldwide economy!

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