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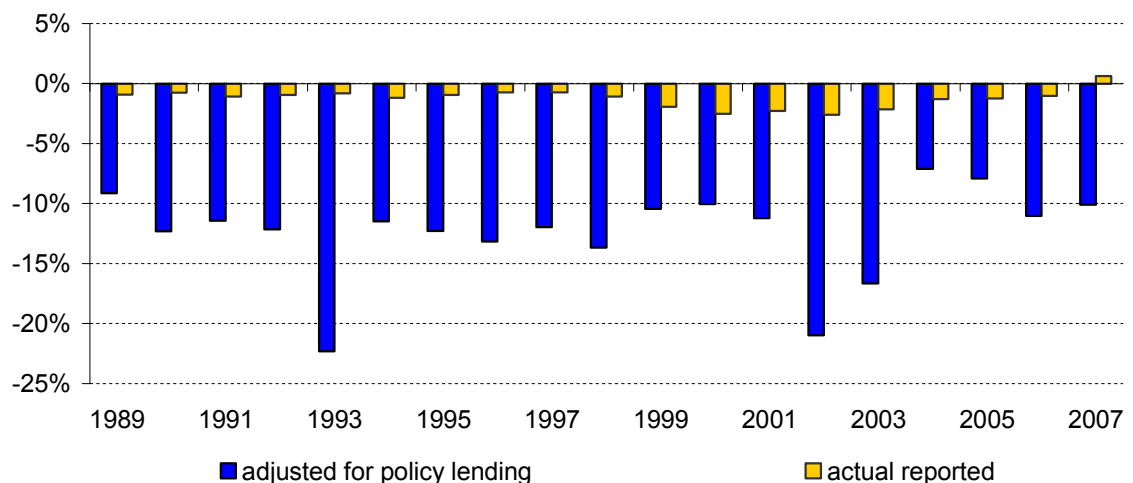
## China's fiscal stimulus – bad news for the world?

**WE SUGGEST: To provide limited immediate relief**

**SUMMARY: Beijing's Rmb4 trillion stimulus package for 2009-10 was aimed at boosting domestic and international confidence. But turning the state sector spending tap is unlikely to be effective in time to avoid a sharp cyclical downswing. Worse still corporate tax and finance support could backfire in propagating wasteful manufacturing investment and production just as global final demand is plummeting.**

On the face of it China's fiscal stimulus package, announced today, ticks all the boxes to provide a much needed boost to domestic and international confidence. Announced just before the upcoming G20 meeting, the package is focused on supporting domestic demand, fending off international pressure for yuan appreciation. It is large enough, amounting to 7% of annual GDP, although at present it is unclear how much of it is previously announced infrastructure spending. The package also appears to balance the short term goal of supporting growth with the long term goal of boosting consumer incomes and increasing production efficiency. Moreover, with the budget in surplus at 0.6% of GDP in 2007, China seems to be able to afford the generous support.

China's budget deficit as % of GDP



As usual in China, much is not what it seems. To start with, when assessing the government's finances one has to take into account the state-owned banking sector. The bulk of the banks are in state hands and do not lend according to market principles, but as directed by the state. As such these loans are a hidden liability of the government. One of today's measures is to remove loan quotas and increase bank credit for priority projects.

The increase in state-directed lending should be included in the government's liabilities. The chart above shows that the adjusted government's finances look much less rosy. At the end of the day, China has a small public debt burden, around 16% of GDP in 2007. Even if China doubles its debt to GDP ratio in two years, it will not be unmanageable. The problem is that because a large chunk of the bank loans have been made with no regard for credit risk, the ongoing severe slowdown could raise the ratio of bad loans substantially. Moreover, China has reached the end of the road when it comes to its mode of expansion based on a giant misallocation of its domestic savings.

On balance, judging by a confluence of data such as the drastic fall in the Baltic dry index, slumping PMIs and power grid output and slower real export and import growth, it seems that slumping external demand has finally pulled the rug from under China's expansion. The government's measures are unlikely to help in the near term. Turning on the state sector infrastructure spending tap is like turning an oil tanker. It does not happen instantaneously. Meanwhile, boosting rural and urban incomes in the face of increased uncertainty and higher unemployment could well result in more saving rather than support consumer spending.

China is currently at major crossroads. The positive path is turning its economy into a fully fledged market economy, which allocates its savings efficiently, whether domestically or abroad, and invests its wealth in search of high return. This involves reforming the banking sector, allowing the yuan to move freely and opening up the capital account. This will be the fastest way in which China can lower its excessive domestic savings rate and become a viable source of domestic demand for the rest of the world, improving its citizens' standard of living and sense of security in the process.

The negative path will be a return to the bad old ways – state resources thrown in wasteful domestic investment to counteract the global downswing. Public infrastructure spending is the less bad option, as it does not necessarily have to be wasteful. The worst option will be to force banks to lend support to the manufacturing sector. The measures announced today do include such support, although it is presented as aimed at technical innovation and industrial rationalisation. But China's dependency on external demand and its huge investment to output ratio make its economy extremely vulnerable in the current downswing. The temptation of the authorities to go for expansion at all costs will be huge. If Beijing does go for state-directed investment binge that boosts manufacturing capacity and production when global consumer demand is flagging, then global price deflation could rear its ugly head.

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