EYE ON THE MARKET

Volume 8, Issue 19 10 November 2008

China unveils RMB4 trillion fiscal stimulus

The Chinese government announced on Sunday that it is spending RMB4 trillion to boost domestic demand – a move that is likely to help the fast-growing economy achieve a soft landing in the face of a rapidly deteriorating external environment. The comprehensive package, estimated to be worth 12% of 2009 gross domestic product (GDP), comes after aggressive interest rate cuts in recent months and underscores the government's priority to support economic growth at a time when the global economy is fast slipping into recession.

The Chinese economy has deteriorated drastically in recent months, with national electricity consumption declining 0.5% in October, and consumption indicators decidedly pointing south. Citi analysts note that the slowdown is spreading quickly from the coastal areas to the inner provinces and from the exports and investment sector to consumption.

The package is scheduled to be implemented over the next two years, with initial measures to kick in as early as the current quarter, demonstrating urgency of the plan. Apart from investments in physical infrastructure, the initiatives include spending on social infrastructure, such as education and healthcare, and income support for individuals.

The fiscal package is not expected to lift China completely out of the current slowdown, but Citi analysts believe that the country is still set for economic growth of 8-9% in 2009 and 2010, which remains very strong relative to the rest of the world.

Widespread and immediate boost

China's State Council, which announced the package, said the government plans to increase spending in 10 key areas:

- Low-rental housing construction and upgrading of poor-quality housing
- Rural infrastructure for gas, drinking water and electricity
- Transportation infrastructure such as railways, highways and airports
- Healthcare, education and cultural development
- Environmental protection and waste treatment
- Technological innovation and structural upgrading
- Post-earthquake reconstruction
- Income support for rural and urban residents (through higher price floors for grain, other agricultural subsidies, and minimum wage support)
- Extension of consumption tax reforms for all companies, which should reduce their tax burden by RMB120 billion and spur technological upgrading
- Stronger financial support to growth

Some of these initiatives have been announced previously, such as plans to invest RMB2 trillion on railways and RMB1.2 trillion on reconstruction, and the real incremental amount of the package is probably closer to RMB1-1.5 trillion. But by pulling everything together into one package, the government is making clear its priority to support economic growth.

Also, measures to accelerate investments worth about RMB120 billion in the current quarter signal the urgency of the plan. The authorities estimate that this move may generate total additional investment, from both private and public sources, of about RMB400 billion in 4Q 2008, equivalent to 5.8% of 4Q 2007 GDP. This, say Citi analysts, should provide some assurance that near-term growth is unlikely to falter.

Citi analysts note as well that many of the initiatives are focused on the construction sector. This should go some way to create low-end jobs for tens of millions of workers who have lost jobs in the manufacturing and construction industries, helping preserve social stability. Many of these workers had migrated to the cities from rural areas. They are unlikely to return to farming and have little savings to survive long in the cities.

Strong government hand supports soft landing scenario

Citi analysts expect a soft landing for China despite the hard realities that are facing the global economy. While pessimists are predicting a hard landing of the Chinese economy, expecting just 5-6% growth in 2009, Citi analysts believe growth of 8-9% is more likely, unless the global economy stays depressed for much longer than expected, well beyond 2009. A key argument by the pessimists is that China has become a typical market economy and so would be subject to normal business cycles with violent fluctuations in growth rates. And even though the government's fiscal package is aggressive, the pessimists say it is likely to be less effective this time round. But Citi believes that China remains quite different from a typical capitalist economy, and that current expectations of a hard landing next year are unlikely to materialise, just as past predictions have proved untrue.

One key factor is the government's still-significant influence on the economy and its robust fiscal health:

- State-owned companies contribute about 43% of the country's total fixed-asset investment, nearly 20% of GDP.
- State-owned commercial banks account for 58% of total banking sector assets.
- Government revenue grew by 24% per annum from 2003 to 2007, while public debt is only slightly above 30% of GDP.
- Markets for labour, land, capital, energy and other resources remain highly regulated or distorted by government policies.
- The government links above-8% growth closely with social stability and its own legitimacy.

Citi analysts also note that the government's ability to mobilise fiscal resources should not be underestimated. In fact, its ability has probably strengthened compared to 10 years ago during the Asian financial crisis:

- Official government revenue accounts for 21% of GDP, up from 11% in 1998.
- State-sector profits are now 23% of GDP, up from 5% in 1998.
- Foreign reserves exceed US$1.9 trillion, up from US$145 billion in 1998.
- The average bank non-performing loan ratio is 7%, down from 30% in 1998.

Indeed, Citi analysts note that total bank deposits in China are considerable, at about 150% of GDP, while the average reserve requirement ratio is still above 16%. Admittedly, such bank liquidity is not very useful in helping the corporate and consumer sectors of the economy. After all, companies are unlikely to want loans as their business slows, while individuals in the current uncertain climate can be expected to exercise prudence in their spending and borrowing. But the government can tap on bank liquidity to finance large investment projects, either by issuing bonds to banks or by setting up state-sponsored projects that will attract bank loans.

One potential risk, however, is that the stimulus package may send the country into a deflationary state, by boosting already over-supplied capacity. This was the case during the Asian financial crisis, when the government launched a massive infrastructure programme to keep GDP growth above 8%.

Going beyond the current cyclical downturn, Citi analysts believe China may be entering a more trend-like growth stage where GDP expansion would be around 8-9%. Going by China's history, in which a relatively deep adjustment tends to follow extended periods of above-10% growth, Citi analysts believe a sharp rebound is very unlikely after the current downturn. Still, relative to that of other countries, China's growth is expected to remain very strong.

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