

Reflating the dragon

Nov 13th 2008 | BEIJING

From The Economist print edition

Can the world's fastest-growing economy avoid a sharp downturn?

WHEN Deng Xiaoping set China on the road of economic reforms in 1978, Western economists argued that "Only capitalism can save China." Exactly 30 years later, some pundits are claiming that "Only China can save capitalism." Most rich economies are now facing recession. But if



China, the world's third-biggest economy, can manage to sustain reasonably robust growth, it will help to cushion global output. A massive stimulus package of 4 trillion yuan (nearly \$600 billion) announced by the government on November 9th was therefore widely cheered at home and abroad. Will it be enough to re-stoke the dragon's fire?

After growing by an annual average of over 10% over the past five years, China's economy has suddenly cooled more quickly than expected. GDP growth slowed to 9% in the year to the third quarter, from 11.9% in 2007. That still sounds pretty impressive, but other indicators suggest weaker times ahead. Construction, steel demand, electricity consumption, car sales and air travel have all been falling in recent months. Industrial production grew by only 8.2% in the year to October, less than half its pace a year ago and its slowest for seven years. Share prices have slumped by 70% from their peak and house prices have started to drop. Property sales are running 40-50% lower than a year ago. Unsurprisingly, surveys show that consumer and business confidence is cracking.

China's slowdown only partly reflects weaker exports as the world economy sags. Some of it is home-grown, caused by a deliberate tightening of monetary policy to curb inflation and an overheated property market. Indeed, export growth has held up surprisingly well. In the first ten months of this year exports were 21% higher in dollar terms than a year ago, compared with growth of 26% in 2007. They have slowed more sharply in real terms, but were still up by 13% in the year to the third quarter. Guangdong province, in southern China, has been hit hardest. Thousands of firms making shoes, toys and clothing have been forced to close this year, partly as a result of a new labour law that has lifted wage costs, as well as weaker foreign sales. According to local newspaper reports, half of China's toymakers and one-third of its shoe firms have disappeared this year. Yet toys and shoes now account for less than 5% of China's total exports. Exports of machinery and transport equipment (almost half of the total) are still rising at an annual rate of more than 20% in volume terms.

The doom and gloom in Guangdong may be overdone. Many small factories close every year as a result of consolidation. Others have moved to cheaper parts of the country. The troubles of many firms in low-value sectors, such as toys and shoes, partly reflects China's success in moving up into higher-value industries, which has pushed up wages.

Across China, companies report that foreign orders have shrunk sharply over the past couple of months as the developed world has slipped into recession. Some economists reckon that next year China's exports may see no growth (in dollar terms) for the first time in more than 25 years. Imports are also slowing sharply, reflecting the high import content of many Chinese exports. Even so, UBS, a bank, forecasts that in 2009 net exports will be a negative drag on GDP growth. In 2007, net exports contributed almost three percentage points of the 12% increase in GDP.

Dismal export prospects will also depress manufacturing investment next year. Residential property construction is likely to continue to fall at least until mid-year, which, in turn, will reduce demand in

industries such as steel and cement. However, China's housing bust is not as serious as those in many developed economies. Although too many luxury homes were built in some cities, there is no massive oversupply at the national level, and urbanisation and rising incomes will continue to support demand for housing.

One bright light amid the darkness is retail sales, which rose by 17% in real terms in the year to October. Some sectors, such as furniture and household electronics, are feeling the pinch from the property downturn, but overall spending is expected to remain brisk next year, thanks to rising incomes and households' low level of debt. Over the past year real incomes have risen by 10% in urban areas and 14% in the countryside. A fall in house prices will hurt Chinese consumers much less than their American counterparts, because Chinese households are not up to their necks in debt. Total household debt (including mortgages) amounts to only 13% of GDP, against 100% in America. During America's boom, it was easy to get a mortgage for 100% or more of the value of a home, but Chinese buyers have had to put down a minimum deposit of 30%.

Adding net exports, business investment, construction and consumption together, China's growth next year would probably drop to less than 6% without any government help—its slowest rate for almost two decades. Most countries would still be happy with such a figure, but it has become an article of faith in China that output needs to grow by at least 8% a year to create enough jobs for the millions of rural Chinese moving to cities. Growth of less than 8%, it is claimed, will lead to rising unemployment and social unrest.

In fact, the original estimate for China's required minimum rate of growth, which was made in the mid-1990s, was 7%, not 8%. And the correct figure is now probably lower, because the original estimate was based not only on the flood of people out of the countryside, but also on the number of new jobs that were needed to absorb massive lay-offs by state firms. In addition, the number of young people joining the labour force each year has fallen with the birth rate, and a spurt in rural incomes in recent years has encouraged some to stay on the farm rather than move to the city.

But even if the 8% rule is no longer based on sound economics, it clearly still carries a lot of weight with government officials. Over the past two months the government has announced a series of measures aimed at sustaining domestic demand. The People's Bank of China has cut interest rates three times and strict controls on bank lending have been scrapped. Measures to encourage home-buying have also been introduced: the minimum deposit on a mortgage has been cut from 30% to 20%, mortgage rates have been lowered and transaction taxes on homes reduced. A far more important boost, however, will come from the planned surge in infrastructure spending.

A New Deal, Chinese-style

The eye-popping 4 trillion yuan stimulus package unveiled by China's State Council this week is to be spent over the next two years. It amounts to 14% of this year's estimated GDP and, in dollar terms, is four times as big as America's fiscal stimulus earlier this year. The total increase in spending, if genuine, would surely represent the biggest two-year stimulus (outside wartime) by any government in history. The package includes public works, social welfare and tax reform. The main spending areas are public housing for poor households; infrastructure projects such as railways, roads, airports and the power grid; speeding up rebuilding after the May earthquake; and increased spending on health and education. A reform of the VAT system will allow firms to deduct purchases of fixed assets, reducing companies' tax bills by an estimated 120 billion yuan (4% of 2007 industrial profits). This should encourage firms to upgrade their capital equipment. The government also plans to boost rural incomes by raising the minimum purchase price of grain as well as increasing subsidies for farmers, and promises plumper social-security benefits for low-income groups.

The snag is that, as yet, there are no details about how exactly the money will be spent. It seems that the deteriorating economic situation panicked the government into rushing out its plans. Certainly

previous prudence has left plenty of room for a stimulus: the budget surplus stands at 1-2% of GDP (depending on how you measure it) and total public-sector debt at less than 20% of GDP, one of the smallest of any large economy (see chart 1). In fact, not all the investment will be funded from the government's budget. A large chunk will be carried out by local government and state-owned enterprises. It will be mandated by the government, but financed by their own revenue, corporate bonds or bank lending.

Cynics have dismissed the package as much smaller than meets the eye. True, some of the infrastructure investment had already been planned, notably the extension of the rail network and rebuilding after the earthquake. In that sense, it is not really new money. But some of the money that was going to be spent over five years on railways has been brought forward. And the 4 trillion yuan excludes the tax cuts and transfer payments to farmers and the poor.

What matters for the economy is how much higher infrastructure spending will be next year compared with actual spending in 2007 or 2008. Rough estimates suggest that the true increase in investment may be between 5-7% of GDP over the two years to 2010: still an impressive figure.

But the most important aspect of the package is that the government seems to have sent a clear message that it will do whatever it takes to maintain growth at close to 8%. The bigger the slowdown, the bigger the likely stimulus.

This signal, says Arthur Kroeber, an economist at Dragonomics, a research firm in Beijing, is more important than the exact amount of cash on offer. It could help to restore business and household confidence, and encourage firms to keep investing.

Some commentators have criticised the package for focusing too much on investment (which is already high as a share of GDP in China) rather than spurring consumption through income-tax cuts. But in a country like China, where the saving rate is high and confidence is failing, infrastructure investment is much better at boosting growth than tax cuts or welfare benefits, which would probably be saved rather than spent. In a developing economy infrastructure spending is also less likely to be wasteful than in a rich country like Japan, which built bridges to nowhere during the 1990s in an effort to keep the economy afloat. China plainly needs bridges and railways.

But in any case, in contrast to previous fiscal stimuli in China, this package does include some modest measures to boost consumption, such as raising the incomes of farmers and low-income urban households. Increased spending on health and education should also help to reduce households' worries about how to pay for these services, and so encourage them to save less and spend more.

In the long term China needs to do much more to boost consumption, but the immediate need is to prevent a hard landing. To the extent that the package boosts domestic demand, it could help deliver better-balanced growth. Unfortunately, the government has also increased tax rebates on exports, on which the economy remains far too dependent.

Déjà Hu?

China last adopted a big stimulus package during the Asian financial crisis, when it succeeded in holding annual GDP growth at almost 8%. However, the country now faces a much bigger external shock than it did then. So can it repeat the trick? Tao Wang, an economist with UBS in Beijing, believes it can. Not



only is this stimulus package probably larger than that adopted during the Asian crisis, but, argues Ms Wang, the corporate and banking sectors are also in much better shape than ten years ago.

Reuters

The Asian financial crisis hit China just as it was making a painful economic adjustment after the bust of a credit boom in the mid-1990s. Huge over-capacity and large losses forced the government to undertake a massive restructuring of state-owned firms. Investment and jobs were savagely cut at the same time as exports stumbled. In 1997-98 state firms made a net loss of almost 1% of GDP; in 2007 their combined profits were over 4% of GDP.

The banking sector, too, now looks much healthier. Ten years ago, after the credit binge, banks' non-performing loans hit 40-50% of their assets. Today the figure is around 6%, and their profits have soared in recent years. Chinese banks have also largely escaped the problems which have paralysed credit markets elsewhere.

Tight restrictions on bank lending over the past year have now been relaxed. But one risk is that with economic growth and corporate profits faltering, banks may be reluctant to increase their lending for fear of future bad loans. Loans to many property developers are likely to turn sour, but these amount to only 7% of total lending.

Most industries still have relatively strong profit margins and low debts by historical standards. China is one of the few countries in the world where total bank lending has fallen relative to GDP over the past five years.

China still has one advantage over most other countries. If necessary, the state-controlled banking system can be directed to increase lending to firms. That would raise long-term concerns about the future quality of banks' assets, but in the short term it would help to keep the economy ticking. The importance of this, says Ms Wang, is that while fiscal stimulus can jump-start the economy, bank lending is the fuel needed to keep it going.

Any analysis of China's growth prospects is clouded by the widely held belief that the government smooths its GDP numbers and always overstates growth during economic downturns. Chart 2 plots China's official growth rate against an alternative estimate calculated by Dragonomics from expenditure data (ie, investment, household spending and exports). This estimate shows much bigger swings than the politically smoothed official numbers.

China has experienced two major recessions in the past three decades. In 1989, the year of political protests and killings in Tiananmen Square, GDP is estimated to have really fallen by almost 2%, but reported GDP growth stayed above 4%. In 1998-99 Dragonomics reckons that the real growth rate fell below 5%, while reported growth dipped only slightly below 8%.

It is possible that reported GDP growth figures will once again be massaged if the economy continues to slide. But perhaps this time China can genuinely avoid a hard landing: the underlying economy, while far from perfect, is in better shape, and the government has more room to boost its spending.

The investment stimulus won't work its magic overnight; it takes time to get projects started. So GDP growth could well drop below 7% in the first half of next year as exports and housing investment weaken. But most economists think the stimulus package will be enough to keep growth at 7.5-8% for the year as a whole. If so, of the world's eight biggest economies, China will be the only one to enjoy any growth next year; most forecasters expect all the others to contract. Indeed, the IMF's latest forecast of 8.5% GDP growth implies that China will account for almost half of all the increase in world output next year.



Keep growing and keep consuming

The rising yuan

China's fiscal stimulus was announced less than a week before President Hu Jintao was due to arrive in Washington for the G20 summit of world leaders, which will discuss ways to revive global growth. Normally at international meetings China is accused of two things: its economy is too dependent on exports, while domestic spending is too feeble; and the yuan is grossly undervalued. Mr Hu will now be able to argue that China is doing its best to support domestic demand.

However many foreign officials, including America's president-elect, still complain that China is holding down the yuan to keep its exports competitive. It is true that China seems to have abandoned its previous policy of allowing the yuan steadily to rise against the dollar: it has barely budged over the past four months. But since the dollar has strengthened dramatically of late, the yuan has surged against other currencies such as the euro, sterling and most emerging market currencies. Indeed, in trade-weighted terms, against a basket of currencies, it has risen by 12% over the past six months. Since July 2005, when China scrapped its fixed peg to the dollar, the yuan's trade-weighted value has risen by 20%, by far the biggest appreciation of any large economy (see chart 3). The strength of its exports suggests that the yuan may still be undervalued. But foreign governments can no longer accuse China of refusing to allow its currency to rise.

Although China's planned fiscal expansion is still vague, it promises, if it is implemented and it works, to save the economy from a hard landing. And if stronger domestic demand sucks in more imports of raw materials and infrastructure-building machinery, that is the best way China can help the rest of the world.

