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China's Stimulus Plan: Repackaged and Misdirected

Derek Scissors, Ph.D.

On November 9, China launched a widely anticipated stimulus program consisting of no less than 16 percent of China's annual GDP, or $586 billion. This percentage is an eye-popping figure, which is exactly the intended effect. In substance, the program is largely a repackaging of previous measures designed to immediately bolster domestic confidence and spin Chinese participation in the upcoming G-20 global financial meetings.

Several of these previously disclosed measures include initiatives to:

- Rebuild after the Sichuan earthquake;
- Formally loosen lending restrictions on state banks that were being ignored over the course of 2008; and chiefly,
- Enhance the nation's transportation network by spending hundreds of billions of dollars over several years in what was already a well-established program.

The State Council promises to rush forward $18 billion in spending in the fourth quarter of this year. But total Chinese investment in the third quarter alone was almost $700 billion.

The package is merely the culmination of a series of steps taken over the previous nine months, measures enacted first to bolster suffering domestic stocks and then to boost a sharply decelerating domestic economy. These steps did not constitute even a small surprise to anyone following the troubles of the Chinese economy, but they may come as a shock to those counting on vigorous Chinese growth to "save" the world from the global financial crisis. Observers pointing to China's financial system as a model for how the U.S. and others could have avoided the crisis will likewise be taken aback.

The Chinese economy is in no position to meet the high expectations that media headlines are creating for it and the just-announced stimulus package is certainly not the fulfillment of those expectations. Perhaps more important, the highly regulated structure of the Chinese economy that some find appealing in light of the current financial shock has proven to be a clear and painful flaw—and absolutely not a model for the global economy.

Present Economic Weakness. China's cup is more than half full, but it is leaking quickly. GDP growth has decelerated from a peak of over 12 percent last year to a flat 9 percent in the third quarter of this year. While 9 percent GDP growth is still the envy of the world, this number presents a rapid decline. And it will get worse. The official purchasing manager's index is in uncharted waters: For the first time in its brief history, it is signifying not just slower growth, but an outright contraction. The data demonstrating this contraction may not be entirely accurate but it does represent the extent of the strain on manufacturing.

Finance is also under pressure. The bull run in the middle of the decade gave way to a very nasty

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(202) 546-4400 • heritage.org

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bear retreat almost a full year before the global economic crunch. Stocks are down 70 percent from their October 2007 peak, despite a series of attempts by the Securities Regulatory Commission to bolster sentiment.

The situation with exports is similar to GDP: a still-excellent performance but a downward trend. Export growth through three quarters was at a six-year low—and this is before foreign demand was blasted by the financial crisis.

Believers in Chinese resilience point to investment and consumption. Investment will certainly go higher, but to what end? Investment growth had already accelerated to 27 percent by the end of the third quarter. China has been investing at a 20 percent annual rate for six years and counting. It has long past the point of investing in low-return projects and the question now is whether this is a bubble with Chinese characteristics. Housing prices, for example, are falling outright in major cities and real estate sales have plummeted. Yet, even before the stimulus, real estate investment growth was above 30 percent.

Consumption has been strong, but perhaps not as strong as widely believed. Better than 20 percent gains in retail sales are welcome news to both domestic and foreign companies but the fastest growing component has been oil and oil products such as gasoline. Under pressure from global crude costs, the People's Republic of China (PRC) finally raised some domestic energy prices this year, forcing consumers to spend even more.

Surprising Financial Weakness. There are also long-run challenges presented by China's financial weakness. Imagine if the U.S. had $2.5 trillion in assets untouched by the financial crisis, budget deficits, and similar challenges. Now imagine the government insisting the money was not available to address the nation's problems, but must be held indefinitely in low-return foreign bonds. The money would be rightly understood as criminally wasted, rather than a source of strength. This is the case with China's gargantuan foreign exchange reserves.

It is true that the PRC is in possession of close to $2 trillion in official reserves and perhaps as much as $500 billion more in foreign currency held by ostensibly commercialized but state-owned entities; Beijing has a lot of money to spend.

Chinese regulators, however, are naturally hesitant to approve aggressive investment in struggling foreign companies after the abject failure of high-profile acquisitions of stakes in companies like Morgan Stanley. Further, passive investment of reserves in response to ballooning American budget deficits was a major cause of the financial crisis. It is difficult to see yet more liquidity as more than a band-aid, even if the U.S. and other countries would allow Chinese acquisitions of multiple, large corporations.

What would be better is if China could drive the world economy forward as other engines are refitted. This does not refer to the PRC boasting a high growth rate that is built in part on a trade surplus drawing money from outside. China would be most helpful by boosting its own imports, stimulating export industries overseas, and naturally paying out some of the huge stock of reserves to competitive companies around the world.

Reserves could be used to do this directly, of course, but the new package does not include any direct spending on imports. This is unlikely to occur—the PRC has always strongly defended the vast majority of its domestic industry from the effect of competition with foreign goods.

The knockout blow is that reserves cannot be used to finance the announced stimulus or for any other internal use. Because the yuan is not convertible, reserves cannot be spent domestically. Why would Beijing adopt and maintain a system to bring in so much wealth that cannot be used? Part of the explanation will be familiar: It is intrinsic to protecting the competitiveness of Chinese exports.

Another part, though, goes to the heart of reactions to the financial crisis: China sees its heavily regulated and sheltered banking system as too fragile to permit something as basic as letting savers send their money overseas. Movement of the yuan must therefore be very tightly controlled. As is now becoming clear, tight financial restrictions have not protected the Chinese economy from the global crisis. Moreover, they are a signal of fear and weakness, hardly policies to emulate.

—Derek Scissors, Ph.D., is a Research Fellow in Asia Economic Policy in the Asian Studies Center at The Heritage Foundation.

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