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China's Stimulus Package: A Catalyst for Recovery?

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Dieter Ernst, senior fellow at the East-West Center, explains that expectations that the current surge in growth from the stimulus package will “catalyze China’s economy and that of its neighbors into sustainable recovery” are unrealistic. While a 6.5 percent growth forecast by the International Monetary Fund “looks like a dream figure from a U.S. perspective, it may be insufficient to cope with China’s growing unemployment.”

China’s massive fiscal stimulus package has generated high expectations in official Washington as well as on Wall Street and in corporate boardrooms. Some observers paint a rosy picture of a surge in growth that will transform this vast economy into a new “locomotive” of the global marketplace. Others are less sure. Will the stimulus package be sufficient to catalyze China’s economy and that of its neighbors into sustainable recovery?

China’s economy is now big enough to shape competitive dynamics, both in Asia and globally. A very low level of net debt and high reserves provide ample space for a large stimulus package. At 7.1 percent of GDP, China’s stimulus package is now in the same league as stimulus packages announced in the United States (8 percent) and Japan (6 percent).

More than any major economy, China is showing signs of improvement. In March 2009, industrial production rose 8.3 percent, up from 2.8 percent in January and February. Sequential growth of GDP has improved from 2 percent in the last quarter of 2008 to 5 percent in the first quarter of 2009. Furthermore, China’s banks have followed the government’s directive – during the first three months of 2009, they have extended a record RMB 4.56 trillion (USD 660 billion) in loans – more than all new bank lending in 2008.

As a result, 2009 growth forecasts have been revised upwards – Morgan Stanley’s, for instance, has increased from 5.5 to 7 percent. The International Monetary Fund, however, remains worried about the sustainability of the “rebound,” and has kept its 6.5 percent growth forecast. While this looks like a dream figure from a U.S. perspective, it may be insufficient to cope with China’s growing unemployment.

Of particular concern to the Chinese government is that 20 million migrant workers lost their jobs or were unable to find employment in 2008, and the picture may grow worse in 2009. China’s Academy of Social Sciences (CASS) reports that 7.8 million graduates will search for jobs this year. Of these, up to 40 percent – around 3 million – will not find jobs. Pieter Bottelier, a respected China expert, projects that, overall, 48 million Chinese may be looking for jobs this year, while the number of newly created jobs is likely to be less than 7 million.

There are reasons to doubt whether the intended surge in growth from the stimulus package is sufficient to cope with this challenge. First, while the central government has pledged to invest RMB 1.2 trillion, the rest of the headline stimulus figure of RMB 4 trillion (USD 568 billion) is expected to come from local governments, state-owned



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enterprises (SOEs) and private companies. But according to the National Audit Office, local governments are unable to raise their share of financing. Second, the fast pace of lending has raised concerns that this may eventually result in an enormous non-performing loan problem. Third, much of the lending continues to end up in mostly large SOEs. This is building up excess capacity in several sectors that are dominated by SOEs, such as steel and petrochemicals, as well as in telecommunications. And it deprives private and especially small and medium enterprises (SMEs) of desperately needed funds, constraining their important role as employment generators.

Fourth, there are flaws in the allocation of the stimulus funds. State-run infrastructure projects account for the lion’s share (almost 82 percent of the stimulus package), with 38 percent programmed for highways, airports, railways, electricity transmission, and water conservation. This leaves no more than 18 percent for future-oriented projects – with 9.25 percent programmed for “domestic innovation,” 5.25 percent for energy conservation, and a meager 3.75 percent for healthcare and education. And of the RMB 370 billion reserved for innovation, RMB 170 billion will be invested during 2009 in the construction of third generation mobile telecommunications infrastructure, most of it for China’s TD-SCDMA standard.

Fifth, corruption and fraud are likely to reduce the intended growth-enhancing impact of the stimulus package. For instance, as part of the stimulus package, the government encourages rural residents across China to purchase TVs, refrigerators, washing machines, and mobile handsets at a 13 percent discount on the normal retail price. Examples of fraud are PC vendors that sell computers with out-of-date components as “new” to rural customers. And for handsets, the biggest winners are copy-cat producers of illegal “shanzhai” handsets, using platforms designed by Taiwanese chip designers.

Finally, the crisis seems to have strengthened proponents of protectionist policies. While Vice Premier Wang Qishan rejects “unequivocally protectionism of all kinds,” new regulations call for all levels of China’s government to give preference to domestic products and services. This is a serious trade restriction, as government procurement in China accounts for one of the highest shares of GDP in the world. This may well prompt other governments to move toward more protectionist policies, possibly igniting trade wars with global ramifications.

China faces a fundamental dilemma, which reflects the extent to which its economy is being pushed and pulled in different directions by a deeply entrenched but outdated export-oriented growth model. In fact, China’s dependence on international trade has doubled since 1998, from 30 percent of GDP to as high as 60 percent in 2008. Hence, China will suffer seriously from spreading protectionism.

If the world economy will take years to recover, which I think it will, the barriers remain stacked high against China’s attempts to engineer recovery. China needs a long-term strategy of upgrading its economy, and this requires innovations in economic institutions, business organizations, and technology. Such a shift in strategy is necessary to address the country’s vast needs in food, shelter, medical services, employment, education, and (primarily rural) infrastructure, as well as to counter its environmental degradation. Without such a strategy, the surge in economic growth from the stimulus package may simply reinforce an outdated growth model, as vested interests in state-owned enterprises, regional governments, and the national security apparatus are pushing for the status quo.