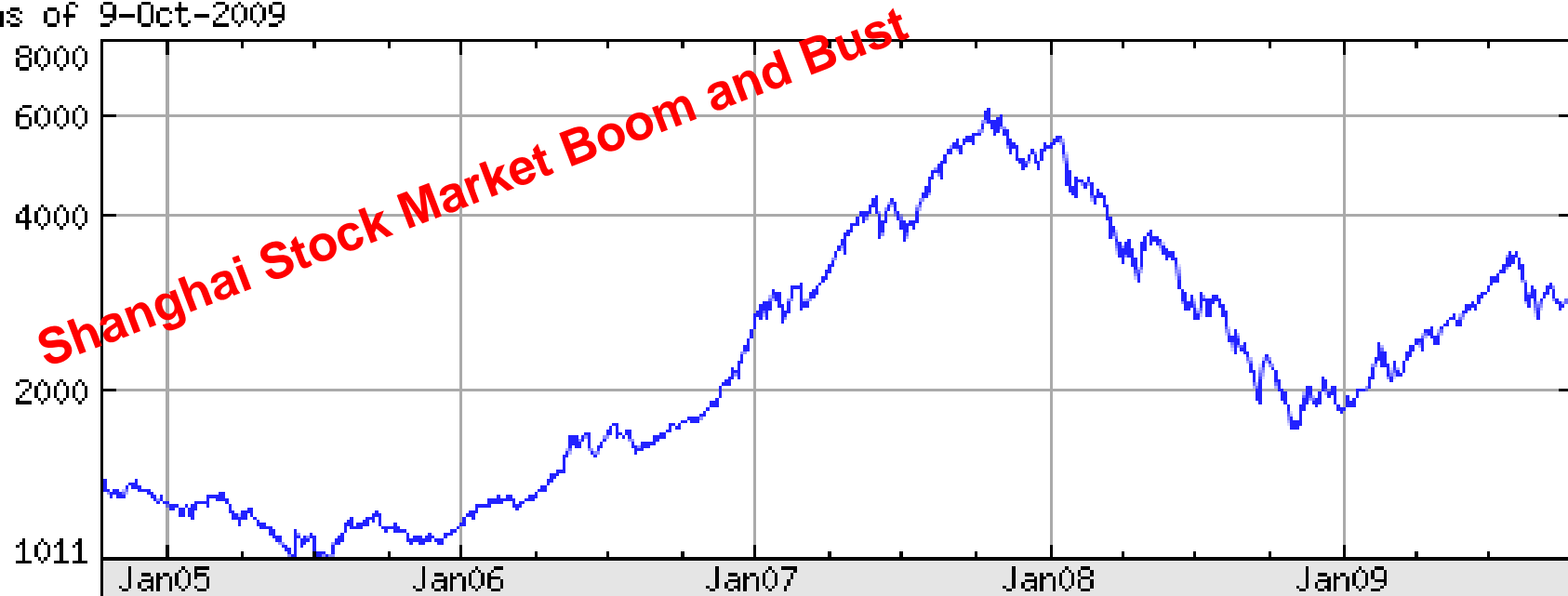


China's Big Gamble and Economic Recovery

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China faced a serious economic crisis at end-2008

SHANGHAI COMPOSIT
as of 9-Oct-2009



The Shanghai stock exchange had already plunged from 6124 in October 2007 to below 2000 by the beginning of September 2008. Obviously, this was driven by domestic Chinese factors, and not by the financial crisis that exploded in the wake of the Lehman bankruptcy. After the global crisis emerged in September 2008, Chinese authorities faced a simultaneous domestic and external shock. The scope of the challenge the Chinese faced helps explain the decisive and large-scale Chinese government intervention that checked the expansion of the crisis.

Faced with this challenge, China gambled on a big policy response:

China's vigorous response was an unusual mixture of Keynesianism and mobilization through the Communist Party system.

In November 2008, a National stimulus plan (4 trillion RMB, or \$586 Billion) was presented by government Premier Wen Jiabao.

Simultaneously, the Communist Party issued an urgent directive on expanding domestic demand. 中共中央18号文件: Central (Party) Document No. 18 of 2008, promulgated through Party channels.

Within days, ministries and provinces met to implement, “make every second count.” Urgent command and precious opportunity. County-level meetings within a week.

Components of Central Government Stimulus Investment

Table 1: Stimulus Package Investment Plan - Composition

	Initial Plan (3 Trillion) Nov. 2008	Revised Plan (3 Trillion) March 2009	First Tranche (100 Billion) Dec. 2008	Second Tranche (130 Billion) Feb. 2009
Transport and Power Infrastructure (Railroad; road; airport; electricity grid)	60%	50%	25%	21%
Rural Village Infrastructure	12%	12%	34%	24%
Environmental Investment; Natural Areas	12%	7%	12%	8%
Affordable Housing	9%	13%	10%	22%
Technological Innovation & Structural Adjustment	5%	12%	6%	12%
Health and Education	1%	5%	13%	13%

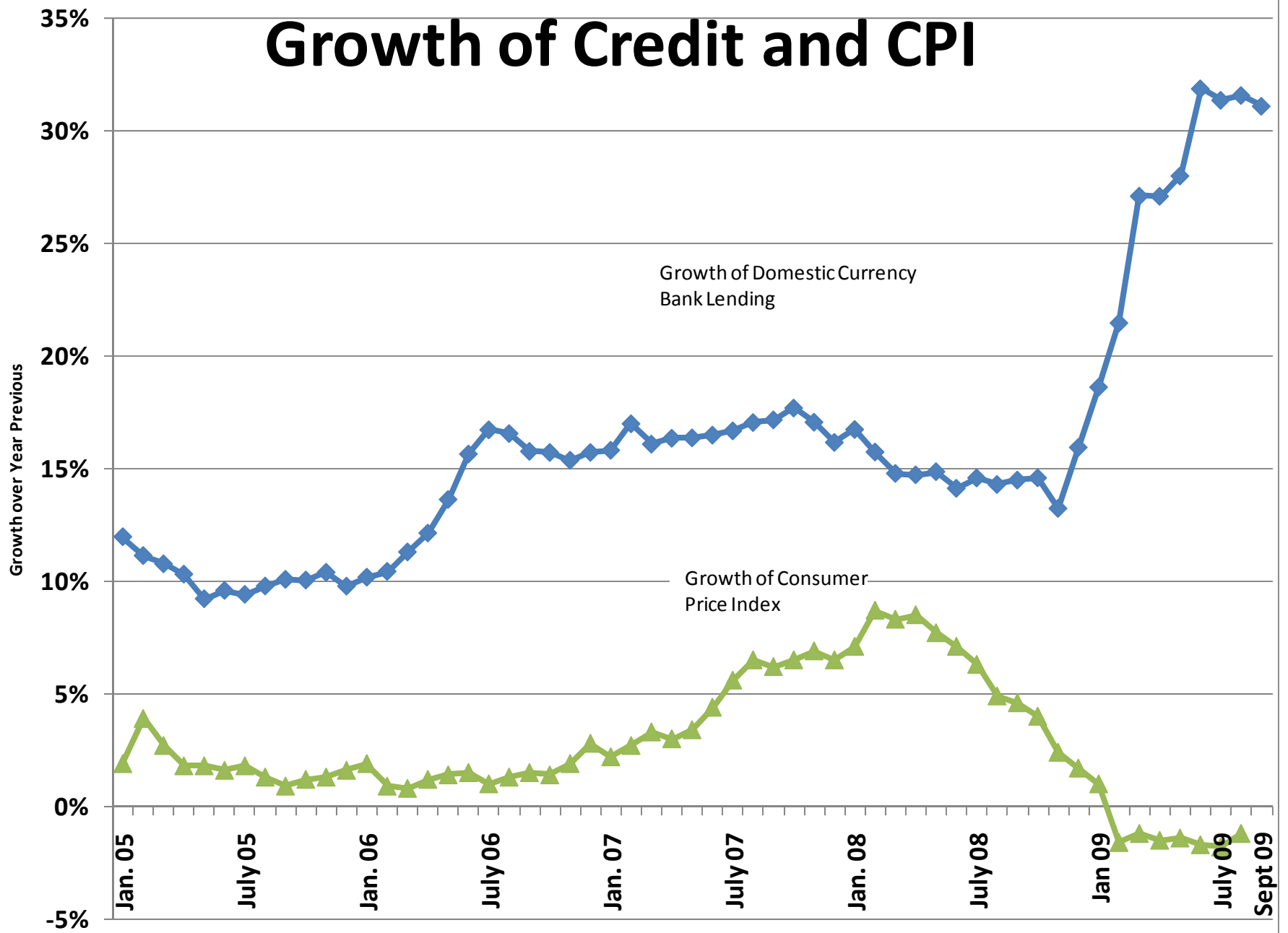
Behind the Stimulus Plan was a Flood of Financing

- Local governments: 200 billion RMB in local borrowing, guaranteed and managed by central fiscal authorities;
- Encouragement for corporate bonds, including those issued by companies that are local government “funding platforms.”
- Long-term loans from China Development Bank, with interest rates subsidized in some cases.
- Instructions to commercial banks to carry out “relaxed” credit policy.
- This funding is *much* bigger than the formal stimulus investment plan, and *much less well controlled*.

A Flood of Financing was released that was much bigger than the stimulus.

- Although arrangements were made to fund parts of the stimulus plan through central and local government budgets, these efforts were dwarfed by the flood of bank credit.
- \$1 trillion in new bank credits issued in first half 2009.
- Bank credits *much* less effectively overseen than the plan.
- The stimulus investment plan calls for an increase in fiscal outlays of just under 2% of GDP per year.
- The “excess” (above-normal) lending in just the first half of 2009 was equal to 14% of GDP.
- Putting these together, along with other fiscal policy impacts, gives a total Chinese stimulus effort in 2009 of 19-20% of GDP.
- Proportionally one of the largest stimulus packages in the world. US fiscal package is about 9% of GDP.

Growth of Credit and CPI



So far, China's gamble has paid off.

By April 2009, it was clear that China had stopped the downward spiral and would be the first major economy to return to growth.

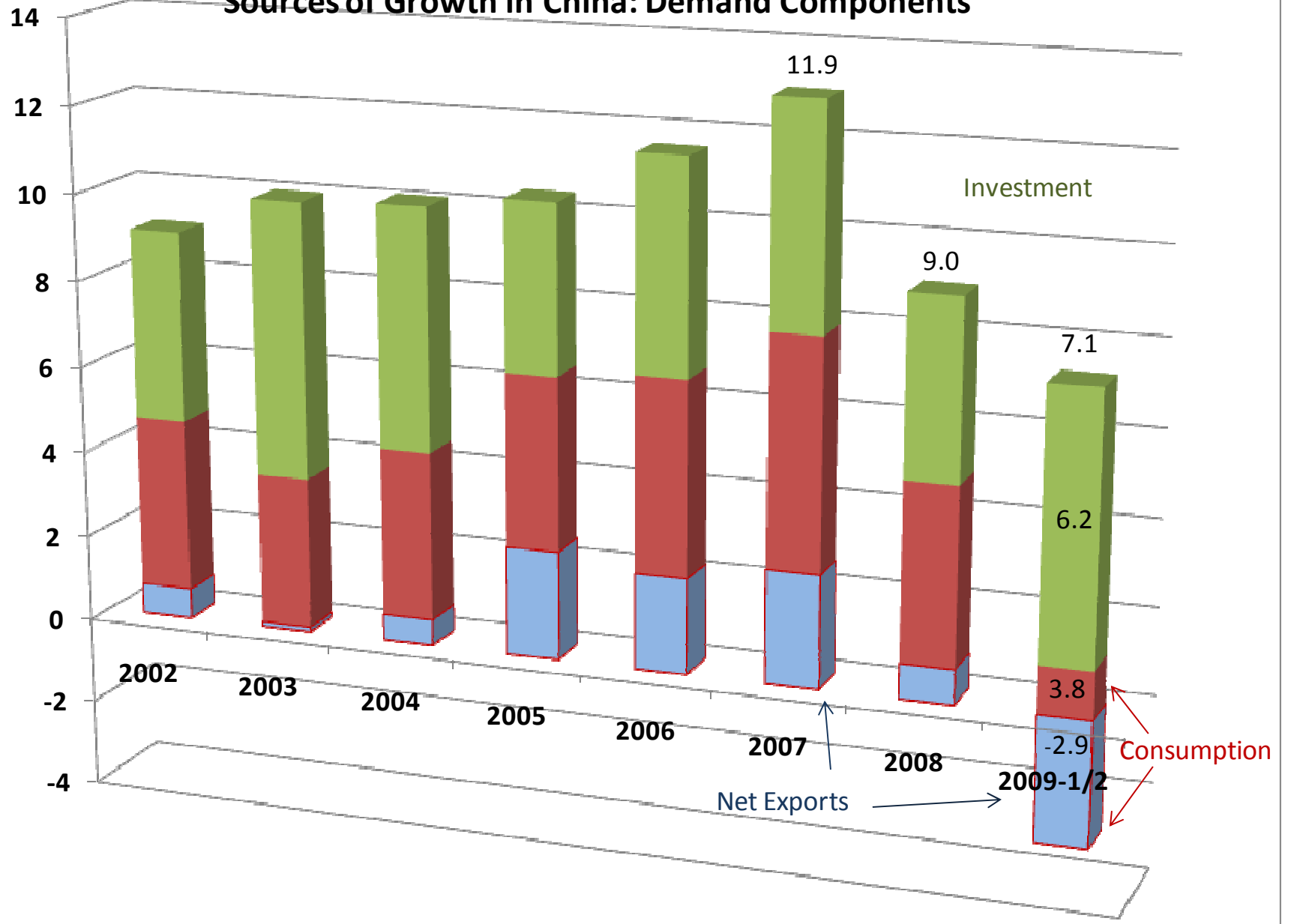
Recovery of the Chinese economy was an important cause of the stabilization of world markets after March lows. In world commodity markets China made a special contribution. For a while, this was the only good news.

Government infrastructure investment doubled in the second quarter of 2009, compared to the year previous quarter.

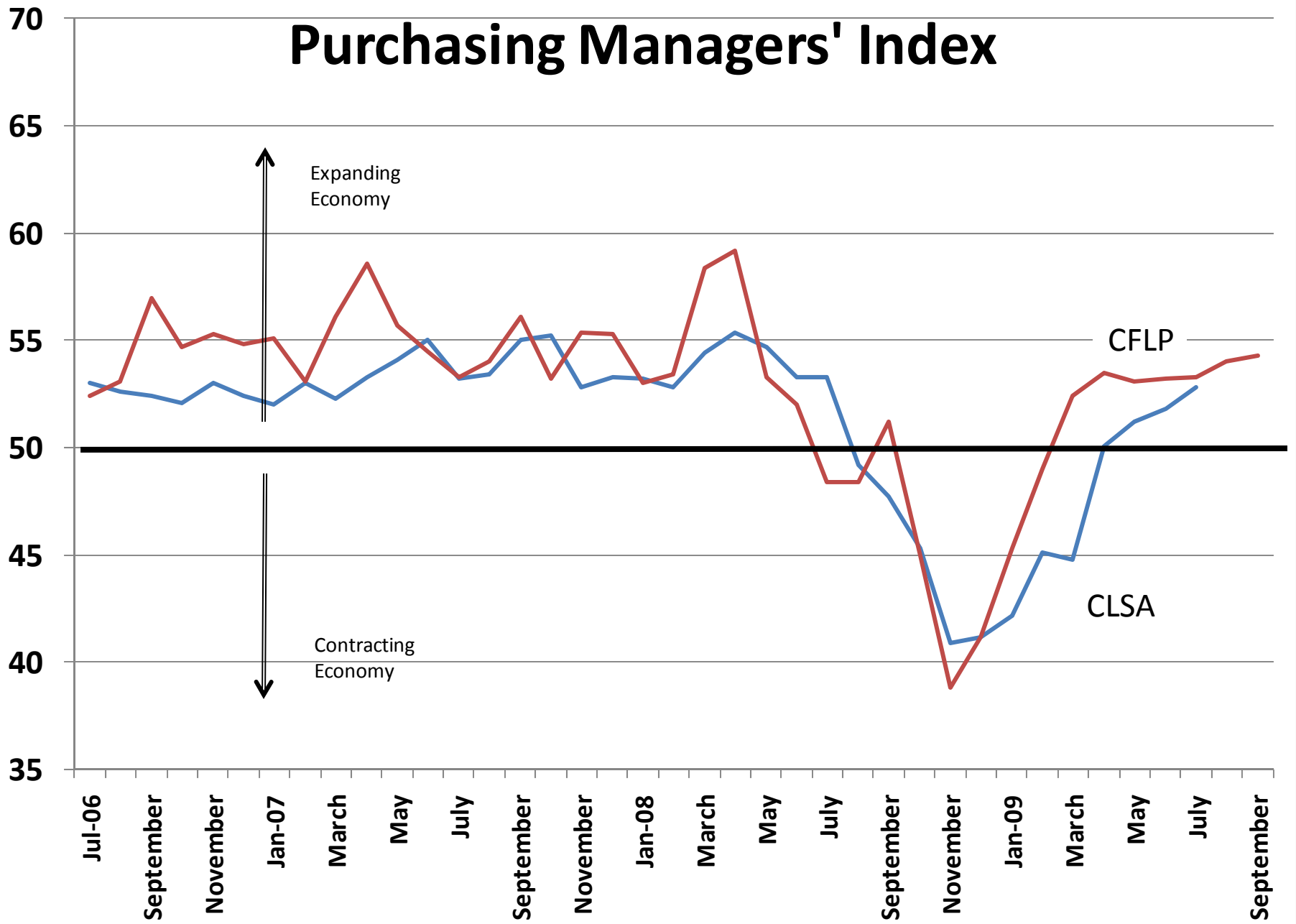
Urban household consumption grew 8.9% in the first half, and rural consumption only slightly more slowly (which are solid, for China, but not extraordinary).

Exports declined more than 20%, continuing through August.

Sources of Growth in China: Demand Components



Purchasing Managers' Index



This dramatic intervention in the economy has come at a cost:

- Credit growth has spilled out into many areas: increased raw material stockpiles (often imported); low return investments; speculation in housing markets and stock market.
- Infrastructure investment has revived demand for sectors with excess low quality capacity, especially steel and cement. A necessary market-led shake-out has been deferred, to be replaced with government-led controls.
- The economy is more “unbalanced,” i.e., dependent on investment, than it has ever been. Ultimately not sustainable.
- Direct government intervention has been strengthened after years of gradually receding controls.
- The evolution of the banking system toward an independent commercial system with a strong credit culture has been checked. Eventually this result in an increase in non-performing loans, and other costs.
- For all that, the benefits almost certainly outweigh the costs, particularly on a global scale.

Three Big Questions Going Forward:

- Will growth in investment and government supported sectors generate employment and spill over into the consumption sector?
- Will exports recover?
- Will the People's Bank of China (central bank) maintain an expansionary policy?
- It looks as if the answer to these questions is going to be positive:

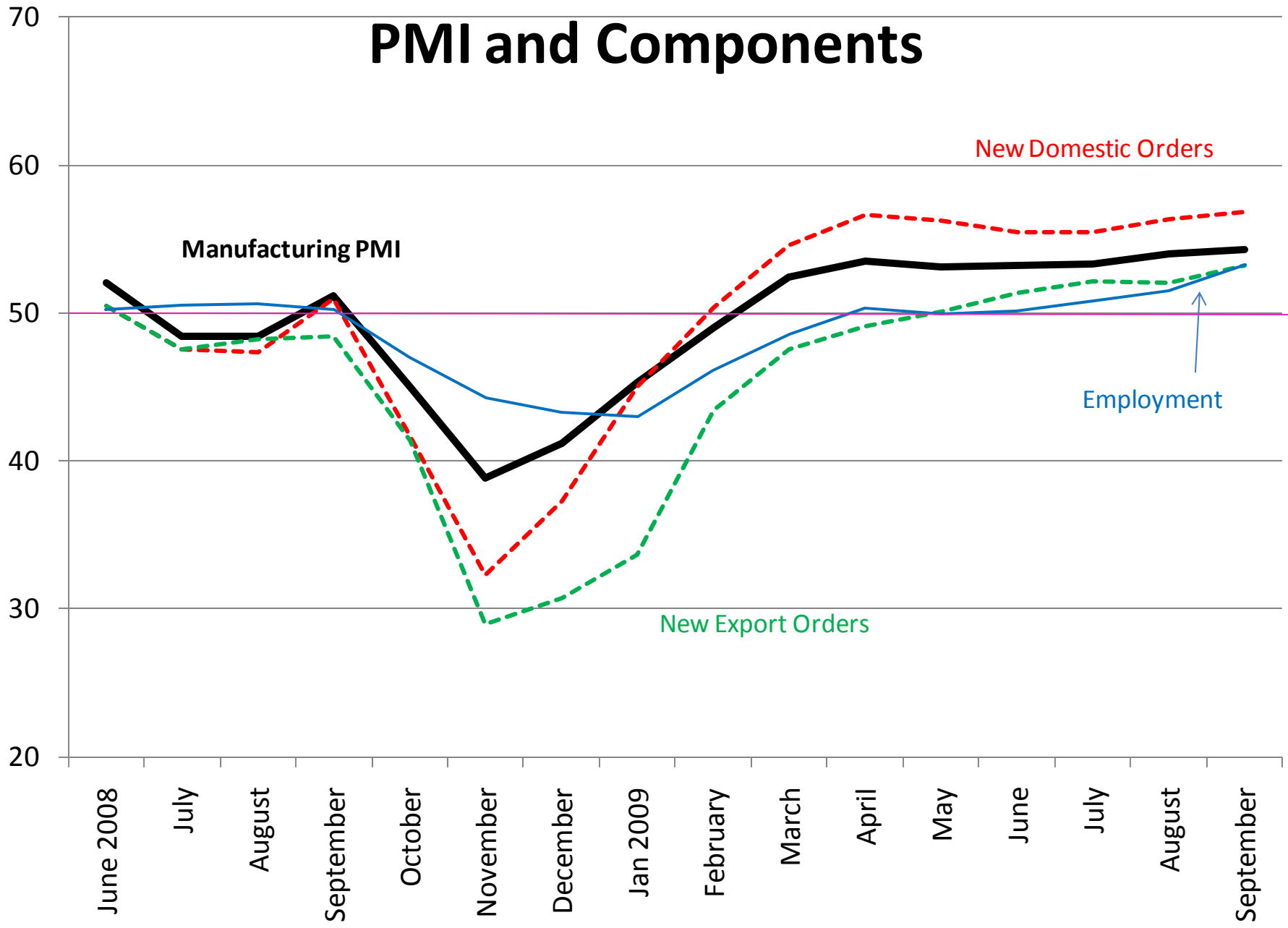
Employment and Consumption

- Data quality on employment is especially weak. There are worries about a “jobless recovery.” Job content of investment is relatively low, although higher for rural investments.
- Official unemployment has risen to 4.3%, in comparable terms, about 6%. Registered urban people whose employers were instructed to hold off on lay-offs
- But this does not count the estimated 20 million migrant workers who returned to their villages around Chinese New Year. A significant number trickled back to construction sites and factories during the summer.
- Some labor shortages have even emerged recently in export dependent areas such as Guangdong, when new orders come in.
- Of 6 million college graduates, 32% unemployed as of July 1, add on 1 million still unemployed from previous year.
- Overall, employment has held up, and began to increase again from about April.

Exports

- Signs of a recovery, but no actual recovery yet.
- August 2009, incoming FDI recorded positive growth over year-previous for the first time this year (+7% to \$7.5 billion).
- New Export orders in the PMI have been above 50 since May.
- During Jan-July 2009, Guangdong exported 46% fewer Christmas goods than in 2008. Realistic to expect some bounce-back.
- Orders are now coming in, but they are smaller batches, and more short-term contracts.

PMI and Components



PBC Monetary Policy

- At mid-year, the PBC was clearly unhappy with unsustainably lax credit policy. Stock markets, in turn, were highly sensitive to signs of policy reversal.
- After June, credit growth, while still rapid, was reined in from earlier explosive rates.
- NEW CONSENSUS: little or no inflation; International discussion on premature exit and the lesson of the 1930s; Chinese weak employment and shaky consumer expectations, all have led to consensus that policy should stay relatively loose for a substantial period.
- PBC will try to accelerate consumer lending, which has been a laggard over the past 2 years, while restraining investment lending (where liquidity is still abundant).
- Result: We should see stability in monetary policy.

Trends to Monitor:

- Trade surplus? Vigorous export recovery will be greatly welcome domestically.
 - Quickly increase international pressure on China to revalue the RMB
 - Would add to abundant domestic liquidity.
- How will consumption hold up as various subsidy programs expire? Electronics to the countryside, etc.
 - Expect a shift from the previously-dominant investment goods market to the consumption goods market.
 - Can the economy rebalance by engineering a sustained growth of consumption more rapid than the growth of investment?
- Will policy divisions re-emerge, especially in the run-up to 2012 leadership succession?

China: Cumulative 12-month Trade Surplus

