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Research Focus

Let the Stimulus Package Work in China

Ligang Song*

We are observing for the first time in modern economic history a joint effort among major economies in the world to stimulate economic growth through fiscal means amid the global economic downturn. China's stimulus package is equivalent to 3.2 per cent of GDP in 2009, well above the 2 per cent of GDP recommended by the International Monetary Fund. This is not so much because China's fiscal fundamentals are relatively sound and enabling China to do more than others, but mainly because too much is at stake for China to maintain a reasonably high growth rate against the backdrop of steeply falling exports and an abrupt easing of domestic economic activities. With much investment still needed for job creation, infrastructure development and provision of public goods, the room for fiscal expansion in China is no doubt considerable. It is also necessary to resort to fiscal means to boost the economy because abundant liquidity makes monetary policy less effective. However, the efficacy of implementing such a large-scale fiscal expansion will depend on a clear understanding of the challenges China faces with respect to the nature and pattern of its growth at this juncture of transformation and industrialisation.

With a growth rate of nearly 10 per cent per annum during the past thirty years, China's economy is like a fully loaded truck travelling at a high speed on a super highway powered largely by capital investment and strong exports. Imagine how precarious it would be if the truck not only needs to decelerate quickly, because of the economic slowdown, but also being forced to make a sudden turn (shift) from being highly dependent on exports to reliance on domestic consumption. Such a shift is generally regarded as necessary in resolving the problems of global imbalances and failure to do so increases the risk of running the economy into 'deflation', increasing unemployment and causing social instability. China's stimulus package might boost domestic demand and accelerate growth, but it may not be able to rebalance the economy towards a new pattern of growth driven primarily by domestic consumption. At the same time, if not implemented well, the package could set back ongoing institutional reform aimed at reducing the direct involvement of local governments in generating growth. The package's underlying growth target could also undermine the government's goals of reducing the energy (as well as pollution) intensity of its industries set as part of China's commitments to deal with energy and environmental problems.

Important questions are whether China's stimulus package works more effectively so that it would not only generate more growth and more employment as is intended, but also whether it will be conducive to 1) enhancing or at least not hindering the ongoing reform which underscores China's achievements in the past, and 2) addressing China's structural challenges including industrial upgrading through technological advancement and innovation, and increasing domestic consumption through boosting rural development and strengthening the social security system. Both are crucially important in determining that China achieves a more sustainable growth path in the long-term.

For the stimulus package to work will require the government to impose strong disciplinary measures on different levels of government to ensure that any investment accords with government planning and guidance. Investment by local governments is prone to inefficiency resulting either from various irregularities in utilising funds or from pursuing financially non-viable projects . Since its effectiveness ultimately determines the real impact of the spending package, the importance of continuing to deepen systemic reform is clear.

So implementation of the package has to be combined with other macroeconomic policies which include policy measures ranging from easing monetary policies to increase bank lending, and to reducing taxation for both enterprises and households. Direct government payments to low-income groups in both urban and rural areas aim to increase domestic consumption.

It is important that the huge expansion of government spending from all government sources won't crowd out non-state and private investment now accounting for more than 70 per cent of China's total fixed asset investment. The stimulus package inevitably strengthens the role of governments which may go against market-oriented reform.

One challenge will be to get the stimulus package to encourage further investment from the private sector, which played a pivotal role in driving past growth in China and holds the key for reviving the economy. With many factories already being closed down, government support in the form of finance and credit will be essential for small and medium-size private firms who continue to rely heavily on borrowing from the informal financial sources at much higher cost. A policy option is to quicken the pace of liberalising the informal financial sector and integrating it with the formal sector.

To make the stimulus package work, both China and its trading partners need to keep their markets open to each other. Guarding against the rising protectionism at this time of crisis will require both China and its main trading partners to make some necessary adjustments both domestically and internationally. As one of the largest beneficiaries from open trade, China can contribute to global economic recovery by importing more goods and by liberalising trading arrangements with its trading partners.

There is no room for complacency with respect to the viability of the commercial banks in China even though their overall ratio of non-performing loans has been falling recently. This improvement could be reversed when the economic slowdown starts impacting on firms' ability to repay their bank loans. Commercial banks will also be lending money to fill the funding gap in the stimulus package further increasing the financial risk for them.

China will be conscious of achieving fiscal sustainability in spite of the estimated budget deficit for 2009 accounting for only 2.9 per cent of GDP (lower than the internationally recognised level for warning). Fiscal expansion has however been accompanied by substantial reduction of taxation for both enterprises and households, weakening the government's fiscal position in the short-term. Moreover, a large proportion of funding in the stimulus package comes from local governments many of which are already heavily in debt.

For China, a failure to deepen its economic, governmental and institutional reform in time of crisis will not only undermine the efficacy of implementing its stimulus package, but also pose more medium- to long-term difficulties for China in confronting the challenges in the post-crisis world in which China is expected to play a more important role.

The current crisis is likely to get worse before it get better. But, the possibilities for further high growth in China have not been exhausted because the fundamentals which have driven past Chinese growth remain basically unchanged. China's room for further industrialisation from its current level of per capita income, its continuing urbanisation, the scope for further improving productivity by deepening reform and institutional change, and the preservation of an open global trading regime should mean that fast growth in China will resume to the benefit of both China and the rest of the world.

* Ligang Song, Crawford School of Economics and Government, Australian National University.

Events

PNG Updates: 16-24 April

Executive Update: 17 April, Port Moresby

Community Updates:

16 April UPNG, Port Moresby; 20 April, Alotau; 22 April, Goroka; 24 April, Madang.

14 July, China Update 2009: *China's New Place in a World in Crisis* Tuesday, The Coombs Lecture Theatre, Australian National University

Information: dominic.meagher@anu.edu.au

Asia Pacific Economic Papers

No 377, *Expansion Abroad and Jobs at Home: Evidence from Japanese Multinational Enterprises*, Nobuaki Yamashita and Kyoji Fukao (2009)

No 378, *Japanese FDI in China: determinants and performance*. Shiro Armstrong (2009)

APEC Economies newsletter mailing list enquiries:

Australia-Japan Research Centre

Tel: (61-2) 6125 3780

Fax: (61-2) 6125 0767