



# China Struggles To Keep Growing

by Peter T. Treadway



**O**N MARCH 4 at the National People's Congress Chinese Premier Wen Jiabao reiterated that China's official fiscal stimulus plan, first announced in November, would remain at \$486 billion. World stock markets, which had been prepped for an increase by some Western economists supposedly "in the know," sold off in disappointment. The markets wanted more. In my view the disappointment was misplaced. Beijing's approach is far from perfect and has a serious flaw in the banking area. But compared to the ever-changing and class-warfare driven American stimulus plans, the Chinese approach seems to be a model of good sense. In the land of the blind, the one-eyed man is king. The perfect plan should never be the enemy of the good plan.

Before we can judge whether the Chinese plan is a good plan, we have to make a judgment as to what a good stimulus really looks like. Different economic philosophies yield completely opposite judgments about stimulus plans. The prevailing ideological view in the world markets and in Washington and London is pure Keynes-

ian. In the current environment that means opening the floodgates of fiscal and monetary expansion. Economic efficiency and moral hazard need not be concerns. Underutilized capital and labor resources mean that the chance of rekindling inflation is low. Fed Chairman Ben Bernanke famously said several years ago that it was okay to drop stimulus money from a helicopter. On the fiscal side, government spending including transfer payments must be rushed into the deflationary gap left by a huge decline in consumer spending. Get the government money into the hands of people who have a high marginal propensity to consume (MPC) on domestic products. That means poor people, as the rich presumably save too much. And maybe they buy too many Louis Vuitton bags and other imported luxury goods.

Keynesian textbooks are replete with talk about fiscal multipliers. Thus, each additional yuan of government stimulus

---

∞ *Mr. Treadway is principal with Historical Analytics LLC, his own global consulting and investment-management firm. He also serves as chief economist, CTRISKS*

will yield some multiple in national income. The increase in national income equals  $(\text{one additional yuan of government spending}) / (1 - \text{MPC})$ . Assume an MPC of 0.6, no spending leakage into imports, unused labor and capital and forgetting about taxes, and you get a multiplier of 2.5. It all looks great in the textbooks and on the computer. But Chinese consumption is only 40% of GDP and maybe the Chinese MPC is less than 0.6. So the fiscal multiplier for China might not be so high.

The concept of a fiscal multiplier is not without its critics. David Ricardo argued two centuries ago that consumers may not increase their spending when they see government debt rising to finance increased government spending and calculate that they will have to eventually pay for it anyway. Under what has come to be called Ricardian Equivalence, consumers are indifferent as to whether they are faced with increased taxes now or government borrowing now and increased taxes later. Give them government money and their MPC drops. There goes the multiplier.

From the Keynesian perspective, some types of government spending are better than others. Infrastructure spending, which can take a while to plan and execute and, which, in the case of China would involve a high import component, is not a good candidate for a Keynesian stimulus program. Transfers to poor people would make more sense in the Keynesian framework. China has lots of poor people. Subsidies for bankrupt or near bankrupt large companies would also make sense since this presumably would preserve jobs.

Based on what is often called neoclassical or free-market oriented economics, there are alternative viewpoints on stimuli. Thomas Jefferson once said “The government that governs best governs least.” The non-Keynesians might want to update this—“The government that stimulates best stimulates least.” Oddly enough, the

normally interventionist, decidedly non-Jeffersonian European Union does not share the Anglo-Saxon unbridled enthusiasm for Keynesian stimuli.

The Austrian as well as the Monetarist schools would argue that bubbles have a monetary origin and result in a major misallocation of resources. From the Austrian perspective, the inevitable bust corrects this misallocation of resources and enables the economy to be put on sound footing to grow again. Government-stimulus efforts to delay or prevent this correction of resource misallocation will only lengthen the bust period. Propping up inefficient bankrupt companies in particular is a major misallocation of resources and a mistake.

An Austrian interpretation of the current situation might be that a global bubble has built up over many years and has shown up as overinvestment in manufacturing and export oriented capacity in China and an overinvestment in real estate and import-oriented consumer spending in the U.S. The bubble is now being unwound. Two sides of the same coin. Government stimulus programs that continue this overinvestment will only lengthen the adjustment process, i.e., lengthen the current global recession/depression. Running up huge deficits to finance government spending programs will crowd out private-sector borrowing.

Anyone evaluating the Chinese or any other country’s stimulus plan should become aware of some interesting empirical work reported by economists Gonzalo Fernandez de Cordoba and Timothy J. Kehoe. Their paper, which appeared in a report from the Federal Reserve Bank of Minneapolis, is based upon the work of a team of 24 economists who have studied the great depressions that occurred in the 20th century including the U.S. in the 1930s and Japan in the 1990s. Messrs. Fernandez de Cordoba and Kehoe have concluded that “massive public interventions in the econ-

omy to maintain employment and investment during a financial crisis can, if they distort incentives enough, *lead* (author's italics) to a great depression." They cite results which show that "a large drop in productivity always plays a large role in accounting for the depression." In other words, the government wasting money to replace private spending is a mistake. Building canals and bridges to nowhere, as Japan did in its "lost decade" of the post-bubble 1990s, does nothing for an economy's productivity and therefore nothing for its economic recovery. They conclude that "we need to avoid implementing policies that stifle productivity by providing bad incentives to the private sector ... Unproductive firms need to die. This is true for the automobile industry as it is for the banking system. Bailouts and other financial efforts to keep unproductive firms in operation depress productivity."

Admitting to a decidedly non-Keynesian bias, in my view the Chinese stimulus, subject to one important reservation, is a better plan than America's and that will enable China to recover faster than the other major world economies. The Chinese program, inasmuch as it is aimed at needed infrastructure improvements and although it may not have a dramatic effect in the short run, has a chance at being a net plus for productivity. And the mantra for China is still Deng Xiaoping's "To be rich is glorious" rather than what appears to be the new American mantra, "To be rich is to be a source of funds for the taxman." Business will want to invest in a country where the national policy is to embrace citizens who sincerely want to be rich.

Let's start with China's \$486 billion of fiscal stimulus. This would be roughly 15% of GDP and lead to a 3% budget deficit. But most analysts view the \$486 billion as an inflated number. Many of the projects included in this number would have happened anyway. If so that's probably good. It

means that the projects were already vetted and will be properly implemented. The bulk of the projected Chinese spending is apparently going to be spent on infrastructure—roads, railways, airports, electricity and water-supply projects. China, like most of Asia ex-Japan, is short on basic infrastructure, the glittering lights and usually near empty Maglev train of Shanghai's Pudong notwithstanding. The returns on infrastructure investment in China will be substantially higher than they would be in the U.S. or Japan. Chinese spending on infrastructure will add to productivity and hence promote economic recovery and long-term economic growth.

It's reasonable to assume that the Chinese have concluded that they do not have the managerial or technical capacity to push infrastructure spending above the announced levels. If that's the case, Premier Wen's resisting market and U.S. pressures to increase the size of the Chinese stimulus program makes sense. Haste makes waste. Both the Chinese president and premier spent the bulk of their careers in the impoverished Chinese hinterland. Men like these do not spend billions of dollars as casually as U.S. Treasury Secretary Tim Geithner. And, like the politicians in Brussels, they don't take everything that Lord Keynes said as revealed truth.

One thought here. Chinese infrastructure projects as mentioned will have a high import component. Given the demise of the American consumer who has been the No.1 Chinese customer, this will cut down or eliminate the Chinese trade surplus. Not to worry. China can finance the import component of its infrastructure project by selling its American Treasuries.

There are other expenditures outside the official stimulus program. Among these most prominent is the health-care program. An additional 850 billion yuan (around \$125 billion) will be allocated in the next three years, including 331.8 billion

yuan from the central government, to ensure smooth progress in the reform of China's medical and health-care system. Economists of all stripes have noted that Chinese consumption must come up to offset the decline in consumption by Western nations. Lack of health care has been cited as a reason for excessive savings on the part of the Chinese. Unfortunately, the health-care initiative, while probably a good idea, is not likely to affect savings rates much in the short term.

Regarding monetary policy, the People's Bank of China has been reducing rates since last September. But with a deposit rate maximum of 2.5%, China has not reached the panic level near-zero federal funds rate obtaining in the U.S. And so far no quantitative easing has been seen either.

There is one big negative in the Chinese stimulus program. Chinese sobriety on the fiscal front is not being matched on the banking front. True the banking system is not the toxic asset black hole that the American banking system has become. Reported nonperformers going into the crisis had been coming down since the bank reforms of 2003 and in recent years the government had taken special measures to cool down house-price speculation. But the big four Chinese banks are controlled and majority owned by the government. They have been given their marching orders to lend. And they have complied: In February 2009, total bank loans were up 24.17% year on year. No one knows where all this money is going. Some of it undoubtedly has flowed into the Shanghai A market which is up 26% since the beginning of the year. But unfortunately it is also possible that a good portion of these loans are going to prop up less efficient state-owned enterprises.

*Returns on infrastructure investment in China will be greater than they would be in the U.S. or Japan.*

In my opinion, capital lent for this latter purpose will not contribute to the economy's growth in productivity or recovery and risks bring with it a new crisis in NPLs. Although it may produce some nice numbers near term, a government directed bank-lending program which adds to the overcapacity in the industrial sector will retard China's long-run recovery. And all the progress China has made in reforming

its banking system will be put at risk. It's the opposite side of the coin from America. Efforts to stimulate the U.S. housing sector are totally misguided since there is already huge excess inventory to be worked off and U.S.

homebuyers are up to their eyeballs in debt. Both China and America have to avoid investing in the bubble. Let the bust do its work. The massive closure of private factories for export on the China coast, while tragic in human terms, is an essential part of the adjustment process. Some of these factories may reopen and produce for the domestic market. The export-to-the-U.S. model as a growth driver for China is dead. Capital should be flowing elsewhere. Overcapacity in basic industries like steel should be treated the same way.

Projected GDP growth for this year is 8%. Recently some optimistic statements by PBOC Governor Zhou Xiaochuan regarding the efficacy of the Chinese stimulus programs have appeared. In all countries investors expect politicians and central bankers to always take an optimistic view in public. The danger is that in China, where the state still has enormous control over the economy, misguided investment decisions will be taken to make the optimistic official forecasts come true. China will pay for that in the long run if it happens. ■