# China’s stimulus shows the problem of success

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China has rebounded from the global slump with vigour. In the second quarter, its official figures showed year-on-year gross domestic product growth of 7.9 per cent. Those who doubt the quality of China’s macroeconomic statistics can check its physical statistics: in June, electricity production increased 5.2 per cent, reversing the falls of the previous eight months. It is almost certain that China’s GDP will grow more than 8 per cent this year.

But there are problems looming. More investment thanks to China’s rescue package threatens to worsen the already severe overcapacity, while the cash injection is already creating asset bubbles.

The reason for China’s stimulus is simple. While it did not suffer a western-style financial crisis, it was hit hard by the second-order effects, as exports suddenly collapsed. In 2007, the growth rate of exports was 25.7 per cent, and exports made up 36 per cent of GDP. In November last year the exports shrank 2.2 per cent on the year, and have fallen continuously since then. In May 2009, exports plunged 26.4 per cent against a year earlier. The fall of exports may have cut GDP growth 3 percentage points. If its indirect impact is included, it may have shaved more than 5 points off China’s 2008 growth.

The Chinese government reacted very quickly. In November 2008, the government introduced a Rmb4,000bn ($580bn, €404bn, £354bn) stimulus package for 2009 and 2010. The prescribed dosage of the stimulus is very large, at 14 per cent of GDP in 2008.

China can afford such an expansionary fiscal policy. Over the past decade, China’s budget deficit was very low, and in 2007 it ran a budget surplus. As a result, China’s debt should only be about 20 per cent of GDP even after the stimulus. The government has plentiful room to manoeuvre.

Here, though, comes the first problem. The most important component in the stimulus package is investment in infrastructure. Fixed asset investment has long been the most important driving force for China’s economic growth, and has been growing faster than GDP since the turn of the century. Due to the dual role of fixed asset investment in creating demand in the short run and supply in the long run, an increasing investment rate will create immediate excess demand for a while, then the economy will shift from a phase of overheating to overcapacity. Correspondingly, inflation pressure will be replaced by deflation pressure.

Since late 2003, China's macroeconomic policy was aimed at controlling overheating. Because the overheating was mainly caused by the rapid increase in fixed asset investment, overcapacity was building up at the same time. Strong external demand postponed the arrival of overcapacity. Unfortunately, the government's efforts failed to contain the investment fever. For example, in 2004, when the government tried to clamp down on investment fever in steel production, China's steel capacity was 400m tonnes. In 2007, it passed 600m tonnes. Only when exports collapsed was the extent of overcapacity exposed – and in a dramatic fashion.

To maintain decent growth and avoid massive unemployment, the Chinese government was left with no option but to replace flagging external demand by domestic demand. But in the short run it is difficult to stimulate domestic consumption; investment demand became the only alternative. As a result of the stimulus package, the growth rate of fixed asset investment hit 36 per cent year-on-year in the first half of 2009, and China's investment rate may have surpassed 50 per cent of GDP.

The government knows very well that the economy has been suffering from overcapacity. This is why government-financed investment in the stimulus package is concentrated in infrastructure, rather than new factories. However, there are still problems with an investment-centred expansionary fiscal policy. Due to the hasty and under-supervised implementation, waste in infrastructure construction is ubiquitous, and the prospective returns of this big push into infrastructure are less than promising.

More resources should be used in building a decent social safety network, so household consumption can play a more important role in driving economic growth. Government spending should be conducive to private investment and help the development of small and medium-sized enterprises, but many local governments are squeezing these businesses hard to compensate for falling tax revenues.

Faced with the clear overcapacity after the sudden withdrawal of external demand, the Chinese government now is trying hard to stabilise export growth. Tax rebates are becoming an important export promotion policy. Unfortunately, it is more likely that due to the adjustment in the US's imbalances – particularly a fall in consumption – contraction of China's export markets is inevitable.

China's rebalancing is more the result of the global economic crisis than of policy initiative. China could do more to eliminate both internal and external price distortions to reduce its dependency on external markets. While China's crisis management has succeeded in reviving growth, its achievements in structural adjustment are mixed.

Now to the second problem. In the first half of 2009, bank credits increased Rmb7,300bn, above the official target for the full year. Credit growth was surprisingly high, and the same was true of the broad money supply, M2, which grew at a record rate relative to GDP. As a result, the inter-bank money market has been inundated with liquidity.

It is right that China should adopt an accommodating monetary policy in response to the global financial crisis and domestic slowdown. However, China did not suffer a liquidity shortage and credit crunch. Its monetary multiplier has been more or less stable. China does not need a helicopter to drop money from the sky.

The excess liquidity has led to the resurgence of asset bubbles. At present, overcapacity is preventing inflation becoming a threat. However, with broad money above 160 per cent of GDP, the situation could change, and change quickly, due to internal or external shocks. Global policymakers are focused on the US Federal Reserve's next steps. China's monetary authority may also need to worry about its exit strategy.

To achieve a sustainable rebound, China needs to strike a fine balance between crisis management and structural reforms. If China fails to tackle its structural problems, including its export dependency, high investment rate and wide income gaps, growth is unlikely to be sustainable. The current crisis has provided China with a good opportunity not only for structural adjustment but also for institutional reforms. It is in China's and the world's interests to see the necessary measures are adopted with conviction.