

China's stimulus package A six-month report card

A Corporate Network special report



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Executive summary

The so-called Rmb4trn stimulus package is more a policy than a package

China's response to the economic crisis has gone far beyond the specific expenditure included in the Rmb4trn stimulus package announced in the national capital, Beijing, on November 9th 2008. The policy context that has shaped China's reaction has its roots in a tradition of state-led economic development, as well as in experience gained during the Asian financial crisis of 1997-98. The phases of the current stimulus policy comprise monetary policy adjustments such as VAT (value-added tax) rebates and interest rate cuts, a core investment plan, funding mechanisms (banks loans, provincial bonds) and a series of templates for industrial restructuring. The sequencing of these segments has not only been in response to global economic conditions, but has also been tailored by domestic political realities.

- **Details are still fuzzy.** Much of the scope and many of the details of the Rmb4trn stimulus package are still opaque. The two-year spending programme is intertwined with investment projects from the 11th five-year plan, which began in 2006. The central government is also fine-tuning its effort on a near-daily basis. Since November, it has introduced several major policy initiatives, such as the "ten industries revitalisation plan" and the blueprint to turn Shanghai into an international shipping and financial centre.
- Main problems are left unaddressed. The stimulus package does not address the underlying problems in the Chinese economy. Of the three pillars of economic growth in China—trade, investment and consumption—exports will continue to falter until the recovery of China's major trading partners, the US and EU. Despite recent figures painting a rosy picture of retail growth—nationwide, retail sales grew by 15% in the January-April 2009 period—domestic consumption will take a long time to compensate for the slump in exports. Indeed, higher levels of domestic consumption will require greater government investment in social welfare, which still accounts for only a fraction of 2009 government fiscal spending and of the entire two-year fiscal stimulus package. Fixed asset investment, on the other hand, has been increased dramatically, owing to the government's promotion of infrastructure projects, ranging from elevated high-speed railways to regional airports. However, corporate investment, from private enterprises as well as from state-owned enterprises (SOEs) and multinational corporations, has been cut back dramatically because excess capacity in the manufacturing sector will take months, if not years, to be fully utilised. Moreover, although the central government is trying to spend its way out of the crisis by pushing up fixed asset investment, it has not addressed the issues of lacklustre domestic demand or unemployment—either of the more than 20m migrant workers laid off from export manufacturing assembly lines, or of the more than 5m recent college graduates who have been unable to find work.

There is also the issue of structural economic reform. In 2006 China began to move up the value chain in the manufacturing sector with the "empty the cage, change the birds" initiative (腾笼换鸟)



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in Guangdong, the then manufacturing heartland. This policy encouraged companies to exit shrinking markets and upgrade to higher-value-added manufacturing. This was followed in January 2008 by the introduction of the Labour Contract Law, which mandated written contracts for workers and increased protection for conditions of employment. However, both policies have been set back by the financial crisis, as companies (especially labour-intensive manufacturers) have pared costs and staff numbers to survive.

- Lack of transparency in process. The stimulus plan itself has certain inherent shortcomings. Its direction, deliberation processes, and specific rationales behind targeted areas and funding allocations all lack transparency. And, like all central government spending, it has created ample opportunities for interest groups, led by powerful ministries and competing provinces, for self-serving behaviour.
- Questionable accounts. The accounts ledgers worry many observers. As of mid-May 2009, the central government has released Rmb304bn, or 25% of its promised share of Rmb1.18trn in funding. However, new bank lending, much of it directed towards government-guaranteed infrastructure programmes, was Rmb5.17trn in the first four months of 2009. Local governments have also competed with one another with their own investment schemes. The inland municipality of Chongqing boasts of planning fixed asset investment of Rmb500bn this year, and the poor coastal province of Guangxi plans to spend Rmb600bn. How these two localities will finance all these additional projects is not yet clear. In some instances, local governments intend to participate in the provincial bond issuance programme, which is now operating on a provisional basis in several areas. Other localities are eyeing more massive bank loans.
- **Dubious projects.** Some of the infrastructure projects themselves are dubious. Poster projects such as the Rmb40bn Shanghai-Nanjing intercity express railway, or the Rmb72.6bn Hong Kong-Macao-Zhuhai bridge, purport to generate social and economic benefits, but raise concerns over whether they will merely be vanity projects that will only benefit steel and cement makers. Critics have also questioned the duplicative nature of projects: the Shanghai-Nanjing intercity express railway and the high-speed express railway between Shanghai and Beijing will have 300 km of overlapping routes.
- **Problems with rent seeking.** The implementation of the stimulus package risks massive rent seeking. Initial audits have already unveiled problems such as inadequate initial funding or duplicative construction. There have also been cases of local governments faking documentation or even faking an entire project to garner funding. Other concerns include speculative commercial paper discounting, funding delays and insufficient stimulus for small and medium-sized enterprises (SMEs).
- Rural land reform. Finally, although there are provisions that help rural households to purchase consumer goods, there is nothing in the stimulus package that touches on the issue of rural land reform, which has the potential to transform the rural economy and accelerate urbanisation. Draft legislation on rural land transfers was introduced in October 2008, but since then the central government has been silent. Although it is understood that administrative preparations for land registration and the like are

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complicated, there is concern that the government has rolled back its original timetable for rural land reform owing to preoccupation with the stimulus package.

Nonetheless, despite all these misgivings, the central government should be given credit for its prompt response to the financial crisis, its efforts to select targets and its capabilities to fine-tune the investment process. Several major indicators show that the stimulus package has already been effective in preventing the economy from slowing down further, and certainly there are parallels between increased rates of fixed asset investment and economic growth. According to the National Bureau of Statistics, China's economy expanded by 7.1% in the first half of 2009, with GDP growing from 6.1% in the first three months of the year, and then accelerating to 7.9% growth in the second quarter. Investment was the main force behind the acceleration, as the government's loose credit policy and stimulus spending supported infrastructure construction. Fixed asset investment (FAI) rose by 33.5% year on year in January-June, up from 28.8% in the first quarter, with FAI in eastern, central and western regions increasing by 26.7%, 38.1% and 42.1% respectively.



1. Why is the government proceeding in this manner?

Late 1990s: Beijing's formative experience, the Asian financial crisis

The lessons learnt from the Asian financial crisis in 1997-98 have shaped many of the government's responses to the current financial downturn. What the government learnt in 1997 was that it could spend its way out of danger, and that it could leverage global weakness into national advantage. However, it failed to learn how to stimulate domestic consumption and how to ensure that fiscal spending trickles down to small and medium-sized enterprises.

In July 1997 devaluation of the Thai baht resulted in a cascade of currency devaluations and economic crises throughout Asia. While the renminbi remained pegged to the US dollar, China took an unprecedented active role in providing economic stability in the region, through grants and loans to affected governments via multilateral channels—such as the IMF, APEC (Asia-Pacific Economic Cooperation) and ASEAN (Association of South-East Asian Nations)—and bilateral assistance. In the decade since then, China has strengthened its relationships in the ASEAN region through a free-trade agreement. China also began a major domestic infrastructure drive to ensure a high degree of economic activity. Much of the infrastructure built in the late 1990s was for roads and highways, which in turn opened up interior regions to more commerce. This was followed in January 2000 with the establishment of a "leadership group for western China development" (西部地区开发领导小组) under the State Council (China's cabinet), which has continued funding development projects in the western provinces.

Much current academic discussion in China revolves around the similarities between the 1997 stimulus and the 2009 version. In the earlier stimulus package, local governments invested more than expected, partly to fulfil targets set by the central government, and partly owing to their vested interests in project accumulation and growth. From 1998 to 2001, the central government planned to issue Rmb100bn in bonds to finance projects valued at Rmb1.3trn. However, the final tally was government issuance of Rmb800bn worth of bonds, to finance projects worth Rmb2.4trn.

State-led investment played a leading role in revitalising the economy in 1997, and the same is true today. However, there are also some significant differences. First, the scale of the present crisis is far larger than in the 1990s, and the Chinese economy now is far more integrated with the global economy. Moreover, central authorities made a crucial decision in the 1997-98 crisis to accelerate the deregulation of the property market. Earlier pilot programmes to privatise home ownership had been under way since the early 1990s, but these programmes were expanded in 1998, resulting in an enormous boost to residential property development and ushering in major social change. Since then, the construction and property sectors have become so-called pillar industries in China, creating millions of jobs and a huge market—as well as huge fortunes for land speculators and property developers.

Another crucial sector that was deregulated in the late 1990s was healthcare. While this undoubtedly



led to the growth of local bio-pharmaceutical companies and medical care, privatisation also placed healthcare out of affordable reach for many. Thus the legacy from the 1997/98 stimulus package was mixed: along with the inter-provincial highway system and new spatial living possibilities, the 1997/98 stimulus also generated high housing prices and inordinately expensive healthcare. An additional negative consequence of increased liquidity was speculative investment, as various investment scams (including pyramid schemes) rocked China in 1998 and 1999. Most significantly, domestic consumption failed to grow. Consumers were worried (as they still are) by the rising costs of housing, healthcare and education, and stubbornly stuck to frugality, maintaining high savings rates.

2007 to early 2008: As the global economy weakened, China reversed policy

China's GDP grew by 13% in 2007, and the country's policymakers spent much of that year worrying about the economy overheating. China had reduced or abolished the export tax rebates for many commodities in June 2007 in order to reduce its trade surplus. In early November 2007, the People's Bank of China (PBC, the central bank) imposed a moratorium on lending by both domestic and foreign banks, as the PBC's yearly quota of loans (Rmb3.63trn) had been exceeded. Although bank lending resumed in January 2008, credit continued to be squeezed by a series of interest rate hikes and increases in the reserve rate requirement for banks (which had risen to 17.5%).

In China, the export sector first felt the impact of global contraction. Specific challenges for exporters in the first half of 2008 included renminbi appreciation (by 6.5% at mid-year), inflation, product safety scandals (particularly for toy manufacturers), reduced export tax rebates, rising wage bills and policy directives to upgrade industrial processing—all of which squeezed the margins of many export manufacturers, particularly smaller enterprises. According to the National Development and Reform Commission (NDRC), over 67,000 SMEs (including over 10,000 textile manufacturers) were forced to close in the first half of 2008. Guangdong—a major base for low-cost, labour-intensive manufacturing and China's top exporting province—was especially hard hit by rising costs and the downturn in export orders.

Mid-2008 to late 2008: Beijing listens, and acts

In the third week of July 2008, the Central Leading Group of Financial and Economic Affairs within the politburo met for an analysis of the impact of economic tightening measures on the export sector, following inspection tours to the main exporting provinces early in the year by China's premier, Wen Jiabao, and the president, Hu Jintao. The resulting decision by the Central Leading Group was to relax the economic tightening measures which had been in place for several months, through adjustments to credit provision and export tax rebates, citing the requirement to maintain "stable but rapid economic growth" while containing inflation.

In late July 2008 the State Administration for Taxation announced adjustments to the tax rebate system for exporters, notably for labour-intensive manufacturing. In a softening of its tight monetary policy, the PBC announced in early August 2008 that it was raising the lending quotas for both domestic and foreign banks: national banks were to have a 5% increase, and local commercial banks were to receive



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a 10% increase. The PBC further instructed that the additional lending quota be directed towards SMEs, the agricultural sector and reconstruction work in the earthquake zone.

In the following months, further export tax rebates and export duties (notably on steel and chemical products) were adjusted to encourage export sales, with the State Council announcing in mid-November that it would raise export tax rebates on 3,770 export items (representing 28% of exports, with a concentration on machinery, electrical products and labour-intensive products), effective December 1st. This measure followed a previous relaxation of export taxes which took effect on November 1st. Other corporate tax relief permitted the deduction of VAT on fixed-asset purchases, and was intended to help the purchase of new equipment. In the following months, further announcements of tinkering to relieve pressure on specific (usually labour-intensive) industries have been rolled out, in the form of tax cuts and adjustments to export tax rebates, in a continuous "parallel track" of assistance to business recovery.

Late 2008 to present: Spending one's way to growth

The bankruptcy of an investment bank, Lehman Brothers, in mid-September 2008 and the panic resulting from the feared collapse of a giant insurance firm, AIG, in the following weeks added new urgency to government responses. China's most noteworthy defensive measure against economic contraction was revealed on November 9th, with the announcement of an Rmb4trn stimulus package to run until 2010, comprising infrastructure investments and redistributive social spending. The timing of the announcement was noteworthy, as the president, Hu Jintao, was scheduled to attend the G20 summit in Washington DC on November 14th, and was therefore able to announce China's stimulus spending as a fait accompli at the meeting, noting that ensuring China's growth was the most significant contribution his nation could make towards global economic recovery.



2. What is in the package?

What is included in the stimulus package and what has been left out? The stimulus package from the start was positioned as a confidence-building measure, rather than a fully-formed programme of spending (such as the five-year plan), although the rhetoric used to describe the package resonated with other government messages. According to the premier, Wen Jiabao, the Rmb4trn stimulus package only constitutes one "pillar" of the overall government rescue plan, and comprises infrastructure and projects closely related to people's livelihood, such as environment, education and healthcare. The other three pillars are the revitalisation plan for ten major industries; support for science and technology; and improvements to the social security safety net.

While the Rmb4trn stimulus package is only part of an overall plan to boost government spending, there are some clear distinctions regarding proposed increases in government spending and investment. The central government has outlined specific target areas and guidelines for investment in the stimulus schedule from end-2008 to end-2010, but at the same time both central and local governments are splashing out on other investment projects that lie outside the Rmb4trn framework.

Broadly speaking, the stimulus projects announced to date fall into the following categories:

- 11-plus: These projects represent no new additional spending but are rather an acceleration of spending that has already been proposed and allocated in the 11th five-year plan. These projects have completed feasibility studies and have been allocated funding, so the stimulus package serves to accelerate funding disbursements and thus the pace of project completion. One example is the 900-km express railway between Harbin and Dalian, which had been approved by the NDRC in 2005 as a major 11th five-year plan construction project with an estimated investment of Rmb82bn. Construction started in October 2007 and was to be completed in 2013. Largely owing to the stimulus plan, the completion has been brought forward to 2011. Various metro rail projects in 11 cities have also been fast-tracked from their original five-year plan schedules—these include the municipalities of Beijing, Shanghai, Chongqing and Tianjin as well as several provincial capitals (Shenyang, Xi'an, Chengdu and Guangzhou) plus commercial centres (Shenzhen, Dalian and Ningbo). The total budget for their construction is estimated to be Rmb171bn.
- Harmonious society: These are projects funded by the central government (with some co-funding from local governments) and relate to livelihood support and redistributive social spending, such as healthcare reform and measures to increase rural income and augments teachers' salaries. These projects are in accordance with the "harmonious society" principles originally outlined by Hu Jintao in his first administration (2001-06) and which have since become the hallmark of his social policy.
- Tax relief: These are additional fiscal measures announced separately from the Rmb4trn stimulus package, as well as tax waivers and reductions which benefit specific industries, such as reduced sales taxes for small-engine cars and incentives for rural households to buy electrical appliances.
- Industrial revitalisation strategies: To date, industrial restructuring blueprints have been unveiled for ten industries—some of these blueprints have a timeline of two years, while others have a longer implementation schedule. Notable measures from the blueprints usually include tax relief, provision of



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credit to upgrade technology and improve energy efficiency, encouragement of industrial consolidation through mergers and acquisitions, and the expansion of rural markets and export sales. The ten industries are: automotives; steel; textiles; shipbuilding; petrochemicals; non-ferrous metals; equipment manufacturing; information technology (IT); light industry and logistics.

Sectoral breakdown and focus

The government's main focus for spending from the stimulus package is on mega-projects, primarily on large-scale infrastructure civil works as well as for the reconstruction effort for post-earthquake Sichuan. Of the civil engineering projects, railway construction accounts for a large percentage of projects, including over 8,000 km of high-speed railway lines. These massive projects will increase demand for cement, steel and other construction materials which have been hit by the economic slowdown.

Indeed, the main function of the funding stimulus is to increase demand for such items, and thus kick-start the economy. Government investment is designed to act as "seed funding" to attract further investment, from co-funding from local governments as well as from private investment (with the help of massive bank lending). The goal is to increase the multiplier effect, which is usually calculated at a 1:3 ratio for co-funding. However, if overheating results, the multiplication could rapidly surpass this target. The question is whether the central authorities will be able to control the pace of project growth, and whether the government will be able (or willing) to rein in investment so as to avoid the growth of speculative bubbles.

The targeted areas include:	Rmb
Low-cost housing for low-income citizens	400bn
Major infrastructure projects, such as railways, highways, airports and power grid	1.5trn
Rural livelihood and infrastructure improvement	370bn
Ecological and environmental projects	210bn
Projects aimed at "indigenous innovation" reform	370bn
Healthcare and education projects	150bn
Sichuan earthquake reconstruction	1trn



3. How will this be managed?

Sorting through the wish-lists

Not surprisingly, the government's announcement of the stimulus package on November 9th started a flurry of bureaucratic effort at all levels of government. Initial post-November 9th government statements focused on specific sectors, noting that the proposed infrastructure build-out included energy and transportation. However, the bureaucratic commotion intensified with the central government's decision to allocate Rmb100bn among 11 ministries by the end of the first quarter of 2009, with spending plans scheduled to be ratified during the spring session of the National People's Congress (China's legislature).

Ministries

In lieu of other guidance, early indications were that carte blanche would be given to ministries to promote strategic programmes and to expand or accelerate ongoing long-term projects, such as the South-North water diversion project and reforms to forestry management. Media coverage paid particular attention to ongoing infrastructure investments that were expected to yield earlier returns for economic growth in the energy sector. These included a gas pipeline to Guangdong and the expansion of existing and construction of new nuclear and hydropower plants. A full suite of airport expansion was also announced, to increase the capacities of major hub airports (Shanghai, Chengdu, Xi'an and Guangzhou) as well as regional airports and new air links to rural communities. Urban rail transport was to be expanded, through subway and light rail links in fifteen major cities.

However, underneath all the often breathless initial media coverage of the fiscal stimulus package, the provenance of funding was unclear—central authorities appeared to be injecting Rmb2.5trn of new spending, but the remainder of the funds seemed to be either already committed under the 11th five-year plan (which coincidentally runs until 2010 and which includes a number of mega-projects, such as the South-North water diversion project as well as the metro rail projects in 11 cities), or would be matched by provincial and local government funding.

Consideration and approval

As the spending guidelines for the sectors and projects were gradually unveiled (including compensatory quotas to redress regional and population disparities) they have been closely studied by provincial and municipal officials, usually in the form of a "small group" task force convened by the provincial party secretary and including senior civilian officials (governor and mayors). The main duty of a provincial-level task force has been to collate and bundle all appropriate projects for consideration. There are certain prerequisites for approval: projects need to be in line with government directives, and they must have completed preparation work and feasibility studies. They also need to demonstrate that they have the ability to raise a significant portion of investment in matching funds. In addition, the State Council has final approval over projects requiring an investment larger than Rmb200m.



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Once the small group at the provincial level developed its wish list of projects for the province (carefully phrased so as to fit easily into the project guidelines), the local Development and Reform Commission (DRC) then transferred the list to the National Development and Reform Commission (NDRC). It should be noted that while the DRC officials at the provincial and sub-provincial levels report to the NDRC, their salaries are in fact paid out of provincial coffers, so they are by no means disinterested parties in this process.

The NDRC has the job of sorting through all the provincial submissions, calling in other ministries for consultation as required. Once the NDRC has approved the provincial projects, it allocates funding en bloc to the provincial-level Ministry of Finance office for disbursement to the specific government bureaus that will be responsible for project management. The leading role played by the NDRC has resulted in a pun on the Chinese idiom 跑步前进 ("run to get ahead", which has become 跑部钱进 or "run into ministries to grab money"). Hotels around the NDRC office buildings have been fully booked ever since November.

Oversight

In the weeks after November 9th, the initial Rmb4trn allocation announced by the State Council underwent some clarification, as well as much augmentation. Deadlines were introduced for at least some of the funding requests, and auditing procedures were highlighted in media coverage. Oversight and auditing are the responsibilities of the Ministry of Finance (at the central and provincial levels) and the National Audit Office. The Central Commission for Discipline Inspection of the Chinese Communist Party has also stated its intention to scrutinise all government allocations of the Rmb4trn.

Special interests

Not surprisingly, the stimulus package began acquiring an "adhesive" quality, in that other government initiatives rapidly became associated in the public's mind with the package. Additional measures (independent of the Rmb4trn stimulus package) had already been introduced to help the sagging property sector. The stamp duty on home purchases and VAT on land sales were lifted on November 1st, and mortgage lending was eased through lower down-payment requirements (to 20% from 30%) and lower interest rates. The Ministry of Housing and Urban-Rural Development had announced that it would spend Rmb900bn on home construction and renovation for low-income families. Several municipalities had devised their own incentive schemes to boost local property markets: in Shanghai the lending quota from the Housing Provident Fund was raised, and Hangzhou offered much prized urban household registrations as a benefit of home purchase.

Other incentive schemes were publicised, in tandem with, but not formally part of, the Rmb4trn stimulus package. For example, Guangdong province announced that it would invest Rmb50bn to retain industry within provincial borders, through schemes to assist companies to relocate to lower-cost regions within the province, and to upgrade their manufacturing processes.



4. How will it be funded?

The original plan

China's annual Central Economic Work Conference was held in Beijing on December 8th, after which several allocations from the stimulus package became more detailed. Specific funding channels were still rather vague, but it was announced at the conference that central funds would make up 30% of the total Rmb4trn amount (Rmb1.18trn), with local governments and enterprises expected to contribute the balance¹. The share from local governments was projected to be Rmb1.23trn, with the balance (Rmb1.59trn) to come from bank lending. Additional liquidity would be gained by expanding the issue of treasury bonds. Funding diversification would be facilitated by permitting insurance companies to invest in infrastructure projects, and further business-friendly measures to simplify administrative and lending procedures and cut taxes were announced.

¹ Initial reports indicated that the contribution of the central government would be Rmb2.5bn, but this shrank to Rmb1.18trn.

The banks

In its drive to boost credit flows, the State Council increased the credit quotas for the state banks through an extra lending tranche of Rmb100bn that it authorised to the three policy banks: the China Development Bank, China Export and Import Bank, and China Agricultural Development Bank. Policy lending quickly already benefited from this, with the Bank of China and the Agricultural Bank of China both signing co-operation agreements with the Ministry of Railways to support railway infrastructure investment. They joined the China Construction Bank, the Industrial and Commercial Bank of China and the China Development Bank, all of which also pledged loan support to the railway infrastructure build-out. In the case of the China Development Bank, 22 specific rail projects were identified for the funding agreement, most of which are in the interior provinces and are presumably riskier investments for commercial lending. In other instances, it was less clear which bank was funding which project: other loan agreements announced coincidentally with the stimulus package (notably the more credit-worthy Beijing-Shanghai high-speed link, which is already under construction) appear to have been well oversubscribed, even before the November stimulus package was released.



5. A budgetary challenge

Problems with the budget

In the new calendar year, China's senior policymakers warned of severe economic challenges to come, even as the country's stimulus package was being expanded to include tax cuts and other sectoral incentives for growth. The finance minister, Xie Xuren, warned of further revenue shortfalls. Whereas fiscal revenue had increased in 2008 to Rmb6.13trn, expenditure had been Rmb6.24trn, resulting in a budget deficit of Rmb111bn. And this was relatively modest, given the volume of unanticipated expenditure in 2008, such as fuel subsidies to offset spiralling oil prices and reconstruction costs following the Sichuan earthquake in May that year.

Nationally

The budget estimate for 2009, which was put forward at the National People's Congress session in March 2009, ballooned as a result of the economic slowdown and the government's ameliorative measures. Apart from the central government's contribution of Rmb1.18trn to the Rmb4trn stimulus package, more spending was needed to fund the series of subsidies and incentive programmes targeted at specific sectoral support. Most of the budget discussions in the course of the March 2009 session of the National People's Congress took place behind closed doors, but the broad outline of the budget estimates was released to the public, and was a mix of annual expenditure with additional stimulus measures. According to the budget proposal for 2009/10 fiscal year, redistributive public spending was to rise by Rmb487bn to Rmb908bn. Agricultural subsidies were to increase by 19.4% to Rmb123bn, which would cover assistance to grain producers and support for agricultural machinery sales. Further subsidies for the farm sector brought the total to Rmb716bn (a rise of 20.2% year on year) to aid the rural economy, including Rmb103bn to subsidise purchases of domestic appliances and vehicles by rural households, as well as increases to grain reserves. Other social spending was to increase by 17.6% (for social security expenses, such as low-income support payments) while healthcare expenditures were to be boosted by Rmb118bn. Spending on low-cost public housing was set at Rmb43bn, with Rmb130bn for earthquake reconstruction work. Rmb42bn was earmarked for job creation programmes. The largesse was not confined to social spending. The defence budget increased by 14.9% to Rmb480bn, and programmes of support for ten major industries (automotives; steel; textiles; shipbuilding; petrochemicals; nonferrous metals; equipment manufacturing; information technology; light industry and logistics), were proclaimed even though in some cases the support was still notional, awaiting precise directives for industrial restructuring. Industrial innovation was also to be boosted by an expanded budget for science and technology, which was increased by 25.6% to Rmb146bn.

Overall central government expenditure was forecast to increase by 24% in 2009/10, to reach Rmb4.38trn, while revenue was only estimated to reach Rmb3.58trn, leaving a deficit of Rmb750bn. Revenue growth in 2009 was forecast to slow to 8%, in tandem with weaker economic results and less buoyant sales. Fiscal revenue had grown by 19.5% in 2008, but the looming shortfall became evident in



fiscal flows in the second half of 2008, when revenue slumped from the 33.5% growth recorded in the first half of 2008 to a paltry 3.2%. Slower growth was attributed to an increased rate of VAT export rebates as well as decreasing car sales and business volumes. Combined central and provincial budget revenue in 2009/10 was forecast at Rmb6.62trn (an increase of 8% year on year), for an aggregated deficit of Rmb950bn. This is an enormous increase compared with the Rmb180bn fiscal deficit in 2008, and represents 3% of GDP.

Work on the budget took on a broader (and more perturbing) policy context as the central government's fiscal revenue continued to decline in 2009: January-April 2009 tax revenue fell by 9.9% from the year-earlier period. Expenditure, however, climbed by 31.7% in the same period. With such losses, additional fundraising was necessary, although central revenue did receive a Rmb50bn grant from the premier's emergency account (the central budget stabilisation fund), as well as increased taxes from fuel sales. Paying for all the fiscal stimulus munificence clearly called for more innovation in public financing.

Provincially

While the central government can arguably afford such deficit spending, most local administrations are less well positioned to increase their fiscal contributions for stimulus measures, especially as they are reliant on income from land sales for much of their revenue, and were thus disadvantaged by the depressed housing market. Their predicament obliged the Ministry of Finance to get into the bond market on their behalf. This fundraising measure has political implications. For the provinces, raising money through bond issuance is complicated by a 1995 budget law that bans local governments from issuing bonds in their own name, or from running budget deficits. In order to circumvent these constraints, the "provincial" bonds bind sub-national governments in complex transfer payment arrangements with the central government. The bonds will have a maturity of three years, and interest income on the bonds will be exempt from taxes. Purchases of these provincial and municipal bonds were liberalised earlier in the year to permit insurance firms to place up to 15% of their total assets in such investments. In mid-May 2009, China issued Rmb13.1bn in three-year local government bonds, as part of its project of issuing Rmb200bn in local government bonds (for the fiscal stimulus package) through the Ministry of Finance. In March, Xinjiang proceeded with a Rmb3bn issuance and the early May allotment was shared among Hubei and Sichuan provinces, as well as with Dalian, in Liaoning province. This was followed in late May when the ministry issued Rmb16.9bn in three-year local bonds on behalf of Guangxi (Rmb3.5bn), Beijing (Rmb5.6bn), Shanghai (Rmb4bn) and Henan (Rmb3.8bn).



6. More forms of relief

Rural finances

Rural finances were to receive a number of incentives to promote rural economic development. Price hikes for agricultural produce and subsidies for farm machinery and planting costs were designed to boost rural incomes. However, specific earmarking of grants to improve rural infrastructure only gained Rmb5bn of the initial Rmb100bn that was to be spent by the end of the first quarter of 2009. Crossfunding of projects was to have boosted that amount (the Ministry of Water Resources had allocated 25% of its Rmb20bn grant on safe drinking water projects, and Rmb2bn on expedited work on the South-North water diversion project). Other cross-funding was allocated to the Ministry of Health for expanding the rural clinic system.

Tax relief

Simplified administrative procedures to boost business confidence constitute an element of the Rmb120bn worth of tax incentives in the stimulus package, but they were also part of a pre-existing sequence of measures. In late November, Rmb19bn in fee cuts were announced for 100 different transactions, to become effective on January 1st. This followed an earlier announcement to cut Rmb17bn in fees payable by markets and household enterprises, effective September 1st. Sector-specific industrial assistance has also featured tax reductions, notably for the textile industry, while reductions in export taxes on 102 items (including contentious agricultural and industrial trade goods such as grain crops, fertilisers and steel) came into effect on December 1st. Export tax rebates on over 3,000 items, including labour-intensive manufactured goods, were raised, effective December 1st.

Subsidies

A trial programme of subsidies for purchases of electronic home appliances by rural consumers had initially been introduced in four provinces in late 2007, and as a result sales reportedly increased by 30%. Following this encouragement, the programme was extended to 22 provinces in February 2009, and by April had been expanded to cover the entire country. Rural purchasers of selected televisions, refrigerators, washing machines and mobile phones (plus computers, which were added to the eligibility list later) receive a subsidy of 13% off the listed price. Additional programmes were announced in May 2009 by the State Council to encourage household spending: consumers in four provinces and five cities will receive 10% discounts for trading in used electronic products to purchase new items.

Controls lifted

Inflation, which had been considered a major economic challenge in early 2008, had subsided to 2.4% in November of that year, and in early December the central government lifted the price controls that had been imposed on food staples in mid-January 2008. Further assistance to the agricultural sector was



granted late in the year through increased government purchases of staples such as cotton and soybeans, both of which suffered price declines owing to lowered demand. Dramatically lower global fuel prices allowed for successive cuts in retail fuel prices (by up to 17% in mid-December, and by a further 2-3% in mid-January 2009), and facilitated the introduction of a fuel tax effective January 1st 2009. The gasoline tax increased from Rmb0.2 to Rmb1 per litre, and from Rmb0.1 to Rmb0.8 per litre for diesel—these tax increases were to compensate for revenue lost by the concurrent abolition of various road tolls.

Reversal of monetary and fiscal measures

In late December 2008, the People's Bank of China (PBC) cut interest rates for the fifth time since September 2008, and reduced banks' reserve ratio requirement. Current one-year policy lending rates are 5.31%. China also announced that its money supply (M2) growth target in 2009 would be 17% (it had been 16% in 2008). Commercial lending was to be more flexible, with a lending quota of Rmb4.6trn allocated for 2009, an increase of 15% over the 2008 quota. According to Ministry of Finance calculations, the 2009 fiscal deficit was expected to increase by 56% year on year in 2009 to Rmb280bn, owing to falling revenue and increased expenditure. Although fiscal revenue increased by 19% year on year in 2008 to over Rmb6trn, this was a much slower rate of growth than the 32.4% revenue increase recorded in 2007.

Tax rebates

China's export sales fell by 2.2% in November and by 2.8% in December. Imports also dropped, by a startling 21.3% in December (to US\$72.2bn), as domestic manufacturers required fewer imported components for their industrial processes. Tellingly, the Ministry of Commerce began to warn Chinese exporters of credit risks, encouraging them to purchase export insurance to guard against payment defaults by importers and shippers. Indemnities paid by the China Export and Credit Insurance Corporation rose by 174.5% in January–November 2008 from the year-earlier period. China's overseas investments also came under stricter scrutiny, and the Ministry of Commerce announced new guidelines requiring its approval for overseas investments of US\$100m or more. Gloomy trade figures prompted more import tax cuts, and China announced in late December that it would raise (or reinstate) export tax rebates on a variety of items, notably machinery and electronic products, to boost export sales. China's exports continued their slump in the new year, as its major trading partners (the EU, US and Japan) all suffered from weak economic conditions, and China's bilateral trade shrunk accordingly. China's exports declined by 25.7% in February 2009, limped to a 17.1% decline in March, and sunk again by 22.6% in April. In alignment with these decreases, the government has increased its export tax rebates and expanded the eligibility list.

Housing assistance

In mid-2008 China's property sector began to falter, and the weaker housing market dragged down sales of construction materials. Part of the Rmb4trn stimulus package announced on November 9th included provision of housing for low-income households, and an additional Rmb10bn in subsidies was announced



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in December for affordable-housing projects, with a target of 1.3m low-cost houses a year to be constructed from 2009 to 2011. Further assistance to low-income households was announced in January 2009, in the form of a one-off payment, timed to coincide with the Lunar New Year, of Rmb100 for rural dwellers, and Rmb150 for urban dwellers (for a total expenditure of Rmb9bn). This reflects an upward revision in the eligibility criteria for "poverty-stricken households" (from Rmb785 to Rmb1,100 annual income), resulting in a rise in that category from 14.8m to 43.2m people.

And so on

Additional sector-specific measures continued to appear in April 2009, as did tax incentives to boost exports. A series of export rebate rises took effect on April 1st for textile and apparel makers, steel and non-ferrous producers, petrochemical and light industrial goods. In early April, the State Council announced a three-year Rmb850bn funding programme of investment in healthcare, as a first step in providing basic medical coverage to 90% of the country's population by 2011. It will also include the establishment of 7,000 hospitals and clinics to provide primary care at the village and township level. This measure is intended to increase domestic consumption by providing a more effective social safety net. Other stimulus measures to boost local consumption have been encouraged by the Ministry of Commerce, and some rather quirky measures were adopted by provinces and municipalities that had been particularly hard hit by the drop in export manufacturing. China's premier exporting province, Guangdong, inaugurated an Rmb20m project to encourage seniors to join tour groups, and Zhenjiang and Nanjing in Jiangsu province, as well as Ningbo in Zhejiang province, issued tourism vouchers for local scenic spots.



7. Where will it go?

Industrial restructuring

Investment in social services, either directly through the stimulus package or through parallel programmes, continued to be overshadowed by direct subsidies by the central government to industry, notably to labour-intensive sectors. The ailing textile industry benefited in the new year from a further increase in the tax rebate for exporters, from 14% to 15%. (The rebate had been raised from 13% in November 2008.) Other industrial support initially may have been prompted by special pleading by industry, but quickly become allied with specific government targets. The petrochemical sector, which was engaged in acrimonious negotiations with the government for most of 2008 over arbitrage subsidies to bridge the gap between high global prices for crude oil imports and controlled prices for domestic sales of refined oil products, received Rmb100bn for investment in upgrades of refineries for cleaner fuels. This was to be divided between Rmb60bn in 2008 to upgrade gasoline refining, and another Rmb40bn by 2010 for sulphur emission reduction in diesel production. China's power sector was also to receive support, in the form of Rmb10bn worth of subsidies to power companies and grid operators, to offset losses resulting from the difference between high coal costs in 2008 and price caps on power prices.

China also unveiled proposals to expand and consolidate its oil sector through a series of fiscal support and mergers. The most significant resource-related infrastructure component of the stimulus package is the planned construction of nine refining bases, which would increase refining capacity in China to 440m metric tonnes. Some energy investments are already yielding benefits for selected equipment suppliers, and are providing hope for further work orders: Invensys Process Systems, a US machinery supplier, signed an equipment contract for two nuclear power plants in early March. The stimulus package includes ten nuclear facilities, comprising expansion of existing plants as well as greenfield projects. The State Grid Corp of China announced in mid-February that it would invest Rmb31bn to upgrade its operations, most notably in the north-western provinces, where it will link local grids and build sub-stations in Xinjiang and Tibet. Additional subsidies were announced by the Ministry of Finance to encourage the purchase of energy-efficient light bulbs. The target in 2009 was increased to 100m bulbs, double the volume of the 2008 campaign.

The automotive sector also became the focus of specific policy attention. Although vehicle sales did grow by 6.7% in 2008, 25% of China's major manufacturers (45 enterprises) in the sector failed to reach half their annual sales targets that year, according to the China Association of Automobile Manufacturers. The sales tax for small cars (engines less than 1.6 litres) was cut from 10% to 5% as a temporary measure (until 2010), and a three-year programme of incentives totalling Rmb10bn was announced to assist automakers to upgrade energy efficiency in auto production. A further Rmb5bn was allocated to subsidise farmers to purchase minivans and sub-1.3 litre minibuses. Such measures appear to have been effective in boosting demand: vehicle sales hit a record 1.15m units in April 2009, up by 25% year on year.

A central element of the stimulus package for the automotive sector involves the consolidation of operations and the promotion of a smaller number of larger carmakers (from 14 major manufacturers



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to 10, by 2011) to lead the industry, each with annual production capacity of over 1m units, with a 10% annual increase. The production target for 2009 is 10m units (up from 9.34m units in 2008), and four auto conglomerates have been identified as major players in the consolidation template: First Automotive Works (Changchun), Dongfeng (Wuhan), Shanghai Automotive Industry Corp, and Chang'an Auto (Chongqing).

Shipbuilding was another sector that asked for help. Shipbuilding orders slumped by 44% in 2008 and shipbuilding companies successfully argued that government subsidies were required to ease restructuring. In early February the State Council announced that it had placed a three-year moratorium on the establishment of any new shipyards in China, in order to cope with a glut of shipyard capacity amid slowing freight orders. Typically, the political cost of such an industrial revitalisation plan has meant the acceptance of a government-mandated consolidation. In the case of shipbuilding, only 20 mainland shipyards will receive stimulus funds, according to Ren Yuanlin, chairman of Yangzijiang Shipbuilding, thereby giving big firms more leverage to acquire smaller players and hence advance consolidation.

Another sector that suffered substantial losses is aviation, and although it is not a sector that has been identified in the industrial restructuring programme under the stimulus package, the central government has injected large amounts of capital in both airline operations and aviation manufacturing. In early January, the China Aviation Industry Corp received Rmb176bn in pledged financing for its aircraft and helicopter manufacturing projects. The Ministry of Finance exempted airlines from paying fuel surcharges (retroactively from January 2008), and government assistance to specific airline operations has taken the form of loans (such as Rmb7bn in new funding for China Eastern Airlines, which suffered a Rmb6.2bn loss on fuel-hedging contracts) as well as capital injections.

Innovative technology

In mid-May, the State Council announced Rmb63bn worth of funding to support 11 national research programmes. These cover a range of biomedical projects (new drug development, as well as research on major infectious diseases such as HIV/AIDS and hepatitis), in addition to IT, energy and environmental technologies. Although specific investment schedules have not yet been released, it appears that funding to pre-established research programmes will be increased, as will special so-called incubator funds to help start-up companies in biomedicine.



8. How has it actually been funded?

To date

Py April 2009, the central government had disbursed Rmb304bn (in three tranches of spending with the first in November 2008, followed by February and April 2009 respectively)—or 25.8% of its share in the two-year investment cycle. The first tranche (in November) amounted to Rmb104bn, and, according to NDRC sources, went to support investment in pre-existing projects. By the time the second tranche was released in February, a sufficient number of new projects had been identified so that the second batch of funding (Rmb130bn) was directed to them. The third tranche was released in April (Rmb70bn).

Focus box

So far three batches of central government funding have been unveiled, for a total of Rmb304bn, disbursed in November 2008 (Rmb104bn), February 2009 (Rmb130bn) and April 2009 (Rmb70bn) respectively.

The focus of projects announced in the course of the three allocations

is in line with the six targeted areas the government has set forth (see case study below, Specific allocations for 2nd tranche of central government funding). In the process, there has been some fine-tuning of specific areas of government attention, particularly following the first round of allocations, when Rmb104bn was disbursed.

In the second round of allocations, of the Rmb130bn that was disbursed, Rmb35bn was to fund central government projects, while the balance (Rmb95bn) was to flow to local government projects.

CASE STUDY: Specific allocations for 2nd tranche of central government funding

(Rmb130bn, February 2009)

Specific targeted areas:

- 1) Low-cost housing: Rmb28bn
- 2) Rural infrastructure (drinking water safety, electricity grid improvement, road repair, methane gas supply, unsafe housing repair and settlement homes for ethnic minorities): Rmb31.5bn
- 3) Major infrastructure projects: Rmb27.5bn
- 4) Major health and education projects: Rmb17bn
- 5) Environmental projects: Rmb11bn
- 6) Industrial Restructuring: major industry development and technology upgrades: Rmb15bn

The government appears to have fine-tuned areas of spending in the second tranche of funds. For example, rural infrastructure projects were narrowed down from 15 categories to six, to generate a more significant impact. In the first tranche, Rmb6bn had been allocated to six areas under the "industrial restructuring" heading: indigenous innovation; industrialisation of high-tech; development of the services sector; nuclear- and wind-power equipment localisation and industry technology upgrades. By the second tranche, the budget for industrial restructuring had been increased to a commitment of Rmb15bn, and the focus had become more specifically directed towards industrial development and technological upgrades.

Interestingly, the third tranche of Rmb70bn is well below the expectations of provinces and observers. It is a clear indication that central authorities have become concerned about potential white elephant projects advocated by provinces. One government official from the NDRC said that the reason the central government has slowed the pace of investment is because many of the projects submitted by the provinces are unsuitable, and require further careful feasibility studies. "The key", he said, "is to make sure of the implementation of the projects invested by the first two batches of funding."



The banks

By far the greater amount of funding for the stimulus has come from bank lending. New loan issuance soared to Rmb4.58trn in the first quarter of 2009 alone, some Rmb3.3trn higher than in the year-earlier period. Of bank lending, 40% (of the total Rmb4.58trn bank lending in the first quarter of 2009, thus equivalent to Rmb1.83trn) was estimated by an NDRC official as having been allocated to medium to long-term stimulus fund projects, most often infrastructure projects with implicit government backing. This means that banks have already contributed Rmb1.83trn to the stimulus programme, or over six times the amount that the central government has invested so far, and well exceeding the Rmb1.59trn initially envisaged as their contribution.

There are three possible explanations for the banks' oversubscription: 1) bank lending has been directed not only at the Rmb4trn stimulus plan, but also at other government projects; 2) banks are lending more quickly than expected, and have taken a much bigger share of project finance than the government had envisaged; and 3) local governments have not come up with sufficient funding for their share, and instead use funding from banks for proxy "shell investments" to serve as collateral for bank loans. The latter practice was common in pre-IPO (initial public offering) days for local banks, but its reappearance now is seen as a worrying sign that policy-directed lending has returned to the banking scene.

The explosion in credit is in part explained by banks' desire to lend to the first batch of approved investment plans, and many banks have formed consortiums to provide financing and share risks. With the government's implicit guarantee as well as the long-term prospects of these projects—the payback period often lasts more than ten years—a potential increase in the non-performing loan ratio is currently the least of their worries, although the speed of the ramp-up in lending suggests that credit risks for individual projects have not been properly assessed.

Despite five interest-rate cuts in the fourth quarter of 2008, monetary policy has remained constant since December 2008, with the one-year lending rate currently set at 5.31%. The one-year deposit rate is 2.25%. By May 2009, China's astonishing growth of credit had appeared to be stabilising, with bank lending in April shrinking to a still robust Rmb591.8bn. This is modest sum compared with the Rmb4.58trn extended in loans for the first quarter of 2009, but still much higher than the usual average for April. In late April, the People's Bank of China (PBC), in a meeting with officials from the five main commercial banks, called for lending to be steadier and more rational, and the chairman of the PBC, Liu Mingkang, warned of growing worries of credit risk. Nonetheless, the bank announced that it would maintain a ""moderately loose" monetary policy. Cai Esheng, the vice-chairman of the PBC, estimated that in 2009 the overall annual rate of bank lending would be Rmb8trn, a significant rise from projections in mid-December 2008 that in 2009 M2 would grow by 17%, which would imply a substantial slowing from the end-April 2009 M2 growth rate of 25.95%. However, bank lending continued in the following months, reaching Rmb664.5bn in May. Lending jumped to Rmb1.23trn in June, bringing the six-month total to Rmb7.37trn and, according to the People's Bank of China, M2 had risen by 28.46% by mid-year.



9. Our assessment

Who has benefited so far from China's stimulus policy? In general terms, the interventionist state is once again taking the leading role in directing the Chinese economy. This phenomenon has been popularly described as a reversal of the political slogan "the state retreats, the private sector advances" (from 国退民进 to 国进民退) to signify the dominance of the state sector in the economy. An explicit aim of the industrial-restructuring programmes (covering ten industrial sectors) is to consolidate smaller players, and facilitate the emergence of a smaller group of major enterprises that will be globally competitive. These emerging so-called champions in the ten identified sectors almost always have a state-owned pedigree.

Another area where China's privately-held companies are at a disadvantage is access to capital. One of the ironies of the stimulus plan is that privately-held companies are complaining of high credit costs, even as liquidity has gushed through the banking system. 40% of bank lending in the first quarter (Rmb1.83bn) has been to medium to long-term projects, most of them relating to infrastructure and favouring state firms as the main contractors.

Bail-outs have also favoured the state sector. Chinese aviation has seen the demise of privately-held airlines, whereas China Eastern Airlines and China Southern Airlines have benefited from state support. China Eastern secured bank facilities totalling Rmb46bn in the last 12 months from four major banks, among them a loan facility of Rmb11bn from the Bank of Communications, covering areas such as project finance, securitisation of assets, international settlement and internet banking.

State support has not been without many strings attached. In return for government funding, enterprises are being pressured into complying with consolidation plans, despite the less-than-bucolic record of arranged corporate marriages, and the failure of past efforts to push consolidation. In early July, China Eastern and Shanghai Airlines announced their merger. In the case of the logistics sector, Rmb100bn in government funding will support the construction of modern multimodal transport and transshipment facilities, but the consolidation that is planned to accompany this will, if implemented, streamline the number of players in the sector from 2.7m trucking firms to a handful of large trucking fleets.

In terms of bureaucratic turf wars, the NDRC is the clear winner. It has re-established its primacy in setting the macroeconomic policy agenda through its role as reviewer, co-ordinator and approver of funding submissions. Another big winner is the Ministry of Railways. As recently as last year, the Ministry faced the risk of being absorbed by an expansionist Ministry of Transport. However, Liu Zhijun, the railways minister (dubbed "crazy Liu" by local railway bureaus because of his frenetic work style) had successfully fought off the merger through a series of high-profile projects: he doubled the speed of passenger trains in the past three years, and introduced the "Harmony" series of fast inter-city trains. The stimulus package has since given him and his colleagues many more opportunities for enhancing their already ambitious plans: in 2007, Liu introduced a Rmb1trn programme to construct more than 5,000 km of high-speed elevated railways. Owing to the stimulus package, this has now grown to a planned network of 8,900 km of track, at a cost of Rmb2trn.



Beijing vs. the provinces

The funding bonanza has also intensified the inherently complicated dynamics of centripetal vs. centrifugal forces in Chinese politics. The central government is relying on local government for cofunding the fiscal stimulus, and in April 2009, the central government in Beijing announced its intention to lower the self-funding ratio for project financing. In other words, banks have been asked to provide a larger percentage of financing for government-sponsored projects. The previous funding formula called for the local government to supply 35% of project financing as "seed funding" before being able to seek central government funding, and having bank loans to cover the balance. This was a generalised ratio; for some specific categories of projects, the balance of funding was different (for example, in May the government lowered the self-funding ratio for budget and general housing projects to 20% from 35%). Now local governments' portions have been lowered, and as they are no longer required to contribute such hefty deposits, they can spread their resources among more projects. One estimate is that even if the provincial share of fixed asset investment remains at its 2008 level (an aggregate of Rmb13.3trn)—which is highly unlikely, given the mega-projects and grand investment schemes proposed by many provinces—provincial funding in 2009 will be spread more broadly among more projects, because of lowered provincial investment thresholds

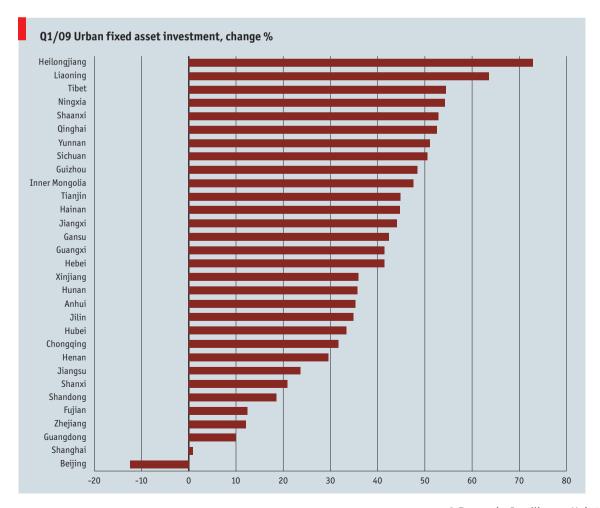
Of course the provinces are taking care to choose projects that ostensibly satisfy both the requirements of the NDRC as well as their own priorities, such as public transportation systems, airports, ports and telecommunications. Nonetheless, some alarm bells have begun to ring, as even with the lowered investment requirements, provincial resources are being stretched. Because of restrictions on provincial debt obligations and bond issuance, local governments often set up purpose-built investment agencies to raise money for project financing and management. These so-called undertaking units are corporate entities that can take on debt, and the expectation is that they will flood the market this year. On May 19th, the National Audit Office revealed that "minor but significant" irregularities had been uncovered in stimulus spending in the first quarter of 2009, citing fraud in local funding and fake contracts. It also noted that some funding had gone into bank deposits rather than into projects. There has already been one case of faked documentation from a locally incorporated municipal development corporation: Yueyang city in Hunan province has had its de facto corporate bonds de-listed from the inter-bank trading platform, pending further investigation. Yueyang's corporate bonds were in fact issued by the Yueyang Municipal Construction Investment Co., a fundraising agency which was viewed by investors as bearing the equivalent of a sovereign quarantee. More serious malfeasance would involve faking the entire project. The National Audit Office has already warned about such dangers in its selected audit of the first rounds of central government investment. "In some less-developed regions, local governments will not be able to provide adequate financing for projects in time because they don't have enough fiscal revenue to finance them," one report reads. Other pitfalls include duplication of projects in rural areas because of lack of co-ordination and careful planning. Another longer term worry is the push-pull influence of the stimulus package: provincial protectionism (and budgets) for local industries will be strengthened, making Beijing's consolidation strategies more difficult to implement. Protectionism on a broader scale is also a concern. In late June, "buy local" notices began appearing on several government agencies'



websites, calling for Chinese companies to benefit from stimulus spending. This prompted criticism from foreign chambers of commerce and trade representatives. China has yet to ratify a WTO agreement on government procurement, which would open such projects to competitive bidding from foreign enterprises.

Allocations in batches and to localities

While co-funding arrangements are a complication of the stimulus package, regional preferences can also have a major bearing on potential beneficiaries. Main criteria for central government allocations to provinces include population size and income per head levels, as well as the degree of reliance on the central government for fixed asset investments, with preference given to poorer provinces with larger populations. The nature of projects can also be significant in affecting the size and nature of the disbursements, with projects spread over a wider geographic area tending to have a more decentralised funding and project management basis. For example, of the second tranche of Rmb130bn announced in February 2009, Rmb28bn was allocated for low-cost housing. Of the Rmb28bn, Rmb3.05bn was to be





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allocated to central government projects, while Rmb24.95bn was to be directed to local projects. Similarly for rural infrastructure or health and education projects, local governments tend to receive the majority of funding. By contrast, funding for major infrastructure projects is usually kept under the purview of the central government. An obvious example of a centrally-managed project is the railway expansion project, which is entirely under the jurisdiction of the Ministry of Railways.

There are also special geographic favourites for appropriations. The four centrally-administered municipalities (Beijing, Shanghai, Tianjin and Chongqing), provinces with large ethnic minorities, and the northern provinces all receive slightly larger portions of the stimulus package. For example, of the first two funding tranches (total Rmb230bn) from the central government, Chongqing was allocated Rmb7.6bn, or 3.7% of total funds, above its proportionate share of 2.1% based on population size. (Its population is 31m, or 2.1% of the national population.)

Although it is too early for definitive calculations on the impact of stimulus projects, certainly the north-eastern and western provinces had extraordinary growth in urban fixed asset investment in the first quarter of 2009. Guangdong and Shanghai had the lowest growth rates, and Beijing (still satiated from its investments made in preparation for the 2008 Olympic Games) shrank in year-on-year comparison.

Local initiatives—another "Great Leap Forward"?

In concert with the central government's Rmb4trn stimulus package, local provinces have been actively rolling out their own grand investment plans. By one calculation widely quoted in the local media, total investment "wish lists" from the provinces have reached an astronomical Rmb18trn.

Guangxi, the poor south-western province bordering Vietnam, provides a good example of unrealistic expectations. The Guangxi provincial government has rather optimistically designated 2009 as "the year of project management", setting out plans to increase fixed asset investment in the province to Rmb600bn. However, of the first two funding tranches from the central government (totalling Rmb204bn), Guangxi has only received Rmb7.93bn (the provincial population is 47.6m).

The managing editor of the Oriental Post, a Shanghai daily newspaper, has commented that Chinese government officials are "economic animals". Officials are used to self-promotion in attracting foreign direct investment (FDI) as well as support from central coffers, and indeed this has become a key performance indicator in assessing the promotional prospects for local officials. It can also result in relentlessly protectionist ambition, whereby the goal is to get funding from the central government first and then decide what to do with the funding later, which usually leads to wasteful vanity projects.

GDP forecasts at the provincial level provide some example of aggressive targeting by local governments. The central government has set a national target of 8% GDP growth in 2009, but many provincial governments have superseded this by setting higher growth objectives. Chongqing has set a 12% GDP growth target for 2009, with the aim to achieve fixed asset investment of Rmb500bn (if realised, this would be Rmb100bn more than what was achieved in 2008). Chongqing's Chinese Communist Party secretary, Bo Xilai (the former minister of commerce), was quoted as saying, "Whatever tasks the central government wants to do, they will be achieved." This is reminiscent of the famous saying during the lunacy of the Great Leap Forward: "How much the land will produce will depend on how brave you are."

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CASE STUDY: Property—an exclusion zone

To date, China's property industry has played a minor role in the shaping of the fiscal stimulus package. Before the industrial revitalisation plan (including the ten sectors) was unveiled in March 2009, the assumption was that the property sector would receive some form of government assistance—after all, construction is a so-called pillar industry in most localities, tax support measures had been announced to encourage home ownership, and many building-

materials supply chains have been adversely affected by the slowing property market. Another argument for government intervention is the reliance on land sales as a revenue source for local government fiscal resources. However, public perceptions of property companies (and property moguls) have been very negative, with many blogs and op-eds accusing property developers of generating excessive profits and certainly undeserving of any government bailout. In the end, property development lost out to the logistics industry, which will receive Rmb100bn for investment and restructuring.



10. Our concerns

A herd of white elephants?

Six months after the stimulus package was unveiled, a number of serious concerns have emerged. The issues that they raise point to systemic weaknesses in the Chinese economic and political systems.

The speed and fragmented nature of project planning are hazards at the best of times, but pose particular risks with the accelerated pace of project work. Some localities (and sectors) seem especially prone to duplicative investments. For example, prior to 2000, there was only one bridge crossing the Yangtze River at Nanjing (the iconic double-decker bridge that was built in the Maoist era). By 2005, two highway toll bridges were built, neither of which has been fully utilised. Now, with the construction of a high-speed express railway link between Shanghai and Beijing shifting into high gear, the construction of yet another trans-Yangtze railway bridge (just one kilometre upstream from the third bridge) will soon be completed.

The obvious query as to why a more careful feasibility study was not done so as to minimise the cost and effort of bridge construction unearths an illuminating answer. Highway (road) bridge construction falls within the portfolio of the Ministry of Transport, whereas building a railway bridge is the job of the Ministry of Railways. Over the past five years, the Ministry of Railways has fought a bitter campaign to avoid being absorbed by the Ministry of Transport. The Ministry of Railways has now seen its power increased as a result of the stimulus' investment in the rail sector, so it will proceed at full speed ahead. In one fell swoop, the railways ministry has enlarged its plans for a high-speed railway network by 50%, and total investment for the network is now budgeted at Rmb2trn.

Critics have pointed out that acceleration of railway building will benefit manufacturers in Japan, Germany and France more than those in the local economy, as China sources advanced technology from the world's leading high-speed train manufacturers. The utility of such a vast network of elevated railway links has also been questioned, as the costs of ordinary rail lines are only 5% of costs of express railways. However, the construction of elevated rail links will provide ample opportunities for construction firms such as the China Railway Construction Corp., as well as local contracts for domestic cement and steelmakers.

Other practices are reminiscent of historical legacy. The railway expansion project frequently touts itself as a leading example of "no-obstacle" construction, using language from Maoist-era campaigns (workers continued work during the Lunar New Year, as well as the May 1st holidays). Rather improbably, local media reported that residents along the rail route volunteered to move away to make sure that no disputes about land appropriation or compensation impeded the progress of construction, owing to the efforts of local government. Such altruistic practices (even if true), are actually in contrast with the government's policy shift in 2008 to provide more security for farmers' land rights. More significantly, they also signal the risk that land appropriations will continue under the guise of accelerating projects and economic recovery.



Focus box

Disclosure of government information

The unprecedented scale of government spending has prompted pressure for more government candour. A Shanghai-based lawyer, Yan Yiming, has filed a series of requests to the Ministry of Finance and the NDRC seeking disclosure of information about the fiscal stimulus package. His applications to the Ministry of Finance sought information on the government's budgeting processes, and the suits against the NDRC called for more specific information on the stimulus package. Mr Yan has been an activist for shareholders' rights and corporate disclosure, and his calls for more transparency

in government spending have been echoed by many social commentators, with even delegates to the National People's Congress urging more fulsome project descriptions.

In response, in March 2009 the NDRC announced that it would publish project details from the stimulus package on its website, although it still refrains from providing any specifics plans of investment details or targets. It says that it will only unveil plans batch by batch once the approval process has been completed. One reason as to why the NDRC may prefer to keep deliberations on spending decisions private is because powerful ministries and provinces have been lobbying so aggressively for their share of the funding. An increase in transparency risks turning behind-the-scenes lobbying into on-stage fighting—a spectacle that the central government in Beijing wishes to avoid.

Haste over speed presents another hazard. By the end of February, Guangdong had already collected all investment proposals from the sub-provincial government levels and submitted them to the NDRC for approval, apparently in an attempt to garner as much government funding as possible. The widely-held suspicion is that many of the submitted projects had insufficient feasibility studies and rickety funding arrangements (hallmarks of "tofu", or shoddily-made, projects). Tellingly, Guangdong only won Rmb2.1bn, or 1.6%, out of the second tranche of Rmb130bn investment. This is a much smaller share than that of Chongqing, even though Guangdong has three times as many people. Moreover, this is at a time when Guangdong is suffering particular hardship. Industrial output in Guangdong only rose by 0.9% in the first quarter of 2009, compared with 13.6% growth in the first quarter of 2008.

Environmental feasibility studies are also suspected to be a casualty of the rush for funds, although the Ministry of Environmental Protection is putting a brave face on its claims to monitor projects. The vice-minister, Zhang Lijun, told a news conference in early June that his ministry has rejected or postponed 29 project proposals and approved 365—although he did acknowledge that some regions may have jumped the gun and started construction before receiving approval.

Certain mega-projects have been brought forward for implementation, regardless of unresolved controversy as to their feasibility and budget. For example, the long-disputed Hong Kong-Macao-Zhuhai Bridge, which has been in the headlines since the 1990s for funding issues or disputes among the three parties over the details of the route, is now set to proceed, largely owing to the stimulus package. The 36-km seaboard construction, consisting of 26 km of bridges and 6.7 km of tunnels, will cost Rmb72.6bn.

Gigantism is another common hazard in Chinese project cycles, and it is often difficult to gauge appropriate scales for projects, so that they can be integrated (or scaled up or down) as required. The government plans to invest Rmb90bn by 2010 for wastewater treatment, including plants, pipeline networks, pollution prevention and clean-up treatment for major rivers and lakes. Of this, Rmb12bn has been earmarked for environmental technology, of which Rmb5bn was allocated for wastewater treatment plants. In the five days following the announcement of the funding, the Ministry of Construction received



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500 applications nationwide for construction of wastewater treatment plants. This deluge of proposals represented over one-third of existing plant capacity, and many of the proposals were for large-scale installations, each requiring funding over Rmb100m.

Recipients of funding are also cause for concern, as the beneficiaries are overwhelmingly SOEs rather than privately-invested companies. Government purchase orders also favour SOEs. According to a senior executive at the New Hope Group, an aluminium producer (and one of the largest private enterprises in China), when the government announced plans to buy large quantities of aluminium for the national reserve to support commodity prices, plants of the state-owned Chinalco were favoured over those of New Hope, despite the fact that New Hope's product is cost competitive. "We don't expect to gain much from the government stimulus," he concluded.

Whilst every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

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