China in 2009 – Battling the Storm

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Preface

The Chinese government announced an aggressive 4 trillion renminbi stimulus package to pump-prime the economy. Since then, a number of questions have centered on this fiscal package. Where would the capital come from? How would it be spent? When would the impact most likely take effect? In this report, George Nast, a partner in our Shanghai Office, Janamitra Devan, a Senior fellow with the McKinsey Global Institute, Rae Chen, a Senior Associate in our Beijing Office and I provide our perspective on China's fiscal stimulus package and its potential implications. Given the unprecedented uncertainty in how the Chinese government and the Chinese economy manage implementation risks, this document represents our current, but evolving perspective.

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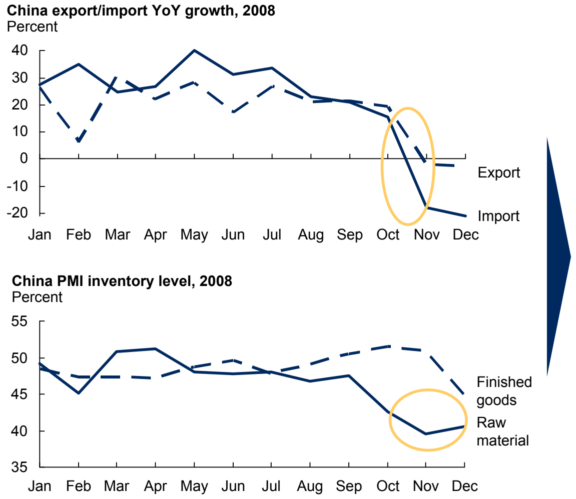
China in 2009 – Battling the Storm

The latest macroeconomic data have confirmed our view that, despite taking a hit from the global economic downturn, China is likely to achieve sustained economic growth going forward. In 2008 China registered real GDP growth of 9 percent, the lowest rate since 2001, and the first time that economic growth has dipped into single-digit territory since 2003. China's exports suffered its first decline in 7 years, plunging from a year-on-year rate of 19.2 percent in October 2008 to -2.2 percent in November 2008. In December, exports dropped by another 2.8 percent. The decline in imports was even more staggering: in the last three months of the year, imports plunged by 15.6, 17.9 and 21.3 percent, respectively. At 6.8 percent, quarterly GDP growth hit the lowest level it has reached in the past 4 years[1].

However, in what appears to be the silver lining in an otherwise bleak scenario, Chinese manufacturers began to re-stock in December 2008 after undergoing substantial de-stocking since the middle of the year (Exhibit 1). Retail sales growth also remained remarkably stable at about 20 percent in November and December, with total sales volume exceeding 10 trillion renminbi for the

Exhibit 1

Due to decreased external demand, Chinese manufacturers had sharply reduced imports, and experienced a substantial de-stocking; the position recently is that re-stocking has begun



- External demand for Chinese products has dropped substantially since mid-2008
- Expectation of a continuation of a demand decline led to a sharp decrease in China's Q4 2008 imports
- Exports are expected to further decrease in 2009
- Manufacturers experienced a substantial de-stocking from mid-2008, but started re-stocking in Dec 2008

Source: CEIC; NBS; McKinsey Global Institute analysis

1 The 6.8 percent rate is a year-on-year figure. Nouriel Roubini estimates that if measured quarter-on-quarter, China's 4th quarter growth rate would be "close to zero if not negative." See *The Chinese Devil Wears Prada: Why 0% Growth is the New Size 6.8%*, January 22, 2009. MGI analyses, triangulating what quarter-on-quarter growth would have been, suggests a similar finding.

first time in 10 years. As we indicated in our previous update, much of the current slowdown in the domestic sector is attributable to domestic policy decisions taken as far back as 10 months before the global crisis came to roost, although the crisis has added fuel to the fire.

The outlook for China's economy could change fast. The Chinese government announced an aggressive 4 trillion renminbi stimulus package that has included fiscal, monetary, industrial and consumption policies to pump-prime the economy. A number of questions have centered on this fiscal package: Where would the capital come from? How would it be spent? And, when would the impact most likely take effect?

To help address these questions, we conducted a detailed analysis of the economic stimulus package. Our analyses show that China is able to fund the 4 trillion renminbi package. In addition, our research shows that, while the 8 percent real GDP growth rate that the Chinese government has targeted for 2009 is achievable, much depends on the government's ability to manage implementation risks.

CHINA HAS SUFFICIENT CAPACITY TO FUND THE 4 TRILLION RENMINBI STIMULUS PACKAGE

China is in a strong position to fund the stimulus. The State Council announced that 1.2 trillion renminbi of the 4 trillion package will be directly funded by the central government. We expect an additional 1.4 trillion renminbi to be funded by local governments, and the remainder from SOEs.

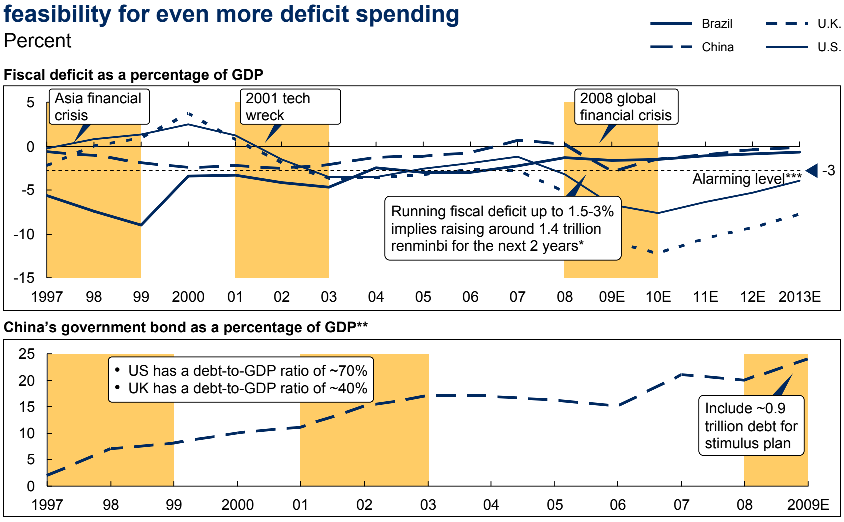
Having run a fiscal surplus for the past 2 years, China is well-positioned to run a fiscal deficit going forward. We calculated that by running a fiscal deficit in 2009 and 2010 of between 1.5 percent and 3 percent (considered a manageable level for the short and medium term), Beijing could raise about 1.4 trillion renminbi (Exhibit 2), which would more than cover the spending targets announced by the central government under the two-year economic stimulus plan.

Our research indicates that about 1.4 trillion renminbi of the stimulus package will be funded by local governments. Local governments are by law required to maintain balanced budgets. However, the central government could direct local governments to run fiscal deficits by allowing them to issue bonds that

Exhibit 2

By running a fiscal deficit of between 1.5 and 3 percent of GDP, the central government can raise ~1.4 trillion renminbi over the next 2 years; there is feasibility for even more deficit spending

Percent



* Estimated GDP with 8% projected growth is around 30 trillion renminbi.
** For 2009 bond balance, the 2002-2008 CAGR of 10% is first applied, and then ~ 0.9 trillion bond issuance for the stimulus plan is added.
*** A 3% deficit level is considered as reasonable for a country to manage; going beyond this could create fiscal issues in the short to medium term.

Source: EIU; CEIC; US bureau of public debt and bureau of economic activities; Literature search; McKinsey Global Institute analysis

the central government underwrites[2]. The rest of the 1.4 trillion renminbi is likely to come from SOEs. Our estimates show that SOEs have the capacity to raise up to an estimated 2 trillion renminbi from cash reserves, or by issuing new debt (Exhibit 3).

INFRASTRUCTURE PROJECTS ARE LIKELY TO BE THE MAIN FOCUS OF GOVERNMENT SPENDING

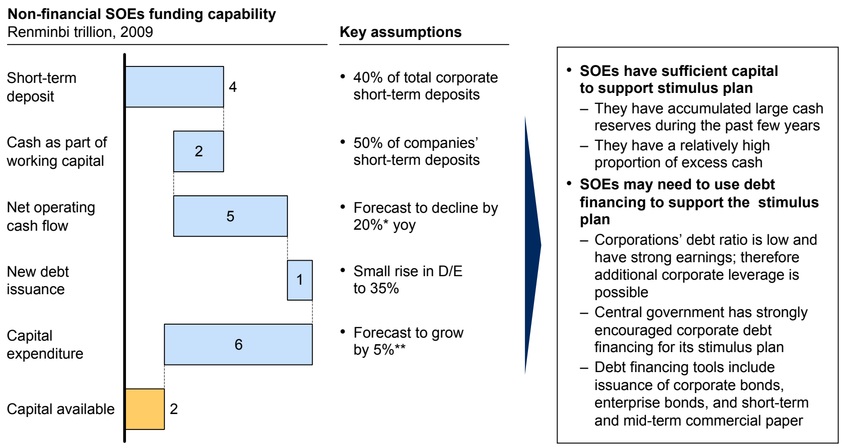
About 70 percent of the announced stimulus package, or approximately 2.7 trillion renminbi, will be spent on infrastructure. China has significant infrastructure requirements, and lags behind other developing countries in terms of infrastructure penetration. For example, in 2006 China's road density was 1.2 km per 1,000 km^2 arable area while rail density was 49 km per 1,000 km^2 arable area, compared to 4.4 km and 103 km in Malaysia, respectively.

As the McKinsey Global Institute's recent study on urbanization in China noted, while infrastructure spending has grown by leaps and bounds in recent years,

2 See news releases: *"Announcement of the State Council issuing bonds for local governments", "Temporary measures of the MOF in the issuance of bonds for local governments",* and *"Announcement of how MOF will manage the budgeting issue of local government bonds"*, January 1, 2009.

Exhibit 3

By using excess cash, operating cash flow and new debt issuance, non-financial SOEs potentially have an approximately 2 trillion renminbi pool to fund stimulus projects



* Forecasted by SYWG Research and Consulting.
** Growth rate of cap ex in 2008 is 10%. It is expected to decrease by half due to the economic slowdown.
Source: Literature search; WIND; 30 point plan of State Council (Dec. 13, '08); McKinsey Global Institute analysis

China will continue to require considerable levels of infrastructure investment through to 2025[3]. In addition to expenditures slated for urban areas, Beijing has also earmarked significant funds for infrastructure spending in rural areas in the 11th Five Year Plan (2006 to 2010).[4]

Should China spend all of the funds slated for infrastructure in the stimulus package, up to 25 million new jobs could be created over the next 2 years. Demand for critical construction materials would also rise. For example, China would need to produce an additional 90 million tons of steel (21 percent of the 2008 steel output) and 450 million tons of cement (32 percent of the 2008 cement output) (Exhibit 4). Such spending could have a ripple effect on other Asian economies, easing the impact of the downturn. The additional demand for steel and machinery would, for example, benefit Australia's iron ore exports to China, and Japan and Korea could benefit from increased machinery exports.[5]

3 See MGI, *Preparing for China's Urban Billion*, March 2008.

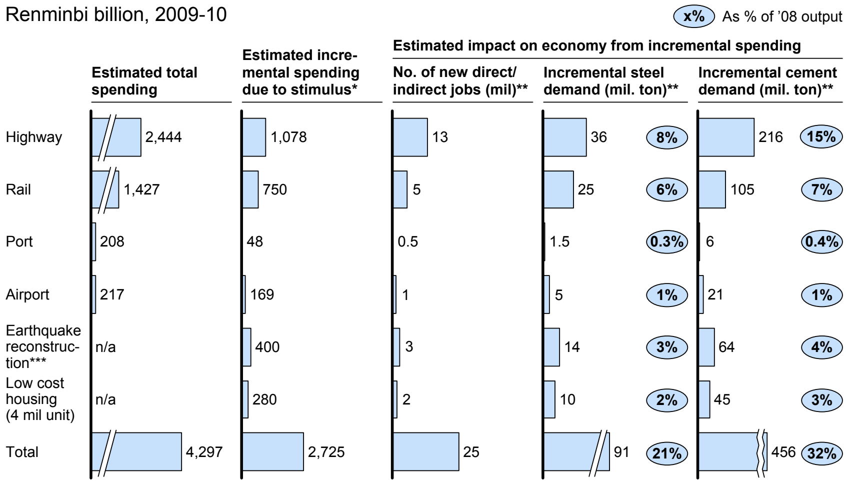
4 See the 11th Five Year Plan which was approved by the State Council on March 16, 2006.

5 Frank Gong, Head of China research, JP Morgan (*BusinessWeek*, November 14, 2008); Graeme Meehan, Minister of the Australian Embassy in China (*People's Daily*, November 12, 2008).

Exhibit 4

Should all incremental infrastructure stimulus be spent, China could create up to ~25 million new jobs over 2 years and register additional demand of ~90 million tons of steel and ~450 million tons of cement

Renminbi billion, 2009-10



* Based on the difference between the estimated total spending with stimulus package less existing national 11th five-year plan spending.
** Assumed estimated impact per billion renminbi spent in each industry based on literature search and historical case studies.
*** It is estimated that 60% of the budget will be spent on FAI. Assume 40% on real estate property, 20% on infrastructure. To avoid double counting, only real estate property portion is included to calculate the impact of incremental spending.

Source: BHI; literature search; interviews; McKinsey Global Institute analysis

ACTUAL SPENDING IS EXPECTED TO BE SIGNIFICANTLY FRONT-LOADED TO 2009

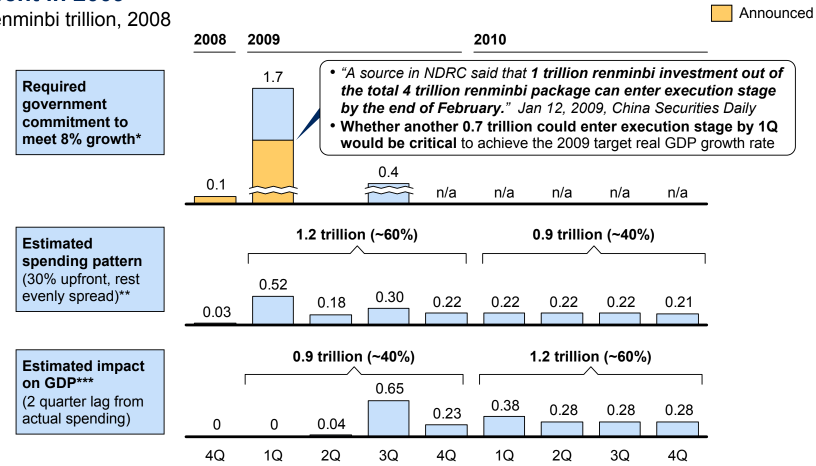
The duration of a typical infrastructure project is about 2 years. 30 percent of the investment is spent upfront, with the rest spent evenly over the life of the project. In addition, there is a 2 quarter lag between spending and GDP impact. Therefore, to achieve its 8 percent real GDP growth target, the government will need to commit 1.8 trillion renminbi by the first quarter of 2009, and an additional 0.4 trillion renminbi by the third quarter of 2009. This would translate to spending 60 percent of the stimulus required in the current year. (Exhibit 5)

Such spending is possible as there is a pipeline of about 9 trillion renminbi of approved infrastructure projects for the next 5 years (2009-2013). Examples include the Hu Hang Yong passenger Line (沪杭甬客运专线), a 28 billion renminbi project, and the Cheng Zi Lu Highway (成自泸高速公路), a 22 billion renminbi project. Several of these projects could be brought forward from the planned horizon and the Chinese government could immediately initiate spending. Bottlenecks on infrastructure projects usually occur in the funding and execution processes. However, the NDRC set up 9 task forces at the end

Exhibit 5

Given the lag between spending and GDP impact, to achieve 8 percent real GDP growth target, total spending to execute projects would need to be about 2.1 trillion renminbi in 2009, and 60 percent of it needs to be spent in 2009

Renminbi trillion, 2008



* To fill GDP gap of 0.9 trillion renminbi in 2009 and 1.2 trillion renminbi in 2010.
** Based on typical 2-year infrastructure projects profile.
*** Assuming the spending multiplier on GDP is 1.25, a mid point of Morgan Stanley's estimate of 1.0-1.5.
Source: OEF; GI; Morgan Stanley; McKinsey Global Institute analysis

of last year to accelerate project approvals. An official from the NDRC was quoted in a recent news report[6] as saying that it would only take 1-2 months to move from project planning to execution. Furthermore, the central government announced a 1.6 trillion bond issue for 2009 and major commercial banks have announced that they intend to fully support government projects.[7]

CHINA MAY NOT NEED TO SPEND THE ENTIRE 4 TRILLION RENMINBI STIMULUS PACKAGE

According to Oxford Economic Forecasting (OEF) and Global Insights (GI), without the government stimulus package, China's real GDP growth rate is expected to land at about 5.3 percent in 2009 and 7.1 percent in 2010[8]. This would represent a shortfall of around 0.9 trillion renminbi and 1.2 trillion renminbi in 2009 and 2010, respectively, assuming a target GDP growth rate of 8 percent. Applying a conservative multiplier of 1.25[9], we believe that China

6 *China Securities Journal*, December 12, 2009.

7 In a press conference held on December 28, 2008 the National Audit office announced it would pay special attention to the stimulus plan to ensure its smooth execution.

8 See OEF and GI, December 2008 baseline forecast.

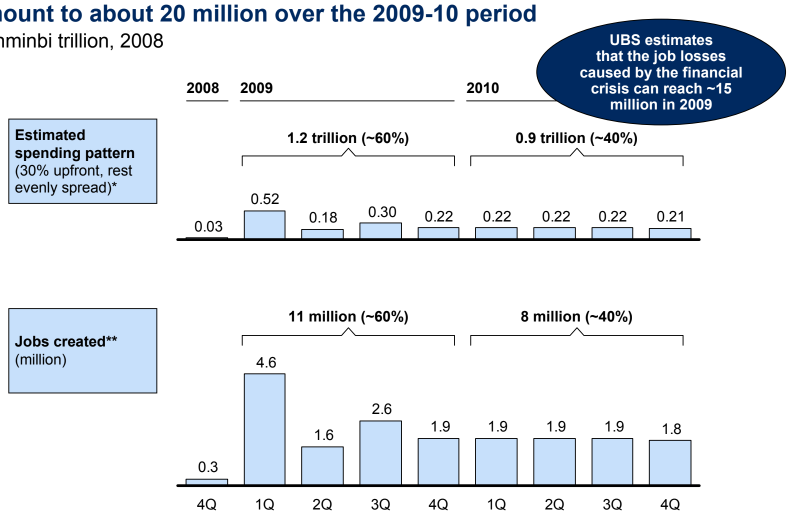
9 That is, 1.25 renminbi in GDP is generated for every 1 renminbi spent; the previous two recessions yielded about 1.32 renminbi on average per renminbi of fiscal stimulus. See ADB, *Asia Economic Monitor 2008* published in December 2008.

would only need to spend about 2.1 trillion renminbi to boost real GDP growth to the 8 percent target rate and close this gap. Nevertheless, with its 4 trillion renminbi announcement, the Chinese government has sent a strong signal of its commitment to mitigating the current slowdown and managing its downside risks aggressively.

If China were to spend the 2.1 trillion renminbi entirely on infrastructure projects, about 20 million jobs could be created over the 2009-2010 period: 11 million in 2009 and 8 million in 2010 (Exhibit 6). This is unlikely to be sufficient to completely offset the 15 million jobs that UBS estimates[10] would be lost in the export and construction sectors in 2009. In addition, with 6 million new college graduates expected in 2009, the Chinese government will face growing pressure to create employment opportunities. We expect between 2 and 4 trillion renminbi would actually be spent to balance employment and growth targets.

Exhibit 6

Under an 8 percent GDP growth target, where ~2 trillion renminbi in infrastructure/ construction spending is expected, job creation could amount to about 20 million over the 2009-10 period
Renminbi trillion, 2008



* To fill GDP gap of 0.9 trillion renminbi in 2009 and 1.2 trillion renminbi in 2010. Based on typical 2-year infrastructure project profiles.
** Assume weighted average jobs created per billion spent (~8,800). Weighted average of road, railway, port and real estate construction.
Source: Literature search; McKinsey Global Institute analysis

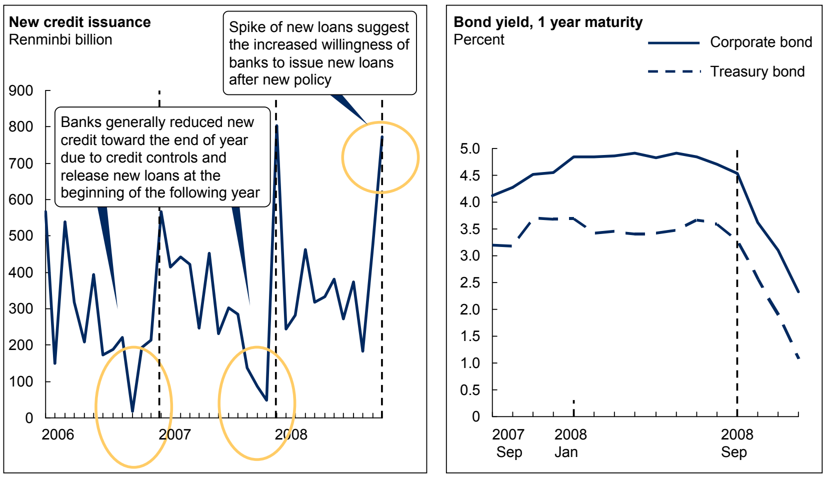
10 See UBS, *How Will China Grow*, January 7, 2009. The State Council announced in a press conference held on February 2, 2009 that 20 million migrant workers have lost their jobs due to the downturn.

Exhibit 7

Due to monetary policy easing, new credit issuance has soared while financing cost for corporations has decreased

New credit issuance soared in Dec 2008 due to looser monetary policy

Corporate and treasury bond yields decreased sharply, which lowered the financing cost and diversified the financing channel



Source: Bloomberg; Literature search; McKinsey Global Institute analysis

LOOSER MONETARY POLICY WILL SUPPORT FUNDING FOR STIMULUS PROGRAMS

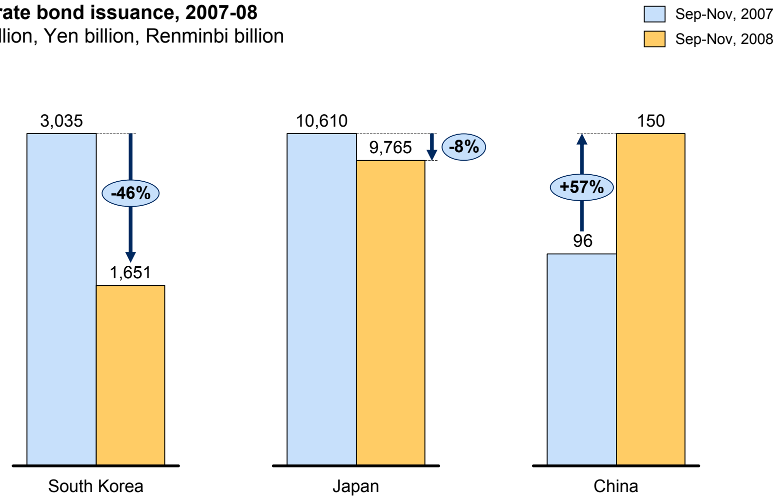
The PBOC lowered interest rates five times (the 6-12 month base loan interest rate decreased from 7.2 percent in September 2008 to 5.31 percent in December 2008), and reduced the Reserve Requirement Ratio (RRR) three times (from 17.5 percent in September 2008 to 15.2 percent in December 2008). In addition, the PBOC also eased financing for SMEs by allowing the trade of short-term SME corporate bonds on the interbank market, and cancelling the restriction of the interbank bond issuance size.

The effects of looser monetary policy are already becoming visible. While in recent years China's banks have sought to limit the size of NPLs and reduce the ratio of NPLs to outstanding loans, by the end of 2008, new credit issuance had soared (Exhibit 7). New credit issuance amounted to 772 billion renminbi, bringing the 12-month lending growth rate in December 2008 to 19 percent from the 16 percent registered just a month earlier. In addition, the corporate bond issuance level also maintained its high growth rate (57 percent year-on-year from September through November 2008), although other major Asian economies experienced declines (Exhibit 8).

Exhibit 8

Year-on-year growth of corporate bond issuance in Korea and Japan declined significantly in late 2008, while China continued to maintain high growth

Corporate bond issuance, 2007-08
Won billion, Yen billion, Renminbi billion



Source: Dealogic database; McKinsey Global Institute analysis

Beijing has also announced other policies to ensure uninterrupted capital flow in the financial sector: mid-sized banks have been allowed to increase their loan-to-deposit ratio to above 75 percent in 2009; financial institutions have been urged to set up specialized divisions to provide financial services to small and medium enterprises (SMEs); foreign banks have been allowed to trade corporate bonds in the interbank market for the first time; and, the stamp tax for stock market trades has been lowered from 0.3 percent to 0.1 percent. While these credit easing policies are likely to lead to higher NPLs, they are expected to stimulate business activity this year.

DEPLOYING INDUSTRIAL POLICY TO BOOST BUSINESS CONFIDENCE

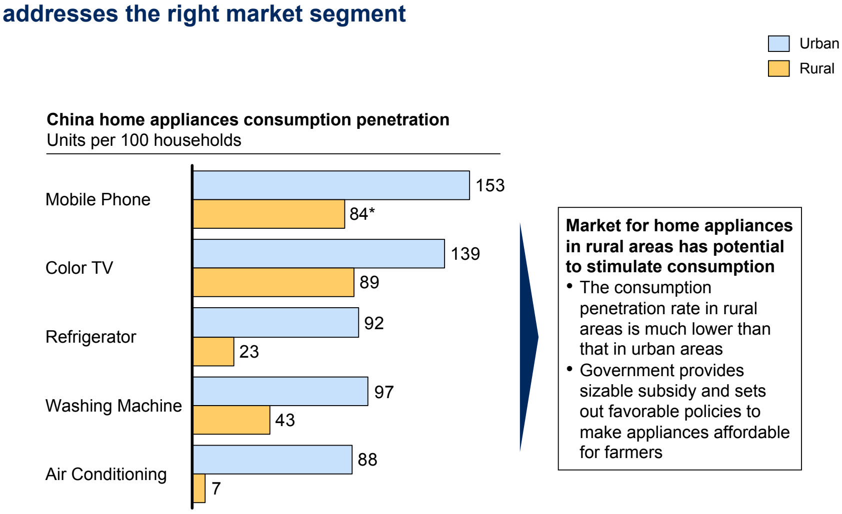
In December 2008, the National Development and Reform Commission (NDRC) announced it would implement a series of policies to support the development of 10 pillar sectors (iron and steel, automobiles, shipbuilding, petrochemicals, textiles, light manufacturing, nonferrous materials, equipment manufacturing, IT, and, announced later, real estate). The government plans to deploy multiple levers aimed at revitalizing these sectors, such as tax reductions, subsidies and loan guarantees. Detailed plans for autos, iron and steel were approved by the State Council in January 2009, while plans for the remaining sectors are being reviewed. These policies could improve business confidence.

INCENTIVES TO BOOST CONSUMPTION MAY BE LAGGING

Policies aimed at increasing disposable income and improving job security are also expected to spur domestic demand and counter the impact of falling external demand, but these are largely still being developed, and are thus limited in scope and scale., In addition to cutting education fees and drafting policies to create employment opportunities for newly-minted college graduates, the government has increased the subsidies it provides to farmers to encourage them to purchase home appliances. This "rural home appliance" program, whereby farmers are eligible for a 13 percent rebate on home appliance purchase, has been piloted in Shandong, Henan and Sichuan since 2007. The severity of the global economic slowdown prompted the government to roll-out the program to the rest of the country starting from February. In addition, the government announced in January that it would expand the range of products covered by the program, from four (color TVs, refrigerators and freezers, mobile phones and washing machines) to eight (adding most recently, motorcycles, computers, air conditioners, and water heating equipment). Given the low penetration rate of home appliances and consumer electronics in rural areas, this move could potentially increase consumption of these categories in the short term (Exhibit 9). However, we have yet to see major initiatives that would appreciably boost consumer spending (e.g., reform of healthcare insurance).

Exhibit 9

Government's move to encourage home appliance sales in rural areas addresses the right market segment



* Insights China, 2008 survey
Source: 2006 National Statistic Bureau; McKinsey Global Institute analysis

POTENTIAL RISKS IMPEDING THE IMPACT OF THE FISCAL STIMULUS

As much as the fiscal stimulus would yield benefits, the government will need to manage several execution and implementation risks. Moreover, the stimulus package may end up creating imbalances in the economy in the near term. The following represent our views on a few of the most significant issues that would arise from the economic stimulus package:

- **Implementation lags:** Any lag in decision-making or execution of infrastructure projects could delay the impact on the economy. Focusing on projects that are already in the pipeline will be critical to minimizing the lead time from project planning to execution. New projects could take considerably more time to move towards execution. In this regard, the 9 new taskforces established by the NDRC to accelerate the approval process and manage implementation lags will go a long way toward managing unforeseen delays.
- **Inflation:** Infrastructure-focused stimulus could potentially cause inflation of basic materials prices. The government would have to closely monitor inflation risks by monitoring inventory trends and resorting to further regulatory levers if necessary.
- **Labor shortages:** Infrastructure projects are highly labor-intensive. There may not be a sufficient number of skilled workers to tap into quickly. In spite of worsening unemployment in certain provinces, mobilizing labor from sectors that are losing jobs to infrastructure sectors will not be easy. While migrant workers returned home for the recent Lunar New Year festivities, the National Bureau of Statistics indicated that some 80 percent of them are expected to return to urban areas to look for jobs. Consequently, migrant worker recruitment processes and re-deployment and re-training programs would need to be managed expeditiously and efficiently to secure a sufficient supply of workers for the infrastructure sector.
- **Execution risks:** Inefficient government spending or potential corruption would reduce the impact of the stimulus package. In addition to periodic National Audit Office oversight, central and local governments would have to set up efficient budgeting systems to monitor and track the usage of capital, and ensure transparent reporting processes.
- **Deteriorating health of the banking system:** In the absence of a robust risk management system, central government directives to increase lending could erode bank profitability and jeopardize the long-term health

of the banking system. Chinese banks should strengthen internal control mechanisms especially in credit issuance, and work closely with central and local governments to identify viable projects and negotiate better terms. They should also set up monitoring mechanisms after disbursing credit. In the longer term, Chinese banks will have to consider accelerating their compliance with Basel II requirements.

- **Unbalanced growth:** Last, but not least, the quality and sustainability of a predominantly infrastructure-led build-out would potentially render the economy unbalanced in the short-term. Investment could comprise an even greater share of economic growth, requiring that the Chinese government ramp-up policies to stimulate consumption. At the same time, the central and local governments would have to continue the process of restructuring industries that began in 2008, and not revert to supporting low value export-oriented sectors.

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In the short-term, with its 4 trillion renminbi stimulus package, China has the potential to maintain a relatively high rate of GDP growth despite declining external demand. However, this short-term policy response brings many challenges. We hope to see further initiatives aimed at ensuring sustainable economic growth in the long-term, without sacrificing short-term stability.

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