TD Bank Financial Group

TD Economics

Special Report

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CHINESE FISCAL STIMULUS CAN'T BUY HAPPINESS

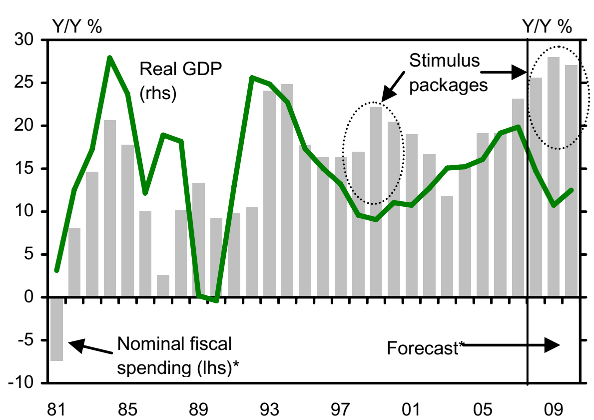
HIGHLIGHTS

- **Chinese government announces aggressive fiscal stimulus package.**
- **The announced amount was US$586bn, but new money to be spent over the next two years seems closer to US$380bn.**
- **This package is aimed as stemming the downside risk of how slow the Chinese economy could grow, as well as shoring up the confidence of the Chinese people.**
- **As such, this spending will help contain the damage, but it will not make up for falling demand for Chinese exports or limited appetite for aggressive investment in the private sector.**

The long-awaited Chinese fiscal stimulus package was announced on Sunday by the State Council. The infrastructure-heavy spending package is estimated at 4 trillion yuan (about US$586bn or 13.5% of 2008 Chinese GDP). About one-tenth of this is estimated to be spent in the fourth quarter of 2008, with the remainder planned for 2009-2010. Of this, around one trillion yuan appears to be infrastructure spending which was previously announced (i.e. earthquake assistance in the Sichuan province) which means "new money" for the next two years amounts to about 2.6 trillion yuan (US$380 billion), or about 9% of GDP.

The announcement of "proactive" fiscal policy, with more "moderately loose monetary policies" to follow, is thin on details. In additional to the infrastructure spending, the package includes the removal of the lending caps on new bank lending (some of which will be needed to finance the planned spending), as well as changes to the VAT equivalent to about 0.50% of GDP in corporate savings. Moreover, some of the spending will target poorer sectors, with social spending in areas like healthcare and subsidized housing, as well as increases to subsidies for low-income families, both rural and urban. This package is aimed as stemming the downside risk of how slow the Chinese economy could grow, as well as shoring up the confidence of the Chinese people.

CHINESE FISCAL STABILIZERS AND ECONOMY



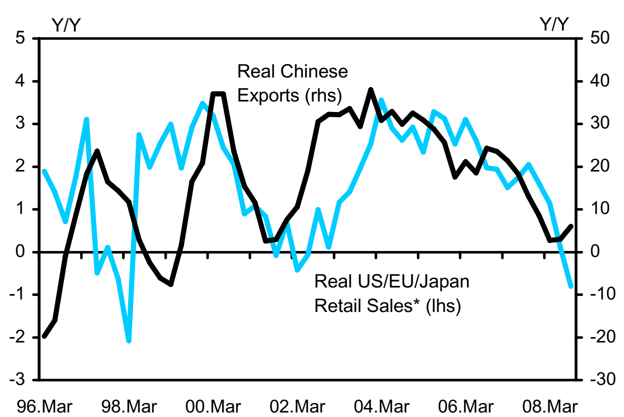
*Forecast by TD Economics as of November 2008.
Source: China National Bureau of Statistics and Haver

Missing from the package is any significant spending to shelter exporters from eroding global demand, as well as any bailout for the domestic housing industry, coping with its own bubbles. Moreover, Chinese fixed asset investment in 2008 will total around RMB 12 trillion. So, while RMB 120bn in tax savings per year from the VAT tax reform is helpful, it will do little to stimulate significant new corporate investment in the private sector as long as the global slowdown drives consolidation in Chinese industries.

This stimulus package appears to get the spending items with a long fuse underway. Some of these infrastructure projects must still be planned, zoned, approved, and financed. As such, a significant economic impact is doubtful for at least another six to nine months. This data does not lead us to revise our economic forecast for Chinese GDP for 2009 (7.6%-8.3%) or 2010 (8.4%-9.0%). While the package included more long-term investment than we had assumed in our economic forecasts, it included less of the short-term, traditional stimulus measures such as personal and corporate income tax breaks. Given that Chinese retail sales has proven remarkably resilient up to this point, policymakers likely saw little need to provide direct assistance to households nationally at this point. But should the economic slowdown broaden and Chinese GDP risk slipping below 8%, further measures are likely.

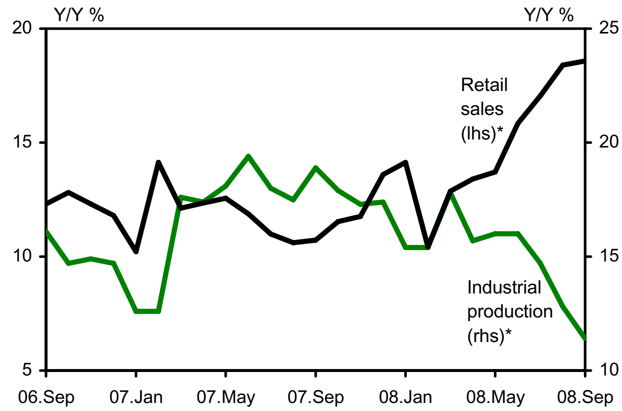
Equities and commodity markets generally took this package as good news. But should they? Chinese policy announcements are typically closely timed with market news. Authorities likely wanted to have a package announced before world leaders meet in Washington later this week, but we also suspect a slew of Chinese data to be released this week (investment, international trade, and retail sales to name a few) may paint a sour picture of the economy in the month of October. So perhaps markets are buying the rumor on Monday only to sell the fact as the economic data unfolds during the week. Moreover, Chinese fiscal spending has shown only a tenuous relationship with commodity prices or commodity demand in the past. In fact, there has been a better historical relationship between commodity prices and Chinese inflation – a sign of overheating in Chinese demand. Well, Chinese inflation is easing as demand pressures wane and this fiscal spending will not stop this. It can only hope to contain it. The government also used its fiscal might to moderate the domestic impact from the Asian financial crises which impacted China's neighbors. Just as a prescription of penicillin is not a sign of health, but a sign of trying to get healthy, this spending is not a sign of economic might, but a hope that the economy might avoid a hard landing.

CHINESE EXPORTS AND GLOBAL CONSUMERS



*Weighted by share of Chinese exports;
Source: National statistical agencies and Haver Analytics

DIVERGING TRENDS IN CHINESE ECONOMY



*Inflation-adjusted; Source: China National Bureau of Statistics and Haver Analytics

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