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Outlook for China's Economy in 2009 and Beyond

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Observations and analysis from a recent trip to China

I recently spent a few days in Beijing attending the China Development Forum. This is the yearly highest level encounter between a group of foreign businesspeople, financial sector participants and academics with the most senior level Chinese economic policy leadership, an event capped by a final meeting with the Premier Wen. The topic of this year's Forum was China's Development and Reform in the Global Financial Crisis. The gap between the foreigners assessment of the risks to the global economic and the mantric repetition by the Chinese that they will achieve this year their targeted growth rate of 8% (caveated only by the term "around 8%") was the biggest disconnect in this dialogue between the Chinese and their guests.

Indeed, speakers such as Joseph Stiglitz, Marty Feldstein, Steve Roach, Ben Friedman and myself stressed – to different degrees – that the US financial crisis and recession are severe and protracted – the worst since the Great Depression – and that the need for the US consumer to retrench and for US net exports to improve implies that current account surplus countries – starting with China but also the rest of emerging Asia, Japan, Germany and other advanced economies with surpluses – cannot rely anymore on the US consumer to be the "consumer of first and last resort" spending more than its income and running persistent large external deficits. Thus, China and other surplus economies cannot be any more the producers of first and last resort spending less than their income and running ever larger current account deficits. China and other surplus economies will have – if they want to achieve and return to their potential growth – to rely less on net exports and investment directed to the production of more exportable and rely more on domestic demand, government spending in the short run but especially consumption over time, as consumption is dismally low (about 36% of GDP) in China.

The Chinese policy makers understand this need to have smaller net exports and greater public and private consumption and they realize that household savings are high (and their consumption low) because of structural factors (lack of a safety net, poor public education and health care, poor rural infrastructures and public services, lack of a proper social security system, underdeveloped credit market for mortgage and consumer finance, a still overvalued currency) that can be changed over time with appropriate policies. But in the short run, i.e. this year, there is a sharp fall of external demand with exports now sharply down while the policies that will eventually lead to greater consumption have been woefully slow to be implemented; thus, the job of lifting domestic demand is mostly in the hand of an aggressive ("pro-active" in their term) fiscal policy and a more easy ("moderately easy" in their terms) monetary and credit policy.

Global recession and a sharp slowdown of growth and near stall in economic activity in Q4 of 2008 bodes poorly for 2009 growth

But the gap between a very weak US and global economy and the Chinese growth target of 8% for 2008 is wide. While all the Chinese repeated – following the official party line – the 8% goal as achievable, foreign observers were very skeptical. Even official organizations attending the event had a very different forecast: the IMF and the World Bank now predict a growth of 6.5% while the OECD has a similar forecast (6.3%). The ADB still assumes a slowdown to 7%. And the private sector has even weaker forecasts: 6% according to Goldman Sachs, 5.6% according to Fitch 5% according to RGE and some other participants to the Forum would – in private – speak of the risk of a growth of 4%. For a country that has been growing at an average of 10% for the last decade (and as high as 13% in 2007 down to 9% in 2008) and that needs a growth close to

10% to move millions of poor rural farmers to the modern urban manufacturing sector every year, a growth rate of 5% would be the equivalent of a hard landing, and even 6% would be extremely weak.

And the deceleration of growth in the last six months has been severe. Following the collapse of the US and global economic growth in Q4 of 2008, China also entered a contraction. The Chinese publish their GDP figures on a year-over-year basis unlike everyone else that measures growth on a quarter on quarter basis at an annual rate. Based on the conventional definition in Q4 US growth was about -6%, -6% for the Eurozone, -8% for Germany, -12% for Japan, -16% for Singapore, -20% for Korea. And the collapse of exports in Japan, Korean and Taiwan – major trade partners of China - is now about 40 or 50%. The Chinese reported Q4 year over year growth of 6.8% translates into a figure close to 0% - or according to some even negative – measured on a quarter over quarter annualized basis. So going from 13% to 0% or even 2% in 12 months is indeed a hard landing; and the manufacturing sector of China – that accounts for about 40% of GDP – was certainly in a recession by Q4 of 2008.

It is clear that China entered a contraction in Q4 of 2008 based on a number of indicators: GDP, industrial production, production of electricity, PMI, weakness of auto sales, fall in residential home sales, manufacturing data, falling imports and exports.

Recent sharp monetary, credit and fiscal policy easing to restore growth

The relevant question now is whether the aggressive policy action undertaken by the Chinese authorities starting with Q4 of 2008 will reverse this contraction and how fast. On the monetary/credit side, these policy actions include both monetary policy easing (lowering of policy rates, lowering of reserve requirement rates, easing of credit restrictions leading to a sharp increase in credit). Given this monetary and credit easing, credit growth has started to boom in Q1 of 2009 and indices of financial conditions – such as the Goldman Sachs FCI – signal a policy easing equivalent to a 300bps reduction in policy rates. On the fiscal side, these actions have taken the form of a fiscal stimulus; this is a large package officially of 4 trillion yuan of government spending, tax cuts, provision of social safety net, subsidies to poor and unemployed, and moral suasion to state banks to lend more and provincial governments to spend more. Some tax actions to stimulate sagging exports have also been undertaken.

Some indicators suggest that the growth recovery will be rapid in Q2 and the rest of 2009

So how effective have these policy measures been so far? The optimists point to a number of factors that suggest that growth is recovering in China (or better that the second derivative of economic activity is very positive) with the caveat that the data assessment is complicated because of the Chinese new year effect: the PMI measures of manufacturing sector, while plunging to the low 30s in Q4 (anything below 50 is a contraction) has now risen for a few months being in March above 50 for the CFLP measure of the PMI (while the CLSA measure still shows figures below 50 and still contracting in March relative to February); measures of retail sales show a still robust growth if lower than last year (16% y-o-y growth in February compared to the 18% of H2 of 2008) ; urban fixed investment – a proxy for capex spending – is still growing robustly; credit growth has been very rapid in January, February and March, averaging over 1 trillion RMB per month; there is some evidence of recovery of housing in Q1: discounting of residential prices and government incentives to buy property are contributing to a recovery in sales volume - but not yet in sales price - and inventories of unsold homes are being worked off; the rate of contraction of industrial production is starting to slow down (with a recovery in February) and the reduction of unsold inventories may set the stage for a rapid recovery of production if the weakness in final sales reverses; auto sales are recovering (but mostly because of incentives) and appliances sales among rural farmers have been increasing (but mostly because of government vouchers to incentivate such purchases); the stock market has sharply rallied in Q1; and steel prices rose significantly in January after falling in Q4. More circumstantially, local observers argue that, leaving aside rural migrants and college graduates, most urban workers have safe jobs, stable and growing incomes, high savings and pent-up demand for consumer goods; so consumption should not slow much this year. Also, some of the foreign CEOs of multinational corporations who attended the Forum told me that, while orders plunged in Q4, there are signs of recovery in Q1. Based on these data some argued that, after an ugly Q4, economic activity and growth are recovering in Q1; and while no one really believes that China can achieve 8% in 2009, growth may end up better than some of the more pessimistic views.

In general, while January and February were relatively weak months (but better than Q4 of 2008) there are greater signs of economic recovery in March and most forward looking indicators suggest that Q2 through Q4 growth will significantly accelerate relative to the dismal Q4 of 2008 and weak Q1 of 2009.

Some reasons to be more cautious and pessimistic about the recovery of growth in 2009
What is the evidence for the more pessimistic and skeptical view? Many indicators suggest that growth in Q1 may not be any better than in Q4, i.e. close to 0% and that the sluggish growth path will continue through most of 2009 with growth closer to 5% for the year (even if sequential growth will show quarter over quarter growth accelerating relative to the year average in Q3 and Q4). Let us consider the more pessimistic case.

Weakness in employment and rise in the unemployment rate
First of all, China has a serious employment problem. Even the official press refers to a figure of 20 million migrant workers who have already lost their jobs (that means that the actual number may be above 40 million) and many more millions will lose such jobs in 2009. And the policy actions of the authorities to provide social safety net and income relief to unemployed, urban poor and rural farmers are still very modest compared to the job and income risks; vouchers to farmers to buy appliances are small change compared to the need for a true and strong social safety net. Also 1 million out of the 6 million college graduates in 2008 did not get a job and that excess supply of job seekers will be on top of 6 million students graduating in 2009 and looking for jobs. Given the capital-intensivity of Chinese economic growth and of the fiscal stimulus – that is infrastructure-biased - and given the weaknesses of the labor-intensive SMEs in the export sector labor markets are likely to remain soft and with significant slack for most of 2009. Also, polls published in the official press suggest that, even among the so-called stable urban workers, stress about jobs runs high: over a third of such workers are very worried about losing their jobs or significant income weakness and about two of them are worried.

Slowdown of consumption growth given concerns about jobs, incomes and wealth
Second, this concern about jobs and incomes is significant as Chinese workers have always had large precautionary savings because of the lack of a social safety net; thus widespread concerns even among workers with jobs and incomes may lead to a slowdown in consumer spending. There is also a negative wealth effect on consumption from the fall in stock markets and in home prices in 2008. Thus, concern about jobs, incomes and wealth may lead to a slowdown in consumption growth. Such consumer spending already slowed down in 2008 relative to 2007. To make a case for relatively bearish outlook for Chinese growth you don't need to assume negative consumption growth. As long as job and income concerns lead to a significant

slowdown in consumption growth in 2009 compared to 2008 you will get a GDP growth rate in 2009 significantly lower than in 2008. What matters is whether there is a fall in the positive rate of growth of consumption and most evidence – even the positive official data for January-February - suggest that this slowdown in the *growth* rate is occurring compared to H2 of 2008. Note also that sales have been artificially boosted on a temporary basis by incentives (for auto sales) and vouchers (for appliances sales in rural areas). Another indication of excess capacity and softness in real consumption is the rapid deceleration in price inflation. From a peak close to 10% last year CPI inflation has rapidly decelerated and in February the CPI actually showed y-o-y deflation. Such deflationary pressures are a clear signal of weakness in aggregate demand and real consumption.

Likely weakness in housing and private capex spending given economic slowdown, fall in profits and excess capacity

Third, given widespread excess capacity because of the overinvestment done in the last few years private capex spending should be weak, even falling, in 2009 relative to 2008. One factor keeping capex weak this year will be the weakness in profits that were falling by almost 40% y-o-y in Jan/Feb and by over 50% for State-Owned Enterprises (SOEs). Given that over 50% of investment is financed from sources internal to corporate firms - mostly retained earnings – this fall in profits suggests pressure on capex in the months ahead despite the growth of credit.

Investment in China can be decomposed in various components, some of which are directly and indirectly controlled by the state sectors and most of which are decided by private enterprises: you have capex spending by private firms, capex spending by state owned enterprises, residential investment, government investment in infrastructures and in other public investment, inventory change. Of these components, capex spending by private firms will certainly fall in 2009 as there is massive excess capacity especially in the traded sectors: thousands of factories – some estimate as high as 17 thousand – have closed down especially in the labor intensive export sectors. Thus, excess capacity will imply falling capex spending by such firms. Residential investment is a mixed bag: home sales were falling until Q1 and home prices are falling because of the residential bubble of the last few years that left a large inventory of unsold homes. The optimists point out that while the high end of the housing market is falling as there is excess capacity, there is significant demand for housing at the lower end of the urban housing market; indeed the Q1 figures suggest a significant recovery of home sales in the quarter and a significant fall in inventories. That may be true but with dozens of millions of migrant workers returning to their farms even the lower end demand for housing services may be weak in 2009.

Government spending in infrastructures is certainly booming now and for the rest of 2009 as the government is committed to front load a large number of infrastructure projects. Certainly such investment will surge in 2009 but from a low base and low share of total investment; only a third of all fixed investment is government influenced (about half government investment and about half investment by SOEs and related semi-public institutions).

Also, even the alleged ability of the government to induce SOEs to massively increase their investment is subject to limits. Those SOEs are partially under control of central or – more likely – local/provincial governments and there are perks associated with increasing local capacity and jobs. But many of these SOEs are now semi-autonomous (and many even trading on stock exchanges) and they need to look at their bottom line: with their profit now falling over 50% (y-o-y in January/February) with massive excess capacity in their own sectors because of their overinvestment in capacity for the last decade why would they want to open new factories and increase capacity when demand is weak and thousands of private factories are closing? So far these SOEs are borrowing massively from the state banks – given that the credit spigots have been turned on – but they are holding the borrowed funds in short term deposits rather than spending them in new capacity. SOEs may be more malleable to political pressures to maintain employment in their firms than in massively increasing capacity given the overcapacity in the economy. And if political pressures were to go as far as inducing them to grow capacity such additional excess capacity – given the weaker domestic and external demand – will eventually lead to even lower profits, lower future production, greater losses and greater amounts of non-performing loans in the banking system.

Weakness in exports and imports with a likely reduction of the trade surplus

Fourth, the data on the exports and imports of China are very weak and ominous. Exports were already starting to fall in Q4 but their rate of fall has accelerated in Q1 with February figures showing a 25% plus contraction. Imports are also falling in February at a similar rate as exports; and since most of Chinese imports are those of raw materials and intermediate inputs used in the production of exportables this sharp fall of imports is a signal of a likely further fall of production and exports in the months ahead. With exports being much larger than imports and falling at a similar rate, the trade surplus is shrinking. The trade balance has now switched to a much smaller surplus (from $40 billion to $4b in February). The World Bank is still forecasting a current account for 2009 as high as in 2008 as exports and imports both fall over the year but at slower rates than in Q4 2008 and Q1 2008. The trade surplus is likely to modestly shrink; thus, net exports will negatively contribute to GDP growth in 2009 and they are certainly contributing negatively to GDP growth in Q1 of 2009. Optimists point out that the value added contribution of exports of Chinese growth is much smaller than the one derived from looking at the share of exports in GDP: China purchases raw materials and intermediate inputs, adds value and then exports them to the rest of the world; thus the value added contribution of the traded sector is more modest than traditionally considered. This is a fair point: still, the export share in value added has doubled in the last decade and with greater amount of import substitution (as intermediate inputs are increasingly produced in China) the value added contribution of the traded sector has been growing. Also, with an economy where exports are almost 40% of GDP, where the trade surplus is close to 10% of GDP and where a large fraction of fixed investment goes to the production of more factories and more capital goods for production of more exportable goods one should not underestimate how much China still relies on exports and trade with the rest of the world for its growth.

The Chinese have reacted to the sharp fall in exports by freezing the nominal appreciation of the Yuan relative to the US (that had been over 20% since July 2005). The Chinese were even tempted to let the Yuan depreciate relative to the US dollar; but such action would have for sure triggered tariff retaliation against China by the US. Thus, not being politically allowed to let the Yuan weaken and not being willing to let it appreciate they have effectively returned – for the time being – to a de facto peg relative to the US dollar. But, since the US dollar has been appreciating on a traded weighted basis over the last few months (as the economic weakness in the Eurozone, Japan and many emerging market economies has been sharp) the Yuan has been appreciating in nominal and real traded weighted terms as well. Such real appreciation and the weakness of global demand – in advanced economies, in oil exporting economies, and in other emerging markets) will keep Chinese exports weak and falling in 2009 compared to 2008, even if the rate of contraction in exports may slow down relative to the Q4 2008 and January-February period.

A side implication of the policy decision to prevent further appreciation of the currency relative to the US dollar is that, in spite of the Chinese concerns about their stock of dollar reserve assets and in spite of their noises about wanting to reduce the role of the dollar in the global financial system, China not only will not be able to diversify its existing stock of reserves away from dollar assets, it will also have to keep on accumulating even more forex reserves, mostly in the form of dollar assets. The rate of reserve accumulation in 2009 will be somewhat lower than in 2008 as the current account surplus may be smaller, as FDI inflows will be smaller and as hot money inflows will be smaller (given the likely stability of the currency relative to the US dollar). Still, the 2009 current and capital account surplus of China may still be well above $400 billion, thus requiring a massive accumulation of forex reserves, especially in US dollar form to prevent further appreciation of the currency relative to the US dollar.

Circumstantial evidence – from surveys of foreign companies operating in China – of continued economic weakness

Fifth , other circumstantial evidence suggests that the pick-up of growth in Q1 after a dismal Q4 is still weak: steel prices were rising for a while at the turn of the year after having fallen sharply in Q4 but in the last few weeks they started to fall again, a fact consistent with an economic recovery that looks shaky; conversations with CEOs of foreign companies operating in China and Hong Kong suggests that domestic demand and foreign demand remains quite weak in China, especially for those multinational firms that produce in China for export markets (less so for those that produce for the domestic markets; conversations with ordinary folks suggest concerns about jobs and income and thus caution in spending patterns.

Evidence from the forward looking manufacturing surveys is mixed: some show still continued weakness

Sixth, the evidence from the PMI measures is mixed: the CFLP measure showed an increase above 50 but the CLSA measure showed a slight drop in March relative to February; this index has been below 50 (signaling contraction in manufacturing) for 8 months in a row. The CLSA's PMI measure is considered as more reliable and more relevant to the state of the SMEs while the CFLP's PMI measure reflects better the larger SOE firms. So the divergence of the two measures in March suggests still significant weaknesses in the tradeable sector dominated by smaller private firms compared to the larger SOEs that have had privileged access to the open credit spigot. Among the components of the CLSA's PMI new orders, output and input prices fell in March relative to February, signaling continued weakness and worsening in manufacturing conditions; while the new exports orders and employment index rose in March while still remaining below the contractionary level of 50.

Capital-intensivity of Chinese growth model and of the fiscal stimulus is problematic for sustained growth recovery and employment recovery

Seventh, with fixed investment being over 40% of GDP, Chinese growth has always been more capital intensive than labor intensive and the marginal return to such investment – as measured by the inverse incremental capital-output ratio (i.e. the ratio between the growth rate of GDP and the ratio of fixed investment to GDP) has been relatively low and falling over time. In other terms, Chinese growth has been capital intensive and driven more by the accumulation of inputs – especially the capital input – rather than by total factor productivity growth. And now the fiscal stimulus – that is concentrated in infrastructure spending – is also capital intensive rather than being labor intensive. Also, the sharp increase in credit growth is going mostly to capital intensive SOEs; and this SOE-biased credit growth may crowd out financing for labor-intensive SMEs that are already struggling because of the sharp fall in exports.

The sharp credit growth in Q1 is mostly not going into productive activities

Eighth, credit growth has picked up sharply in Q1 2009 with credit increasing over 1 Trillion RMB per month in that quarter. But most of this credit growth is not going to productive activities as there is already excessive over-capacity in the industrial sector. Most of the growth of credit has gone either to the stock market; or has taken the form of SOEs borrowing from banks in the form of short-term (3-6 month) bills and reinvesting the funds in higher yielding deposits. In January-February over 40% of the growth of credit was in the form of these short term bills. So SOE are parking these borrowed funds rather than increasing working capital or capacity. In March the share of credit growth going to short term bills has fallen to 10% but only because banks are now starting to worry that bank regulators and supervisors are likely to restrict the excessive credit growth in the next few months; banks are thus worried about not being able to renew those short term bills credit growth when it comes to maturity.

Weak global outlook – especially in advanced economies – will limit the recovery of externally-dependent Chinese growth.

Ninth, the Chinese growth rate for 2009 will of course depends – on top of domestic policy actions – on the state of the global economy. If – as predicted by the consensus estimates - US growth would turn to positive in H2 of 2009 the recovery of growth in China would be more robust. But, RGE and myself are predicting that US – as well as Japan and Eurozone - growth were remain negative through all of 2009 even if the rate of contraction will slow down in H2 (-2%) relative to H1 (-6% in Q1); we also expect very weak growth in the US and other advanced economies in 2010. This is a very below consensus call as the consensus expects positive growth – around 2% - in the US in H2 of 2009 and return to a growth close to potential in 2010. Thus, if these worse than consensus predictions were to materialize, such a persistently severe recession in advanced economies would remain a negative drag for the recovery of growth in China.

Given the weakness of the US consumer China needs to rely less on net exports and more on domestic demand, especially consumption

Tenth, even once US returns to growth it will rely less on consumption and imports and more on an improvement in its net exports; the world where the US was the consumer of first and last resort, spending more than its income and running ever larger current account deficit and where China was the producer of first and last resort, spending less than its income and running ever larger current account surpluses is over. Global rebalancing where US consumption grows less than GDP, where US savings are rising and where the trade deficit shrinks will require surplus countries like China (but also Japan, Germany and other export-led growth economies) to reduce their surpluses and rely more on domestic demand. But so far the ability of China to increase domestic private demand – and rely less on net exports – has been severely limited. Thus, weakness in net exports at a time when domestic private demand cannot grow fast enough will limit the recovery of growth in China. While in the short run the fall in net exports can be in part compensated by the growth in public domestic demand (government spending and investment) over time China needs to rely on private domestic demand – especially private consumption – as there are fiscal constraints – including a weaker path of tax revenues – to how much the public sector can take the slack from a weakening net exports.

There are many structural reasons – that cannot be modified in the short run – why Chinese savings are high and consumption low as a share of GDP

Eleventh, there are many structural reasons why Chinese private and households savings are high and the consumption share in GDP is low; and these structural factors will not change any time soon. The Chinese save a lot because even the poor rural farmers want to send their children to private schools as public education is of low quality; they save a lot because public health care is poor and they need precautionary savings in case they get sick; they save a lot because there is almost no social safety net (such as unemployment benefits) and precautionary savings are necessary in case they lose their job; they need to save a lot as there is almost no social security system (total lifetime – not yearly - social security benefits add up to a per capita amount of about $60 according to Steve Roach) and the traditional household based model of social security - children taking care of their parents in old age – is breaking down because of urbanization; they save a lot because down-payment for mortgages to purchase a home are still very high (30-40% though the government halved it for first time home buyers) ; they save a lot because consumer finance – such as credit cards – is barely existing and thus the ability to smooth consumption is limited; they save a lot because the RMB is still overvalued – even if less than before – and imported goods are still relatively expensive. Since the development of a social safety net, of a social security system, of a large scale provision of public services to the rural sector, of public health care and education is still lagging behind – in spite of repeated government plans to increase all these public services – it is highly unlikely that household savings will fall sharply any time soon; thus, the consumption share in GDP is likely not to increase fast enough to compensate for a fall in net exports.

The low consumption share in GDP is also driven by another important set of structural factors: the low share of household income in GDP and the related large share of corporate savings in GDP. Studies suggest that, while Chinese household savings rates are high, they are not much higher in China then they are in Hong Kong or among Chinese in Taiwan or in other Chinese communities in Asia (Singapore, etc.): Chinese households all over Asia tend to save about 30 percent of disposable income. What differentiates Chinese households in China from Chinese households outside of China is that the share of household income in GDP is extremely low in China, at about 40% of GDP. Given this low level of household income it is no surprise that the consumption share in GDP is extremely low.

The dual mirror of this very low level of household income in GDP (and the ensuing high rate of private household savings) is the very high share of corporate savings (retained earnings) in GDP. The problem in China – and a similar pattern occurs in Germany and Japan – is that most of the very high corporate sector's profits are retained by the firms in the form of retained earnings rather than distributed to shareholders in the form of dividends. In China such large retained earnings – especially those of the SOEs - are then reinvested in new capex thus exacerbating the overinvestment and over-capacity problem (in Germany and Japan instead such large retained earnings are invested in foreign assets rather than domestic capex). The lack of dividends disbursements is behind the very low share of household income in GDP and the very low level of consumption in GDP.

Changing this perverse pattern of excessive corporate savings, excessive capex and lack of private consumption would imply a radical change in corporate governance: either a privatization of the SOEs so that households would become owners of such firms and able to exert pressure for their earnings to be distributed as dividends to boost household income and consumption; or forcing the SOEs to disburse most of their earnings back to the central and local governments so as to induce such public sector to strengthen the broad social safety net and thus induce a lower level of precautionary household savings. But privatization of SOEs is out of the question in the short-medium terms as it would sharply reduce the power of the provincial governments and of the central government.

And the second alternative (disbursing earnings as dividends to the central government) is also not likely despite plans to introduce such a requirement: the central ministry/agency that has the equity shares in the SOEs has no intention of inducing such SOEs to disburse dividends as such dividends would be controlled by the general government - and thus passed to spending ministries – rather than remain in the hands of the SOE-controlling ministry.

So, with high corporate savings that remain as retained earnings that are not disbursed – directly or indirectly – to households implies that household income is low and – for any level of household savings rate – household consumption is a very low share of GDP. Until a radical change in corporate governance occurs in China – a highly unlikely event given the still large government control of large parts of the corporate sector – household income and household consumption will remain a small share of GDP, thus limiting the growth of private domestic demand in China.

The Chinese authorities - while rhetorically recognizing the need for greater private consumption and lower savings rate – are doing little – such as developing a serious social safety net - to boost consumption and they even argue that they high savings rate are endemic and structural and unlikely to fall. The Chinese indeed argue that the high savings rate of China – and East Asia – is among other factors driven by structural cultural factors that cannot be easily changed, i.e. "Confucian values". For example, the governor of the Chinese central bank recently stated: "Tradition, cultural, family structure, and demographic structure and stage of economic development are the major reasons for high savings ratio in the East Asia. First, the East Asia countries are influenced by Confucianism, which value thrift, self-discipline, zhong yong or Middle Ground (low-key), and anti-extravagancy." He then went on arguing why little can be done in the short run and even in the medium term to reduce such high savings rate. But the arguments discussed above suggest that savings rate can be meaningfully affected – over time – by structural policy changes such as a social safety net, provision of public services, development of consumer credit and financial markets.

Monetary, fiscal and bank regulatory authorities tend to be conservative and unlikely to undertake excessively loose macro policies

Twelfth, in spite of the aggressive policy stimulus most of the monetary, fiscal and bank regulatory authorities remain quite conservative and prudent. Monetary easing and credit easing has been very significant in Q1 but there is now concerns that, given the surge in credit during that quarter, monetary authorities – especially the central bank - may soon want to slow down that rate of growth of credit. Also, in China the bank regulatory commission is conservative and concerned about a possible rise in non-performing loans – given the overinvestment of the last few years and the risk that the most recent credit growth would exacerbate such over-capacity. Thus, both the central bank and the bank regulatory commission may exert ahead in Q2 and beyond some restraint on the excessive rate of growth of credit that occurred in Q1. Moreover, even the Ministry of Finance is relatively conservative as far as fiscal discipline is concerned. Such ministry takes the 3% deficit limit of the Eurozone as an implicit ceiling for how high it will let its own central government deficit to go. This is why the large November fiscal package was light in the participation of the central government and heavy in its reliance on provincial governments (which face even greater revenue shortfalls), lending by state owned banks and spending by state-owned enterprises. Since central government revenue growth has been sharply shrinking in Q4 – and most likely in Q1 as well – given the slowdown in the economy, sticking to a 3% fiscal deficit target would imply not letting central government spending to grow faster than what that deficit constraint allows. Thus, while the Chinese authorities have said that they have a lot of "ammunition" - and indicated indirectly their willingness to use such ammunition if growth disappoints below the 8% target - their willingness to use such additional fiscal resources may be constrained by their concerns about not letting the central government's fiscal deficit to overshoot the 3% of GDP limit.

Summary of the growth outlook for 2009: recovery of growth from Q2 on but overall 2009 growth of 5% with stronger performance in H2 of 2009.

In summary, when one thus adds up the components of aggregate supply and aggregate demand together – the fall in exports and net exports, the fall in private capex spending, the slowdown in consumption growth and the large increase in government spending and infrastructure spending – one gets an estimate of growth for Q1 that is not much better – maybe marginally better but not by very much – than the one in Q4 of 2008. And since Q4 growth at a SAAR was close to 0% (as opposed to the y-o-y 6.8% growth) Q1 growth at a SAAR may be only modestly positive (say about 0% to 1% at best based on January to March data). Given the massive policy stimulus in the pipeline – monetary, fiscal and credit one – and given the likelihood of further fiscal stimulus if the growth outlook looks as sharply slipping relative to the government target a realistic forecasts of 2009 growth may still be 5%, a tad below the forecast by Goldman Sachs and a somewhat lower figure than the 6.5% predicted by the IMF and the World Bank. The government authorities may report a figure closer to their 8% target regardless of the actual true figure. But no one realistically believes that a growth close to the 8% target can be achieved. Certainly the recent March data and the forward looking indicators of economic activity suggest that growth will pick up in Q2 and for the rest of the year from the near stall of Q4 2008 and Q1 2009. One cannot rule out that, by Q3-Q4 of 2009 growth may return to quarterly growth rate of 7% So, while the growth may effectively average 5% for the year (compared to authorities officially reporting a figure around 7% close to the 8% target) the sequential quarter over quarter path will show a significant acceleration from near 0% in Q1 to a figure close to 7% by Q4.

Still, there are downside risks to this scenario if the global growth recovery – especially in advanced economies – disappoints and starts only in 2010 rather than 2009; if the Chinese policy stimulus turns out to be insufficient and further stimulus is delayed; if a drugged recovery – via easy money, easy fiscal and easy credit – leads to further over-capacity, rising non-performing loans, falling profits or rising losses and thus loses its steam when such policy actions reach their peak but are unable to sharply reverse the underlying forces that slow down the economy.

Longer term growth issues: China's concerns about environmental degradation and resource constraints from high growth

Another interesting longer term growth issue that I noticed during this latest trip to China is that, for the first time, authorities seem to care about the environment and pollution and are willing to do something about it; every senior official at the China Development Forum spoke with some emphasis about the environment and reducing pollution and environmental degradation. For the first time in years you could breathe fresher air in Beijing – rather than breathing toxic smog – and see the sky and the sun. Some of this may be transitory: factories around the capital city were closed down before the Olympic Games and not started again. But apart from the official rhetoric – talk is cheap and the actual policies to improve the environment have lagged the official statements the Chinese are realizing the importance of dealing with environmental degradation for a number of reason: millions of Chinese are getting sick with pulmonary disease because of polluted air and millions are getting sick because of water pollution; environmental degradation hurts Chinese exports (think of recent bank of Chinese seafood products because of polluted waters); the rising middle class is starting to care about the quality rather than just the quantity of growth.

More importantly, energy-inefficient technologies keep the demand for raw materials and energy resources very high and pushes higher commodity and energy prices; in his private meeting with us during the China Development Forum the Premier Wen pointed out that any time Chinese growth accelerates energy and commodity prices sharply spike and that negative terms of trade effect hurts China; thus, developing energy efficient technologies can reduce over time the demand for oil and energy and control those upward pressures on global energy and commodity prices. Of course China is also dealing with this resource constraint by trying to control resources – and ensure stable supplies - at the source (buying mines in Africa, Latin America, supply contracts with national oil companies in Russia). But such strategy can only ensure a stable supply of raw materials, not their price. In order to avoid sharp spikes in energy and commodity prices demand for such commodities needs to be controlled. And the best way to control such demand - for a country whose appetite for energy and commodities will spike because of industrialization and urbanization – is to control demand via implementation of energy efficient technologies and other policies to reduce the demand for energy. Thus, environmental protection, pollution control and climate change control make good business sense for China as they may limit the insatiable demand for resources that will put a medium term strain on their price, a negative for a commodity importing country such as China.

These rising concerns about the environmental impact of high growth and the resource constraints from rapid growth also suggest that the Chinese authorities may – over time – be willing to trade off high but unsustainable and environmentally-degrading growth for a slightly lower but sustainable growth rate. If a growth rate of 10% - like the one of the last decade – is environmentally damaging and unsustainable (and does not include the social costs of environmental and health degradation) while a growth rate of 7-8% is more sustainable, at some point the Chinese will be willing to accept that lower high-quality growth to a higher but low-quality growth rate. In other terms the Chinese are starting to realize that there is some meaningful tradeoff between the quantity and the quality of economic growth. This growing Chinese interest in environmental protection may also imply that China may be convinced - like the new US administration is – to constructively join an international agreement that would be a successor to the soon expiring Kyoto agreement on greenhouse emissions.