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HOW EFFECTIVE WILL CHINA'S FOUR TRILLION YUAN STIMULUS PLAN BE?

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Summary

1. The current global financial crisis triggered by the US sub-prime crisis in April 2007 has spread widely across the world. Due to China's economic integration with the rest of the world, it has been seriously affected.

2. The Chinese government has stressed the importance of international cooperation and has reiterated its willingness to work with western economies to get through this financial crisis.

3. There has been a consensus among Chinese scholars and policymakers that domestic problems including unemployment, market volatility, a rapid slowdown in economic growth, social security failures and education reform are the most pressing.

4. The Chinese government has announced a two-year 4 trillion-yuan stimulus plan to bolster economic expansion and help sustain global growth. This spending can essentially be classified into two investment categories: infrastructure and people's livelihoods.

5. The intention of the central government is apparent, which is to direct a large part of the spending to the improvement of people's livelihoods. However, local governments and state enterprises backed by powerful vested interests strongly prefer to invest in profitable infrastructure projects.

6. State intervention in the form of public investment in infrastructure to stimulate economic growth has proved to be inefficient following China's own experience during the 1997 Asian Financial Crisis. Another key issue associated with government-led infrastructure investment is the potential for irregularities and corruption linked to vested interests.

7. To achieve the maximum effects of stimulating domestic demand, the government should carry out a radical reform of the social welfare system. The low consumption demand and extraordinarily high savings rate in China are a consequence of the low level of social security services provided by the state.

8. The 4 trillion yuan stimulus will achieve much better results if preference was given to projects related to securing people's livelihoods instead of infrastructure construction.

9. Nonetheless, the central government may have to challenge powerful vested interests in order to realise its goals. This 4 trillion yuan stimulus package may therefore be far from effective.

How Effective Will China's Four Trillion Yuan Stimulus Plan be?

Yongnian Zheng and Minjia Chen*

How Deeply Has China been Affected by the Global Financial Crisis?

1.1 The current global financial crisis triggered by the sub-prime crisis in the US in April 2007 has spread widely across the world. The credit crunch that followed started in August 2007. This is the worst economic crisis since the Great Depression in the 1930s, the first worldwide crisis in the globalised age, the first major recession in industrialised economies since the early 1990s, and the first real crisis China has ever experienced. The impact of this financial crisis is far reaching and still too early to assess. Since the oil crisis and the collapse of the Bretton Woods financial system in the early 1970s, quite a few debt and financial crises have happened in many developing countries on almost every continent, but there had not been any economic crisis originating from a developed economy. Leaders in the developed world had been used to acting as rescuers and commanders of troubled economies via their countries' role in the International Monetary Fund (IMF), the World Bank and other international organisations; they had never expected to become so deeply distressed by an economic system that they had been so proud of, awaiting hopefully the help of some emerging economies.

1.2 On the one hand, due to China's strong economic ties with the world market, especially through its export sector, it does not have the luck this time of being exempted from the current crisis, unlike in the 1997 Asian Financial Crisis. The Asian Crisis started and affected only the financial sectors in certain small Asian countries. At that time, China was not a member of the World Trade Organisation and its financial sector was chiefly closed to the outside world. The impact of the crisis on China then was mainly seen its export industries, largely due to the drastic depreciation of other Asian currencies which made Chinese products relatively expensive. China's real sector was actually not seriously affected. China has since been trying to diversify its economy through reducing its heavy reliance on external demand. It has not been quite successful in this regard however. Its export sector of manufacturing goods is still one of the strongest drivers of economic growth. Being a labour abundant country, China's comparative advantage lies in labour-intensive manufacturing goods. Therefore the drastic reduction in the international demand for its goods in the present financial crisis has hit Chinese producers extraordinarily hard. Thousands of export oriented firms have been forced to shut down. This has inevitably resulted in large-scale redundancies, and consequently social unrest.

1.3 On the other hand, the drawbacks of China's economic integration with the rest of the world has showed its negative side this time. The ongoing financial reform and China's "go out" (*zou chu qu*) strategy in recent

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years have been carried out rather hastily. A significant number of Chinese financial institutions had almost ruthlessly purchased large stakes in former leading investment banks, funds, and other institutions merely a couple of years ago on expectations of sharing their huge profits. However, Chinese financial institutions are still lagging in experience while government policies are themselves immature. As the massive financial assets bubbles burst, Chinese stakeholders of those western financial institutions incurred painful losses as well. Furthermore, almost all these major Wall Street investment banks hold stakes in Chinese financial institutions too. Chinese authorities had hoped to establish some forms of strategic partnership with well-recognised financial institutions and to enable domestic banks to learn foreign advanced operation techniques and management skills by allowing those foreign investment banks to hold significant shares of domestic financial institutions. Obviously, with the collapse of those major investment banks, hopes of such expectations have faded.

1.4 With the collapse of many large lenders and institutional investors the foundation of the real economy has been crumbling. Bankruptcies have spread from the financial sector to the real sector, such as the automobile industry in the US. The US and many EU governments have launched many emergency rescue and stimulus packages worth trillions of dollars. These packages however are not only insufficient, but will also force those governments to run into deep fiscal deficits and simply worsen imbalances in their respective economies. Therefore, many developed countries have turned to some cash-rich developing economies for money through loans, investments, etc. Many western politicians and economists have voiced their thoughts to Gulf oil exporters which had generated large amount of cash from the swell in oil price in the past, and to China, which has one of the strongest fiscal conditions among the world's major economies.

1.5 The Chinese government has stressed the importance of international cooperation and reiterated on several occasions that China is willing to work with western economies to get through the financial crisis. In the two rounds of Strategic Economic Dialogue between the US and China in June and December 2008, Vice-Premier Wang Qishan who is in charge of economic affairs promised then-US Treasury Secretary Henry Paulson that China will continue to hold its huge amount of US treasury bonds despite suffering massive losses from the depreciation of the dollar; in return he urged the US to stabilise its economy and protect Chinese investments. Indeed, China had passed Japan to become the largest creditor of the US government in September 2008.[1] However, as Chinese Premier Wen Jiabao emphasised in his talk with UK Prime Minister Gordon Brown in October 2008, China's foremost focus was on its domestic economy.[2]

1.6 There has been a consensus among Chinese scholars and policy-makers that domestic problems such as unemployment, market turmoil, the rapid slowdown in economic growth, social security failures and education

[1]*The Washington Post*, 19/11/2008, "China Tops Japan in US Debt Holdings—Beijing Gains Sway over US Economy", http://www.washingtonpost.com/wp-dyn/content/article/2008/11/18/AR2008111803558.html, accessed on 22/12/2008.
[2]*People's Daily*, 14/10/2008, "Chinese, British PMs Talk over Phone about International Financial Crisis", http://english.peopledaily.com.cn/90001/90776/90883/6514951.html, accessed on 22/12/2008.

reforms are the most pressing. However, a heated debate ensued around September and October 2008 over whether China should use its foreign reserves to help the west after developed economies slowed down drastically. On the one side, some people believe that this financial crisis has caused many quality assets in the western economies to be underpriced. Therefore, it presents a once-in-a-lifetime chance for China to scoop some great bargains in the international market. They see helping the west as helping China itself because the US and EU are its most important export markets while China and the west share common commercial interests. Besides, helping the US by injecting liquidity so that the Federal Reserve does not have to depreciate the dollar too much will help to save the value of China's large holdings of US Treasury and commercial bonds. On the other side, some argue that China does not yet have the capacity to take this step. First of all, Chinese domestic problems require enormous investment from fiscal and non-government sources. So many Chinese firms are dreadfully in need of funds to avoid bankruptcy, and of restructuring to suit the change in market conditions. Thus China does not have spare funds to carry out overseas operations and should not risk its precious resources under the current circumstances. Secondly, attempts by Chinese sovereign funds to invest in foreign assets on expectations of high returns in the past year have not been successful so far. The value of two major investments by the sovereign fund manager China Investment Corporation (CIC)-- $3 billion in Blackstone and $5.6 billion in Morgan Stanley in 2007 -- have shrunk dramatically.[3] Some of the big state companies which had hedged against high oil prices in the international commodity market have all incurred enormous losses.[4] These examples may suggest that Chinese government and firms still desperately lack the experience to operate in international financial markets. Indeed, the Chinese are still in their infancy in terms of market operations after decades of isolation from the outside world.

1.7 As the crisis worsens, China faces increasing pressure from its own economic slowdown. Growth has slowed to its weakest pace in five years, with gross domestic product (GDP) expanding just 9 percent in 2008 from a year earlier after gaining 13 percent in 2007[5]. The rate is still fast by the standards of any other country and goes to show how important it is for China to maintain its growth and lift the global economy. The IMF estimates that China accounted for 27 percent of global economic growth in 2007 based on the purchasing power parity exchange rate, more than any other country.[6] Ensuring its high rate of growth will definitely be China's most significant contribution to the world at the moment.

China's 4 Trillion Stimulus Plan

2.1 On 9 November 2008, the Chinese government announced a two-year 4

[3] *National Business Daily*, 03/12/2008, "Lou Jiwei: CIC Afraid of Investing in Overseas Financial Institutions", http://www.nbd.com.cn/_NewShow.aspx?D_ID=135417, accessed on 22/12/2008.

[4] For example, *People's Daily*, 01/12/2008, "Air China's Fuel Hedge Contracts Lost Huge 3.1 Billion", http://caac.people.com.cn/GB/114171/8439858.html, accessed on 22/12/2008.

[5] Data source: National Bureau of Statistics.

[6] Figure 1.16, "*World Economic Outlook April 2008: Housing and the Business Cycle*", International Monetary Fund, Washington DC.

trillion-yuan (US$586 billion or £421 billion) stimulus plan to bolster economic expansion and help sustain global growth as the US, the EU and Japan teetered on the brink of recession.[7] This sum represents about 16 percent of China's economic output in 2007 and is roughly equal to the total of all central and local government spending in 2006. In addition, China implemented expansionary fiscal policies such as revamping the value-added tax and income tax which effectively helped to deduct company costs and increase household income. The central bank also loosened credit controls in the banking sector through lowering the base interest rate and the reserve rate requirement for commercial banks. All these new measures signalled a shift in China's economic policy from contractionary to expansionary, while the main government target changed from reining in overheated growth up until 2007 to maintaining reasonable growth and avoiding significant economic slowdown.

2.2 This big stimulus package has been in the spotlight ever since it was unveiled. The international community immediately expressed their welcome as it undoubtedly opened up numerous opportunities to foreign as well as domestic businesses. Stock markets in and outside China promptly rose on its announcement, reflecting the market's confidence in the positive prospects of the plan.

2.3 Originally, the plan was to boost new spending in areas including low-cost housing, road, rail, airport and power generation infrastructure, agricultural subsidies, rural infrastructure, healthcare, social welfare, education, environmental protection and scientific innovation by the end of 2010. The spending can essentially be classified into two investment categories: infrastructure and people's livelihoods. Based on these guidelines, the intention of the central government is apparent to direct a large part of the spending to the improvement of people's livelihoods. However, just like many other state policies, implementation of the plan would involve a sticky process of bargaining and negotiation between the central and local governments. In this case particularly, the central fiscal budget will only directly allocate 1.18 trillion yuan, which is a little less than a third of the planned total.[8] The rest of the funds are expected to be financed by local governments. The local governments would certainly want their opinions to be heard on the distribution of the funds. Immediately after the announcement of the stimulus package, tens of local provincial and city governments set up special working groups to write applications for their proposed projects. They sent lobbying groups directly to the central planning agency, the National Development and Reform Commission (NDRC), in Beijing.[9] The enormous enthusiasm of local governments far exceeded the expectations of the central government. Merely within two weeks, local governments had proposed as much as 18 trillion yuan of projects.[10] This value reflected the possible

[7] *Xinhua News*, 09/11/2008, "China's 4 Trillion yuan Stimulus to Boost Economy, Domestic Demand", http://news.xinhuanet.com/english/2008-11/09/content_10331324.htm, accessed on 22/12/2008.
[8] *China News*, 09/12/2009, "NDRC: Central 4 Trillion and Local More Than 10 Trillion Partly Overlapped", http://www.chinanews.com.cn/cj/gncj/news/2008/12-09/1480434.shtml, accessed on 22/12/2008.
[9] *Xinhua News*, 21/11/2008, "The Central 4 Trillion Stimulus Plan Aroused "Full Sprint" from Local Governments", http://news.xinhuanet.com/fortune/2008-11/21/content_10389836.htm, accessed on 22/12/2008.
[10] *The Beijing News*, 25/11/2008, "Local Governments Unveiled 18 Trillion Investment Plan, Funding Sources Attracted Attention", http://news.xinhuanet.com/fortune/2008-11/25/content_10407671.htm, accessed on 22/12/2008.

amount of vested interests backing those proposals.

2.4 Details of how the stimulus package would be spent were only revealed by the NDRC on 27 November 2008 after initial assessments of the proposals and negotiations. Of the total, 1.8 trillion yuan will be invested in building transportation infrastructure and power grids. One trillion yuan will be used for reconstruction in areas affected by the devastating May 2008 earthquake in Sichuan province, and 370 billion yuan will be targeted at improving rural livelihoods and infrastructure. Another 350 billion yuan was earmarked for environmental protection, while social security and housing will receive 280 billion yuan. Technological innovation will get 160 billion yuan, and 40 billion yuan will be spent on public healthcare and education.[11] Although the NDRC had stressed that efforts to improve quality of life and rural development would be given top priority, the funding allocation simply demonstrates that most of the budget will be spent on infrastructure projects. NDRC Director Zhang Ping also estimated that the 4 trillion yuan could further generate a larger sum of private investment.[12] According to China's past experience the associated private investment may reach three times of the public investment. The country's overall investment in fixed assets is set to reach 17 trillion yuan in 2008 and may top 20 trillion yuan in 2009.[13]

Infrastructure Improvement versus Social Welfare Reform

3.1 State intervention in the form of public investment to stimulate economic growth has been extensively used by western developed countries to deal with economic and financial crises since the Great Depression in the 1930s following Keynes's theory.[14] The effects are still controversial in both theory and practice. This is the second time the Chinese government has ever practised a stimulus intervention. In 1998, when China was affected by the Asian Financial Crisis, then-Premier Zhu Rongji also implemented similar government-led investment projects focused mainly on infrastructure with the hope of stimulating domestic demand. However, that stimulus plan failed primarily. Many projects had been carried out hurriedly to have a quick effect on GDP growth, resulting in indiscriminate construction, waste of resources and projects that had not designed to maximise long-term returns. Furthermore, these government-sponsored investments had become ideal profit-making opportunities for vested interests groups, especially those in local governments and state-owned enterprises (SOEs).

3.2 Local governments have strong motivations to lobby the central government to authorise projects that could directly and quickly generate local GDP growth, which has the largest weighting in officials' assessments. Most of the bids by local governments for a share of the 4-trillion-yuan funding were transportation infrastructure projects. [15]

[11] *Caijing Magazine*, 01/12/2008, "NDRC Details Four Trillion Stimulus Package", http://english.caijing.com.cn/2008-12-01/110033094.html, accessed on 22/12/2008.
[12] *Ibid*.
[13] *Ibid*.
[14] Keynes, J. M. (1936), *The General Theory of Employment, Interest and Money*, MacMillan, London.
[15] For an example of the proposals of some provinces and municipalities: *The Beijing News*, 25/11/2008, "Local Governments Unveiled 18 Trillion Investment Plan, Funding Sources Attracted Attention", http://news.xinhuanet.com/fortune/2008-

Competition among local governments for the limited central resources has led to the operation of hundreds of representative offices of local governments in Beijing. A popular term for these activities is "*paobu qianjin*" which means "running" around the ministries to get money come in. In Chinese, the term has the same pronunciation as the phrase "running forward." This phenomenon nevertheless cannot simply be interpreted as lobbying. It also stems from the manifold and complex paperwork and procedures related to applications and reporting for government funding. Government investment projects are also most likely to be won by SOEs due to their relationships with government rather than commercial competitiveness. Therefore SOEs are also among the most active lobbyists for government investments. Both lobby groups clearly prefer infrastructure projects as they are straightforwardly in line with their interests.

3.3 In the long run, sound infrastructure will definitely contribute to a country's economic development, being necessary to improve people's living standards. In such a vast and populous country like China, there is still immense potential in developing infrastructure. China's attractiveness to foreign investments and rapid growth particularly in the eastern coastal areas can largely be attributed to the region's good quality infrastructure. However, in the short run, in the case of China, infrastructure construction would only play a limited role in boosting domestic demand. Former Premier Zhu Rongji's stimulus plan 10 years ago under a very similar domestic condition provides a real example. While large-scale infrastructure construction could generate employment to some degree, it is far from enough to absorb laid-off workers from once labour-intensive factories. It could create some demand for construction materials, equipments, services etc., but would not contribute much to the government target of boosting domestic consumption. Currently capital formation contributes the most to China's GDP growth relative to final consumption and exports. The government formally proposed to fundamentally transform its economic structure at the Fifth Plenary Session of the Fourteenth Congress of the CCP in 1995, and further proposed the concept of "scientific development" at the Third Plenary Session of the Sixteenth congress in 2003. Both strategies were aimed at shifting growth drivers by increasing consumption and reducing the reliance on investment and exports. However, restructuring has not been successful so far, which is one of the main reasons why China has been deeply affected by the financial crisis. Heavy investment in infrastructure may worsen this imbalance.

3.4 Nevertheless, given the budget for infrastructure the central government should at least take the chance to push forward industrial restructuring by redressing the imbalance between the railway and highway systems. According to figures by the National Bureau of Statistics, from the beginning of the economic reform in 1978 until 2007, China's railway mileage increased by only 50 percent from 52 thousand kilometres to 78 thousand kilometres, whereas highway mileage swelled more than four folds from 890 thousand kilometres to 3.58 million kilometres. Other means of transportation such as civil aviation, ports, and water transports have all been improved by several folds. Compared with other major industrial indicators such as the production of coal, oil, natural gas, electricity etc., development of the railway system has been noticeably backward. The railway system was mostly built before the reform era and

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11/25/content_10407671.htm, accessed on 22/12/2008.

is far from adequate to meet transportation demand nowadays. The stimulus package may therefore offer an excellent opportunity to improve railway transportation capacity and facilities. Driven by the desire to build a strong automobile industry, the Chinese government has put a great deal of investment into highway construction while largely neglecting the importance of the railway system. It is time to readjust the transportation system not just to meet the requirement of further development but also for the sake of conserving the environment.

3.5 Another key issue associated with government-led infrastructure investment is possible irregularities and corruptions. There are many vested interests in such investments which are lobbying hard for project approvals and contracts. Foreseeing the problem, the Ministry of Finance (MOF) issued strict directives shortly after the announcement of the stimulus plan for the funding. Together with the Ministry of Supervision, the NDRC, and the National Audit Office, the MOF set up and sent 24 central audit working groups to the provinces and cities to oversee the funding operations.[16] The authorities also laid strict prohibitions against investing in highly pollutive and energy-consuming industries, duplicate constructions, industries which already face overcapacities, and government office buildings.[17] They have also stressed the importance of supervising the tender process, as well as monitoring the contractors and quality of work.

3.6 To achieve the maximum effects of stimulating domestic demand, the government should carry out radical reform of the social welfare system. The low consumption demand and extraordinarily high savings rate in China are results of the low level of social security services provided by the state. Housing, education and healthcare are depicted as the "three big mountains" repressing ordinary Chinese people, as these pose potential huge costs for families. Therefore, households are forced to save a large portion of their income as a precautionary buffer. It is not that Chinese people do not have the desire to consume but they fear unexpected disruptions.

3.7 Before China's economic reform began, the state-funded social security net provided a complete and free service to everyone, although that formed a huge burden on state employers. In the early 1980s, final consumption contributed as much as more than 80 percent of GDP growth. Reform of the system started in the 1980s, aimed at reducing SOEs' cost. The principal idea of the reform was to commercialise social security services and let the state, employers and individual persons share those costs. The reform so far has failed in many aspects. For example, the housing reform has generated a buoyant estate market and rocketing house prices which have made houses largely unaffordable for most low-income families and young people even though people's living standards have improved considerably. Compulsory school education is free to all Chinese citizens, but higher education tuition fees can be prohibitive to many rural households. The marketisation reform of China's

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[16] *Xinhua News*, 21/11/2008, "Ministry of Finance to Do Its Best to Monitor the Ten Billion New Investments", http://news.xinhuanet.com/fortune/2008-11/21/content_10394102.htm, accessed on 22/12/2008.

[17] *Xinhua News*, 23/11/2008, "Two Ministries Request to Ensure the Expected Effects of the Ten Billion New Investments", http://news.xinhuanet.com/fortune/2008-11/23/content_10400728.htm, accessed on 22/12/2008.

healthcare system was regarded as a failure a few years ago.[18] The coverage of the public health service has reduced significantly. Many people such as groups of migrant workers do not have access to the service at all. Medical resources are unequally distributed, being highly concentrated in large cities and rich areas. It has become increasingly difficult and expensive for people to see a doctor. Costly hospital bills could drive some families into poverty or huge debts. Such daily worries have motivated people to save and prevented them from spending on other items. In fact, in recent years, final consumption has only accounted for less than 40 percent of China's GDP growth. China has become a country which has one of the highest savings rate in the world.

3.8 Such high levels of savings are undeniably a matter of necessity and survival. Without the government's guarantee of protection, people have to guard themselves against illnesses, unemployment, or other unforeseen circumstances. By contrast, if there was a well-functioning social security network, people would not see the necessity to set aside so much precautionary savings and consequently be willing to spend more on other needs such as leisure. These other types of additional consumption are what the government can stimulate using monetary and fiscal policies when people feel their livelihoods are secure.

3.9 In summary, there is every reason to believe the 4 trillion yuan stimulus will achieve much better results if preference was given to projects related to securing people's livelihoods instead of infrastructure construction. This will adjust the imbalances in China's economic and growth structure and limit corruption and irregularities because such social projects are not as profitable as construction projects and hence will not appear as attractive to vested interests. This will undoubtedly encourage people to reduce their savings and spend more. Most importantly, China's social security system urgently needs to be reformed sooner rather than later.

Limited Actual Effects

4.1 In terms of absolute value, spending 4 trillion yuan over two years is considerable compared to the scale of China's economy. Following the Asian Financial Crisis 10 years ago, China had introduced a similar government stimulus package of 3 trillion yuan to be invested over five years. As the central government is aware, it is not as simple to direct the sum of 4 trillion yuan to social projects, as much as they would like to. Resistance from local governments and other groups are extremely powerful. In recent years, the central government's fiscal revenue has increased rapidly. It totalled 5.1 trillion yuan ($750 billion or £537 billion) in 2007, a 30 percent leap from a year earlier[19], and 6.13 trillion yuan ($901 billion or £645 billion) in 2008[20]. The central budget has been in a minor deficit for years and the government's debt is only equivalent to

[18] For example, *Eastday News*, 01/08/2005, "What does the Failure of China's Medical Care Reform Suggest?", http://news.eastday.com/eastday/node127047/node127220/node127261/userobject1ai1302055.html, accessed on 22/12/2008.
[19] Data source: National Bureau of Statistics, Statistical Data.
[20] Data source: Ministry of Finance.
[22] Data source: National Bureau of Statistics, Statistical Data.

about 20 percent of GDP.[22] Compared to the EU's requirement, member states have to keep their government's debt to GDP ratio at 60 percent or less, while in the USA, the figure is about 80 percent. The Chinese central government has actually been investing in improving and reforming its social security, housing and education systems. It has issued many policies to accelerate the process. However, the course of reform has been difficult because of the lack of profits or interests to support it. Local governments or SOEs do not benefit directly from carrying out such social projects. It is apparently even more difficult to engage private partners or foreign investors. The central government has been in the awkward position of having the motivation and excess funds for social projects but still being unable to get the job done. Thus, the central government has to accomplish the task of improving people's livelihoods by itself, instead of relying on local governments or SOEs.

4.2 On the brink of a financial crisis, the time is right for the central government to push forward the social security system reform in order to achieve the maximum results of stimulating domestic demand. Moreover, returns on investment in many real sectors will be relatively low while demand for materials and services in the production sector will be weak given the present economic slowdown. By contrast, demand for public services related to people's livelihoods will be stronger than usual because the financial position of households are worse. Ironically, the importance of the social welfare system does not seem to be well recognised. For example, the Zhejiang provincial government among others recently reduced the amount of pension contribution that employers are required to pay into their employees' accounts to help reduce firms' cost.[23] Although such measures may help firms to some degree, they simply worsen the inadequate welfare protection of workers, which will not help the economy to revive.

4.3 As we have seen, most of the 4 trillion yuan has already been allocated for infrastructure and related projects, which is not optimal for the purpose of a stimulus package and only reflects compromises reached between the central government and vested interests. Some local governments have been somehow opportunistic, as they were aware that some of the projects and amounts of funding that they had proposed were not likely to get approval; even if they had been approved, they would not be able to generate enough matching funds.[24] This situation is obviously driven by interests underlying those investment projects, which account for the desperation of local governments and consequently increase the risks of the central government's whole stimulus plan. Furthermore, the NDRC had requested on 1 December 2008 that 100 billion yuan of investments have to be made by the end of 2008. The central agency expected that the 100-billion-yuan sum will spur another 400 billion yuan of other investments.[25] Given the tight deadline, local governments had no time to make brand-new proposals but to submit old project plans again. Due to the economy's overheating and macroeconomic controls in the past two years, such projects had been

[23] Information source: Zhejiang Provincial Department of Labour and Social Security, Zhejiang Government Document (2008) No.70.

[24] *Shanghai Securities News*, 26/11/2008, "Behind the 18 Trillion Rhetoric: Local Financial Resources Unable to Leverage", http://news.xinhuanet.com/fortune/2008-11/26/content_10412761.htm, accessed on 22/12/2008.

[25] *Legal Mirror*, 01/12/2008, "100 Billion to Stimulate 400 Billion Non-governmental Investment", http://www.fawan.com/Article/ShowArticle.asp?ArticleID=197524, accessed on 22/12/2008.

withheld temporarily. Hence, implementation of these projects may still drive the economy on its old model of development, rather than on a restructuring path.

4.4 It is therefore predictable that the effects from this stimulus plan will be rather limited. Such plans in China or elsewhere are merely aimed at the short term. They are often the last resort of authorities to prevent the economy from worsening too quickly, and often at the risk of incurring long-term costs. In October 2008 China's macroeconomic policy was re-adjusted from contractionary to expansionary, with the main economic target changed from containing inflation to maintaining growth momentum. In the annual Central Economic Work Conference that ended on 11 December 2008, the Chinese leadership urged the need to work hard to attain GDP growth of 8 percent in 2009,[26] which will be the lowest level since the Asian Financial Crisis.

4.5 Instantaneously the stimulus plan gives the market a clear and strong signal that the government is taking pro-active actions to revitalise the economy. This effect has evidently been achieved. Many Chinese scholars, economic policy-makers and business circles are excited by the plan. For government officials, their top focus is on macroeconomic indicators such as GDP growth. In the medium term however, firms have to wait and see whether the domestic market does provide them with profitable opportunities. Consumers will also need stable employment and income growth, in addition to stable inflation, social security and favourable market conditions which affect their expenditure. The central authority expects the 4-trillion-yuan stimulus to stabilise the economy in 2010.[27]

4.6 Another key issue being neglected by policymakers at the moment is that of reducing income inequality by increasing the incomes of those on low wages. Marginal consumption demand is much higher for poor people than for rich people. Inequality has become a more and more serious problem in China since the 1980s when the urban economic reform began. It is now a good time to enable low-income earners to have more disposable income through policy measures So that they will be more willing to spend their additional income on consumption. To fundamentally narrow the gap between the rich and the poor, China indisputably needs to reform its economic structure and growth model. In the short term, tax reductions, direct subsidies, fee waivers, provisions of shopping vouchers and so on would help the low-income class to relieve their financial pressures while promoting consumption within the economy.

4.7 In addition, in allocating and spending the 4 trillion yuan worth of funds, some attention should be paid to small and medium size enterprises (SMEs), which employ the majority of the workforce in the country and contribute a large share to economic growth. They are traditionally discriminated against by the market and always experience extra difficulties when seeking external financing. Owners of SMEs form a significant part of middle class in society, having considerable

[26] *Xinhua News*, 11/12/2008, "Analysing the New Aspects of China's Economy in 2009: "Maintaining Growth" the Top Priority", http://news.xinhuanet.com/newscenter/2008-12/11/content_10490515_1.htm, accessed on 22/12/2008.
[27] *China Economic Weekly*, 01/12/2008, Vol. 3, "Fan Gang: The Four Trillion will have Effects in 2010 at the Earliest", http://www.ceweekly.cn/more.asp?TN_NID=2008-12-01-1014, accessed on 22/12/2008.

consumption potential. Therefore, it is effective and helpful to give extra support to SMEs in order to offset the negative effects of the financial crisis and stimulate the economy.

4.8 Overall, the central government's 4 trillion yuan stimulus package is a necessary tool in the wake of the global recession. Joining other world major economies, China has to a certain extent restored market confidence and boosted its economic outlook with the announcement of the package. However, real stimulus effects of the plan will remain limited, as the central government does not have enough power to fully direct the use of the funds. As the central government requires local governments to finance at least 70 percent of the proposed projects, local governments have strong bargaining clout and powerful vested interests could readily sway local authorities to invest more in profitable infrastructure projects. No matter how eager the central government is to push for reforms in the systems of social security system, education, housing and so on to improve people's livelihoods, the lack of profits in carrying out such reforms will definitely make the exercise a difficult one. In China, government investment will not be an effective way of stimulating domestic demand. Instead, building a secure social welfare network would be a better way to motivate people to reduce their savings and boost consumption. The Chinese leadership has certainly realised this critical point, as reflected in its attempts at reform. Nonetheless, to realise their goals, the central government may have to overcome the power struggle with vested interests. This 4 trillion yuan stimulus package may therefore be far from effective.