

**MEMO**

From: APCO Worldwide  
 Date: January 28, 2010  
 Re: **China's Economic Stimulus: An Update On 2010 Prospects**

**Executive Summary**

- China's stimulus program has remained the driver of economic growth in China, and helped generate GDP growth of 8.7 percent in 2009. The stimulus program will continue through 2010.
- The Central Government has put in place a variety of fiscal policies to preempt risk stemming from non-performing loans, inflation and over-capacity, and retains considerable capacity to ramp up these policies should risk increase.
- APCO expects continuing high levels of government spending and state-sanctioned bank loans into 2010, creating major opportunities in China for foreign companies, as well as domestic.
- Foreign companies are becoming more adept at maximizing stimulus opportunities by strengthening intelligence collection and stakeholder relationships.

**Background**

China's stimulus program continues to move forward at a formidable pace. When the program was announced in November 2008, the Chinese government's goal of 8 percent real GDP growth for 2009 was regarded as optimistic by independent observers, even unlikely. Yet a spending surge funded by an unprecedented tidal wave of state-directed bank loans (RMB 9.6 trillion in 2009, an increase of more than 120 percent over 2008's total of RMB 4.2 trillion), and the expansion of wider – and ongoing – government procurement activities and fixed asset investment (FAI) at every level of the Chinese government saw 2009 real GDP growth come in at a – comparatively – blistering **8.7 percent**.

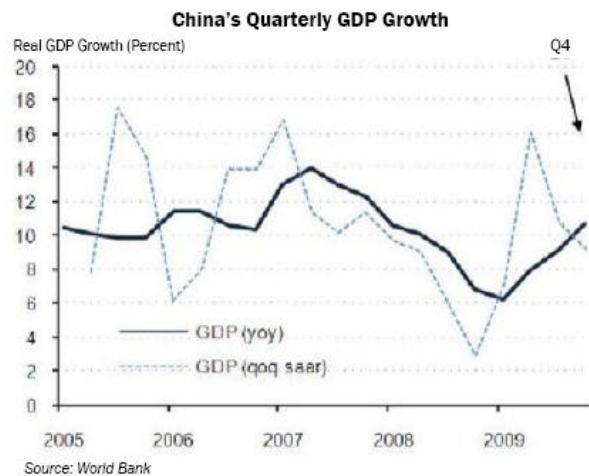
Real GDP Growth	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09
%q/q, saar	5.8	2.4	8.4	14.8	10.0	10.7

Source: JPMorgan

**APCO Analysis**

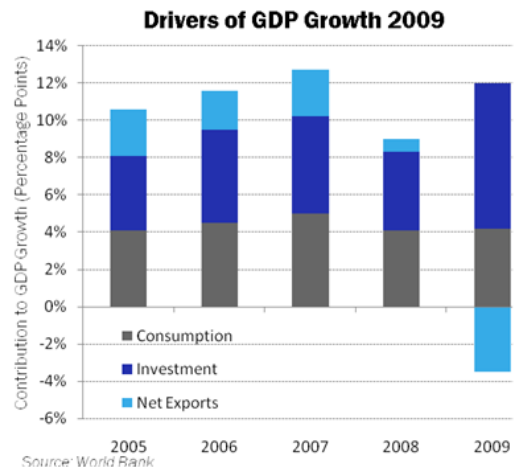
Looking at the details, it is encouraging that growth is reasonably broad-based and domestic demand driven. In 2009 industrial production increased at a solid double digit rate; real estate investment increased 16.1 percent; retail sales increased 16.9 percent. Anecdotally the labor market on the east coast is tightening again. Inflation remains relatively well-behaved (albeit with risk on the upside); and the deflation fears of a year ago are gone.

China has certainly experienced a v-shaped recovery so far. But there is still a perceived risk of a second dip down if external demand falters again,



if the FAI faucet is shut off too soon, or if the shift to domestic demand cannot be sustained. Given current momentum, we do not think this will occur before the fourth quarter of 2010, and we note that if signs of a problem emerge, China retains the fiscal flexibility to respond quickly.

Concern has therefore shifted to possible distortions that may be side effects of a large stimulus program. Many believe, for example, that the surge in bank lending will inevitably lead to an increase in non-performing loans in a few years. The China Banking Regulatory Commission (CBRC) is trying to get ahead of the curve by requiring banks to tighten their supervision of loans (in December 2009 raising tier 1 capital ratios to 13 percent and maintaining loan loss reserves at 150 percent of non-performing assets and in January raising the reserve requirement to drain funds from the banking system). This reflects concern that some of the money from banks has found its way into the stock and property markets, which may be leading to the emergence of asset bubbles.



The EU Chamber of Commerce in China released a report in November 2009 warning that stimulus spending might be simply increasing the existing over-capacity in many manufacturing sectors. For its part, the Chinese media have been quick to cite examples of waste, such as an airport built in the 1997 crisis that received as few as 300 passengers per year, dramatically below capacity, but planned to expand in the current stimulus program. For all this, however, the impact of stimulus activity on China's public debt and credit should not be a major cause for concern, with the Chinese government's fiscal deficit coming in at 3.8 percent in 2009 (paling in comparison to the U.S.'s projected deficit of 12.3 percent).

A broader concern is that the fiscal stimulus can be understood as massive lending by state-owned banks to state-owned enterprises affiliated with provinces and municipalities for the purpose of building infrastructure projects approved by the state planning apparatus. Completing the transition to a market economy has not been a priority. Yet long term prosperity will rest on factor prices set by the market, a more efficient capital market, a stronger private sector, and the development of the service sector.

### **What's the 2010 outlook?**

As we tracked specific stimulus project approvals on behalf of clients in the third and fourth quarters in 2009 we observed sustained and substantial spending directed into renewable energy, mass transit/railway, commercial buildings and major infrastructure projects such as airports and hospitals, among others. More than 10 high speed passenger intercity railroads are now under construction, for example, and 30 cities have received approval for underground mass transit projects. These projects once started are not easily halted. They typically take three or four years to complete. Once operational, they will support increased commercial activity generally, the development of the domestic tourist industry, and improved logistical links between coastal areas and central and western China.

In recent weeks concern has grown around potential for inflation to rear its head again as 2010 progresses – consumer price inflation jumped to 1.9 percent in December 2009, while the result of the 2009 lending binge was a jaw-dropping money supply increase of 35 percent; normally this would indicate severe inflation risk. However, the government and academics advising the

government are arguing that over-capacity in key sectors will mitigate against inflation risks in 2010, and official statements continue to support pro-expansionary policies. Chinese Premier Wen Jiabao at the World Economic Forum in September 2009 stressed that China would continue its loose monetary policy for the foreseeable future, while officials from the National People's Congress (NPC) in October 2009 described the stimulus package as "correct, timely and effective." The December 2009 Central Economic Work Conference emphasized continuity in macroeconomic policy and pledged to avoid a premature exit from the stimulus policy. At the same time the Chinese government has targeted new bank loans in 2010 of approximately RMB 7.5 trillion - down from the stratospheric heights of 2009, but certainly sufficient to drive investment at continuing high levels for the rest of 2010. We therefore do not see an end to stimulus-driven economic activity in China until 2011 at the earliest.

### **Recommendations for FIEs**

Since the onset of the Stimulus Program, APCO has been tracking and analyzing opportunities for a number of clients. We have found that China's stimulus program continues to create significant opportunities, yet the major challenge remains learning about project approval with sufficient advance notice, as when official tender announcements are made bid winners have normally already been identified.

We recommend multinational corporations and foreign-invested enterprises wishing to compete in these markets deploy resources and develop relationships needed to acquire stimulus-related intelligence including:

- Most projects are run at local level, therefore it is necessary to track and analyze markets by sector, province and locality.
- Target provincial and municipal stakeholders as well as the central government.
- Competing directly with local champions is a losing proposition, but there are opportunities to partner, to supply bid winners, to market as a local brand, to use proprietary technology or other comparative advantages to win bids; and given China's size and diversity, there will be areas where there are few local champions.
- Understand the legal process. Most projects are considered government procurement but are actually managed under the Tendering and Bidding Law, which lacks the transparency and disciplines of the Government Procurement Law.
- China's existing focus on energy efficiency and its new offer of a specific target for reduction of greenhouse gas emissions in the run-up to the Copenhagen climate change conference suggest renewable energy and green technology will continue to be priorities for investment and development. Spending on transportation and healthcare infrastructure is also locked in going forwards.

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### **CONTACT INFORMATION**

For further information on how APCO Worldwide can help your organization to understand China's government stimulus program and its implications for your organization, please contact:

Chris Murck, Vice Chairman Asia  
16th Floor, NCI Tower  
12 A Jianguomenwai Avenue  
Chaoyang District, Beijing, China 100022  
Phone: +86.10.6505.5127  
Fax: +86.10.6505.5257  
E-mail: [cmurck@apcoworldwide.com](mailto:cmurck@apcoworldwide.com)

Ken Jarrett, Vice Chairman Greater China  
2102 CITIC Square  
1168 Nanjing Road West  
Shanghai, China 200041  
Phone: +86.21.5298.4668 Ext. 228  
Fax: +86.21.5298.4669  
E-mail: [kjarrett@apcoworldwide.com](mailto:kjarrett@apcoworldwide.com)