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China faces stimulus dilemma

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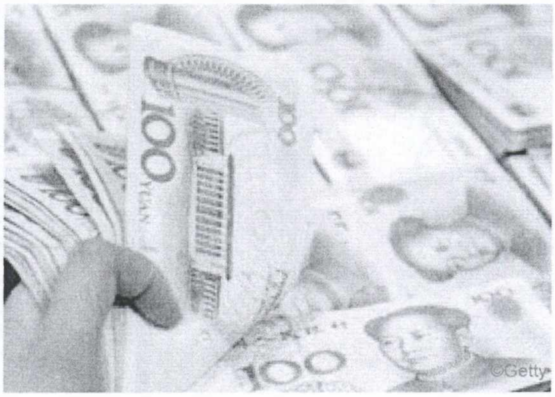
By Jamil Anderlini in Beijing



In chess, the term "zugzwang" describes a situation in which a player cannot skip a turn but any move he makes will put him in a worse situation.

That also neatly describes the situation facing the Chinese government as it cut interest rates on Thursday for the first time since the height of the financial crisis in late 2008, lowering benchmark lending and deposit rates by 25 basis points to 6.31 per cent and 3.25 per cent respectively.

With growth slowing much more than expected and an array of indicators pointing south, Beijing has been forced to act to prop up activity in the world's second-largest economy.

But many economists and analysts from inside and outside the government are warning of the dangers involved in a fresh round of stimulus and easy credit that could reinflate a property bubble and exacerbate the stark structural imbalances already present in the Chinese economy.

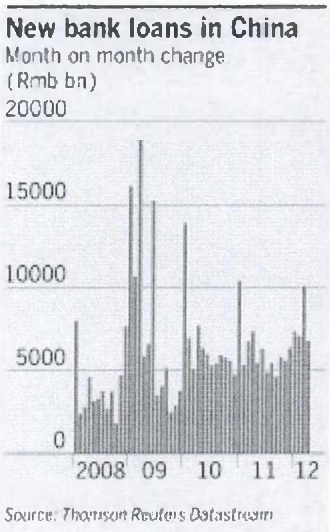
"This rate cut is a clear indication the government sees further weakness in the May economic data [due to be released on Saturday]," says Stephen Green, an economist with Standard Chartered in Hong Kong. "But there's obviously a risk that the increased focus on the short term undermines the structural reform agenda."

For the last two decades, the Chinese economy has been driven by investment and manufacturing for export, but everyone – from China's rulers to Western investment bankers – now agrees the country must shift to a growth model driven more by consumption than investment.

"If China can't become a consumption engine for its own manufacturing base then that will be a real problem for the whole world," says a senior executive at a large private equity firm with investments in numerous sectors in China. "The economy in May feels a lot weaker than April and April was already a shock; when you look at the month-on-month numbers you realise how big a slowdown is occurring and how the trend has turned negative."

Investors in China say most sectors are very weak and almost everyone assumes that a bigger response is on the way that will include large new government investments in infrastructure.

That belief is heightened as this is a "selection" year in China, when the ruling Communist party is scheduled to transfer power to a new generation of unelected leaders and will do whatever it takes to keep growth humming in order to ensure social stability.



"Many harbour doubts about the wisdom of another credit-fuelled stimulus, but the government's overriding objective is to ensure that the economy is not too fragile in the final months before the leadership transition," says Mark Williams, chief China economist at Capital Economics.

Analysts say a fresh round of stimulus is made more likely because the biggest problem is not the price or availability of credit but rather a lack of demand for loans in an environment of falling sales, high inventories, weak profits and overcapacity.

"The weakness in bank lending we've seen recently is not because credit is too expensive but because the outlook is so negative and nobody wants to invest," says Wang Tao, an economist at UBS.

That assessment is backed up by investors in a range of industries who say they have gone from not being able to access bank loans at all last year to being inundated with offers from state banks at a time when they are wary of adding new capacity.

"Cutting interest rates will help sentiment on the margins but it won't prompt a rebound without another round of government infrastructure spending," Ms Wang says. "This is not consistent with the long-term objective of rebalancing but there's not much the government can do because they need growth."

Beijing has said it wants to direct any new infrastructure spending into areas where significant bottlenecks and inefficiencies exist, such as water and sewage systems, electrical grids, waste management and environmental clean-up.

But many analysts predict that stimulus money will instead be channelled back into the lucrative, overheated real estate market.

With such a dismal range of options, this is clearly an economic down cycle that the Chinese government wishes it could sit out.