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China Lifts Spending As Growth Weakens

By BOB DAVIS

GUANGZHOU, China—China is ramping up state spending to counter its sharpest decline in growth since the financial crisis, further entrenching state-owned companies and dimming the hopes of some that China would use the slowdown to restructure its economy with market-oriented changes.

Premier Wen Jiabao said Tuesday the government's primary task is to promote investment. Although policies to stabilize growth "include stimulating consumption and diversifying exports," he said in a statement posted on the government website, "currently the main task is to promote reasonable investment growth."

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To do that, Beijing is turning to giant state-owned companies that hold monopolies in energy, construction, steel and banking. It recently approved construction of two new steel plants despite a world-wide steel glut. It also has increased the pace of approval for wind-power projects, although that industry, too, is plagued with overcapacity.

Even in Chongqing—where the recent ouster of a champion of state control, Bo Xilai, was seen by many as an opening for market-oriented economic change—there are few signs of that. Mr. Bo's successor as Communist Party boss in the megacity has lined up pledges of billions of dollars in investment from state-owned companies.

Some market-oriented shifts are advancing in China's financial sector, which is overseen by the central bank and securities regulators who have long urged that China rely more on markets and private enterprise.

Since April, Beijing has let its currency move in a wider daily trading range. It also has granted private capital greater access to sectors traditionally dominated by the state, offered more room for foreign investors in stock and bond markets, and structured two interest-rate cuts since early June to give banks more leeway to choose lending and deposit rates.

Still, most of these changes are in their early stages, and their impact is hard to judge. Tim Condon, an economist at Dutch bank ING, called them "baby steps" in the direction of a system fully open to international capital flows, which remains far off.

In a difficult period, said Eswar Prasad, a China watcher at Brookings Institution, Beijing is "relying on tried and tested methods of maintaining growth, which involves bank-financed investment spending by state-owned enterprises."

This is an important moment for China, whose growth rate eased to 8.1% in the first quarter—still robust, but the slowest since the spring of 2009. On Tuesday, China said export and import growth weakened in June, suggesting that both domestic demand and foreign demand for manufactured goods have weakened.

A further slowing in the economic growth rate could come in a second-quarter report due Friday, in part because the turmoil in Europe is sapping exports and investment.

European Pressphoto Agency

With China facing a slowdown, Premier Wen Jiabao said the main task now is to promote reasonable investment growth.

Besides its slowdown, China faces a once-a-decade leadership change starting late this year.

Economists argue that China must transition toward a consumption-led growth model, especially as its working-age population shrinks and demand for its exports falters. Top Chinese political leaders in recent years have consistently called for a rebalancing toward consumption.

There is widespread agreement both inside and outside China that if the country is going to reach the ranks of wealthy nations, it must look less to exports reliant on cheap labor and focus more on innovative economic activity involving branded goods and advanced services aimed at domestic consumers.

Yet the state-owned companies China now is looking to for growth are powerful proponents of the status quo. They are seen in China as much less dynamic and innovative than smaller, privately owned businesses.

One of China's largest banks struggled to make the credit assessments necessary to lend to such smaller, privately owned companies after China cut interest rates, said a senior executive at the bank.

"The risk is too high and the return is too low" to turn up the volume of loans for such companies, the banker said.

The last time China faced a sharp economic slowdown, during the global financial crisis of late 2008 and early 2009, it responded with more than $1 trillion in bank financing and infrastructure spending. Chinese officials, especially in the central bank, now believe that so large an expansion of lending was a mistake because it set off a property bubble and led to a spate of bad loans.

Bloomberg News

State-owned Baosteel Group Corp. has won the go-ahead to build an $11 billion plant. Above, rolls of steel at a Baosteel facility in Shanghai.

The bubble must not be reignited, Mr. Wen said over the weekend. China must "make controls against speculative housing demand a long-term policy," he said, according to a statement on the government website.

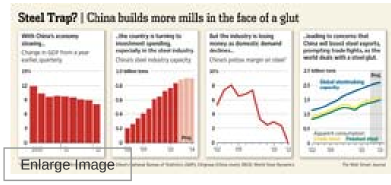
Mr. Wen also remarked that China's economy faces "huge downward pressure." He said the government was committed to spurring growth.

In fighting the current slowdown, Chinese authorities plan to provide more of the stimulus through the budget rather than bank lending. They haven't put a number on amount of stimulus needed to stabilize growth but say they are calibrating their response to the danger posed by the European slowdown.

Among projects newly approved, the government has dusted off steel-industry investment plans that had languished. State-owned Baosteel Group Corp. has won the go-ahead to build an $11 billion plant it first broached more than 15 years ago.

The plant won a preliminary approval in 2008 that was later suspended out of concern it would deepen the steel glut. In late May, however, Mr. Wen spoke publicly of the importance of policies "to maintain stable and relatively fast growth."

The next day, Beijing approved 100 projects, according to Spanish bank BBVA.



Enlarge Image

A photo of the elated mayor of the city where the new steel plant will be built, Zhanjiang, kissing the approval letter circulated on the Internet.

It wasn't that concerns about steel oversupply had faded. China's large and midsize steel plants lost money overall in the first quarter, according to Citigroup Inc. But political imperatives shifted as the government searched for projects that could boost growth. "The market situation may be the same as before, but the political motives have changed," said Lin Jiang, a finance professor at Sun Yat-sen University in southern China.

As a condition for getting approval of the project, the province where the mill will be built, Guangdong, agreed to reduce steel production capacity elsewhere by more than the amount added by the new plant.

But the stimulus from building the plant will be immediate, while the reductions will come later—if at all. Many doubt the capacity cuts will be carried out, at least in full, given China's worries that a slowdown could cause a wave of unemployment.

"Interest groups—state-owned enterprises and local governments—are strong" and may successfully lobby to prevent capacity closures, said a Guangdong government official, who, while saying his province will follow through on the conditions set for getting a new facility, expressed doubt that others would.

In Shaoguan, site of an aging Baosteel plant, some workers are skeptical there will be significant production cuts. A city of 50,000 people, with grimy apartment houses, schools, clinics and market streets, has grown up around the plant and its workforce of 17,000. "These are just rumors. They can't cut a huge amount of people here—it would affect the whole economy," said a 50-year-old steelworker as he waited to have a key made at an outdoor stall.

Baosteel said it would help China restructure the industry by eliminating less-productive plants but didn't comment on how much capacity it would cut or where.

The new plant will add to the steel industry's overcapacity even if it provides a short-term economic boost, said Scarlett Chen, a Citigroup steel analyst. Referring to the powerful Chinese agency that approved new projects in May, she said, "How desperate is the National Development and Reform Commission for meaningful projects" if it is approving a project such as this.

At a think tank affiliated with the development commission, senior economist Wang Yuanhong said the steel plant and other projects have long been in the pipeline. "The decision to approve them now was to stop growth slowing too much," he said.

He added: "The size of the stimulus in the end depends on what happens in Europe."

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