Larry & Xin discuss US & German & Chinese Stimulus Policies

What is the objective of stimulus programs? Where is their design falling short? How could policies achieve a more comprehensive economic recovery?

Welcome to a new discussion between Larry and Xin, two prominent economists from the Keynesian tradition, offering a bi-weekly US-Chinese debate. Today, Xin shares her perspective from Beijing with two charts and Larry responds from Washington. Disclaimer: names are fictional but analysis may be realistic.

Xin: Good morning Larry, happy Monday from a newly locked-down Beijing.

Larry: Hello Xin, and greetings from a newly re-opened Lafayette Square.

Xin: Well, we seem to have three life-time events this year, Larry: The pandemic with its health impact, the crisis from the economic lock-down, and now the racial tension. I watched the QuoVadis movie again with Rome burning. With all these fires in the US, this could become your "Nero moment", and I am wondering how this is going to end.

Larry: Yes, what a special Chinese gift into the middle of our explosive political and social environment. But let's focus today on the economics of stimulus programs.

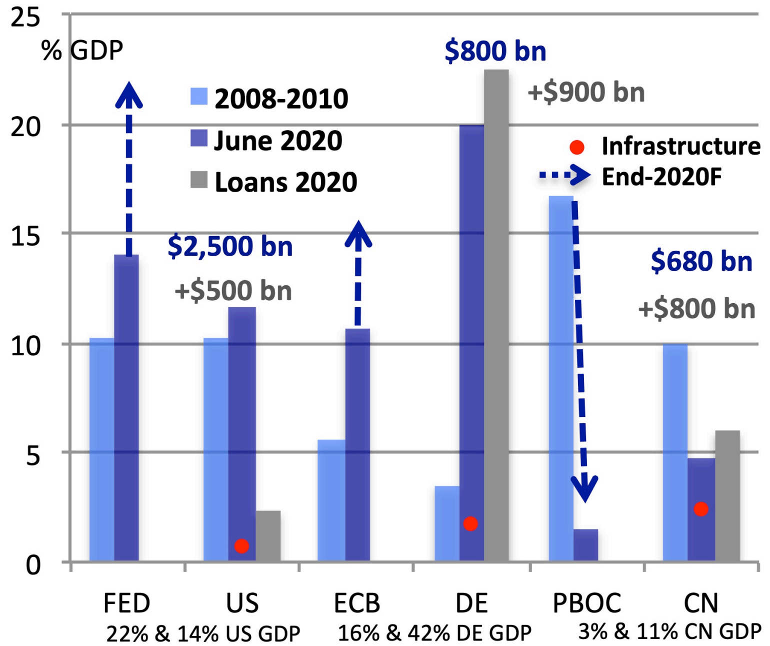
Xin: Quo vadis stimulus? Our research team crunched some numbers on monetary and fiscal stimulus here in China, as compared to Germany and the United States. And we are getting seriously worried whether stimulus is growing into some poisoned chalices.

Larry: We did a good job after the 2008 great financial crisis in the US and have some positive reviews and suggestions. But our new massive response could get out of hand.

Xin: We also have great reviews of China recovering after the 2008 crisis where we created new jobs and built some impressive infrastructure. But that is hard to repeat.

Magnitude of Stimulus — Chart 5

Monetary and Fiscal Stimulus 2020 versus 2008-2010
Comparison between United States, Germany, and China



Sources: IMF, World Bank, Bruegel, FED, ECB, PBOC, EM Leaders (June 2020)

Stimulus enhancing Productivity — Chart 6

Factors driving productivity and long-term growth

	CHINA	GERMANY	USA
Innovation	FIN-TECH	E-CARS	
Education			
Efficiency	?		ANTI-TRUST
Infrastructure	HS RAIL	DIGITAL	?
Institutions	CORP-GOV		
FDI Inflows ($bn)	137	40	251
Urbanization	60%	77%	82%
TFP Growth	2.5%	1.0%	0.5%

Sources: IMF, World Bank, OECD, World Economic Forum, WIPO, EM Leaders (June 2020)

Larry: At a high level, we have **three objectives for stimulus programs**: (1) ensure financial stability, (2) support economic activity, and (3) help companies survive. McKinsey & Co. compared trade-offs for liberal economies compared to "coordinated" European economies and to "managed" emerging economies, and explained that we are facing greater short-term risks from social and economic shocks in the US system.

Xin: I thought it might be helpful to compare stimulus programs today with those from the previous crisis (chart 5). Let me start with **China**, where we had a massive 2008 stimulus program of ¥4 trillion (14% of GDP), of which 40% went into infrastructure as we constructed a modern high-speed rail system that supported urbanization and increased productivity, but we also added 60% of GDP to corporate debt over the past decade. Hence we are more careful today with fiscal stimulus of about 5% of GDP and additional credit stimulus of about 6% of GDP. But we could double these cautious programs later in the year when we hopefully get a recovery of economic demand.

Larry: We did pass a massive $3 trillion US recovery program (14% of GDP) of which $500 bn are loans and guarantees by the **US Treasury**. But it looks to me like a three-month holding operation with barely anything included for recovery or infrastructure investments and even unemployment benefits are running out in July. But the FED is pulling out all the stops, is propping up credit markets and supporting fallen angels and doubling its balance sheet to $7 trillion today and likely $9 trillion by December.

Xin: The FED would add 22% of GDP this year, more than QE1+QE2+QE3 combined over the past decade? And the ECB is now planning to add 16% of Eurozone GDP this year? While PBOC had added 16% of GDP during the previous crisis, we now expect at most 3% monetary stimulus in **China** this year. We take the opposite policy approach from the FED and the ECB, and we may have larger objectives for the Renminbi as we also develop the digital RMB and may compete with a declining dollar as reserve currency.

Larry: Look, we heard that before … but China still has some debt dynamics to sort out. In the US system, we dislike directing credit and bailing out companies, where you have more expertise in China. But now we have no choice but to support our airlines, hotels, car and energy companies. The FED has to provide liquidity so that these companies have continuing market access, and then the FED has to purchase most of the new government debt although it may take a generation to pay for that.

Xin: And the ECB seems to follow like a copy-cat given fiscal policy constraints at the EU level. And **Germany** appears to generate the largest stimulus ever, as estimated by Bruegel, at over 40% of GDP, although half are loans and guarantees and equity injections, often including poison pills to discourage Chinese crisis investors. That would be the equivalent of ten times the size of the Marshall Plan, but without any war damage. German SMEs account for 60% of German employment and most would collapse without state aid, and Germany today accounts for 52% of all EU state aid.

Larry: So we both agree that **stimulus policies should be targeted and limited**. That works better in Europe and better yet in China, with a big role for policy banks. Both Germany and China have so far managed to keep unemployment in single digits, well below half of the current US levels. Given our limited social safety net and restricted scope for state aid, the pressure on the FED is enormous, but it cannot do it all alone.

Xin: Well, this straw may break the camel's back … just remember that the FED has become a one-way street, it was only able to claw back 7% of the QE that was issued over the past decade, and now it is doubling its balance sheet during 2020 and is fully monetizing an additional fiscal deficit exceeding 14% of GDP. Investors may prefer the RMB as a more stable currency, which I would expect to appreciate further.

Larry: I agree that our monetary stimulus only offers a short-term band-aid and it also comes with unfortunate side effects such as increasing inequality and rising asset bubbles that cannot be sustained if our earnings continue to decline. And yes, its size could become astronomical if that short-term timeframe was extended to 18 months. And I would prefer the unemployed shale workers to fix methane leaks in their pipes and unemployed construction workers to help rebuild our crumbling infrastructure.

Xin: That brings us to China's reasoning on **how to design strong recovery programs** that go beyond band-aids. We identify bottlenecks in our economy where investments can unleash productivity growth, and we have settled on urbanization plus real-estate development plus modernized infrastructure. The World Bank has listed five factors driving productivity: innovation, education, efficiency, infrastructure and institutions.

Larry: Right, and on these important policies, I am amazed how Germany is eating our lunch with their electric car program and their broadband and digital transformation, which add up to an equivalent of $330 bn that the US would need to invest to catch up. Our 2008 recovery program had earmarked $100 bn for infrastructure (majority was not implemented) and current US programs approve just $30 bn. The Conference Board calls it "productivity stagnation" and Aecom shows a huge employment upside.

Xin: That's the big question mark for the US recovery program (chart 6) combined with increasing monopoly power of large corporations and institutional weaknesses. China has invested over $1 trillion in its 30,000 km of high-speed rail, more than twice of the total US investment into its highways. Europe and Japan continue to advance while the US plans are still being blocked by powerful old industry alliances.

Larry: That's sadly right, our President had called for a $2 trillion infrastructure program earlier this year, which now becomes even more essential as core component of our envisaged recovery program. Our total-factor-productivity growth has dropped to barely 0.5% of GDP, and we cannot count on any boost from growing trade or rising FDI or more urbanization, as these three factors now appear to go into reverse.

Xin: Our big question mark in China is labor productivity with an effort to increase modern skill-sets and reallocate labor from state-owned firms to more dynamic growth firms, which would also help to improve our corporate governance. We are facing headwinds from an aging workforce, from relocating supply-chains, declining trade and FDI and will likely see TFP growth drop below 2% unless our innovation in 5G broadband, supercomputing, and fintech can unleash new waves of innovation.

Larry: Thank you Xin, I have great respect for Chinese innovation and infrastructure. We now have an opportunity to turn our massive US stimulus into a more productive recovery program. If we don't succeed, we may witness our Nero moment indeed.

Xin: Let's stay optimistic Larry, and let's plan to discuss EM prospects in our next call.

http://emleaders.com/pdf/eml-quovadis-2020.pdf