11th Nov. 2008

CAPITAL DAILY

Global economic and market analysis from Capital Economics

Chinese fiscal stimulus package not as impressive as it sounds

- ***German ZEW survey unlikely to show much of a bounce (10.00 GMT)***
- ***UK BRC retail sales continuing to fall (00.01 GMT)***
- ***Chinese CPI set for a big fall (02.00 GMT)***

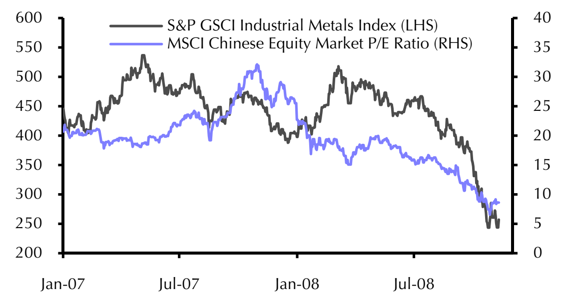
Key market themes

The announcement of a huge **fiscal stimulus package in China** is not as impressive as it sounds. (For further analysis please see our *Asian Economics Focus* published on Monday.)

At face value, the suggested RMB4trn ($586bn) investment package would increase government spending on the economy by around 6% of GDP in each of the next two years. However, no details have been given on how much of this spending would be new. The net increase is likely to be a lot less. Indeed, in past years, total government investment (broadly defined) has accounted for a similar share of GDP, suggesting that the headline number may simply be a restatement of existing plans.

The government's primary concern is ensuring that unemployment remains low, which it interprets as requiring GDP growth of around 8%. If it had to, the government could easily afford to spend an extra RMB4trn to achieve this. However, it is hoping that the signal it is giving with the announcement of this package will in itself be enough to catalyse a revival in confidence and stronger private sector spending. If this succeeds, the final stimulus will be far lower.

CHART 1: INDUSTRIAL METALS & CHINESE EQUITY P/E RATIO



Source – Bloomberg

KEY DATA AND EVENTS

				GMT	Previous	Median	CE Forecasts
Mon 10th	**Jpn**	Trade Balance (Sep)		23.50	-¥236bn	+¥236bn	-
	Jpn	Current Account (Sep)	s.a.	23.50	+¥903bn	+¥1024bn	-
Tue 11th	**UK**	BRC Retail Sales Monitor (Oct)		00.01	(-1.5%)	(-2.0%)	(-2.0%)
	UK	RICS House Price Balance (Oct)		00.01	-84.0%	-86.0%	-
	Chn	CPI (Oct)		02.00	(+4.6%)	(+4.2%)	(+3.2%)
	Mly	Industrial Production (Sep)		04.01	(+0.9%)	(+0.6%)	-
	Jpn	Eco Watcher's Survey (Oct)	Current	05.00	28.0	26.8	26.0
	Jpn	Eco Watcher's Survey (Oct)	Outlook	05.00	32.1	-	31.0
	Swe	CPI (Oct)		08.30	+1.0%(+4.4%)	+0.1%(+4.0%)	0.0%(+3.8%)
	UK	Trade in Goods & Services Balance (Sep)		09.30	-£4.8bn	-£4.7bn	-£5.0bn
	UK	Trade in Goods Balance (Sep)		09.30	-£8.2bn	-£8.0bn	-£8.4bn
	UK	CLG House Prices (Sep)		09.30	(-3.4%)	(-5.4%)	-
	Ger	ZEW Survey (Nov)		10.00	-63.0	-63.0	-55.0
Wed 12th	**Ind**	Industrial Production (Sep)		-	(+1.3%)	(+3.1%)	-
	Chn	Retail Sales (Oct)		02.00	(+23.2%)	(+22.0%)	(+21.0%)
	Kor	Unemployment Rate (Oct)	s.a.	04.30	3.1%	-	-
	Jpn	Consumer Confidence (Oct)	All households	05.00	31.4	30.1	29.0
	Jpn	Consumer Confidence (Oct)	Ex. single pers.	05.00	31.8	29.5	29.0

m/m(y/y) unless otherwise stated; p = provisional estimate

The package's focus on investment has been widely interpreted as strongly positive for **commodities** such as industrial metals, which bounced on Monday along with the Chinese stock market after taking a hammering in recent months. (See Chart 1.) We are more cautious. Government investment has been expanding rapidly for the last decade – indeed several large-scale infrastructure projects apparently covered by the package were already expected under the current five year plan. Any attempt to substantially accelerate investment beyond current growth rates could soon run into capacity constraints.

For this reason the government could end up relying more on tax cuts than spending increases if the economy continues to worsen. That would help to stimulate consumer demand but do little for commodities.

The potential impact on world growth too should be kept in perspective. China accounts for only 6% of global output at market exchange rates. This package provides reassurance that its economy will continue to grow strongly, but it provides little comfort for the rest of the world. (**Mark Williams**)

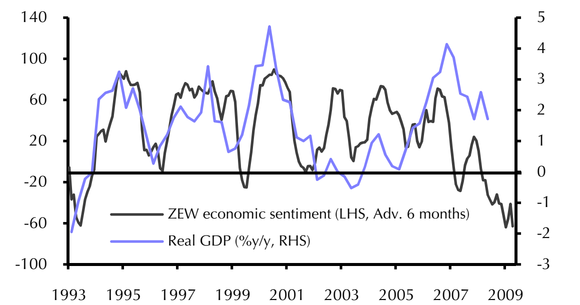
What to watch for today: US

No major events or data releases scheduled.

Continental Europe

Last month's **German ZEW** survey (10.00 GMT) was taken too late to fully incorporate any positive impact from government measures to support the banking sector. The few responses taken afterwards were not as weak as those taken before, suggesting that investor sentiment might recover a little this month. The latest 50bp interest rate cut and a dovish tone from President Trichet should also have helped to ease investors' concerns, as might a slight pick-up in the DAX index and the euro's depreciation.

CHART 2: GERMAN HEADLINE ZEW INDEX & GDP GROWTH



Source – Thomson Datastream

In the current environment, however, sentiment will not have recovered markedly and we expect only a modest increase to a very low level of around -55.0. The one consolation is that the index has not been well correlated with German GDP growth in recent years. (See Chart 2.) (**Jennifer McKeown**)

UK

We expect the **BRC** measure of like-for-like retail sales values to have fallen to -2.0% in October (00.01 GMT). September saw this measure slow for the third month in a row, dropping from -1.0% to -1.5%.

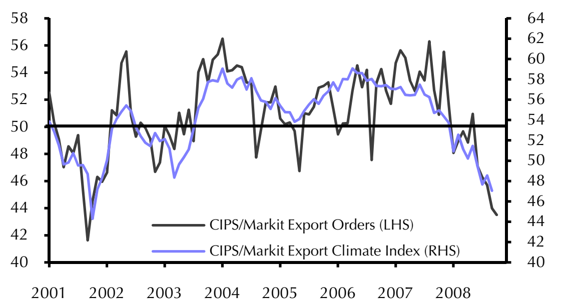
Admittedly, a 50 basis points cut in interest rates at the start of October, as well as the fall in petrol prices, may have boosted consumer confidence. But not all lenders passed on the rate cut, while falling house prices and rising unemployment are still giving households plenty to be gloomy about.

Even though the annual growth rate of the official sales measure has moved back towards the survey measures, another drop in the BRC survey would clearly leave it pointing to a further slowdown in the official measure. On the face of it, this would imply another monthly fall in sales in October, following September's 0.4% drop.

The most recent fall in the pound is likely to provide a significant boost to the **external sector** further ahead (09.30 GMT). But an immediate surge in exports seems unlikely at a time when external demand is so weak.

In October, the export orders balance of the CIPS/Markit survey fell to its lowest level in its 13-year history. (See Chart 3.) And the available data on prices still show that exporters are offsetting part of the fall in the pound by raising their selling prices. As such, we have pencilled in a further widening in the trade in goods deficit, from August's record high of £8.2bn to £8.4bn in September, due to another poor performance of exports.

CHART 3: UK EXPORTS ORDERS & EXPORT CLIMATE INDEX



Source – Thomson Datastream & NTC Research

If the trade in services surplus were to hold steady at £3.5bn, this would leave a total trade deficit of £14.5bn in Q3 as a whole. This would be wider than the deficit of £12bn seen in Q2 and Q1, suggesting that net trade became a drag on GDP growth in Q3 after making a small positive contribution in Q2.

The plunge in October's **producer prices** provided yet further confirmation that inflation is the least of the MPC's worries (data released on Monday). Thanks to the 30%-odd fall in the oil price last month, producers' raw material costs fell by a whopping monthly 5.6%. Not only was this a much larger fall than the 2.5% drop anticipated by the consensus, but it was also the largest seen in the 23-year history of this series.

The most recent drop in the oil price suggests that input price inflation will fall further in the coming months. In fact, even if the oil price were to remain at its current level, input price inflation would turn *negative* early next year.

More importantly, the sharp easing in cost pressures and the marked weakening in demand have forced firms to continue cutting their selling prices**.** The 1.0% monthly drop in output prices (consensus -0.5%) was the largest since 1986 and pushed the annual growth rate down from 8.5% to 6.8%. Most of this reflected a fall in the price of energy-related products. But for the first time in 17 months, producers also reduced the selling price of food.

Even after excluding energy, food, drink and tobacco, producers' selling prices fell by a monthly 0.5% (consensus -0.2%). Of course, it is possible that the *previous* sharp rise in producers' core selling prices could yet filter through into higher inflation on the high street. However, we continue to think that the deepening recession will force retailers to absorb higher costs.

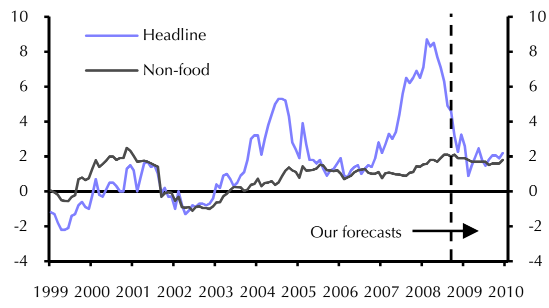
Overall, these figures confirmed that there is nothing to prevent the MPC from slashing interest rates further to support the real economy. Wednesday's Inflation Report is likely to hint that rates will be cut again in December. We continue to think that they will eventually fall to 1%, if not lower. (**Paul Dales**)

Asia-Pacific

Chinese consumer price inflation (02.00 GMT) is set for another big fall. Agricultural wholesale prices fell 5% in October relative to September, which on past form will bring the headline inflation rate down to a little over 3% y/y. We are forecasting 3.2% against a consensus 4.3%.

Further ahead, food price inflation looks likely to turn negative on an annual basis around Chinese New Year. This will probably not quite be enough to tip the headline rate into deflation, but it will be a close thing. (See Chart 4.) (**Mark Williams**)

CHART 4: CHINA CONSUMER PRICES (% Y/Y)



Sources – Thomson Datastream, Capital Economics

The **Economy Watchers Survey** for October (05.00 GMT) is the first of two sentiment surveys released this week which will help to gauge how hard the worries about the global economy are hitting **Japan**. Consumer confidence follows on Wednesday. Both surveys showed signs of stabilising in September, helped by plummeting commodity prices. Reduced concerns about energy and food prices at least will have carried over into October. However, we fear that will be trumped by the global pessimism and the slump in Nikkei, which fell by nearly a quarter during the month. The weakening of global demand is also likely to be reflected in the September data on **external trade** (due Tuesday morning Tokyo time).

Meanwhile, September data confirmed that **machinery orders** fell by 10.1% q/q in the third quarter, including a 7.3% q/q fall in overseas orders. The latter are predicted to fall by a further 13.3% in the fourth quarter. Nonetheless, domestic orders are actually expected to pick up, reducing the overall decline in orders in the fourth quarter to 3.1%. There may be an element of wishful thinking here, of course, but these results are still a useful reminder that Japan is not entirely dependent on external demand. (**Julian Jessop**)

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