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THE FISCAL STIMULUS PACKAGE IN CHINA

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We have given priority to undertakings concerning people's well-being in the economic stimulus measures and pooled resources to accelerate relevant key projects...We are making every effort to address issues concerning the immediate interests of the people, such as employment, medical care, housing, old-age support and environmental protection...China has also intensified efforts to improve the social safety net and has substantially raised social security benefits.

(Hu Jintao, Chinese President, 2009)

The Context

The world economy is currently facing the most severe slowdown since the 1930s. According to the most recent data released by the IMF, the world GDP fell in absolute terms by nearly 1.1 per cent between 2008 and 2009. The economic slowdown in the G7 economies was much more severe, and their GDP fell in absolute terms by 3.6 per cent between 2008 and 2009. The most disturbing trend emerges from central and eastern Europe, where the GDP shrank by 5 per cent between 2008 and 2009.

Amidst this gloom, the only ray of hope appears to be developing Asia, where the GDP grew at 6.2 per cent between 2008 and 2009, though at a slower rate than between 2007 and 2008, when the GDP grew at 7.6 per cent. Within developing Asia, the strongest performer is its largest economy – China – that recorded a growth rate of 8.5 per cent between 2008 and 2009. The performance of other East Asian economies was not as remarkable; Malaysia and Thailand remained in the negative growth territory and GDP growth in India fell from 7.4 per cent between 2007 and 2008 to 5.4 per cent between 2008 and 2009.

China has shown greater resilience to the current economic downturn than any other economy in the world. This is surprising since the Chinese economy is highly export-oriented and a very large share of its exports are directed towards the US and Europe, which are the epicenters of the current crisis. A comparison with India would be illustrative. In 2008, exports constituted 23 per cent of India's GDP and 36 per cent of China's GDP. Yet, India's GDP growth fell by 2 percentage points in 2009, whereas China's GDP growth fell by only 0.5 percentage points.

The remarkable success of China in insulating itself from the global downturn can be ascribed to its massive fiscal stimulus package, towards which we now turn our attention.

Why is a Fiscal Stimulus Required?

Episodes of economic downturn involve a sharp decline in private spending on goods and services. Firms become pessimistic about future and cut down their spending on capital goods. Similarly, households become apprehensive about their employment and income, and cut down their spending on consumer goods. The net result of this decline in private spending is lower production and employment in the economy, which only reinforces the initial decline in private spending.

Fiscal stimulus involves the use of government budget, either through tax cuts or through direct spending, to shore up the level of demand in the economy. Governments can counteract the decline in private spending by shoring up their own spending, such as by building new roads or hospitals. Governments can also try to stimulate private spending by reducing taxes and putting more disposable income in the hands of corporates and households. However, tax cuts are not a foolproof way of increasing spending in the economy because the private sector may simply save this increase in disposable income instead of spending it on goods.

China's Stimulus Package in a Comparative Context

While the rationale for providing a fiscal stimulus is straightforward, most countries have struggled to put together a reasonably large stimulus package. In these countries, the barriers to effective stimulus appear to be largely political. For instance, conservative elements within the US political system have vehemently opposed any plan for the revival of the US economy through a pro-active fiscal policy. The US administration was forced to give in to the demands of such elements by keeping its stimulus package mild and, to the extent possible, administering even this meager stimulus through tax cuts rather than direct spending.¹

A feature of policymaking in China, on the other hand, appears to be the near absence of pressure from financial conservatives. China could, therefore, respond to the current crisis with amazing alacrity by putting together a very large fiscal stimulus package of nearly 4 trillion Yuan (or US\$ 585 billion) in November 2008 itself. In fact, when measured relative to GDP, China's fiscal stimulus is by far the largest in the world: 12.3 per cent of GDP compared to only 5.5 per cent in the US.²

¹ Total size of the US stimulus package is US\$ 787 billion, of which US\$ 288 billion is in the form of tax cuts.

² A large part of the US stimulus is neutralized by the decline in tax revenues of the local and state governments, who would, as a result, be forced to cut down on their expenditure (or raise new taxes). Local and state governments are prohibited from running budget deficits. Additionally, nearly US\$ 146 billion of the stimulus amount in the US would be spent after 2010, and therefore does not aid the current recovery. After taking these factors into consideration, according to one calculation, the size of the US stimulus falls to US\$ 126 billion annually for 2009 and 2010. See Dean Baker and Rivka Deutsch (2009), "The State and Local Drag on the Stimulus," CEPR Reports and Issue Briefs 2009-17, Center for Economic and Policy Research (CEPR), Washington.

Moreover, the actual size of stimulus in China is larger than the one announced in November 2008. As a media report recently clarified:

Apart from the 4-trillion-yuan package, China will cut tax by 600 billion yuan, raise the old-age pension for retired workers, hike the salaries of 12 million teachers, increase farmers' income and provide more subsidies for them.³

Additionally, China is planning to undertake the expenditure of nearly US\$ 125 billion till 2011 as a part of an overall programme to universalize health by 2020. This expenditure was also not accounted for in the stimulus package announced in November 2008. If only the tax cuts and half of the total amount meant for extension of healthcare are added, total size of China's stimulus package for 2009 and 2010 increases to US\$ 5.02 trillion or US\$ 757 billion. There is, in other words, a strong likelihood that China's stimulus package is greater than that of the US, even in absolute terms.

Composition of Stimulus Spending

The largest component in China's stimulus package is directed towards major infrastructure projects (Table 1). According to reports, most of the infrastructure spending is directed towards transportation and the electricity grid. Within transportation, the focus is on the construction of new railway lines, expressways and airports. A very large amount is also being spent on relief and reconstruction in the earthquake-devastated Sichuan region.

Almost 10 per cent of the stimulus package is directed towards low-cost housing. This initiative would include construction of new houses as well as the upgradation of shanty towns.

Within rural development, which accounts for 9.25 per cent of the package, the focus is on

infrastructural items such as roads, rural electricity, irrigation and water conservancy, provision of safe drinking water and electricity. A significant amount is also allocated for industrial upgradation, new technology and environment. The expenditure on social services would appear small, but it should be noted that much of the increase in health expenditure is placed outside the stimulus package announced in November 2008.

Financing the Stimulus

Out of the 4 trillion Yuan stimulus package, the central government would reportedly contribute 1.18 trillion Yuan and local governments another 1.23 trillion Yuan. Rest of the increase in expenditure is supposed to take the form of bank loans to State Owned Enterprises (SOEs).⁴

To ensure increased availability of credit for stimulus financing, the State council increased credit quotas of the State Owned Banks (SOBs) and directed them to increase lending. In fact, Bank of China and Agricultural Bank of China signed co-operation agreements with the railway ministry to support the upgrade of railway infrastructure. Thus, a large part of the observed increase in social and economic infrastructure spending is being financed by the banking system. SOEs have therefore acquired a special role in the recovery.

Examining the Recovery

The economic recovery in China is clearly investment-led. While the GDP grew by 8.7 per cent between 2008 and 2009, fixed investment grew by 30.5 per cent. Consequently, the share of investment in GDP increased from 48.2 per cent in 2008 to 57.9 per cent in 2009.

³ See http://news.xinhuanet.com/english/2009-03/13/content_11004933.htm

⁴ Economist Intelligence Unit (2009), "China's Stimulus Package: A Six Month Report Card".

Table 1 *Composition of the Chinese Fiscal Stimulus Package, in billion Yuan and %*

Item of spending	Amount to be spent (in billion Yuan)	Share in total amount (%)
Major Infrastructure	1500	37.5
Post-Quake Reconstruction	1000	25
Low Income Housing	400	10
Rural Development	370	9.3
Industry and Technology	370	9.3
Environment	210	5.3
Health, Education and Culture	150	3.8
TOTAL SPENDING	4000	100.0

Source: Compiled from <http://blogs.wsj.com>.

The increase in fixed investment has been led by the SOEs. Fixed investment by SOEs increased by 35 per cent between 2008 and 2009. Consequently, the share of SOEs in total fixed investment increased from 43 per cent in 2008 to 44.6 per cent in 2009.

On the other hand, China's trade surplus fell in this period from US\$ 298 billion in 2008 to US\$ 196 billion in 2009. This happened because China's exports fell at a faster rate than its imports between 2008 and 2009. The fall in the trade surplus implies that other countries have also gained from China's stimulus package.

Additionally, retail sales of consumer goods increased by 15 per cent between 2008 and 2009. Here, one must note the presence of the "rural home appliance subsidy programme" that was initiated in 2009. Under this programme, subsidy is offered to rural residents for the purchase of home appliances. The subsidy disbursed under this programme was not accounted for in the 2008 stimulus package.

To further investigate the nature of recovery in the Chinese economy, we have examined the composition of fixed investment in China in 2008 and 2009 (Table 2). Total fixed investment in China increased by 4.47 trillion Yuan between 2008 and 2009. The tertiary sector accounted for 2.7 trillion Yuan (or nearly 60 per cent) of this increase in fixed investment between 2008 and 2009. Within

the tertiary sector, the strongest increase in investment was in "transportation, storage and post", which accounted for nearly 28 per cent of the total increase in tertiary sector investment. Thus, major infrastructural projects have received the highest priority within the stimulus package.

"Real estate" and "water conservation, and environment and public facilities" were the other two major destinations of fixed investment. "Production and supply of electricity, gas and water" also played an important role, accounting for nearly 6.5 per cent of the increase in fixed investment. We may recall that construction and upgradation of grids was an important component of the major infrastructural projects towards which 1.5 trillion Yuan were set aside in the package. In sum, the economic recovery appears to be in consonance with the priorities set in the stimulus package.

Misgivings about the Package and the Recovery

There are two misgivings about the nature of economic recovery in China. First, it is argued by some that the current recovery is based on massive speculation in real estate and stock markets, fed by a nearly 30 per cent credit growth between 2008 and 2009. When this bubble bursts, the Chinese banking system would also go under. In the doom scenario, the banking crisis in China would cause a long

Table 2 *Increase in Fixed Investment in China, 2008 to 2009*, in 100 million yuan and %

Sector of investment	Amount in 2009 (in 100 mn yuan)	Growth, 2008-09 (%)
1. Total investment	44742	30.5
2. Primary sector	1123	49.9
3. Secondary sector	17389	26.8
Production and supply of Electricity, Gas and Water	2891	27.3
Manufacturing	12431	26.8
4. Tertiary sector	26918	33.0
Transportation, Storage and Post	7581	48.3
Railway transport	2749	67.5
Real estate	7148	19.9
Water Conservation, Environment and Public Facilities	5537	45.1
Health, Social Security and Social Welfare	624	58.5
Education	962	42.4

Source: National Bureau of Statistics, China.

recession similar to the one experienced by Japan in the wake of its banking crisis in 1990s. Zhang Hong, for example, warned in his column in *The Guardian*:

The fast-rising stock and real estate markets suggest a large portion of the new loans have been used in speculative investments, causing another round of asset bubbles in China. This won't much help China's real economy. When the bubble bursts, the banks will be sitting on a huge amount of bad debt. China risks repeating the same game as America after the dotcom boom and burst.⁵

Secondly, many observers see the current revival as based on 'inefficient' investments by state owned enterprises (SOEs), and thus detrimental to the long-term interests of the Chinese economy. Credit directed towards SOEs would only increase the Non-Performing Loans (NPLs) of the banking system. Since the government may have to bail out many of these banks, the current recovery would be a drag on government finances in the future. SOE-led revival may therefore severely

compromise the long term growth prospects of the Chinese economy.⁶

Let us examine these two arguments sequentially. Going by the number of newspaper stories and anecdotal evidence about booming property markets in China, there must be some truth in the claim that China is currently witnessing a real estate bubble. However, there is a need to temper this view with some hard facts.

First, real estate investment forms only 16 per cent of the increase in total fixed investment between 2008 and 2009. Even if fixed investment in real estate had remained constant, total fixed investment in China would still have grown by 25 per cent between 2008 and 2009.

Secondly, public housing is stipulated to form 10 per cent of the stimulus package announced in November 2008. Since a part of the increase in real estate investment is likely to have been directed for this purpose, it would be wrong to treat the entire increase in

⁵ Zhang Hong, "Too early to hail China's stimulus success", *The Guardian*, 28 August 2009.

⁶ The view that SOEs act as a drag on banking system and government finances can be found in Wing Thye Woo (2006), "The Structural Nature of Internal and External Imbalances in China", *Journal of Chinese Economics and Business Studies*, February.

real estate spending as being speculative in nature.

Thirdly, even in December 2009, sales price index of buildings in 70 medium and large cities across China was only 7.8 per cent higher than its December 2008 level – not an awful lot for a country enjoying an annual growth rate of 8.7 per cent.

Fourthly, while the credit growth figure of 30 per cent is extremely high by any standard, it may not be fair to treat the entire growth in credit as being driven by speculative pursuits. After all, nearly 40 per cent of the financing of the stimulus is supposed to come from the banking system.

Of course, all the above is not to deny the existence of any problem in China's real estate market. Real estate prices were probably too high even before the recovery started in China. However, in the light of facts presented here, it would also not be an exaggeration to state that the recovery in China would have been on a strong footing even in the absence of the bubble.

As far as the alleged inefficiency of SOEs is concerned, two points need to be made. First of all, a large part of the SOE investment is on infrastructural items, which play a key role in economic development. It would, therefore, be a mistake to look at the lower profitability ratio of SOEs and conclude that they are inefficient. The SOEs produce goods that are socially useful even if these social benefits cannot be captured as private profits by firms that produce them.

Secondly, Dic Lo (2005) has pointed out that, historically, pre-tax profit rate in China's SOEs has not been lower than the average profit rate in the Chinese industry.⁷ The profit rate was higher than the average in the 1980s and slightly lower than the average in the recessionary conditions of the late-1990s.

⁷ Dic Lo (2005), "China, the 'East Asian Model' and Late Development", Paper Presented at the Conference on Comparative Political Economy of Globalisation, SOAS, London.

Moreover, the gap between pre- and post-tax profit rates is higher in case of SOEs. Lo concludes that,

In contrast to the allegation that SOEs have been a drag on the economy in the form of taking up state subsidies and generating bad loans for state banks, the distributive relationship between the state and SOEs has been characterized by surplus transfer from the latter to the former.

The Problem of Large Capital Flows

Since the current recovery in China is driven by debt financed investment by SOEs, it is important to examine the macroeconomic conditions under which this strategy is sustainable. As the experience of the East Asian countries during the crisis of 1997 and 1998 has amply demonstrated, the corporate strategy of high debt and high investment is sustainable only when there are extensive controls on capital flows. A sudden outflow of capital can completely wreck the highly indebted domestic firms by necessitating a sharp rise in domestic interest rates. The problem can be especially severe if firms have borrowed in foreign currency and the country is forced to devalue domestic currency due to capital outflow.

One can argue that, unlike all countries hit by the crisis of 1997 and 1998, China has a very large current account surplus and a record level of forex reserves for any country till date. Here, it needs to be kept in mind that China's trade surplus has eroded at a very fast rate in the last one year and looks all set to fall further in future. In the longer run, therefore, the conflict between capital mobility and the high debt-high investment model is likely to become binding for China as well.

It is precisely in this direction that some problems have become visible in the last year. China accumulated nearly US\$ 485 billion of

foreign exchange reserves in 2009.⁸ Reportedly, China's trade surplus and net FDI flow in 2009 were US\$ 196 and US\$ 46.7 billion respectively. This suggests that a very large chunk of foreign exchange accumulation in 2009 was on account of hot money flows.

This large inflow of hot money, occurring at a time when the trade surplus is shrinking fast, may end up presenting difficulties in future. When this capital flows out, China may be forced to raise its interest rates thereby throwing a spanner in the works of economic growth led by debt-financed investment.

Clearly, therefore, the long-term sustainability of the current growth path depends on policy choices China makes with regard to international finance. If the deluge of foreign capital continues, the Chinese government would need to consider some curbs on inflow of speculative capital into its economy.

In Conclusion

Large and timely fiscal stimulus measures implemented by China have ensured that the downswing in its economy has neither been steep nor painfully long. A good point of contrast would be the United States, where GDP growth hovered in the negative territory for a good part of 2008 and 2009.

It is true that the Chinese recovery has been accompanied by some irrational upswings in real estate and stock markets. However, it would be a mistake to view China as being a bubble-ridden economy akin to Japan in the 1980s or the US prior to the recent housing market crash.

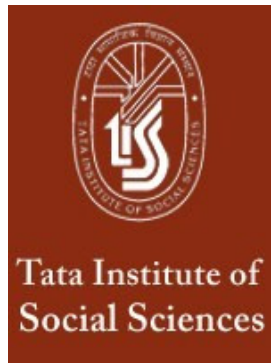
At a deeper level, China's ability to undertake a large fiscal stimulus package shows the relative autonomy of the Chinese government from the pulls and pressures of finance capital. In other countries, especially the US, vested interests in the financial sector have

opposed any major programme of revival through government spending. Government intervention was acceptable to these interests only to the extent that it involved bailing the banks out.

On the other hand, the financial system in China has played an important role in the execution of the government's stimulus package. Despite some adverse trends in its financial markets, China still stands out as a country that can direct its financial sector resources towards goals of national development.

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⁸ The data are from the State Administration of Foreign Exchange, Beijing.



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