

ECONOMICS: ASIAN PERSPECTIVES—FEBRUARY 26, 2010

China Returns to a Neutral Fiscal Stance as Economy Recovers

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China, in our view, has once again demonstrated that it is very good at running a countercyclical fiscal policy.

Last year, we published several pieces which highlighted the dramatic improvement in China's fiscal account and, in particular, the all-out effort by Beijing to collect taxes more efficiently to prevent the risk of a fiscal blowout. While China has overtly emphasized infrastructure spending and tax concessions to the household sector to support the economy, it has also been firmly enforcing tax collection from the corporate sector so as to ensure a redistribution of income that will fund an expansionary budget. In short, China has been priming the pump with one hand but taking some of the stimulus back with the other.

From a fiscal standpoint, we disagree with some of the hawkish comments that China's stepped-up government spending will exacerbate the risk of overheating. In fact, the reality check suggests that China has, once again, demonstrated that it is very good at running a countercyclical fiscal policy—that is, stimulating during an economic downturn but reversing the policy when economic expansion resumes.

Countercyclical Policy

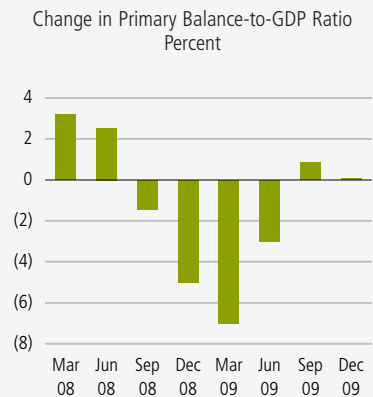
Economists analyze the extent of stimulus from a government budget by estimating

the so-called, 'fiscal impulse', which is defined as the change in the government's primary balance—that is, the budget balance minus interest payments on outstanding public debt—as a share of GDP. **Display 1** shows that Beijing has scaled back the fiscal stimulus to a more or less neutral stance in second half 2009 following the outsized stimulation (which reached as much as 7% of GDP in first quarter 2009) since late 2008.

Besides increased tax collection effort, the improvement in the fiscal account was aided by China's economic recovery since the middle of last year, which has led to a sharp V-shaped recovery in government revenue growth. Growth of public spending, in fact, remained fairly robust throughout last year, although the growth momentum has eased off from the exceptionally strong pace in early 2009 (**Display 2**).

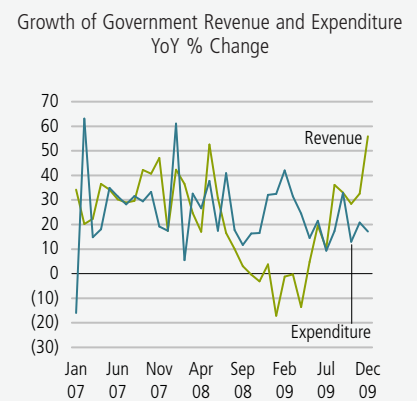
The result was that last year's fiscal deficit, at RMB740 billion (US\$108 billion), was a one-fourth smaller than targeted, and accounted for a fairly manageable 2.2% of GDP. Excluding debt interest payments, the primary balance shortfall was even smaller at 1.8% of GDP (**Display 3**).

Display 1
The Fiscal Impulse



Source: CEIC Data and AllianceBernstein estimates

Display 2
V-Shaped Revenue Recovery



Source: CEIC Data and AllianceBernstein estimates

Strong Revenue Growth

On the revenue side, the key trends we highlighted in previous reports have all gathered steam. Better business conditions and greater collection efforts have further boosted corporate and related revenues, while individual income tax has also showed a steady recovery as household income improves (**Displays 4 and 5**).

Importantly, we expect China's budget deficit will easily decline to 1% of GDP in 2010 (Display 3, again), as long as revenue growth remains firm at 20%–25% (versus 40% year on year in fourth-quarter 2009) even with no apparent slowdown in public spending (18% versus 17% year on year in

2009's final quarter). If either of these two trends performed slightly more favorably than our assumptions above, China could comfortably return to a balanced budget or even a surplus this year.

Bottom Line

It is clear that China is in an enviable fiscal position which equips policymakers to cushion the risk of a double dip in growth—the worst-case scenario. The base-case scenario, in our view, is that Beijing has the means to expand rapidly and spend significantly on social welfare and pension reforms, which are crucial for the country to fulfill its goal of making the economy more consumption-driven. ■

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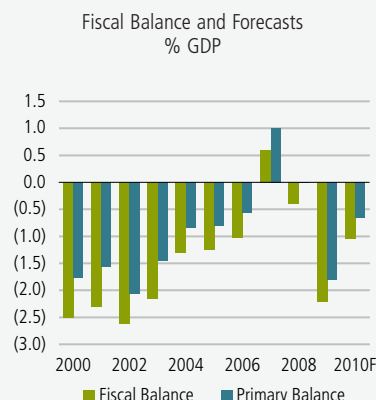
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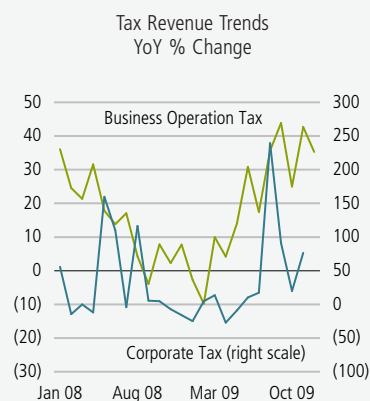
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Display 3
Improved Fiscal Position



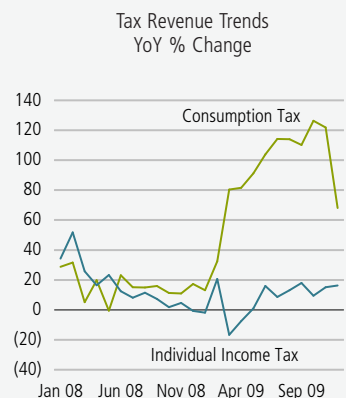
Source: CEIC Data and AllianceBernstein forecasts

Display 4
Business Taxes Revive Markedly



Source: CEIC Data and AllianceBernstein estimates

Display 5
Individual Income Tax Also Improves



Source: CEIC Data and AllianceBernstein estimates