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The 10-point fiscal stimulus package: China's serious response to economic slowdown

- China just announced a 10-point fiscal stimulus package today approved in a meeting of the State Council on November 5. The package plans to spend RMB 4 trillion (USD 586 billion, 16% of 2007 nominal GDP) through 2010 to boost the Chinese economy. Key points of the plan are as follows:
  - Sectors that will benefit from the extra spending include affordable housing, rural infrastructure, transport networks, environmental protection and technical innovation.
  - China will speed up the investment and development in medical system, education and cultural projects. In addition, the subsidies to agriculture and low-income group will be raised.
  - The State Council also confirmed the reform of value-added tax (VAT) to encourage technology innovation. The reform is expected to reduce corporate tax bill by RMB 120 billion a year. This is in addition to the corporate tax reduction from 33% to 25% started in January this year.
  - On monetary policy, China has removed credit ceilings on commercial banks. The government encourages financial institutions to increase lending to important infrastructure projects, agriculture sector, small- and medium-sized enterprises, technology upgrading, and corporate merges and consolidations.
  - China will invest an additional RMB 100 billion in infrastructure this quarter and will earmark an extra RMB 20 billion next year for reconstruction efforts in areas hit by the Sichuan earthquake. These initial funds are expected to generate a total of RMB 400 billion (or 1.6% of 2007 nominal GDP) from investments made by both local governments and private sectors.
- Our business cycle analysis (see our China Economic Observatory on October 8) suggests that the Chinese economy would decelerate in the next two years because of a severe and a protracted external economic slowdown. In particular, this deceleration would be intensified according to the historical pattern of China's political business cycle. In terms of the magnitude of the effect, we estimate that a simultaneous G-3 economic slowdown by one percentage point will lead to a slowdown in China's real GDP growth by 0.73 percentage point one year later.
- This newly announced fiscal stimulus program is in line with our expectations and these programs also have elements of structural reforms, for example, the VAT reform and increased spending in medical care, education, and the rural sector. We believe that this fiscal stimulus program will, to some extent, help reduce pre-cautionary savings motives and thereby help boost private consumption expenditure. That said, the government will probably roll out the medical reform package that is currently in consultation with the public soon.
- The fiscal stimulus package is also accompanied by expected further relaxation of monetary policy. This suggests that the authorities are fully aware of the limitation of relying on monetary policy alone to stimulate the economy. Therefore, we expect this policy mix will first induce banks to lend to state-sponsored infrastructure programs and then eventually to other sectors of the economy as confidence on sustainable growth returns.
- Will such a large fiscal stimulus program affect China's fiscal sustainability? We don't think so. China ran a consolidated budget surplus in the first nine months of the year of more than RMB 1.25 trillion and its national debt remains low at less than 20% of GDP. Meanwhile, it is also a net creditor country in terms of its external positions. However, fiscal deficits over the next two years are expected to rise sharply from a close to a balanced budget in the last two years to at least 3% a year in 2009 and 2010 on slowing economic activities.