

## **China's Fiscal Policy in the Post-Crisis Period**

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### **Abstract:**

The main reason to get more effectiveness by Chinese fiscal policy was that China is at different stage of the development. As a result, the government has a much greater room for maneuvering in the areas such as public infrastructure, public service and private consumption.

In face of the uncertain economic development in the world, the recovery growth of domestic economy and growing fiscal debt level, the major task for China's fiscal policy in the post-crisis period is that while strengthen financial capacity of the central government, it should keep a smooth, sound and sustainable development for domestic economy.

# China's Fiscal Policy in the Post-Crisis Period

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After the outbreak of the American financial crisis in 2008, due to the sluggish demand in international market, China's export volume decreased swiftly, the domestic investment declined and a large number of enterprises suffered losses. As a result, China's economy, after witnessing a high growth for seven consecutive years, was confronted with a rather stern situation. In face of the crisis, the Chinese government promptly made adjustment to its macro economic policy and adopted a moderately easy monetary policy and a proactive fiscal policy, including the 4 trillion yuan investment plan for major construction projects announced by Chinese premier, which is already known to all. By now, the above-mentioned policy measures have produced tangible results and China's economy has gained a recovery growth since the latter half of 2009. It is expected that China's economic growth might reach 10% in 2010.

## **I. Reasons for the tangible results achieved by China's expansionary fiscal policy**

The impact of global financial crisis on China was no doubt quite great due to the fact that China's export is based on low-end products and its export dependence is over 30%. The adoption of the monetary policy and the fiscal policy by the Chinese Government did not go beyond the expectations of the international economic circle. But compared with the policy measures implemented by relevant Western countries, the effects produced by China's expansionary fiscal policy seem to be more explicit.

**1. Subjectively speaking, the reasons can be narrowed down to two points: first, the efforts to expand fiscal input was greater; second, the monetary policy gave an active response to fiscal policy.**

### **a. The efforts to expand fiscal input was greater**

Take as an example the 1180 billion yuan investment undertaken by central treasury for major construction projects. In the fourth quarter of 2008, 108 billion yuan were promptly allocated in the first batch; in 2009 130 billion yuan, 70 billion yuan, 80 billion yuan and 200 billion yuan totaling 480 billion yuan were respectively granted; the rest 600 billion yuan were appropriated in the first half of 2010. According to the actual annual plan, 103 billion yuan would be allocated in the fourth quarter of 2008, 487.5 billion yuan in 2009 and 589.5 billion yuan in 2010. In other words, in the short span of two years and three months, a total sum of 1180 billion yuan of investment had all been granted and scheduled. With regard to investment for

major projects in China, the investment by central financing is generally used as the key capital, and played an important guiding role of investment. The prompt allocation of central investment had accelerated the launching of key projects and pushed forward the investment made by various social sectors. It had played as the mainstay in reversing the decline of aggregate demand and the down drift of economic growth. But it should be pointed out that the government had paid high price: the government financial deficit had been continuously increased<sup>1</sup> and the government gross liability level had been raised year on year<sup>2</sup>.

#### **b. The monetary policy gave an active response to fiscal policy**

Under the shadow of the international financial crisis, it is hard for any government investment to bring forth the private investment, and China is no exception. The difference between China and other countries is that banks have always played an important role for project financing. This character has not seen big changes after the commercialized reform of the former four state-owned banks. Chinese banks have sufficient funds reserves, when banks in the world face funding shortage. The reasons are two: first, during the commercialization process of the state-owned banks in previous years, the government had replenished necessary capital for them; second, the saving habits of Chinese people brought sufficient cash flow to the major banks. Therefore, when the plan of key projects was identified and financial investment was in place, the major banks followed up actively. In the first quarter of 2009, loans of commercial banks increased by 4.58 trillion yuan, an increase of 3.25 trillion yuan year on year<sup>3</sup>, which had given a strong support to the government expansionary fiscal policy. In the whole year of 2009, loans of commercial banks increased by 9.59 trillion yuan, an increase of 4.69 trillion yuan year on year whereas the financial condition of banks did not get worsened. One major reason is that in 2009 the savings deposits of households increased by 4.28 trillion yuan and fiscal deposits increased by 436.8 billion yuan, with the aggregate deposits exceeding the incremental loans.

**2. Objectively speaking, compared with the Western countries, China is at different stage of development. As a result, the government has much greater room for maneuvering in areas such as public infrastructure, public service and private consumption.**

In a sense, a country's industrialization level or its development stage can be judged by per capita steel stock. Of late, the United Nations Environment Program

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<sup>1</sup> The financial deficit of the central government stood at 180 billion Yuan and 750 billion Yuan respectively in 2008 and 2009. It is hoped that the government deficit could be controlled within 850 billion yuan in 2010.

<sup>2</sup> By end of 2008, the balance of public debt of the central government was 5327.154 billion yuan and it increased to 6023.768 billion yuan by end of 2009. It is expected to reach 7120.835 billion yuan by end of 2010.

<sup>3</sup> Due to negative growth of export in 2009, foreign exchange loans of commercial banks in the first quarter decreased by US\$8.5 billion, a drop of US\$57.3 billion year on year (in the first quarter of 2008, foreign exchange loans of commercial banks increased by US\$48.8 billion.)

(UNEP) issued a report entitled “Metal Stocks in Society”, which indicates that the per capita steel stock in the United States is 11-12 tons whereas it is only about 1.5 tons in China, equivalent to 1/8 of that of the United States. In a lower stage of the development, government’s expansionary fiscal policy could be more easily brought into play, whether in the sectors of public infrastructure, public service or private consumption. Three examples are given below to illustrate the point.

**a. In the area of public infrastructure** (Take as an example investment for railway construction)

According to the “Mid- and Long-Term Railway Network Plan” drafted by the Chinese government in 2004, the target for national railway operating mileage would be 100,000 kilometers by 2020<sup>4</sup>, out of which 12,000 kilometers would be passenger dedicated lines<sup>5</sup>. In 2008, in line with the requirement for the construction of overall transportation system, these targets were revised to 120,000 kilometers and 18,000 kilometers respectively.

After the outbreak of international financial crisis, the Chinese government has increased investment for railway construction and the above targets are expected to be fulfilled ahead of schedule. The bulletin issued by the Ministry of Railways shows that in 2009 the actual investment in national railway fixed assets<sup>6</sup> stood at 701.321 billion yuan, an increase of 286.579 billion yuan over the previous year, registering a growth of 69.1%, equivalent to 80.3% of the aggregate investment made during the 9<sup>th</sup> Five-Year Plan and the 10<sup>th</sup> Five-Year Plan periods. Out of that, investment for capital construction posted 600.564 billion yuan, an increase of 77.9% year on year; investment for renovation was 22.681 billion yuan, a year-on-year growth of 10.4%. Out of the total investment, the gross amount of investment for railway construction stood at 623.245 billion yuan, up by 73% year on year. In 2010, the government planned to put in a total investment of 823.5 billion yuan for fixed assets of national railway construction, including an investment of 700 billion yuan for capital construction, an increase of 17.4% and 16.6% respectively compared with the actual used investment in 2009. During the 12<sup>th</sup> Five-Year Plan period, the projects for the construction of high-speed railway<sup>7</sup> and intercity passenger lines would be launched one after another, the intensity of investment will not only be maintained, and would be enhanced.

In the eastern region of China the population is dense, the large-sized cities are close to each other and residents’ income has witnessed a swift increase. These conditions are favorable for the development of high-speed railway and capital recovery. Since the implementation of the 11<sup>th</sup> Five-Year Plan, China’s high-speed

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<sup>4</sup> Based on open data released by mass media, the railway operating mileage of the United States is over 260,000 kilometers.

<sup>5</sup> “Passenger dedicated line” refers to rail transportation equipment for passengers only, including wheel-rail and Maglev technologies.

<sup>6</sup> Investment for railway fixed assets includes capital construction, renovation and purchase of locomotive vehicles.

<sup>7</sup> “High-speed railway” refers to the wheel-rail technology-based high-speed rail vehicles especially for passenger transportation.

railway, starting from scratch, the current mileage has reached 7055 km in operation, including existing speed-raising lines (meet or exceed speed 200 km / hour line) with a total length of 2876 kilometers. At present, the high-speed railway lines under construction are over 10,000 kilometers. In the coming three years, China will complete 42 passenger lines with the highest speed of over 250 kilometers per hour and the total mileage would then reach 13,000 kilometers. The development of high-speed railways will fundamentally change the status of travel difficult during the holidays. It is not only beneficial to the enhancement of industrialization and urbanization as well as the coordinated urban-rural and regional development, but also favorable for the building of a resource-saving and environment-friendly society. It could also promote employment and the upgrading of industrial structures, increasing the cargo capacity of ordinary railway in China.

**b. In the area of public service** (Take as example to increase the budget input for agriculture, rural areas and farmers<sup>8</sup>)

At present, rural population accounts for about 60% of the total population in China with per capita income less than 1/3 of urban residents. After the implementation of household responsibility system, the collective economy-based security system for rural welfare service in most parts of China only existed in name, and the responsibility for social security had gradually shifted onto shoulders of the government such as compulsory education, cooperative medical system, pension benefits and poverty alleviation. Owing to the imbalanced regional development, the financial resources of local governments also varied to a big margin, which had led to a great difference for the coverage of social welfare service. Since the turn of the century, the central government has pursued a policy for equal public service in rural areas through increasing subsidy to the central and western regions. The situation has been improved to some extent.

After the occurrence of international financial crisis, the Chinese government, in order to stabilize grain production and expand domestic consumption, has made additional allocation of funds in the budget for agriculture, rural areas and farmers. In 2009, the expenditure covered by central budget for agriculture, rural areas and farmers was 716.14 billion yuan, up by 120.59 billion yuan year on year, an increase of 20%<sup>9</sup>. Out of that, 123.08 billion yuan were subsidized for grain, chemical fertilizer, pesticides, seeds and agricultural machinery and tools; 264.22 billion yuan were spent on the development of modern agriculture and the enhancement of agricultural comprehensive production capacity; 269.32 billion yuan were earmarked for the development of social undertakings in rural areas. In 2010, the central expenditure on agriculture, rural areas and farmers stood at 818.34 billion yuan, up by 93.03 billion yuan, an increase of 11%.

These measures have stabilized grain production in China and accelerated the

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<sup>8</sup> The central budget covers expenditures for the enhancement of overall agriculture production capacity, rural capital construction, agriculture subsidy and rural social undertakings.

<sup>9</sup> Based on Report on the Work of the Government 2010, the completed part was 725.3 billion yuan, an increase of 21.8%.

improvement of rural infrastructure and public service facilities in central and western regions of China.

The Report on the Work of the Government 2010 shows that in 2009 the government built and upgraded 380,000 kilometers of roads and 266,000 kilometers of rural electric power lines in rural area, implemented rural drinking water safety projects that benefited 60.69 million people, and renovated 800,000 dilapidated houses in the countryside. The total number of people covered by the new type of rural cooperative medical care system had increased to 830 million with per-capita subsidy reaching 80 yuan and basically embracing all the rural population. The target of making 150 million students receiving free compulsory education (free tuition, free sundry fees and free textbooks) had been realized a year earlier ahead of schedule. A total of 11.2 million primary and secondary school boarding students from poor families in the central and western regions had received government cost of living grants. In most parts of rural areas, the nursing homes for the elderly<sup>10</sup> had been taken care of by the township governments.

Through these efforts, the Chinese government has not only enhanced the feeling of security for rural residents and maintained the swift growth momentum of the means of production and consumer markets in rural areas, but also created conditions for the healthy growth of the younger generation and the promotion of people's quality and competence, laying a solid foundation for further industrialization and urbanization.

**c. In the area of private consumption** (Take as an example the policy of promoting industrial products to the countryside and trading-in old durable consumer goods for new ones)

China's economic development level is still low, the amount of people's deposits is large, and people's propensity to consume is more conservative. In order to quickly reverse the sluggish demand of consumer market caused by export decline, the Chinese government has implemented the expansionary fiscal policy in the area of private consumption and got good result.

**c1. The financial subsidy policy on promoting industrial goods to the countryside<sup>11</sup>**

The end of 2008, the Chinese government made a decision: in 2009, a total of 20 billion yuan of subsidy would be used for the purchase of home appliances and motorcycles by farmers, and the amount of subsidy would be equivalent to 13% of the sale price of products; and another 5 billion yuan of subsidy for those farmers who prepare to scrap the three-wheeled cars or low-speed trucks to purchase light trucks or minivans with a displacement of 1.3 liters and below, the lump-sum subsidy for each car ranged from 3000 Yuan to 6000 yuan.

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<sup>10</sup> In China, the old people living in nursing homes for the elderly include widowers, widows, and childless, singles and disabled elders. Generally speaking, old people mainly depend on the care of their children.

<sup>11</sup> The policy on bringing industrial goods to the countryside also includes subsidy given to farmers for purchasing agricultural machinery and tools. Such subsidy allocated by the government in 2009 accounted for 13 billion yuan, 2.25 times more over that of 2008.

According to calculations by relevant departments, the actual used subsidy in 2009 for promoting home appliances to the countryside was 7.54 billion yuan. In 2009, 34.5 million sets of various kinds of home appliances were sold with a sale volume of 64.7 billion yuan. Along with the increase of the sale volume of home appliances, the farmers' living standard had also been improved. The number of cars bought by farmers had also been increased. In 2009, the total number of sold cars in countryside was over 2 million, up by 85% than 2008. Under the impetus of the government subsidy policy, the aggregate retail volume of social consumer goods in rural areas of China exceeded 4 trillion yuan, up by 15.7% year on year and the speed of growth surpassed that of urban areas for the first time since 1986.

In 2010, the central government has continued to implement the subsidy policy related to promoting industrial goods to the countryside and enforced regulation on the quality and post-service of these products. This policy has made the products that not only affordable to farmers, but also meet their daily needs truly. Relevant R&D work is made by the government to find out what new items of home appliances should be added to the list of subsidy, so as to further enlarge the demand of rural market.

### **c2. The financial subsidy policy on trading-in old home appliances for new ones in urban areas**

In 2009, the Chinese government decided to put in practice the financial subsidy policy on trading in old home appliances for new ones , an additional 2 billion yuan had been allocated toward this end. The pilot work started from June 1 with subside standards equivalent to 10% of the market price.

The pilot work had been carried out in Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Shandong, Guangdong, Fuzhou and Changsha. The subsidy covered TV set, refrigerator, washing machine, air condition and computer. The central finance shouldered 80% of the total subsidy and the rest was borne by relevant provincial and municipal governments. Statistics show that In the second half of 2009, the total amount of subsidy used in the above-mentioned provinces and cities for pilot practice was over 1.4 billion yuan and sales volume had thus been increased by 14.09 billion yuan through selling 3.602 million sets of home appliances, accounting for nearly 1/3 of the sales volume of the above-mentioned five kinds of home appliances. It shows that the subsidy policy has achieved tangible results in fuelling the market of home appliances.

In May 2010, the State Council decided to continue implementing the subsidy policy on trading in old home appliances for new ones as of June 1 and gradually put into effect this policy across the country in light of the dismantling ability of old home appliances in various localities and the tentative closing day is made on December 31, 2011.

### **c3. Subsidy on trading in old cars for new ones and the policy of cutting vehicle-purchasing tax by half for cars with a displacement equal to or less than 1.6 liters**

In June 2009, as regards trading in old cars for new ones, the government

increased the year-based subsidy from 1 billion yuan to 5 billion yuan, mainly targeting the reduction of those cars whose emissions had not reached the standards<sup>12</sup>. Those car owners who could appropriately scrap the old cars at an early time and purchase medium-sized trucks, medium-sized coaches, light vans or minivans could enjoy a subsidy of 6000 yuan, 5000 yuan, 4000 yuan and 3000 yuan respectively.

Due to the little effects resulting from the policy of trading in old cars for new ones implemented in the latter half of 2009, the previous subsidy of giving 3000 yuan to 6000 yuan was further increased from 6000 yuan to 18000 yuan, which has led to explicit results. According to statistics made by relevant departments, from January to August 2010, the total number of cars receiving subsidy under the policy of trading in old cars for new ones was 210,000 in the whole country, and the average number of cars receiving subsidy each month was 6.9 times higher than that in 2009. A total sum of 2.955 billion yuan of subsidy was granted which had driven forth the consumption of new cars with a total sale volume of 25.3 billion yuan.

The policy of cutting purchasing tax by half and targeting cars with a displacement equal to or less than 1.6 liters was implemented from January 20 to December 31, 2009. According to calculations made by relevant departments, the sale volume of cars with a displacement equal to or less than 1.6 liters in 2009 was as many as 7.1955 million, up by 71% year on year, showing explicit effects resulting from the policy.

## **II. Challenges facing China's fiscal policy in the post-crisis period**

Whether China will continue its expansionary fiscal policy in the post-crisis period depends on the judgment of the following three issues: first, the world economic performance in the future; second, China's economic development trend; and third, the financial capacity of the Chinese government.

### **1. The uncertainty of world economic performance in the post-crisis period**

After experiencing pains triggered by the financial crisis, people in the world desire for stability and hope the global economy could quickly resume its shape as that before the crisis. But people might not be that optimistic if they observe carefully the reasons leading to the financial crisis, the present policies adopted by various developed countries and the actual performance of the world economy.

#### **a. The developed countries are in a dilemma in dealing with the crisis**

The developed countries have adopted two measures in dealing with the financial crisis. First, they have reinforced supervision and control over financial institutions so as to prevent illegal and irregular practices; second, they are trying to explore ways to write off the "toxic assets" of the financial institutions.

At present, in dealing with the "toxic assets", governments in developed

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<sup>12</sup> The emission standard for petrol cars is under China I and for diesel cars under China III. There are some differences related to the standards from place to place.



countries would first of all have them frozen and then try to rescue the commercial banks and other financial institutions through capital injection. After these banks and the financial institutions get their business operation recovered to the normal shape and the “toxic assets” are written off step by step, these governments would then withdraw the injected capital. But such a way of dealing with “toxic assets” face major risks because it will definitely increase the governments’ debt level in the developed countries. Based on the latest estimation by the International Monetary Fund (IMF), the total sum of accumulated “toxic assets” of global financial institutions from 2007 to 2010 might have reached US\$ 4 trillion and only 50% of them have written off and there are still US\$ 2 trillion remained to be written off. Out of that, the United States has about US\$ 400 billion, EU and relevant developed countries have about US\$1.6 trillion. At present, the governments’ debt ratio in total GDP in developed countries has exceeded the international accepted alarm level<sup>13</sup> and these governments only possess little resources left to digest the remaining “toxic assets”.

The dilemmatic issue facing governments of developed countries is that if they adopt the expansionary fiscal policy to bolster the fragile economic performance, the governments’ debt will continue to expand; but if they pursue a tight financial policy to reduce the debt level, it would bring harm to the weak economic recovery. Under such a dilemma, the developed countries have no way out but to prolong the periods for the implementation of the expansionary monetary policy so as to avoid a double dip of the economy. Such a practice makes little difference in essence from expanding governments’ debt level, and will inevitably lead to serious inflation. The consequence is that the whole nation would have to experience together the bitter wine brewed by the violators of market laws and disciplines and the administration by governments of developed countries might become unstable.

### **b. A gloomy picture for global investment, trade and employment**

At the beginning of 2010, the report issued by the United Nations Conference on Trade and Development (UNCTAD) estimates that after the drastic fall in 2008, the foreign direct investment (FDI) inflow to developed countries continued to drop by 41% in 2009 and FDI inflow to developing countries and the emerging economies also witnessed a drop of 35% and 39% respectively. In October 2010, the report issued by UNCTAD shows that after four quarters of slow recovery, the global FDI dropped again in the second quarter of 2010, looming a gloomy picture.

In July 2010, the World Trade Organization (WTO) issued an annual report in China, indicating that due to the fall of the prices of oil and other bulk commodities, the total world trade calculated in US dollars dropped by 22.6%<sup>14</sup>. In terms of

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<sup>13</sup> The general view in the world is that as regards governments’ debt ratio in total GDP, the safe critical point is below 60%. The financial review report issued by IMF on May 5, 2010 reveals that the public debt ratio in total GDP in developed countries might increase from 73% in 2007 to 110% before 2015.

<sup>14</sup> In 2009, the total volume of import and export in China dropped by 16 and 11 percentage points respectively.

container numbers, the global trade volume in 2009 dropped by 12.2%, recording the highest drop since 1965. Global exports accounting for a percentage of GDP dropped by 2.3%, hitting the lowest point since the end of World War Two. It would take at least more than two years for the total world trade to resume the level prior to the outbreak of the international financial crisis.

In August 2010, the report entitled “Global Employment Trends for Youth in 2010” issued by the International Labor Organization (ILO) shows that by the end of 2009 and among the total 620 million young laborers aging between 15-24, 81 million of them were unemployed, with an unemployment rate of 13.0%, one percentage point higher year on year. It is the sharpest increase in unemployment in a single year, the first of its kind ever occurred over the past 20 years, according to the global-based evaluation data. The report predicts that the unemployment rate for youth in the world would increase to 13.1% in 2010.

The global lukewarm investment and trade performance has a direct impact on the recovery of the world economy. The worsening unemployment in the world will not only delay the recovery of consumer market, but also lead to the intensification of social contradictions in various countries.

### **c. Trade protectionism has added uncertainty to the recovery of world economy**

Some politicians in developed countries, in order to shift off the responsibility for economic imbalances, growing unemployment rate and the sluggish economic growth in their countries, have repeatedly claimed that some governments “have manipulated the exchange rate”.

Since the US government completely abandoned the policy of U.S. dollar linked with gold on August 15, 1971, the US dollar has shown a long-term devaluation trend. The price parity between US dollar to gold was then 35 dollars to one ounce and now it's 1300 US dollars to one ounce as a result of continuous devaluation. The outbreak of the international financial crisis will accelerate the devaluation speed due to the prompt increase of the amount of US dollars issued. Therefore, the Chinese government cannot and is not willing to block appreciation of the Renminbi (RMB) through the so-called “manipulation of exchange rate”. The measures taken by the Chinese government are only to control RMB not to appreciate at a too fast speed. The excessive appreciation of RMB is not only disadvantageous to China's export and value preservation of foreign exchange assets, but could not address the imbalance issue related to trade between the United States and China. The major reason causing such an imbalance is that the American government prohibits the export of hi-tech products to China.

Under the backdrop of economic globalization, the excessive appreciation of RMB will not only bring harm to China's export businessmen, but also to contractors and investors from developed countries as well as to raw material suppliers beyond China. Those who are familiar with international trade are aware of the fact that in China's export, over half of the items are processed products. Their brands, capital, technology and raw materials are mostly from abroad. For example, the woolen

sweaters that China exports to the United States bear the brands of the United States or relevant developed countries and the wool is imported from Australia or New Zealand. The processing charges received by Chinese enterprises are less than 1/5 of the purchasing price given by American contractors. Once the RMB gets excessively appreciated, it will affect the export volume of woolen sweaters that China exports to the United States whereas the major sufferers would no doubt be American contractors and wool producers from Australia and New Zealand.

The rising of trade protectionism trend has affected the foreign economic policy of some countries, adding much uncertainty to the global economic recovery.

## **2. China will not witness major changes to its economic growth**

In the wake of the Asian financial crisis occurred in the last century, doubts about China's economic growth have prevailed in the world and even Chinese officials from the planning departments are also influenced by these sentiments. They have claimed more than once that China has entered the phase of stable growth<sup>15</sup>, but the actual economic growth always goes beyond the expectations of the planning departments.

### **a. Long-term factors affecting China's economic growth**

The per capita resources of China are lower than the average level of the world. Since reform and opening up, the inflow of FDI and the introduction of technology have greatly sharpened the international competitive edge of the processing sector. After China's entry into the WTO, trade surplus have swiftly increased and the adequate foreign exchange reserve<sup>16</sup> has provided financial guarantee for China to make use of foreign resources.

The propensity to make savings by Chinese residents is rather high. With the expansion of economic aggregate, residents' saving balance has rapidly increased. In 2009, bank savings by Chinese residents exceeded 26 trillion yuan, equivalent to 77.6% of GDP in the same year, which has laid a solid foundation for capital accumulation. In 2009, when other countries across the world witnessed a drop of FDI, China's FDI had maintained the level of the previous year and its place in world rankings had risen from the 6<sup>th</sup> to the 2<sup>nd</sup>.

Under the impact of the family planning policy, China is entering the aging society with a swift increase of aged people<sup>17</sup>, which has changed the scenario of

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<sup>15</sup> These are terms exclusively used by Chinese planning departments, meaning that the economic growth has slowed down under 8%, which is in fact worked out according to the newly-added labor force required by employment market. At present, due to the explicit effects resulting from family planning, it will not induce unemployment of the newly-added labor force even if the economic growth rate is under 8%.

<sup>16</sup> In 2009, the balance of China's foreign exchange reserve was over US\$ 2 trillion, ranking first for 4 consecutive years in the world.

<sup>17</sup> By the end of 2008, the number of aged people of 65 and above stood at 109.56 million, accounting for 8.3% of total population, up by 0.2 percentage point year on year; the number of aged people of 60 and above posted 159.89 million, accounting for 12% of total population, up by 0.4 percentage point year on year.

supply exceeding demand in the labor market. The efforts made by the government on universal 9-year compulsory education since the 1990s have ensured the smooth promotion of labor quality, which has laid a sound foundation for the replacement of labor force with capital and technology.

The developed countries have so far not rescinded the decision on banning the export of hi-tech products to China, but the technological level and independent innovation ability of the entire manufacturing industry in China have been enhanced to a new height through the past 30 years of reform and opening up and the adjustment of economic structure as well as by drawing on and making use of other countries' technological achievements,

### **b. Impact of the international financial crisis on China's economy**

Owing to the fact that Chinese financial market is open to the outside world in light of certain conditions, the "toxic assets" in the hands of financial institutions of China are quite limited and the direct impact of the international financial crisis on Chinese banking sector is not that great. However, since the United States will not put aside the Expansionary monetary policy, it is inevitable for RMB to gradually get appreciated, leading to some losses of China's foreign exchange reserve.

The major impact of international financial crisis on China's economy focused on reduced demand for Chinese export due to the economic recession and shrinking market of the developed countries. Under such an impact, China's foreign trade value in 2009 dropped by 13.9%, but it might not be a bad thing in light of China's long-term economic growth because it has forced China to undertake necessary restructuring so as to meet the need of expanding domestic demand and sustained economic growth. For example: the 4 trillion yuan investment program launched by the Chinese government has accelerated infrastructure construction and enhanced social protection for the vulnerable groups. It has helped the Chinese economy to quickly walk out of the low ebb and greatly supported the long-term growth of national economy.

Another impact triggered off by international financial crisis on China is possibly the trade protectionism waged by developed countries and the consequence to China is somewhat like that mentioned above. Thanks to the dependence of China's economic growth on foreign resources, China will not retreat from the present stance of trade liberalization. Besides, in view of the long-term development, it is quite promising for increasing trade volume among emerging economies and clinging to trade protectionism will only lead to the economic depression of developed countries at a faster speed.

### **c. China is able to maintain high economic growth**

A general view in the world is that the swift growth of China's economy since reform and opening up is mainly due to its high investment rate and the so-called "population dividend", which has enabled China to make a high labor input. In view of the high deposit rate by Chinese residents and the large size of labor force, this

analysis is not groundless. But people might have neglected the following facts: China's technological progress in the course of swift industrialization and urbanization, and the improvement of efficiency brought about by the reallocation of labor resources between urban and rural areas<sup>18</sup>.

With regard to the four major factors affecting the long-term economic growth (resources, capital, labor force and technological progress), only labor force has witnessed some changes. With the fast increasing of the number of aging population, the size of labor force will become smaller, but the promotion of the quality of labor force will, to some extent, make up the deficiency. Besides, the factor related to resource scarcity and the abundance of capital will not witness much changes. The factor of technological progress in a broad sense will get enhanced along with the reallocation of labor resources and the promotion of independent innovation ability.

China is a country with a huge population and vast territory. While undergoing the course of industrialization and urbanization, China has much room for the development of consumer market and the promotion of industrial production and will be less affected by external factors. China will not slow down its pace of economic modernization so long as its social policies could keep the right track and avoid social disruptions experienced by Western countries in the course of industrialization.

### **3. The sustainability of the financial ability of the Chinese government**

The sustainability of financial ability is governed by three factors: deficit, debt level and the ability to raise income.

While adopting the expansionary fiscal policy with an unprecedented scale, the fiscal deficit of the Chinese central government increased to 750 billion yuan in 2009, and the deficit of the central government would be controlled under 850 billion yuan in 2010, within the internationally-accepted safety line (3% of GDP). In 2009, the cumulative balance of national debt was 6023.8 billion yuan and it is expected to increase to 7120.8 billion yuan in 2010, far below the internationally-accepted safety line (60% of GDP)<sup>19</sup>.

Generally speaking, people in the world have no doubt about China's fiscal deficits, but they are suspicious of China's debt issue. Even if all debts are put together including the intangible debts of local governments<sup>20</sup> and the financial bonds issued by policy financial institutions<sup>21</sup>, the estimation made by various international institutions shows that the maximum debt level of the Chinese government is still less than 60% of GDP.

It should be pointed out that the central fiscal revenue of the Chinese government is only about 30% in GDP, lagging behind the average level of 35% in

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<sup>18</sup> Li Shantong, Hou Yongzhi and Zhai Fan: *China's Economy Boasts the Potential for Fast Growth*, [www.people.com.cn](http://www.people.com.cn), July 12, 2000

<sup>19</sup> These figures are all quoted from the Budget Report on Government Work, [www.npc.gov.cn](http://www.npc.gov.cn)

<sup>20</sup> According to Liu Mingkang, Chairman of China Banking Regulatory Commission, the intangible debts of local governments are about 7.38 trillion yuan.

<sup>21</sup> Estimation made by Goldman Sachs shows that the financial bonds issued by policy financial institutions accounted for 6% of GDP.

GDP of developing countries and far below the 40% level of the developed countries. Even if such a revenue ratio is maintained, there is still much room for Chinese government to increase fiscal revenue due to the sound economic growth momentum.

If it is required under the new circumstances, the Chinese government has, according to internationally-accepted standard, the ability to further implement the expansionary fiscal policy to boom the economic development.

### **III. Major concern for China's fiscal policy in the post-crisis period**

In face of the uncertain economic development in the world, the recovery growth of domestic economy and growing fiscal debt level, the major task for China's fiscal policy in the post-crisis period is that while strengthen financial capacity of the central government, it should keep a smooth, sound and sustainable development for domestic economy. Government concern should be focused on the following four major points.

#### **1. Pushing forward the tax reform continuously**

Since the reform of tax regime in 1994, the ratio of central fiscal revenue in national revenue has been steadily improved, leading to the intensification of the ability of the central government on macro-economic control and on the fulfillment of social public functions whereas the overall tax burden of enterprises has not been increased. In 2008 when the international financial crisis broke out, China realized the unification of income tax for both the foreign firms and domestic firms and implemented a 25% flat tax for both firms, meeting the requirement of "equal competition" in line with the commitment made by China at the entry of WTO. In 2009, China accomplished the transformation of production-type value-added tax toward consumption-type value-added tax, allowing the deduction of the value-added tax contained in the fixed assets bought by the enterprises and further alleviating burden of the enterprises. In May 2010, a pilot project of resource tax reform, changing from "levied by weight" to "levied by price", was carried out in Xinjiang, which is beneficial for resource conservation and environmental protection. Research on the reform of property tax and personal income tax is ongoing. The government should, for further tax reform, continue to implement the principle of standardizing tax regime and reinforcing tax collection and management and gradually phase in the reform of property tax and personal income tax, to narrow the income gap among residents and increasing government fiscal revenue.

#### **2. Rebuilding the government budget system**

Through the implementation of the decentralization of fiscal system in the 1980s, the enthusiasm of local governments were brought into full play and China's reform and opening up made further achievements. Over the past 30 years, with the swift development of economy, the difference related to inter-regional and urban-rural economic development has been quickly enlarged, causing much difficulty to the government in providing equal public service and building a social security system.

After reform of tax regime in 1994, with the enhancement of fiscal ability of the central government, the increment of transfer payment had also been promoted. But due to the impact of the decentralization of fiscal system, the non-standardized budget system had led to a large amount of nonrecurring special expenditure and transfer payment at random, resulting in imbalanced distribution of social and economic benefits and much waste of government fund. In order to address the issue of the fragmentation of social security system and the non-standard management of state-owned enterprises' (SOEs') assets, a more detailed government budget system should be worked out. From the long-term point of view, only by establishing a three-tiered budget system<sup>22</sup> based on public budget and supplemented by social security budget and state-owned capital budget could we better deal with the various economic contradictions and social issues emerged in the course of industrialization and urbanization in China.

### **3. Fiscal policy should focus on restructuring and institutional building**

In view of the lessons drawn from the Asian financial crisis, China pursued a “proactive”<sup>23</sup> fiscal policy for seven years (from 1998 to 2004), which was replaced by a “prudent” fiscal policy only in 2005. In fact, “proactive” also varies in degrees, which might not necessarily include a “4 trillion” yuan project, but it is impossible to withdraw from the “proactive” one to the “prudent” one in a reckless manner. Only when large-scale infrastructure construction is completed could it become possible to withdraw government capital. And for the public service area such as public health, rural cooperative medical care and compulsory education, when the government put in money for improvement, it is rather difficult to withdraw. The only way out is to make an adjustment in the budget system.

#### **a. Focus on economic restructuring and industrial upgrading**

When implementing an expansionary fiscal policy, the government would focus its investment on public infrastructure, but it has to make relevant industrial options and follow a certain technological roadmap. Since the 1990s, the total length of highway built in China has been increased which has boomed the development of auto industry and relevant industries. The high-speed railway construction project based on wheel-rail technology and launched in 2005 will not only accelerate China's urbanization process and promote the technological progress of heavy-machinery building and information technology service, but also speed up the upgrading and updating of raw material industrial products in China. Besides, the government should also make investment in the fields of basic science research and education so as to meet the need of economic restructuring and industrial upgrading.

#### **b. To speed up the institutional building in the field of social policies**

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<sup>22</sup> The three-tiered budget system includes central budget, provincial (autonomous and municipality) budget and county (city) budget.

<sup>23</sup> “Proactive” means expansionary while “prudent” means “neutral”.

China has entered an aging society in the process of industrialization and urbanization. Given the fact that China has entered an aging society before becoming rich, quite a number of people are not yet covered by social security system. When giving priority to the improvement of people's welfare, the government should focus its money input on the building of social safety net with a wide coverage and low security level, including the construction of low-rent housing, maternal and child health care, compulsory education, public health, basic medical treatment and life insurance for aged people. This will not only be beneficial for narrowing the gap between urban and rural areas, freeing the people from worries about the future and promoting the development of consumer market and life service industry, but also advantageous for the long-term social stability in China.

#### **4. Control debts scale, and strengthen risk prevention**

The Chinese economy itself does not need to continue pursuing the expansionary fiscal policy<sup>24</sup>. And with the swift development of economy, the size of its fiscal revenue will be expanded and the debt level will naturally come down. However, in face of the uncertain economic performance in the world, it is necessary for China to look ahead and make advance preparations so as to cope with any incidence that might occur in the future. Therefore, while further pushing forward the reform of tax regime and rebuilding the budget system, the government should keep its debt size within a reasonable and appropriate limit and adopt effective measures to clear up the implicit debt of local governments and various kinds of policy-based financial bonds. The smooth development of Chinese economy will no doubt make a major contribution to the world community.

The end

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<sup>24</sup> On October 20, 2010 the People's Bank of China raised 0.25 percentage point the benchmark interest rate for deposits and loans.