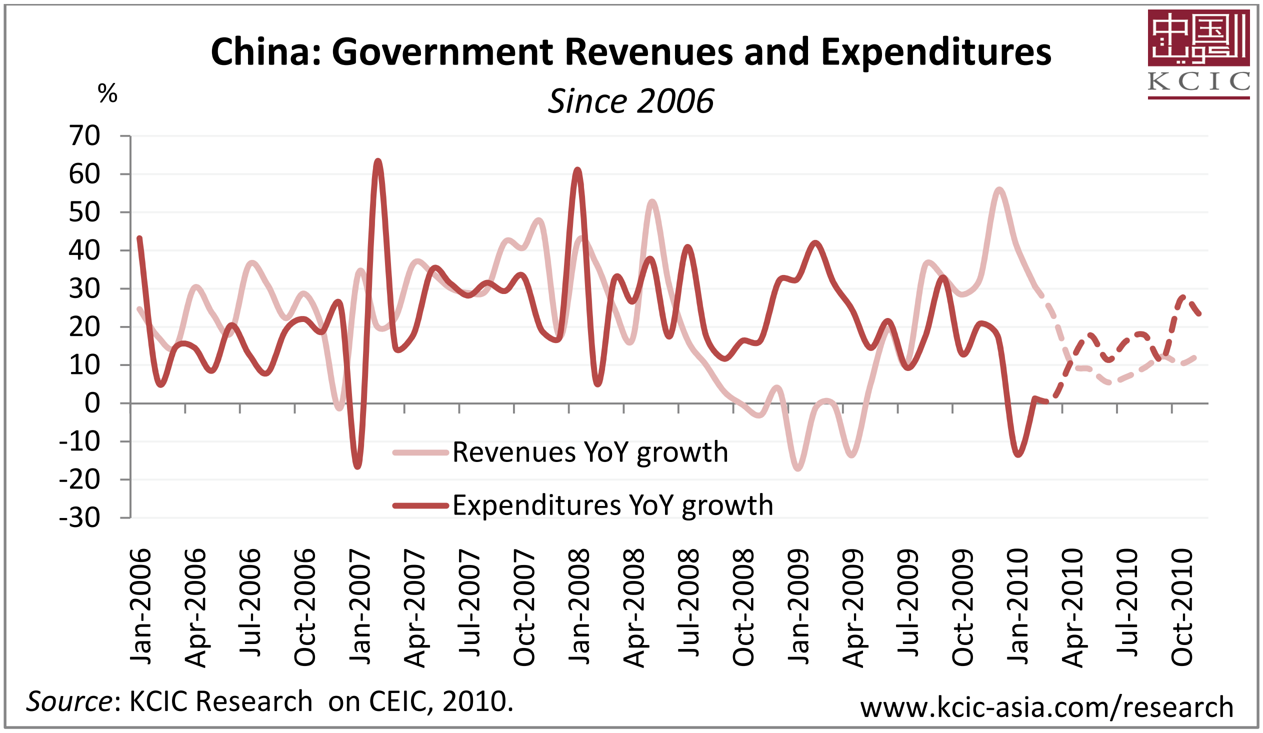
Fiscally induced growth to continue in China in 2010



Why is this graph important?

In his statement at the annual National People's Congress, the Chinese Premier Wen Jiabao announced that the expansionary fiscal policy would continue into 2010, as China continues to invest in infrastructure projects to promote growth. The two key items under the government budget - namely the revenues and expenditures - displayed in the graph combined with Premier's remarks suggest that 2010 will be another high growth year for China, and a positive one for the Asian markets in general.

What does the indicator tell us?

The graph displays the historic trend of government revenues and expenditures in China for the past four years. Tax income makes up nearly 90% of total revenues in China and since tax income is highly related to the growth in the economy, the revenue side of the budget is largely determined by GDP growth. Since most governments, China included, tend to spend (expenditures) in line with their income levels (revenues), the expenditure side of the budget is usually determined by the level of government revenue in that country. Expenditures, however, can be adjusted as a need to stimulate growth arises.

In fact this is precisely what the Chinese government officials have done at the onset of the crisis as a preemptive measure to stimulate growth. With an immense stimulus package of US$587bn announced in November of 2008, expenditures grew and promoted growth. They also caused an increase in revenues. The markets reacted positively to the growth in China as the Chinese markets averaged a much higher return than the developed economies in 2009.

What are the economic and financial implications?

The extension of loose fiscal policy in 2010 suggests we might see more fiscally induced growth in 2010 which should again reflect positively on the markets. Yet this articially introduced growth must be approached with caution.

There is always a risk of the diminishing effect of increasing government expenditures on growth. This means that higher expenditures does not always translate to higher growth and sometimes with a less of an effect on growth as time goes by. In these situations governments end up with increased expenditures but a loss of revenues creating the need to borrow. Increased borrowing needs as well as a high level of existing debt often scares the markets – as it was seen in the case of Greece.

Such risks are not yet relevant for China as the budget deficit to GDP ratio at 3.12%, as of 2009 end, and public debt to gdp ratio at 30.5% is acceptable compared to the Maastricht criteria, a set of rules to determine the safe level of government finances. However, the local government's borrowings are not incorporated in the budget figures and these, sometimes backed by the central government, could create a risk for the China in the medium term. Still with nearly US$2 trillion in reserves, China should not need to go to the markets to borrow and have little trouble borrowing from the markets if in need. As a result, we can see Asian markets continue to outperform their G3 counterparts as cyclical fiscal policies feed into the Chinese economy.

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