

MoF INTERNATIONAL SEMINAR on

**FISCAL POLICIES FOR EXPANDING
CONSUMPTION DEMAND**

**Zhuozhou
Hebei Province**

January 7-8, 2009

Short-Term and Medium-Term Policy Challenges: The Role of Fiscal Policy

Presentation by
Vivek Arora*

IMF Senior Resident Representative, Beijing

* These are the opinions of the author alone and should not be taken to represent the views of the IMF, its executive board, or its management.

Overview

- Global downturn and policy responses
- Fiscal policy: short-term and medium-term challenges
 - Some conclusions and lessons from international experience
 - China's situation
- Some conclusions

Fiscal policy: main points

- **Many countries** face need to address downturn while meeting MT challenges
- **Considerations:**
 - How to structure the stimulus
 - How to balance ST needs with MT challenges and sustainability
- **China:** ST challenge (fighting downturn) provides **opportunity** to address MT challenge (rebalancing/sustainability): measures to boost consumption.

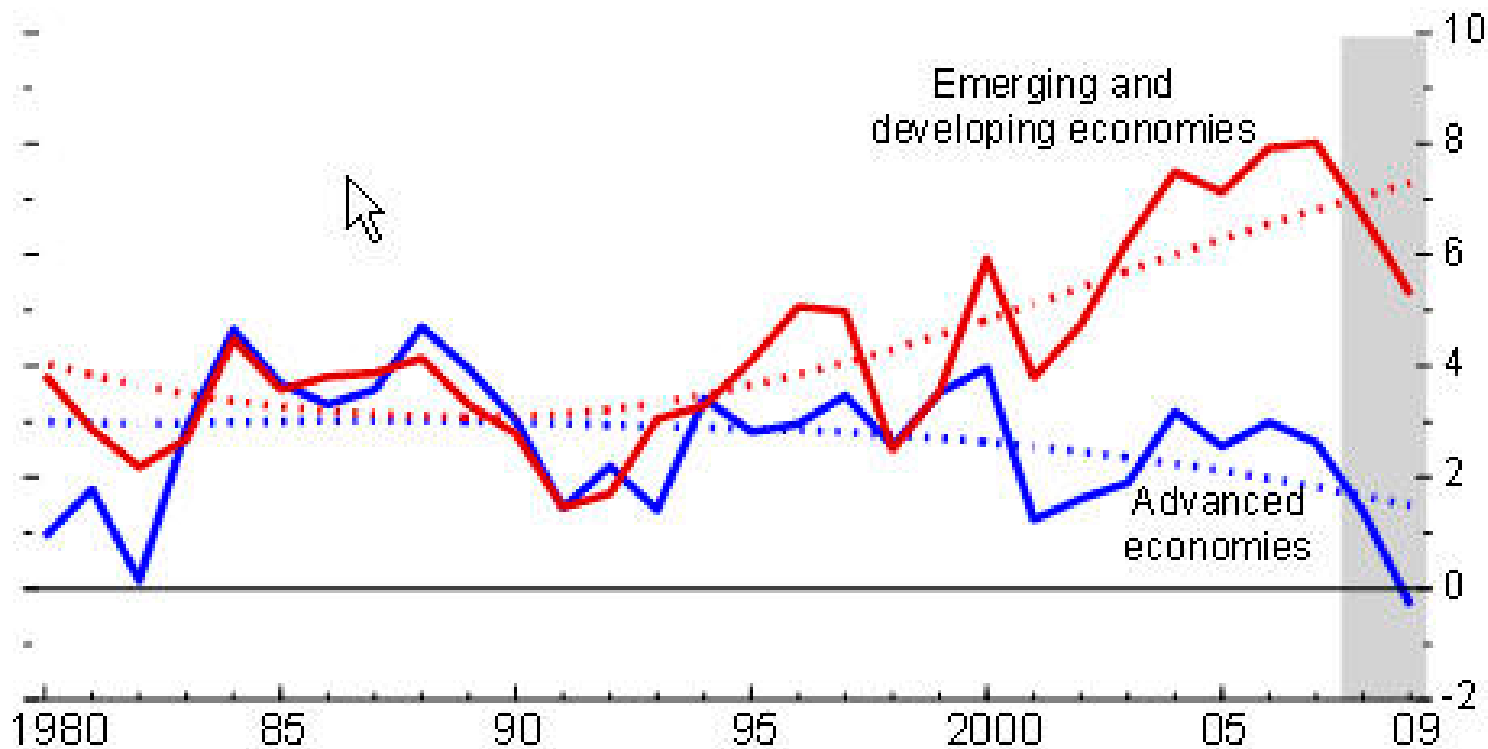
World Economic Outlook

- Picture worsened over past month.
- Major economies going into recession.
- Emerging economies also slowing.

World economy slowing sharply

Figure 1. Real GDP Growth and Trend

(Percent change)



Source: IMF staff estimates.

Particularly advanced countries

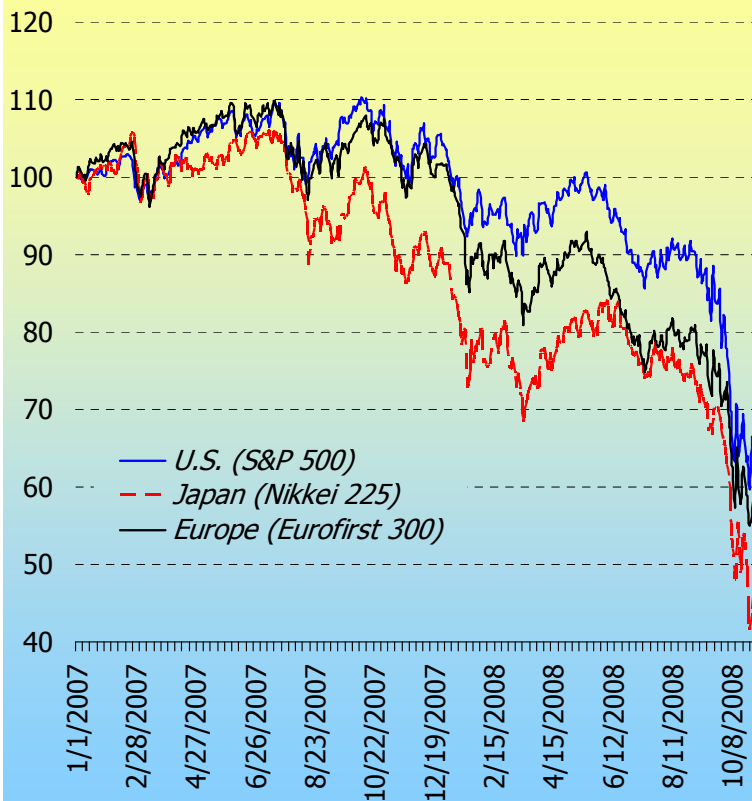
GDP growth (in percent) (WEO Update - November)

	2008	2009
World	3.7	2.2
Advanced economies	1.4	-0.3
United States	1.4	-0.7
Euro area	1.2	-0.5
Japan	0.5	-0.2
Emerging and developing economies	6.6	5.1

Market panic, leading to sharp price declines, risk aversion, volatility....

Stock Market Indices

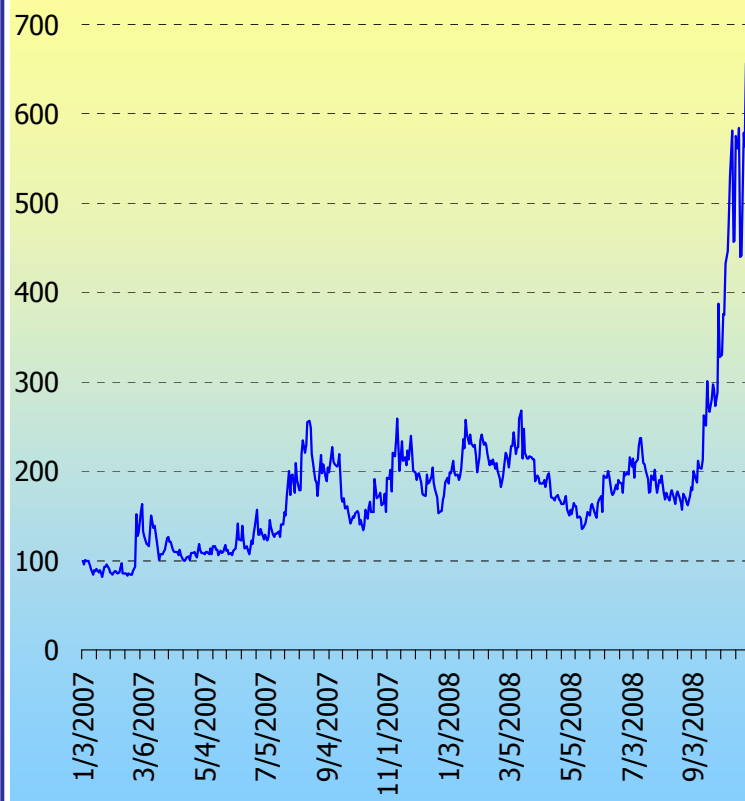
(January 1, 2007=100)



Source: Bloomberg LP.

VIX Index

(Index, January 1, 2007=100)

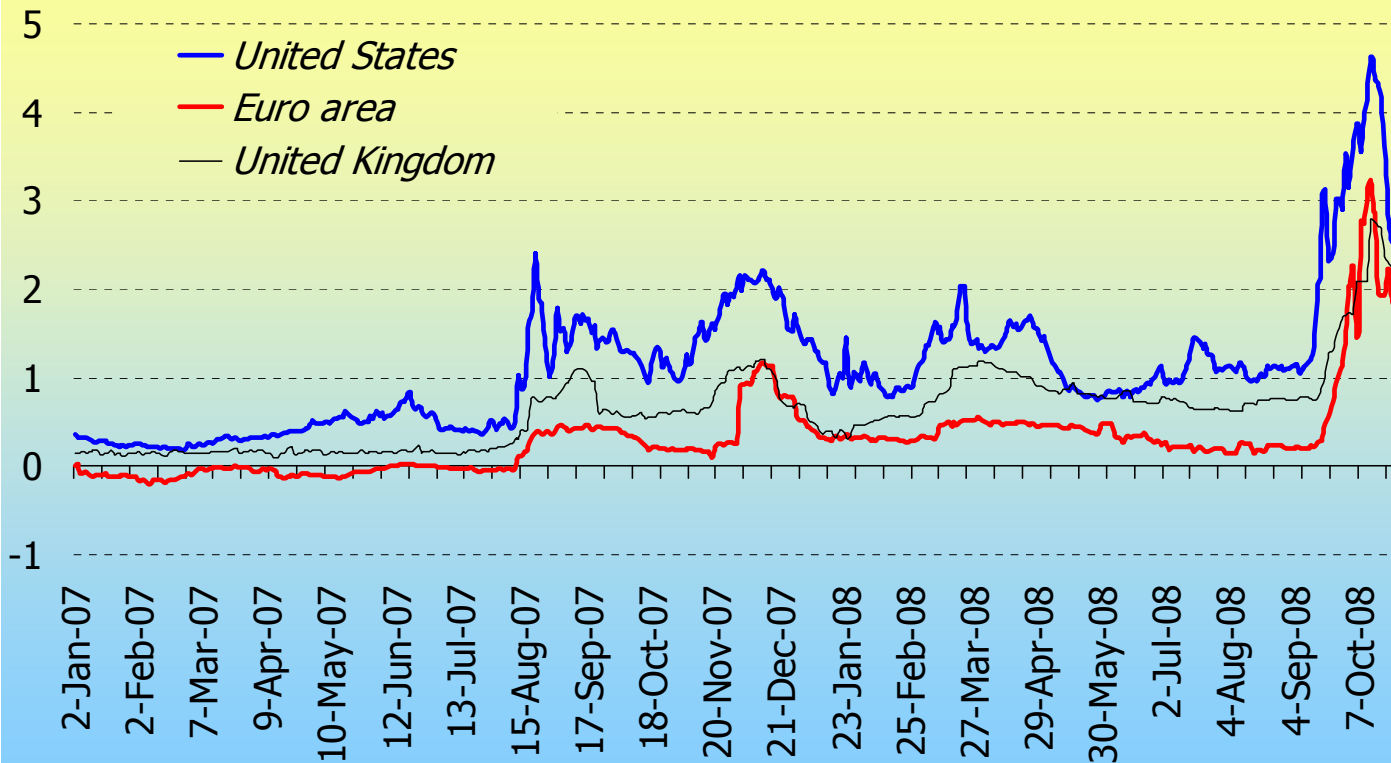


Source: Bloomberg LP.

...and shortage of liquidity.

Money Market Spreads

(3-month LIBOR minus government bond yields, in percent)



Sources: Bloomberg LP; and Datastream.

International policy responses

- **Financial system repair and rescue**
 - Bailout packages (recapitalization, distressed assets)
 - Liquidity provision
- **Support aggregate demand**
 - **Fiscal stimulus**
 - Other policies

Asia: countries taking measures to maintain confidence in banking system...

- **Liquidity injections:** new facilities/collateral; expanding access to central bank discount windows.
- **Extended guarantees** to bank deposits (Hong Kong SAR, Malaysia, Singapore, Australia) and bank debt (Australia, Korea).
- Plans for **bank recapitalization contingency funds** (Japan, India, Hong Kong SAR).

...and provide macro stimulus

- With inflation easing, **cuts in policy rates** (e.g., Australia, China, India, Korea, New Zealand, Vietnam).
- **Fiscal stimulus** measures (e.g., Australia, China, Japan, Korea, and New Zealand).

Composition of fiscal stimulus: international discussion

- Policy diversification, using both expenditure and tax measures, given uncertainty about transmission mechanism
- Long downturn means more scope than before for expenditure measures
- Countries that created “fiscal space” in past now have more room for stimulus

Expenditure measures: general

- **Maintain existing programs.** Support subnational governments in critical areas
- **Investment spending:** frontload existing projects; increase maintenance; plan new projects if downturn continues
- **Targeted transfer payments:** unemployment benefits; transfers to vulnerable households
- **Not recommended:** new large entitlement programs; public sector wage bill; subsidies to specific industries

Revenue-side measures

- Temporary ↓ in consumption tax rates
- Lump-sum tax rebates, temp. ↑ EITC
- Temp. ↓ unemp. insurance contributions

- Not recommended: ↓ CIT rates, dividends, and capital-gains tax; ad hoc special incentives; amnesties/exemptions for specific firms; generalized tax measures to boost financial markets

Stimulus aimed at consumers

- Clarity of policy and strong commitment help reduce uncertainty, precautionary saving
- Target tax cuts/transfers at **credit-constrained** consumers
 - Unemployment benefits
 - Earned income tax credit
 - Expansion of social safety nets

Stimulus aimed at firms

- Government guarantees on new credit, in context of Chapter-11 restructuring
- But support to entire “highly visible” sectors not advisable.

Medium-term sustainability

- Stimulus should take account of MT sustainability (market stability, interest rates, consumption)
- To do this, options include:
 - reversible measures; sunset clauses
 - policies to eliminate distortions
 - expand automatic stabilizers
 - commit to corrective measures (e.g., U.K.)
 - commit to unwind stimulus at fixed date

Medium-term (continued)

- Use medium-term fiscal framework
- Strengthen fiscal governance
- Improve expenditure procedures

- Credible plans to deal with key challenge of aging populations: pension and health

China's economic situation and challenges

- Economic slowdown, will persist into 2009
- Fiscal stimulus helpful
- But composition very important. Focus on consumption, essential infrastructure preferable to capacity expansion
- Risks: domestic (overcapacity), foreign (growth, protectionism)

China's fiscal stimulus

- Substantial fiscal stimulus the right policy
- Infrastructure upgrade also useful for MT
- VAT reform helpful: clean move to consumption VAT; full zero-rating of exports
- Measures to boost productive capacity would be less helpful.
- Medium-term need for **rebalancing** away from exports and investment to private consumption

Scope for measures to boost private consumption

- ↓ household income taxation
- transfers to vulnerable groups
- enhance social safety net
- Temporarily ↑ government health/education contributions

Needed medium-term reforms

- Pension
- Health
- Education

- Capital market development
- Interest rates
- SOE dividends

International dimension: collective international approach helpful

- Open economies benefit less because of “leakage.” Joint action reduces size needed by each country
- Subsidies/other support to troubled industries can cause retaliation
- Trade barriers a threat to global growth

Conclusions (general)

- Fiscal policy critical in response to downturn all across world
- Clear, strong policy signal important
- Structure of stimulus should take into account medium-term needs

Conclusions (China)

- China can address both ST and MT challenges at same time by focusing on consumption (& key infrastructure) in stimulus and implementing other reforms as a package
- In addition, announcement of clear plan, with goals over next 2-3 years, to deal with pensions, healthcare, education would also help boost consumption