China Fiscal Stimulus – Careful Calibration

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Fiscal response – comparing & contrasting it to 2008

p.03

At a glance

- China has abandoned a GDP growth target for 2020 for the first time since 1990. Instead, a very strong approach is underway that will tackle unemployment in a targeted manner.
- In response to the COVID-19 crisis, China has announced a headline fiscal stimulus package equivalent to 8.4% of GDP. The goal is to provide subsidies and tax reliefs to small and medium enterprises (SMEs) and micro firms, create savings via the reduction of social security contributions, and fund a new infrastructure push.
- This fiscal response is 'softer' than was the case in 2009, as a much larger proportion is focused on tax reliefs and providing subsidies as opposed to almost entirely going towards investment.
- Most of the RMB2trn deficit spending around consumption support will appear in the second half of 2020, leading to a potential surge in the third quarter.
- The government views its new infrastructure plan as being instrumental in accelerating China's transition into a more domestically-oriented, consumption-driven economy. Over the next 5 years, we expect new infrastructure to unlock RMB15tn in investment to support this transition.
- In the initial response to COVID-19, monetary policy took the lead. However, easing momentum has slowed since May. This lends credence to our view that policymakers are acutely aware of financial imbalances and are unlikely to turn the credit spigot with the same gusto as in 2009.
- With a relatively strong growth rebound from the crisis, China's current COVID-19 stimulus plan is not a big one-off bazooka, unlike in other developed markets. The authorities seems to be using this opportunity to address long-term structural improvements in a calibrated way so that they are better positioned for the future.

The government views its new infrastructure plan as being instrumental in accelerating China's transition into a more domestically-oriented, consumption-driven economy.

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China's policy of targeting growth is changing

In 2019, China had set a growth target of 6-6.5% and ultimately achieved 6.1%. In the first quarter of 2020, GDP contracted 6.8%, according to official statistics, whilst growing 3.2% in the following quarter. This rebound was substantial considering the global demand collapse in the second quarter, and the rebound can be witnessed in strong auto and home sales as well as consumption data. Notwithstanding this anticipated rebound, the authorities have for the first time in several decades at their May 2020 meetings, abandoned providing a GDP growth target for this year.

China has a long tradition of setting growth targets. Many experts have argued that this should be abandoned as such targets create incentives for inefficient government spending and potentially inappropriate fiscal policies in the short-term. Focusing on numerical growth targets is also said to reduce the authorities' emphasis on solving long-term and deep structural issues in the country, which could ultimately impact employment and standard of living of its large middle and low-income population.

Authorities abandoning the growth target has raised the following concerns or questions amongst investors:

1. What about visibility of forthcoming government credit and spending? Growth targets usually serve as a signal as to the level of stimulus and support authorities will provide in the short to medium term.
2. Will the type of stimulus being contemplated be significantly different in nature than in past cycles, primarily owing to the weaker global setting and US-China trade tensions?
3. How effective would forthcoming stimulus be in transmitting growth to the rest of the global economy and to global asset prices including bond yields and commodity prices?
4. Will authorities be prepared to accept a low level of growth in 2020, and what about the next 2-3 years? China accepting a lower growth over the medium-term will naturally have significant ripple effects globally.
5. Does China think the world is fundamentally more challenging than the rest of us realise?

Instead, a very strong approach is being taken to tackle unemployment in a targeted manner. Authorities have announced its intention to create nine million new urban jobs in 2020. In line with this strategic shift, China's fiscal response in 2020 has been more calibrated than in previous years as we discuss below.

Fiscal response in 2020

In response to the COVID-19 crisis, the politburo[1] meetings have communicated a strong pro-growth signal, and have announced a headline fiscal stimulus package of RMB8.5tn (8.4% of GDP). Significant among them was:

- Modestly increasing on-budget fiscal deficit target (3.6% of GDP versus 2.8% in 2019)
- Issuing central government special bonds (RMB 1tn)
- Increasing local government special bonds (RMB 3.75tn or 3.6% of GDP from RMB2.2tn in 2019)
- Monetary policy driven measures such as lowering the lending interest rate and maintaining liquidity at a "reasonably ample" level (utilizing tools such as relending and rediscounting, and delaying repayments on loans).

A large focus for the fiscal policy is to:

- Provide subsidies and tax reliefs to small and medium enterprises (SMEs) and micro firms to help them stay afloat without massive layoffs. RMB2trn (1trn from 3.6% budgetary deficit and 1trn from central government special bond issuance) will be transferred via a special fiscal transfer program, to help SMEs in areas of fee reductions and subsidized interest rates, as well as to provide subsidies to low income families, unemployment compensation, old age care, and people living in poverty.
- Create savings via the reduction of social security contributions, the surplus fund accumulated in unemployment insurance, reduced prices from monopolies (electricity and broadband fee, etc.), and interest rate subsidies from state-owned commercial banks.
- New infrastructure push. Around RMB2trn extra funds (RMB1.6trn net increase on the provincial special bond and a portion of central government special bond) will be used to expand so-called 'effective investment', especially in areas of new infrastructure, new urbanization, and key infrastructure projects related to national development strategy and people's livelihood.

[1] The principal and highest level policymaking committee of the Chinese government, chaired by the President.

Fiscal response – comparing & contrasting it to 2008

We tend to measure the overall fiscal impact in China in terms of the augmented fiscal deficit which includes on-budget fiscal deficit and major off-budget financing sources (local government special bonds, local government financing vehicle (LGFV) bonds, policy bank support, shadow banking lending, and land sale revenue, and now special bonds). This is expected to hit 15.1% of GDP (from 12.6% last year) which is greater than the fiscal response in 2009.

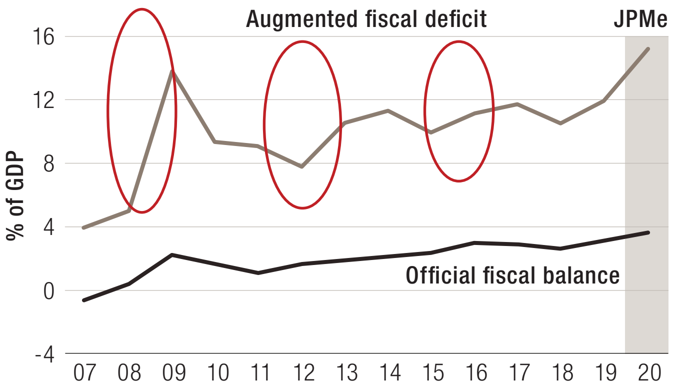
Still, compared to 2009, 2020's fiscal response is 'softer' as a much larger proportion is focused on tax reliefs and providing subsidies as opposed to almost entirely going towards investment as in 2009. The fiscal 'impulse' in 2020 is expected to be only a modest 3.2% of GDP compared to the RMB4tn stimulus directly into investments back in 2009. Furthermore, the policy mix being adopted is also different this time around – the traditional trio of property, auto and infrastructure has now given way to just an infrastructure-led push.

The fact that the property and manufacturing sector is largely excluded from the demand stimulus package is significant for three reasons:

a. Authorities are serious about maintaining financial stability. Under the leadership of President Xi Jinping since 2014, authorities have been clear about the management of system-wide credit and leverage growth. Indeed, between 2015 and 2018, the government tried to reduce the rate of credit and leverage growth both in the local governments and private sector. There is clearly an understanding that the overall system-wide indebtedness is high (see Figure 2), and any stimulus will need to be carefully calibrated to prevent a build-up of imbalances. This is evident in a still shrinking shadow financing sector, with central government and local governments taking up the leverage burden this crisis instead.

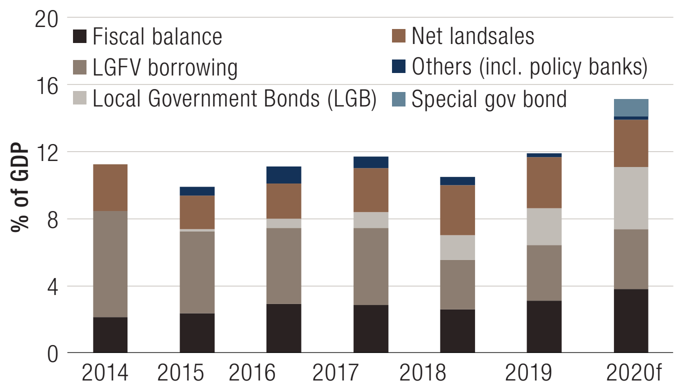
FIG. 1 CHINA'S FISCAL RESPONSE

CHINA'S FISCAL DEFICIT



Source: MOF, J.P. Morgan. Note: Red circle indicates fiscal easing episodes.

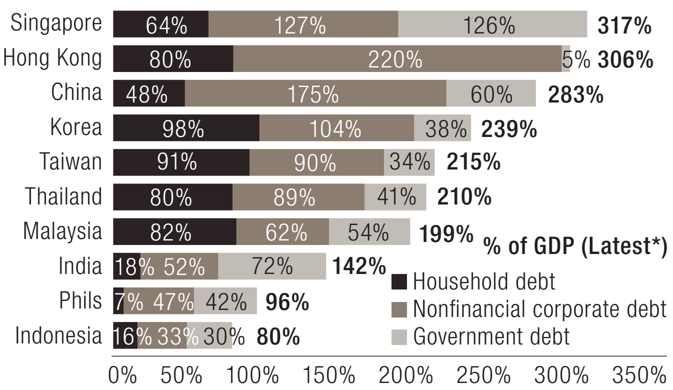
AUGMENTED FISCAL DEFICIT AND BREAKDOWN



Source: NBS, J.P. Morgan estimates.

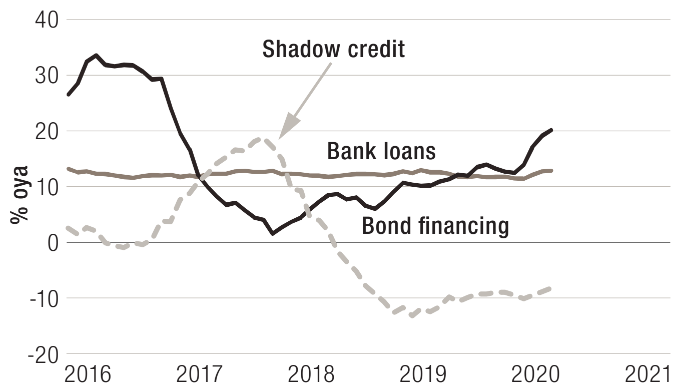
FIG. 2 SYSTEM-WIDE INDEBTEDNESS IS HIGH

AXJ DEBT-TO-GDP BY SECTOR 7 OUT OF AXJ ECONOMIES HAVE TOTAL DEBT-TO-GDP RATIOS AROUND 200% OR MORE



Source: CEIC, Morgan Stanley Research estimate;
Note: *Data as of 1Q20 for China, India, Malaysia and Taiwan, 4Q19 for other economies.

AGGREGATE FINANCING BY TYPE



Source: CEIC; J.P. Morgan.

b. The positive impact on commodity-exporting EMs could be limited. The widely expected rebound of demand from China for key raw materials is unlikely to be as strong as during previous easing cycles because of muted manufacturing and property-related investment going forward. Manufacturing Fixed Asset Investment (FAI) will likely continue to be affected by lingering uncertainty in demand conditions, PPI deflation, weak profits and corporate cash-flow, and the lack of investment incentives. On the property sector, policy makers have been clear about stemming unnecessary speculation and ensuring stable property markets, and we expect property fixed asset investment (FAI) to remain stable in the second half of 2020. As a result, marginal demand from China into the rest of EM as likely to be far more muted than was the case in 2009.

c. US-China Relations are shaping China's investment priorities. It is clear that the re-escalation in US-China tensions, post COVID-19, are shaping China's priorities over the next five years and beyond. As the trust deficit between the two countries grows, it is becoming clear that the strategic divide and selective decoupling between them will continue to increase, regardless of the US election outcome later this year. In this context, China has made a marked shift towards favouring a domestically oriented and consumption-related economic rebound rather than an externally focused one. This is also bearing out with respect to the government's new infrastructure push, where there is now a heightened focus on on-shoring the semiconductor supply chain to reduce dependence on Hauwei related restrictions.

Fiscal response – timeline and implementation

Since the details of the 2020 fiscal stimulus weren't revealed until late May, most of the fiscal impulse will likely bear fruit in the second half of this year, adding a further fillip to the growth recovery out of China, in our view. The special fiscal transfers from central government to provinces and then to county level governments was completed this month. This suggests that most of the RMB2trn deficit spending around consumption support will be spent in the second half of 2020, leading to a surge in the third quarter especially.

So far, the off-budget fiscal financing has been frontloaded this year, and this will support a further infrastructure investment recovery in the second half of this year. The government and quasi-fiscal entities including LGFVs and policy banks have significantly ramped up borrowing in recent months to execute on the plans (see figure 3). Furthermore, since the start of June, central government borrowing has also increased to accommodate the RMB1tn 'anti-virus' sovereign special bond issuance, which should also be deployed during the second half of the year.

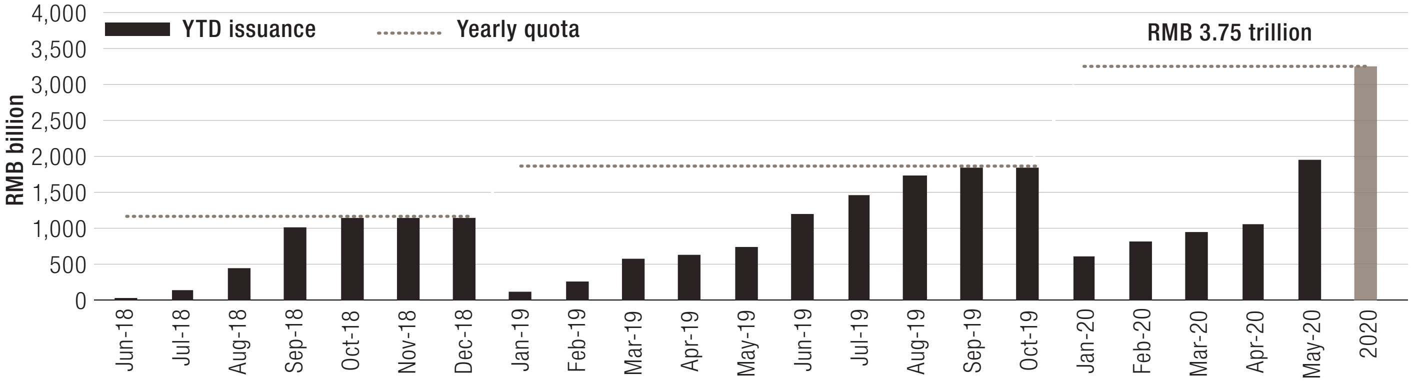
Fiscal response – focus on new infrastructure and industries to watch for

The government views its new infrastructure plan as being instrumental in accelerating China's transition into a more domestically-oriented, consumption-driven economy. "New Infrastructure" represents a significant shift in China's priorities, into building new digital-era infrastructure, and broadly consists of 7 key areas:

- 5G base stations and networks,
- Data centers
- Ultra High Voltage (UHV)
- Electric Vehicle charging piles
- Artificial Intelligence
- Industrial internet of things (IoT)
- Intercity rail/urban transit network

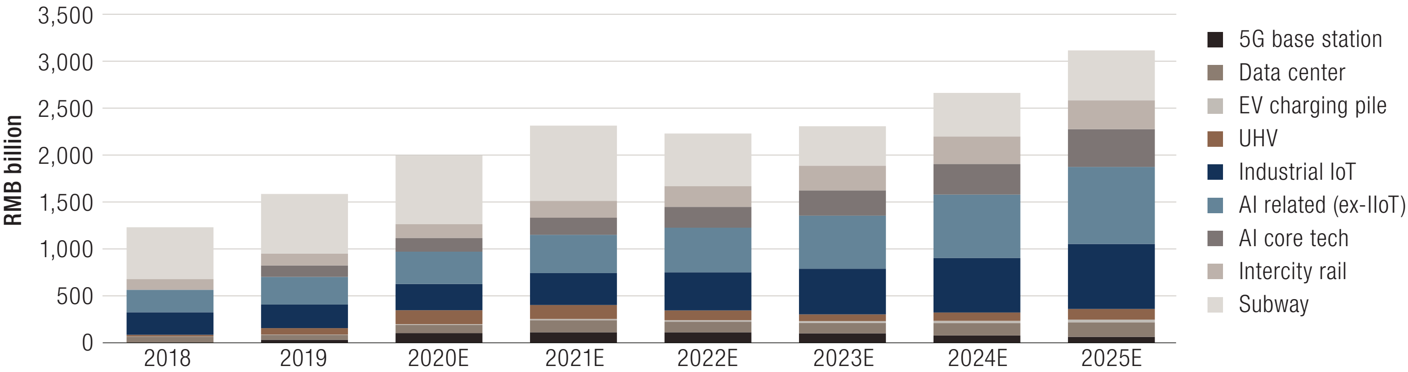
Over the next 5 years, we expect new infrastructure to unlock RMB15tn in investment to support this transition. The significant breakdowns within the investment are shown in Figure 4.

FIG. 3 CHINA SPECIAL LGB NEW ISSUANCE TO RISE



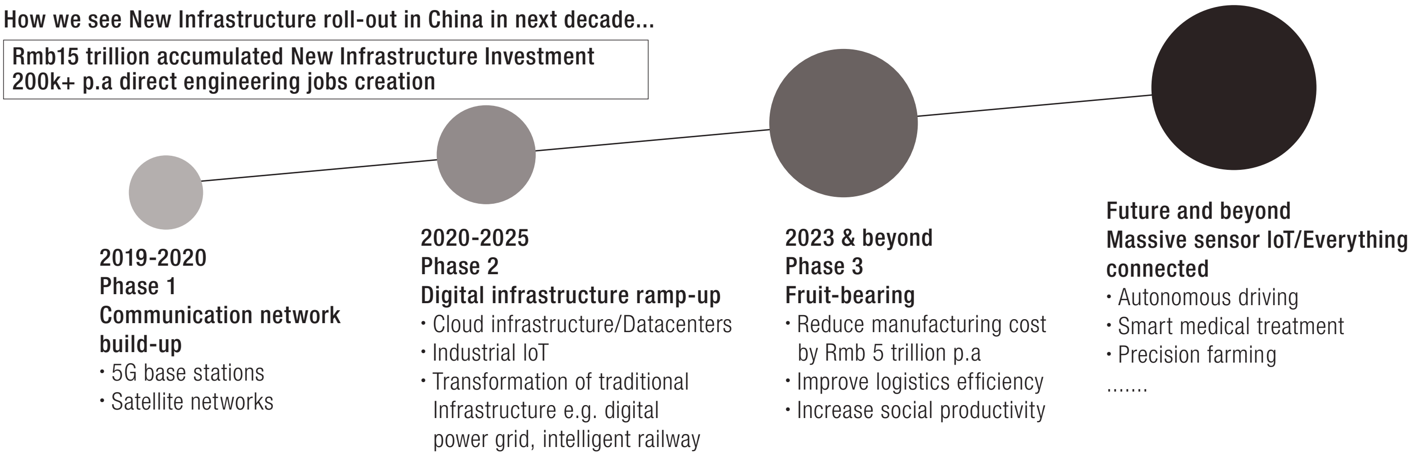
Source: MOF, WIND, J.P. Morgan.

FIG. 4 BREAKDOWN OF NEW INFRASTRUCTURE SPENDING



Source: Goldman Sachs.

FIG. 5 ROLL-OUT OF NEW INFRASTRUCTURE BY PHASES



Source: Goldman Sachs.

Phase 1 of the new infrastructure plan focuses on connectivity, and is well underway with the construction of 5G base stations. By 2022, China is expected to have 4.9 million macro base stations (1.3x that of 4G), with capex ramping up to USD 30 billion in 2022 versus USD 5 billion in 2019. Phase 2 has commenced this year and aims to have 300K cloud-based industrial companies by 2022. This involves significantly upgrading the digital infrastructure across industrial IoT, cloud and data centers, driving demand through the new economy as well. Phase 3 will then focus on the productivity improvements that can be made possible through connected network efficiencies in manufacturing, improved logistics and supply chains domestically, for example. If successfully implemented, the potential for dramatic change is significant and can support China's transition from the old economy into the new economy.

How does monetary policy fit into all this?

In the initial response to COVID-19, monetary policy took the lead and the People's Bank of China (PBoC) introduced various measures to both ease monetary policy and to support the banking system. M2 and total social financing (TSF) growth were guided to be significantly higher than 2019. Measures included:

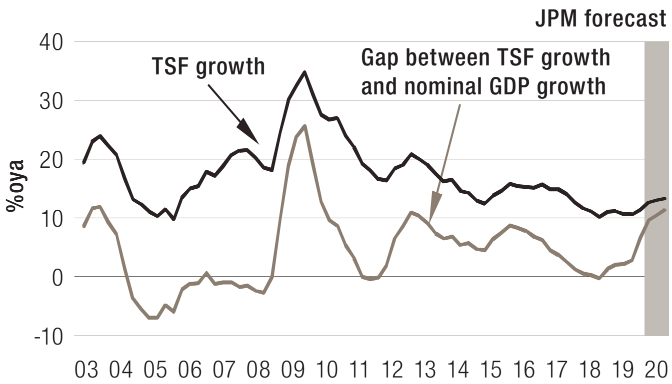
- Rate cuts: 25bps in benchmark deposit rate; 30bps in 1Y medium-term lending facility (MLF); 7d reverse repo by 20bps, RRR cut by 50bps for large, 100bps for smaller banks releasing RMB 950 billion in liquidity. Further cuts to RRR ratios and MLF rates are likely in the second half of 2020, in our view.
- Set up of relending and rediscounting facilities to support bank lending to SMEs (RMB2.2tn). On June 30, PBoC cut the re-lending and re-discount rates by 25bps.
- Liquidity injection through open market operations (OMO).
- Regulatory forbearance to encourage lending to affected sectors, such as temporarily lowering the provision coverage ratio for small and medium-sized banks by 20ppt to increase lending to SMEs, and directed the state-owned banks to increase inclusive finance loans by 40% yoy.
- Deferring inclusive finance loan payments (due by end-2020) to end-March 2021 for small- and micro-sized companies and individual businesses, and extending more unsecured inclusive

finance loans to small- and micro-sized companies and individual businesses.

- Bank interest on excess reserves cut by 37bps to 0.35%.
- Supply chain financing to SMEs (RMB 800 billion).

However, PBoC's easing momentum has slowed since May. In fact, the RMB1tn net liquidity injection in March and April turned into a net withdrawal of RMB 753 billion in May, and a much smaller liquidity injection of RMB140 billion in June. This lends credence to our view that policymakers are acutely aware of financial imbalances and are unlikely to turn the credit spigot with the same gusto as in 2009. Indeed, total social financing (TSF) growth will be far more muted at 13% compared to the eye-watering levels seen in 2009.

FIG.6 CHINA SPECIAL LGB NEW ISSUANCE TO RISE



Source: MOF, WIND, J.P. Morgan.

Conclusion

With a relatively strong growth rebound from the crisis, China's current COVID-19 stimulus plan is not a big one-off bazooka, unlike in other developed markets. The authorities seems to be using this opportunity to address long-term structural improvements in a calibrated way so that they are better positioned for the multi-polar environment in the next decade. In particular:

- We believe that China has abandoned its growth target so that it can focus on what is critical at this juncture – reducing unemployment. This gives them more flexibility to calibrate their policy responses in the context of financial stability as well as in response to the evolving US-China dynamic.
- While the fiscal response is sizeable, it is much 'softer' than it was in 2009, as it strikes a more balanced tone between consumption support and investment support. Within investment, there is a higher focus on infrastructure versus the traditional manufacturing, property and infrastructure troika, and this has implications for the magnitude of marginal follow-through demand EM commodity exporting countries can expect to see this time around.
- An exciting sub-segment within infrastructure spend is the new infrastructure plan, which has the potential to accelerate the transformation of the new economy sectors as well.
- Monetary policy is also well-calibrated and cautious this time around.

Important information

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