CHINA: Fiscal stimulus is a tactical, not strategic, shift

- China's fiscal stimulus will emphasize support for medium- and long-term growth rather than immediate jolts to household consumption and infrastructure spending.
- Fiscal stimulus will focus on supporting indebted local governments, increasing capital adequacy at big banks, digesting unsold housing inventory, and supporting consumption by disadvantaged groups.
- The leadership's shift to more forceful stimulus is a tactical adjustment rather than a strategic one; industrial policy and national security remain the top priorities.

China's pending fiscal stimulus will focus on strengthening vulnerable local governments and state-owned banks, while measures to help household consumption will play a modest supporting. That was the message from Minister of Finance Lan Foan's remarks on fiscal stimulus at an unusual weekend press conference. Lan's remarks may disappoint markets because he declined to provide a specific number for new fiscal borrowing this year, though that figure is likely to emerge when China's mini-parliament convenes later this month. Despite this lacuna, Lan provided significant new details on the structure of the pending fiscal expansion.

Stimulus outline emerges

Lan outlined four uses for the proceeds of new central government bonds, which market chatter now suggests may total RMB 3tn (USD 423bn):

1. supporting indebted local governments, especially those dealing with off-budget "hidden debt";
2. injecting capital into the six largest state-owned banks, which are suffering from shrinking margins and rising bad loans;
3. supporting the housing market by enabling local governments to purchase unsold apartments and undeveloped land from developers;
4. subsidizing consumption by "key groups" including low-income households and students.

The respective shares of new fiscal spending devoted to each these four priorities remains uncertain, but Lao's remarks suggest that the first two will take precedence. If confirmed, this prioritization may disappoint investors in China's stock market, which has surged since the central bank unveiled monetary stimulus last month. Investors believed interpreted that announcement as a signal that fiscal stimulus would soon follow, but we warned that markets showed signs of irrational exuberance. Lao's remarks confirm expectations of fiscal stimulus, but targeting fiscal spending towards local governments and bank capital will deliver a smaller boost to short-term growth than spending on infrastructure or large-scale cash handouts to households. Policymakers apparently aim to achieve this year's official GDP growth target of "around 5%" and to stabilize next year's growth at around that level, but not to trigger a big growth re-acceleration.

Debt swaps and bank re-capitalization

On local debt, the finance ministry is launching a new debt swap program that will enable local governments to swap debt owed by off-budget financing vehicles (LGFV) into on-budget municipal bonds. The central government has conducted several rounds of such swaps over the last decade. Each time, Beijing has hoped these would be one-off events, after which localities would finance fiscal spending through on-budget borrowing, while LGFVs would evolve into self-sustaining commercial entities that do not serve as *de facto* agents of fiscal policy.

The newly announced swap program acknowledges the reality that this evolution remains incomplete. Still, the swap program will serve to reduce debt repayment pressures on local governments, since the provincial bonds will carry longer maturities and lower interest rates than the original LGFV bonds and bank loans. Reduced debt pressure should in turn allow localities to boost spending on public services and infrastructure construction. As previously discussed, some cities have even struggled to pay civil servant salaries.

Similarly, recapitalizing systemically important banks is a sound policy choice for the longer term but does not maximize the boost to short-term growth. For all six of the largest commercial banks, official capital ratios appear healthy — far healthier than at many smaller, regional banks. Even so, the Big Six's official non-performing loan ratio of just 1.24% probably understates the reality, and the weak economy of the last two years will generate further defaults in the coming years.

Even assuming that the Big Six's balance sheets are as healthy as official ratios indicate, the banks have achieved this health only by adopting a highly conservative approach to lending. This conservatism has led to slower money and credit creation, which has in turn contributed slow growth and deflation. The banks' weak response to policymakers' appeals to increase lending to cash-starved housing developers is one manifestation of this conservatism. Larger capital buffers should persuade banks to take on more loan risk.

Housing and consumption

On housing, the finance ministry will let local governments use the proceeds of provincial bond sales to purchase unsold flats from developers for conversion to affordable rental housing. As previously discussed, localities have shown little interest in such purchases, because the financing available through a previously-introduced central bank loan facility is too expensive to make such rental conversions commercially viable. But interest rates on provincial bonds are similar, suggesting that the latest initiative on its own may do little to increase local governments' enthusiasm.

Consumption support appears to be the smallest of the four stimulus initiatives. Though detail is lacking, Lao emphasized that subsidies for consumption will be targeted at students and other needy groups, which suggests that Beijing will not embark on the kind of expansive cash handouts that many foreign and some Chinese economists have advocated.

Tactical not strategic

The lack of detail on numbers suggests that top leaders themselves are still deciding on the scale of fiscal stimulus both this year and next. Beyond the four initiatives described above, Lao left open the possibility of deploying unspecified additional tools. Moreover, besides an expanded fiscal deficit for this year, Lao's rhetoric strongly suggests that the deficit target for 2025 is likely to exceed this year's original target of 3% of GDP.

Despite the lack of numbers, Lao's remarks are sufficient to conclude that the top leadership's shift to more forceful stimulus is a tactical adjustment, rather than a strategic one. Recent economic data apparently showed China's growth decelerating past the invisible line beyond which social stability could be at risk. But the policy response does not indicate that industrial policy and national security have been dethroned from their top position — ahead of GDP growth — in the leadership's current hierarchy of objectives.

Client Portal >>

Gabriel Wildau
Managing Director
+1 (347) 714-4962
gabriel.wildau@teneo.com