Economic Watch

China | Is China's expansionary fiscal policy sustainable?

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Expansionary fiscal policy is to be deployed in support of growth in 2022

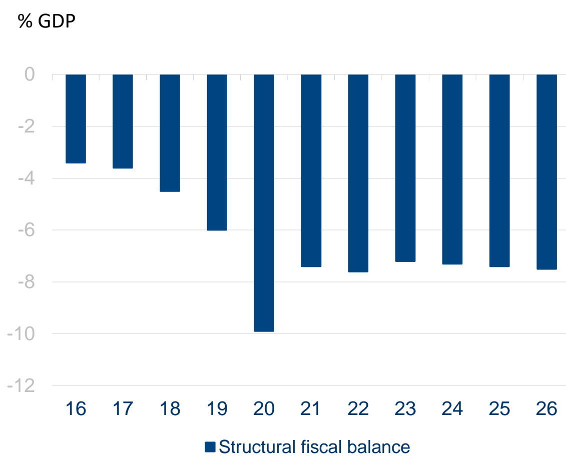
The recent growth slowdown of Chinese economy has prompted Chinese authorities to unveil easing monetary and fiscal measures, so as to bring the economy to the right track. After the GDP growth peaked in Q1 2021, the economy has entered into a downward trend as the authorities took advantage of the time window of "first-in, first-out" of the pandemic to press ahead a series of regulatory tightening measures in various sectors and to promote "common prosperity" in the past year.

A number of growth headwinds weigh on the 2022 growth outlook, including a gradual normalization of exports growth, the fast-rising default risk of large real estate companies and crackdown on the housing sector, and the "zero tolerance" strategy of Covid-19 that dragged on consumption and local government fiscal balance. Indeed, growth slowed to 4% in Q4 2021 from 4.9% y/y in Q3 and is expected to further dip to 5.2% in 2022 from 8.1% in 2021. With the awareness of growth slowdown, the authorities have already reversed their previous tightening policy stance to a more loosening one at end-2021.

Among all the policy tools to be deployed by Chinese authorities, proactive fiscal policy might be more effective to heal the economy compared with the easing monetary policy in 2022. Here are two important reasons: First, China's monetary easing room is limited given that the US FED has already started the QE Tapering while interest rate hike and central bank balance sheet reduction will be conducted by FED soon. In order to circumvent large scale capital outflow and sharp RMB exchange rate depreciation, the unsynchronized and independent easing monetary policy is expected to be halted after the US interest rate hike starts in the coming March. Second, the monetary policy transmission mechanism is not smoothly-going in China. Although the central bank cut RRR and LPR twice recently, commercial banks have been still reluctant to lend to enterprises particularly SMEs during the economic downturn. That means, banks' role of financial intermediation has been significantly weakened due to the deteriorated market sentiments.

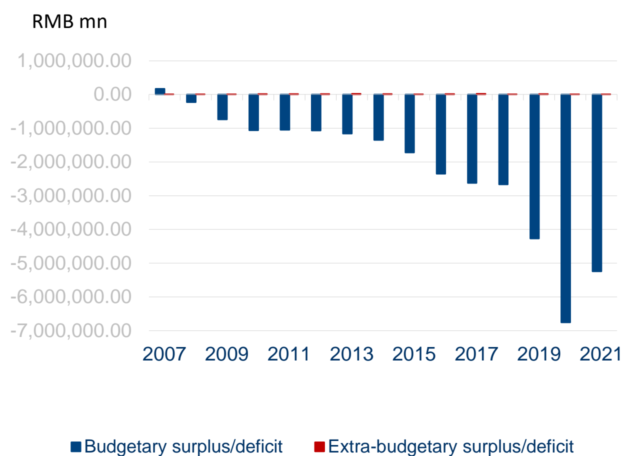
Based on the above reasons, proactive fiscal measures will play a leading role in this round of stimulus in 2022 while monetary policy coordinates to make sure the market interest rate will not be too high when the government conducts a large-scale government bond issuance. Figure 1 shows the authorities have always adopted expansionary fiscal policy during economic slowdown historically. (Figure 1 and 2) Although the details of fiscal stimulus will not be promulgated until the "Two Sessions" in March 2022, based on the policy directions announced in the Central Economic Work Conference, we anticipate the 2022 fiscal stimulus package will include the following elements:

Figure 1. **THE AUTHORITIES HAVE CONDUCTED EXPANSIONARY FISCAL EASING DURING ECONOMIC SLOWDOWN (AFTER 2022: ESTIMATED BY IMF)**



Source: IMF Article IV –China

Figure 2. **THE EXTRA-BUDGET, ALTHOUGH SMALL IN SCALE, CONTRIBUTES FISCAL SURPLUS IN THE PAST YEARS**



Source: BBVA Research and CEIC

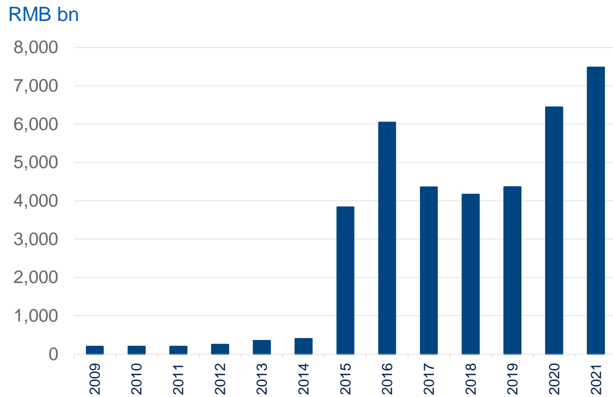
(i) To maintain the budget fiscal deficit to GDP ratio by at least 3.2%, although the ratio is in line with 2021's budget, it will be around RMB 360 billion increasing from 2021 due to the aggregate GDP expansion; on the other hand, the augmented fiscal balance (including both general public budget and the budget of central government-managed funds) is anticipated to increase to 5.8% of GDP, higher than 5.2% in 2021;

(ii) The authorities will continue to emphasize the efficiency and quality of the fiscal funds allocation to support green economy, technology advancement, SMEs, regional strategic infrastructure projects and social welfare etc.;

(iii) To increase tax cut and fee reduction with the scale to around RMB 1.5 trillion (larger than RMB 1.1 trillion in 2021);

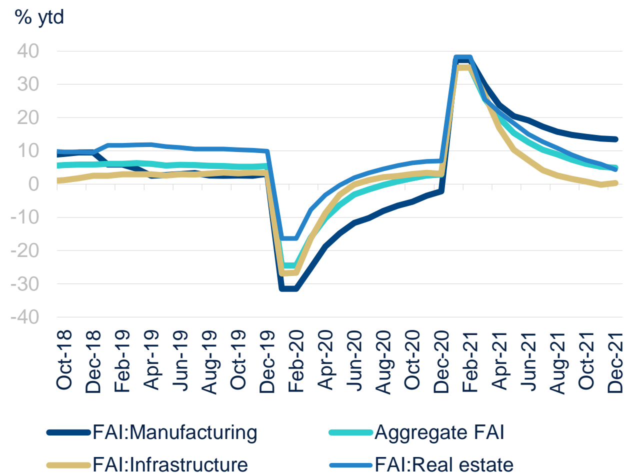
(iv) To expand local government special bond issuance to at least RMB 3.65 trillion to support infrastructure investment and to particularly accelerate the bond issuance in 1H 2022; among which, RMB 1.46 trillion of local government bond quota has already been released in Q4 2021 to deal with growth slowdown and infrastructure investment slump. (Figure 3 and 4)

Figure 3. **RMB 1.46 TRN LOCAL GOVERNMENT BOND ISSUANCE QUOTA OF 2022 HAS BEEN PRE-ALLOCATED IN Q4 2021… (NEW ISSUANCE)**



Source: CEIC and BBVA Research

Figure 4. **…TO DEAL WITH A SHARP DECLINE OF INFRASTRUCTURE INVESTMENT AND GROWTH SLOWDOWN**

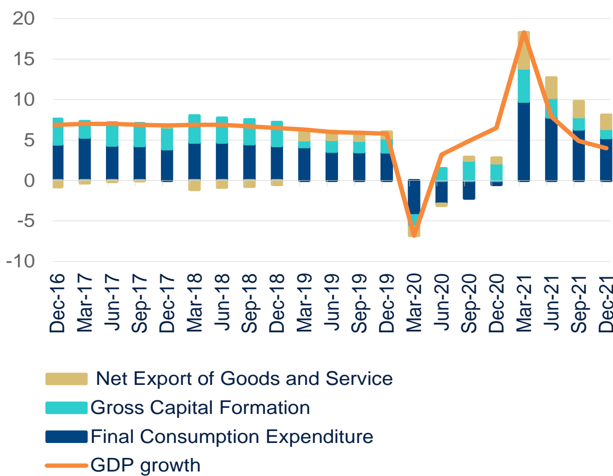


Source: BBVA Research and CEIC

However, a sliding fiscal revenue amid growth deceleration adds to the concerns of government debt sustainability

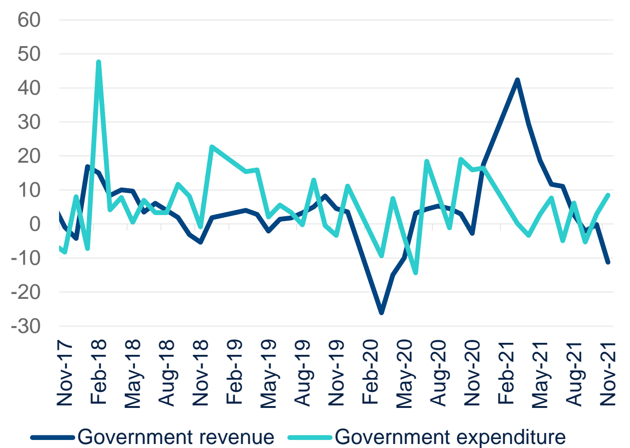
The market worries about China's fiscal sustainability due to the economic slowdown in the short term particularly the past year, as well as the local government debt overhang, decelerating potential growth and aging population in the long run.

Figure 3. **CHINESE ECONOMIC GROWTH TURNED TO A DECELERATION TREND AFTER ITS PEACK IN Q1 2021**



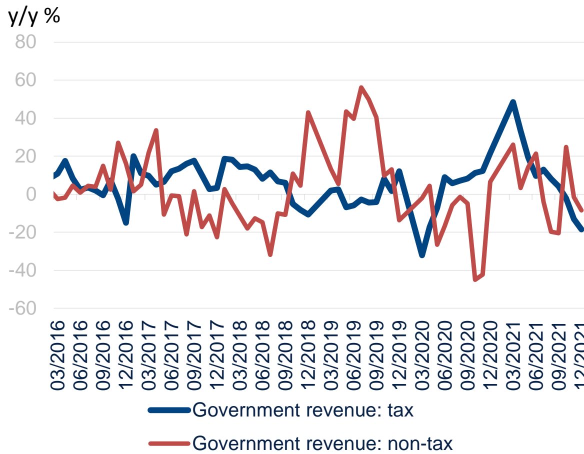
Source: CEIC and BBVA Research

Figure 4. **FISCAL REVENUE DECELERATED SIGNIFICANTLY SINCE Q1 2021, WHILE FISCAL EXPENDITURE INCREASED**



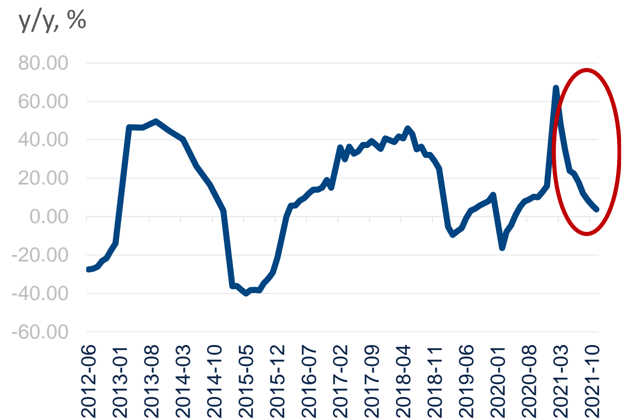
Source: BBVA Research and CEIC

Figure 5. **BOTH TAX REVENUE AND NON-TAX REVENUE DECLINED RECENTLY**



Source: CEIC and BBVA Research

Figure 6. **LAND SALES REVENUE WHICH IS CRUTIAL TO LOCAL GOVERNMENT INCOME DECLINED SIGNIFICANTLY**

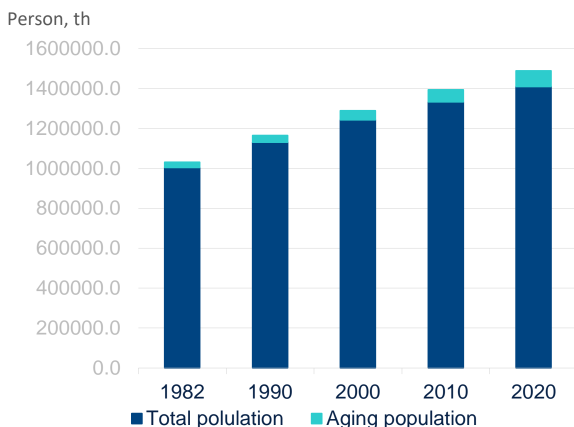


Source: BBVA Research and CEIC

In the short term, two factors have staggeringly dragged on fiscal revenue: a fast deceleration of land sales revenue due to the real estate market crackdown and the "zero tolerance" strategy towards the pandemic, such as repeatedly universal Covid-19 tests, which have given a lot of fiscal burden to local governments.

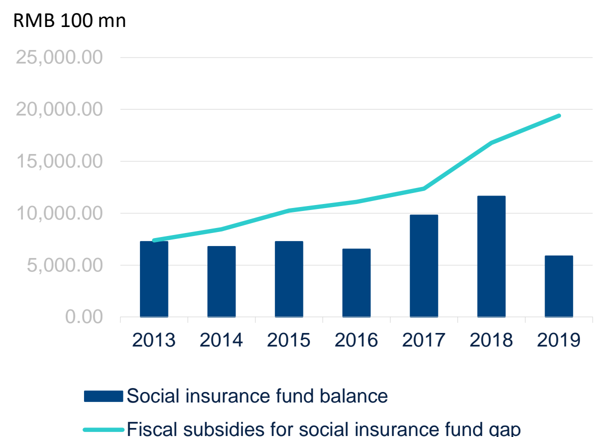
In particular, at the local government level, the land sales revenue which takes a large proportion of local government fund income, dropped to 3.8% y/y in December 2021, a sharp decreasing compared with 67.1% growth in Jan-Feb 2021. On top of that, the recent economic slowdown naturally added more pressure on fiscal revenue in terms of tax revenue and non-tax revenue. (Figure 3 to 6)

Figure 7. **CHINA'S AGING PROBLEM WILL ALSO ADD A LOT OF BURDENS ON FISCAL BUDGET IN LONG-RUN**



Source: CEIC and BBVA Research

Figure 8. **FISCAL SUBSIDIES FOR SOCIAL INSURANCE FUND INCOME-EXPENDITURE GAP HAS BEEN RISING OVER TIME**



Source: BBVA Research and CEIC

The long-term issue, such as aging problem, will also give a lot of burdens on social insurance expenditure etc. Actually, the social insurance income-expenditure gap has been expanding with the aging population in the past decade. (Figure 7 and 8) Thus, fiscal subsidies for the social insurance fund have been continuously rising over time to fill in the gap.

Fortunately, China's government debt level is still manageable

Based on the above short-term and long-term factors that are deteriorating Chinese government's balance sheet, the market has sufficient reasons to concern about China's fiscal balance and debt sustainability. To answer this question, we need to first of all divide the fiscal debt issue into two parts: central government debt and local government debt.

At least, what we could comfort the market is that at the central government level, the fiscal balance remains healthy and sustainable compared with international counterparts. Figure 10 pointed out that among the main advanced and emerging economies, China's general government debt to GDP ratio stands at around 68% which is much lower than that of Japan (254.13%), US (133.92%), UK (104.47%) and Spain (119.92%) etc. Among all the debt categories of macro leverage in China, such as household debt, government debt and corporate debt etc., central government debt should be of the least concern in China. (Figure 9)

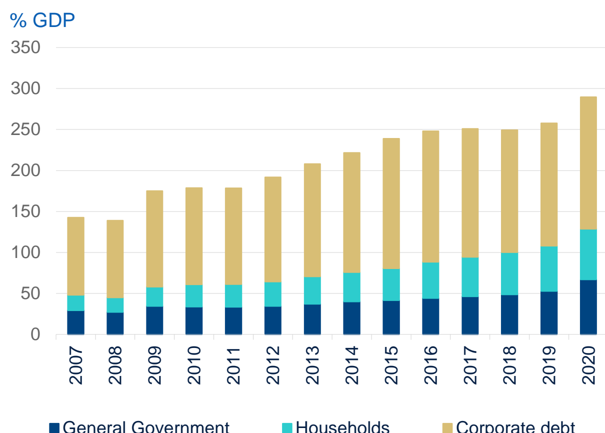
Several other recent debt indicators also suggest China's fiscal balance and debt level remains comparatively sustainable. For instance, in 2021, China's macro leverage ratio (total debt/GDP) was 272.5%, declined by 7.7% of that of 2020, and the quarterly macro leverage ratio has been declined for five sequential quarters. In addition, the 2020 central government debt stood at RMB 20.89 trillion, plus local government debt at RMB 25.66 trillion, the combination of which to GDP ratio was 45.8%, still lower than the international warning line of 60%. Moreover, the budget fiscal deficit of 2021 stood at 3.2%, lowered by 0.4% from that of 2020 while the budget local government bond issuance also declined from RMB 3.75 trillion to RMB 3.65 trillion in 2021.

On the other hand, even when we peer into the long-lasting local government debt overhang problem, it has also been eased after the authorities' arduous measures to crackdown on local government financial vehicles (LGFV) and PPP (public-and-private partnership) as well as to wipe out implicit local government debt in the past years since 2017.

The authorities' efforts to solve the local government debt overhang problem focused on moving LGFV financing, PPP (public-and-private partnership) and related shadow banking activities to a more explicit way, either by explicit local government bond or central government bond issuance. Obviously, the characters of infrastructure investment projects are long-tenor and low-return (the features of public goods), the government bond could also match these characters. However, if financing local government deficit mainly through LGFV or PPP which are ultimately financed by commercial bank loans, there are obvious mismatch problems of high-interest rate and short-tenor of commercial banks' loan to long-tenor and low-return, thus ballooning the accumulative local government debt by rolling over the existing debts continuously. In addition, the authorities also took efforts by pressing ahead the local government debt swap and restructure.

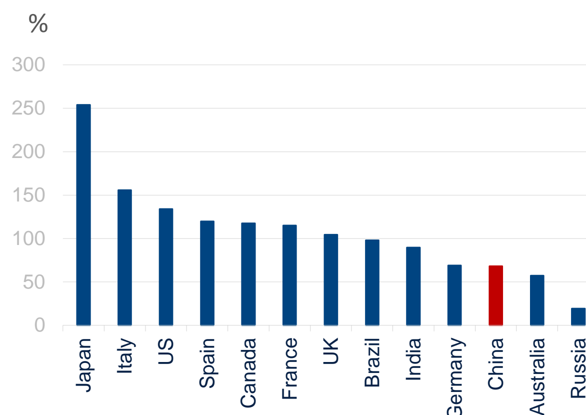
The above efforts bear some early fruits. The estimated local government debt has been significantly slowed to RMB 28.47 trillion till August 2021(based on the estimation of Ministry of Finance China Government Debt Research Center), almost half of its peak at RMB 40-50 trillion in 2017. (More details of local government debt estimation could be found in our previous China Economic Watch | Peering into the local government debt: rising risks call for prompt actions)

Figure 9. **AMONG THE CATEGORIES OF MACRO LEVERAGE, CHINA'S CENTRAL GOVERNMENT DEBT IS OF THE LEAST CONCERN**



Source: CEIC and BBVA Research

Figure 10. **INTERNATIONAL COMPARISON OF GENERAL GOVERNMENT DEBT TO GDP RATIO**



Source: BBVA Research and IMF data

How to finance fiscal deficit? Issuing central government treasury bond is the key

Given that China's central government debt level has been sustainable and comparatively healthy, financing the fiscal deficit by means of conventional measures such as by issuing central government bond in the secondary market still has lot of room. More importantly, taking the lesson from RMB 4 trillion stimulus package in the aftermath of 2008-2009 Global Financial Crisis which created a long-lasting local government debt overhang problem, China should finance the fiscal deficit more through central government bond instead of local government financial vehicles (LGFV).

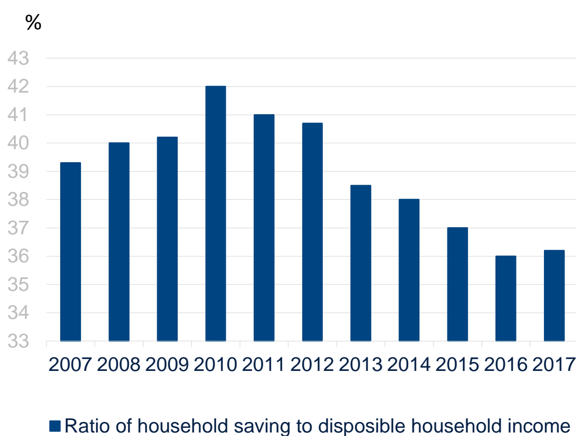
There are abundant reasons indicating China has lot of room to finance fiscal deficit through central government bond issuance. First, Chinese household deposit savings are very high compared with that of other countries. However, the underdeveloped financial market in China with limited investment choices forced households to put their savings in the bank deposit and housing market, which is the so-called financial depression. Thus, issuing central government treasury bond will largely diversify their investment channels. (Figure 11 and 12)

Second, the ratio of China's central government debt to total government debt is very low, making the room for central government bond issuance. (Figure 13) Actually, in China, the demand of government bond in various tenors and durations is strong due to its higher interest payment compared with deposit rate. (Figure 14) Thus, financing the deficit through issuing government bond is equivalent to transfer the bank deposit to the government bond market, which could diversity households' investment choices and more importantly help to complete and smooth the government bond yield curve formation.

Third, monetary policy could coordinate expansionary fiscal policy by lowering the cost of sovereign bond issuance through cutting interest rate. People may doubt that issuing government bond will unavoidably raise the sovereign bond interest rate and transmitting to interest rates in the whole financial markets thus will hit the economy. Given that China still has room to reduce LPR by the PBoC as China's benchmark interest rate remains much higher than that in advanced economies, the monetary policy should coordinate fiscal expansion by means of interest rate cut.

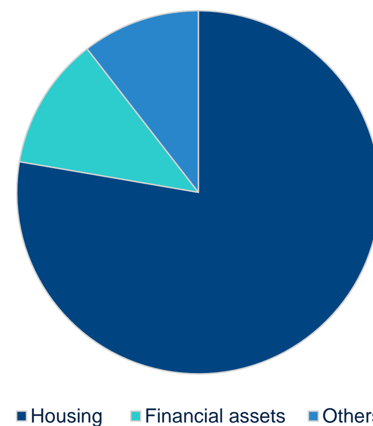
Last but not least, issuing government bond by various tenors and durations could attract international investors in Chinese onshore bond market and press ahead capital account opening reform and RMB internationalization. After all, amid global liquidity flooding and zero interest rate in advanced economies (although interest rate hike is coming soon), Chinese bond yield, with its absolutely higher yield than that of advanced economies (due to higher potential growth) and less sovereign risk, attracts global portfolio managers to invest. The foreign investors' share of Chinese aggregate bond market only accounts around 3% at the current stage, which is very low compared with 28% in the US, 14% in Japan, and 9% in Brazil etc. That means, there will be plenty of room to attract capital inflow to domestic bond market going forward.

Figure 11. **CHINESE HOUSEHOLD SAVINGS ARE HIGH COMPARED WITH OTHER COUNTRIES**



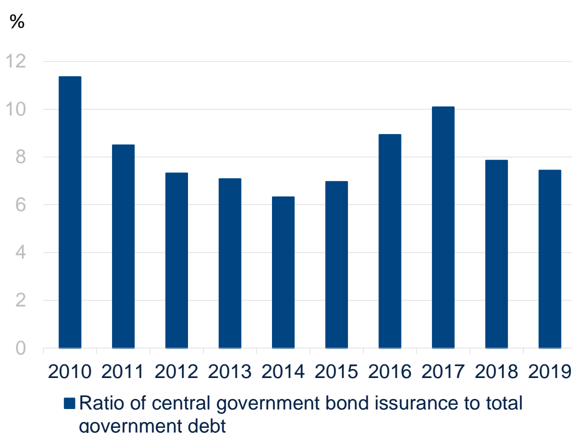
Source: CEIC and BBVA Research

Figure 12. **MOST OF CHINESE HOUSEHOLD SAVINGS ARE IN THE FORMS OF BANK DEPOSIT AND REAL ESTATE**



Source: BBVA Research and Southeast University of Finance and Economics, Survey and Research Center for China Household Finance

Figure 13. **RATIO OF CENTRAL GOVERNMENT BOND ISSUANCE TO TOTAL PUBLIC DEBT REMAINED LOW, BELOW 10% FOR MOST OF TIME**



Source: CEIC and BBVA Research

Figure 14. **TREASURY BOND YIELD HAS BEEN HIGHER THAN DEPOSIT RATE MOST OF THE TIME, DIVERSIFYING HOUSEHOULD ASSET ALLOCATION**

Source: BBVA Research and CEIC

The thrust of proactive fiscal spending: New infrastructure or Old infrastructure?

After discussing China's government debt sustainability and financing issue, the final topic of fiscal policy expansion in 2022 is how to allocate fiscal resources to different kinds of infrastructure projects. After all, infrastructure investment through fiscal support has always been the pillar to smooth business cycle in the past decades, particularly in the 1998 Asian Financial Crisis and 2008-2009 Global Financial Crisis.

However, due to the authorities' over-normalized fiscal policy back to 2021 taking advantage of China's "first-in, first-out" of the pandemic when other countries were grappling with the virus, China's infrastructure investment dipped to historical low at 0.3% y/y in December 2021, compared with 3.3% y/y in the pre-pandemic in December 2019. (Figure 2) Although the authorities have already conducted expansionary fiscal measures in Q4 2021 and pre-allocated RMB 1.46 trillion local government bond issuance quota at end-2021, the infrastructure investment remains lackluster due to the lack of profound infrastructure investment projects.

We normally categorize China's infrastructure investment into "new infrastructure" and "old infrastructure". Old infrastructure means traditional investment in airplane, high-speed road, train trail, public facilities etc. while new infrastructure includes "ABCDG", namely AI, Blockchain, Cloud computing, Big data and 5G etc. Although the New Infrastructure investment will have a long-term positive spill-over effect to the economy and support China's technology advancement, its total scale, at least at the current stage, remains much lower than the Old Infrastructure investment. For instance, in 2021, the scale of new infrastructure investment reached RMB 1.16 trillion, only around 7.7% of total infrastructure investment. Although this ratio is expected to rise over time, it could not wobble the role of the old infrastructure to stimulate the growth.

Given that the scale of new infrastructure investment cannot compensate the old infrastructure investment slowdown, fiscal expansion in 2022 needs to synergize both old and new infrastructure investment. That means, in order to stimulate growth, we cannot abandon old infrastructure investment and only prioritize the new infrastructure of green economy and technology advancement etc. After all, "new infrastructure" such as infrastructure of digitalization, AI and big data etc. could significantly increase efficiency of "old infrastructure".

Conclusion and policy suggestions

The ongoing economic slowdown calls for expansionary fiscal policy to play a leading role in 2022, given that the transmission mechanism of China's easing monetary policy to the real economy is not smoothly going. We anticipate the 2022 fiscal stimulus package will include not only increasing general government deficit and local government bond issuance quota, but also the tax cut and fee reduction; meanwhile, efficiency and quality of the fiscal funds allocation will be emphasized.

The recent economic slowdown and housing market crackdown have indeed sharply reduced the fiscal revenue, however, we should not worry too much about China's debt sustainability issue, at least at the central government level. On the other hand, local government debt situation has also improved since the authorities' crackdown on LGFV and shadow banking in 2017. Thus, China still has a lot of room to take use of traditional methods to finance its fiscal deficit through issuing central government treasury bond going forward, given China's high household deposit savings and limited investment choices. Moreover, issuing government bond by various tenors and durations could attract international investors in Chinese onshore bond market and press ahead capital account opening reform and RMB internationalization.

Look ahead, the authorities need to take the methodical steps to finance their fiscal stimulus package via expanding central government bond issuance while control the public debt level and maintain financial stability over the longer term. Here are some policy suggestions:

First, the authorities should enhance the degree of transparency in the government fiscal deficit particularly at the local government level. This will alleviate the problem of the soft budget constraint for local government financing and put the local government debt under public surveillance. In addition, it will help to reduce the systematic financial market risk. Actually, the authorities pushed forward the deleveraging for LGFVs in the past several years and have born some early fruits. However, the ballooning fiscal deficit for the counter-cyclical stimulus measures might raise the LGFV borrowing and other forms of local government debt issuance. Thus, controlling the implicit debt at the local government level still constitute a key challenge to the authorities.

Second, more fiscal transfer from the central government to local government should be conducted so as to reduce the burden of local government. Amid the global economic recession, increasing the ratio of central government fiscal deficit to total public debt could make the fiscal stimulus more targeted and more coordinated at the central government level. Local governments might have less incentive to implement relief measures in support of the COVID-19 affected enterprises and households. Instead, they are more willing to put the money in certain investment projects to pursue high local GDP growth as the officials' promotion is always linked with GDP.

Third, the Ministry of Finance should consider increasing the supply of short-term Treasury bonds such as one-year term or even shorter, which will help to cater to the diversified demands of households, enterprises and commercial banks. Moreover, the provision of treasury bonds with various tenors will contribute to completing the yield curve in the secondary bond market.

Fourth, from the perspective of special local government bonds, how to match these bonds with projects with reasonable return is the key to make the local government debt sustainable in the future. The main reason leading to local government debt accumulation and continuous roll-over is that the local government debt always matched these bonds with low-return and long-term infrastructure projects. That means, without profitable projects, these local government special bonds will unavoidably become the long-term fiscal burden of local governments. In addition, the local government cannot only prioritize "new infrastructure" and ignore "old infrastructure", thus synergizing both should be the key.

Finally, the authorities need to increase the SOEs' profit submission to the central to fill in the fiscal gap. Under China's system, SOEs are entitled to retaining the majority of their earnings even those profits stem from their actual monopolization in their respective sectors. Moreover, Chinese SOEs have easier access to external financing resources and government subsidies. Thus, it is the social responsibility of SOEs to support fiscal revenue amid growth slowdown. We believe that the proportion of profit submission could be increased to a higher level to offset the current shortfall of fiscal revenues.

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