China reaches for a fiscal solution

The policy levers that Beijing will pull to lift growth this year are becoming clearer.

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Key takeaways

- This week's Central Commission for Financial and Economic Affairs meeting, chaired by Xi Jinping, confirmed officials' plans to boost infrastructure construction.
- However, if officials are serious about undertaking an infrastructure stimulus, they will have to provide more generous fiscal funding than they have so far budgeted for this year.
- This year's issuance quota for special-purpose bonds – the primary source of fiscal funds for infrastructure projects – was left at 2021 levels.
- Furthermore, a plunge in land sales revenue risks leaving a hole in this year's budget. Local officials may need to tap into unused funds from bonds issued last year to fix this, rather than using this surplus money to finance infrastructure investment.
- This leaves open the possibility that this year's fiscal budget may be adjusted part way through 2022 to make it more generous. Another option is that officials increase non-fiscal sources of financing for infrastructure projects. We think that the quickest and easiest source of funds will be an increase in policy bank lending, underwritten by collateralized loans to these institutions from the central bank.
- Investors should not get too excited, however. This is not going to be a repeat of 2008's infrastructure stimulus.
- Unlike then, an increase in infrastructure spending is not part of a broader stimulus package. Instead, more infrastructure construction will be used to offset the drag on the economy from a still weak real estate industry and a crisis-hit retail sector.
- The intended result is a stabilization of growth, not a boom.

Things are getting interesting.

Tuesday's meeting of the Central Commission for Financial and Economic Affairs (CCFEA), chaired by Xi Jinping, was the strongest signal that stimulus is in the cards, and the CCFEA indicated that the main channel for this will be an increase in infrastructure construction.

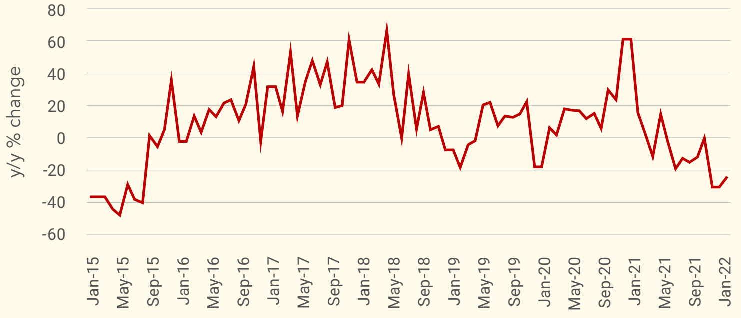
There had been hints of this before. At the end of last year, local governments were told to bring forward infrastructure spending in 2022. On April 20, the China Banking and Insurance Regulatory Commission (CBIRC) and Ministry of Transport (MOT) jointly issued a notice encouraging banks and insurance companies to support highway construction. This notice was the first explicit confirmation that officials are looking to infrastructure to boost economic growth. The meeting laid out a laundry list of investment priorities for local officials to focus on, saying that existing infrastructure in a number of sectors was still inadequate.

The problem, however, is that the fiscal budgets that China has set for this year do not give officials much scope to ramp up infrastructure spending in a serious way. Local government special-purpose bonds (SPBs) are the main source of fiscal funds for infrastructure projects. However, the issuance quota for this year was set at the same level as last year: RMB 3.65 trillion. RMB 1.25 trillion of these bonds were issued in 1Q, more than forty times higher than the same period last year. But this means that issuance over the rest of the year is going to be down sharply from 2021. Local governments have RMB 2.4 trillion of SPBs left to issue in the final nine months of this year, compared with RMB 3.6 trillion in bonds issued April-December 2021.

This year's figure will be padded out by the RMB 1.2 trillion of SPBs that were issued last year but remain unspent. However, assuming that the money left over from last year has still not been spent, this means that the amount of funding available from SPBs out to December is going to be flat y/y.

Moreover, it increasingly looks like some of these funds will have to be used to plug a growing hole in this year's fiscal budget. SPBs are used to fund the deficit in the government-managed funds budget. However, fiscal revenue in this budget fell sharply in 1Q, plunging 25.6% y/y, mainly due to a 27.4% y/y fall in local governments' fiscal receipts from land sales [FIG 1]. The government has budgeted for a 0.2% y/y increase in fiscal revenue in this fund in 2022, meaning that there will be a financing shortfall unless there is a recovery in land sales. The SPBs funds left over from last year are the obvious solution to this. This, however, is going to further reduce the money available to finance infrastructure investment.

Fig. 1 - Local government revenue from land sales



Funding options

If China is serious about lifting economic growth via an infrastructure stimulus, officials will have to solve this funding bottleneck.

One potential solution is that officials adjust the fiscal budget for the year – particularly the issuance quota for SPBs. There is some precedence for this. In both 1998 and 1999, the budget for the year was altered in August to release more funds. The mechanism for such an adjustment is fairly simple: the Ministry of Finance, on behalf of the State Council, will need to get approval from the Standing Committee of the National People's Congress at one of its bi-monthly sessions.

Another option is that officials look to increase non-fiscal sources of funding for infrastructure projects. Among the 23 economic support measures that the PBOC announced April 18 was a call to broaden the channels of infrastructure financing:

> ***"Policy banks should step up financing support for major investment projects, and all banks should proactively seek out projects, including those focused on 'new infrastructure', such as data centers. Banks should also buy government bonds to support front-loaded infrastructure investments, and meet the reasonable needs of local government financing vehicles".***

The CCFEA meeting also called for officials to "guide private capital into the operation of municipal utilities."

We think that a relaxation of the regulations governing the off-balance-sheet debt that local governments accumulate via local government financing vehicles is unlikely. More probable is a scale-up of efforts to attract private capital into the infrastructure sector, particularly via infrastructure real estate investment trusts (REITs). The government is looking to expand the pilot program for these securities that it launched in June 2021 to cover a broader range of projects.

However, we think that the most likely avenue for infrastructure stimulus funding is policy bank lending. The advantage of this source of financing is that Beijing can ensure that projects get built relatively cheaply in the regions most in need of an economic boost. In contrast, investors demand a premium for SPBs issued by provinces with weak economies, and private investors tend to want to steer clear of these struggling regions.

The other advantage is that there is already a mechanism in place for the central bank to get funds quickly to policy banks: The pledged supplementary lending (PSL) facility. Under the PSL facility, the central bank makes collateralized loans to policy banks (China Development Bank, Export-Import Bank of China, and Agricultural Development Bank of China) exclusively to fund central government priorities. The PSL facility was used successfully to reverse the real estate downturn in 2015 and 2016, with the central bank financing loans via the policy banks to local governments for slum redevelopment.

Will it be enough?

Even if officials can get funding in place to finance an increase in infrastructure construction, the question still is will it be enough to boost overall economic growth?

Infrastructure investment is, in fact, already growing at a reasonable pace. It increased 11.8% y/y in March, up from 0.2% y/y growth in 2021 [FIG 2]. This increase, however, has not been enough to compensate for the fall in real estate construction to lift overall construction activity. Growth in value-added output in the construction sector was just 1.4% y/y in real terms in 1Q22. Output of building materials also remains very weak, with steel production down 6.4% y/y in March and cement 5.6% y/y [FIG 3].

Fig. 2 - Infrastructure FAI

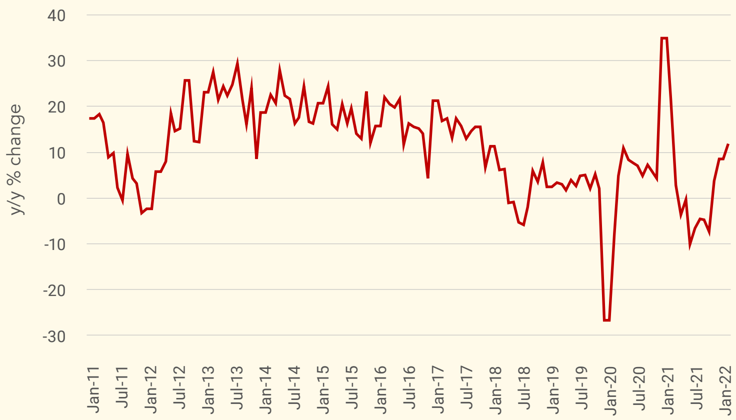
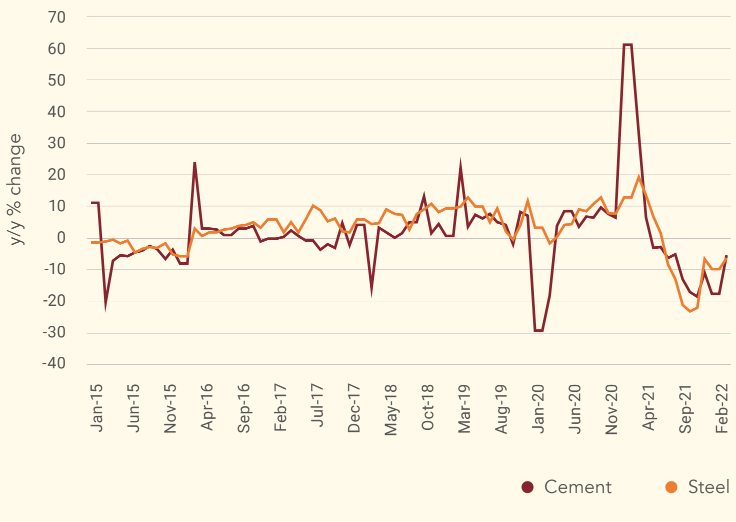


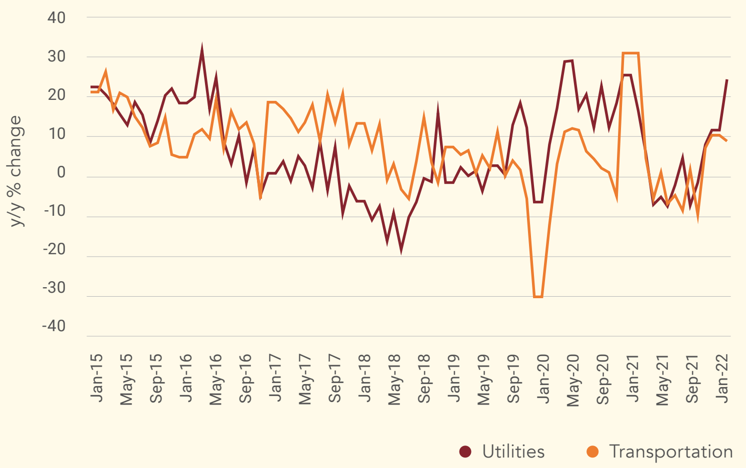
Fig. 3 - Output of cement and steel



Even if infrastructure investment growth accelerates further in 2Q, the impact on the overall economy is going to be mitigated by the fact that, as well as the continued weakness in real estate construction, China is now also seeing a collapse in retail sales due to lockdowns, as well as weaker manufacturing activity because of COVID-19 related supply chain disruptions.

The other question around how much support to economic growth an increase in infrastructure spending will provide is where this investment will be channeled. The uptick in infrastructure fixed-asset investment in the first quarter of this year was focused mainly on utilities rather than transportation investment, the latter of which generates more of an immediate boost to growth by lifting construction activity and raising demand for building materials [FIG 4].

Fig. 4 - FAI in utilities vs transportation infrastructure



The CCFEA meeting also framed the drive to increase infrastructure investment in terms of structural policy concerns like national security and Common Prosperity, with officials stressing the need for more investment in areas like AI, cloud computing, and fiber optic internet access, as well as in traditional destinations like transportation. These other sectors will yield long-term productivity benefits for China but are less impactful in the short term.

The upshot is that investors should not get too excited. This is no repeat of 2008's infrastructure stimulus. Unlike then, this is not part of a broader stimulus package. Instead, an increase in infrastructure construction will be used to offset the drag on the economy from a still weak real estate industry and the fall in consumer spending. An increase in infrastructure investment will help put a floor under the current slide in growth, but it will not trigger the kind of stimulus-fuelled boom that China has seen in the past.