July 4, 2022
No. 114

China's coming Q3 infrastructure investment surge

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For months now, we've been highlighting the disconnect between China's punchy high-level economic goals in 2022 – namely the ambitious "around 5.5%" GDP growth target – and the relatively weak direct policy support that officials have pushed through.

- That disconnect still exists, in our view – with a range of government-linked domestic economists increasingly acknowledging that the best-case economic growth scenario for China this year is closer to the 4.5% range.

Still, over the past few weeks, officials have finally begun to put more oomph into the policy push. Specifically, they've primed the infrastructure investment pump via record issuance of local government special-purpose bonds (SPBs) in June and chipped in another chunk of financing for infrastructure projects through the policy banks.

As we outline below, these efforts are starting to add up, setting the stage for a major surge in infrastructure spending in July and August.

- What's more, as officials assess the impact of that spending over the next couple of months, they could add further policy firepower by issuing another RMB 1 trillion or so of special treasury bonds.

So something akin to stimulus is finally starting to roll through China's economy. Importantly, though, this stimulus is markedly different from past rounds of pump-priming for two reasons.

- First, it is being financed primarily through on-budget bond financing rather than bank lending – leaving the impetus on local governments to find the right projects to spend on.
- Secondly, it is taking place even as officials keep a tight leash on the property market – maintaining their pledge that they will not use the property sector as a lever to boost short-term growth.

This all leaves the efficacy of the coming infrastructure spending surge in doubt.

- Given these uncertainties, it will be essential for investors to monitor the speed and smoothness with which China's local governments can deploy infrastructure funds over the next two months, in particular.

While it's almost a given that H2 2022 will see much higher growth than H1 2022 in China, the speed and scale of the recovery will be critically important for global asset prices.

- If the best-case scenario comes to fruition, China may again help buoy global economic growth at a precarious time for many major developed economies.
- But if the infrastructure push undershoots, China's upstream producers will face a sudden need to destock – which could make the country a global disinflationary force far earlier than many investors expect.

Gimme that stimmy

In the coming two or three months, officials are set to unleash a major infrastructure stimulus – which will likely end up in the range of RMB 2.55-2.75 trillion.

- This sum equals about USD 380-410 billion – or 2.2-2.4% of Chinese GDP.

The funds will primarily come from local government bonds, which have seen accelerated issuance throughout June.

- In late May, State Council officials ordered local governments to issue the entire RMB 3.65 trillion annual quota of SPBs by the end of June – and to deploy the capital by the end of August.
- This requirement came after significantly curtailed SPB issuance throughout April and May. Both months saw just about RMB 200 billion worth of SPB issuance, with the weak figures thanks primarily to COVID-related shutdowns. This left total SPB issuance for the year standing at just RMB 1.85 trillion as of May 27, up from RMB 1.65 trillion at the end of April.
- As of the end of June, however, total SPB issuance stood at RMB 3.4 trillion – or 93% of the annual quota.
- As such, from end-April to end-June, local governments issued RMB 1.75 trillion in new SPBs – which senior officials require be put to work on infrastructure projects by the end of August.

In addition, we think it's likely that the majority – or perhaps even all – of the RMB 200 billion in SPBs issued throughout April remains undeployed, as well, taking the total potential SPB spend over the next two months up to RMB 1.95 trillion.

Moreover, in May, the State Council also announced that RMB 800 billion in fresh lending will be made available through the policy banks.

- In late June, the State Council said that RMB 300 billion of that lending will be financed through financial bonds issued by the policy banks – and we suspect the other RMB 500 billion will be financed via the central bank's pledged supplementary lending facility

Putting this all together, then, we assess that there is up to RMB 2.75 trillion – RMB 1.95 trillion in unspent SPB funds and RMB 800 billion in policy bank lending – that could be deployed into infrastructure projects in July and August – boosting the economy ahead of the 20th Party Congress in the fall.

Where will the money go?

Central and local officials have outlined several priority spending areas in the coming months. The State Council's most recently highlighted areas of focus include:

- Water conservancy (including water diversion, flood control, irrigation, and reservoir repair projects)
- City infrastructure upgrades (like pipeline networks)
- Industrial park construction
- Renewed focus on shanty town redevelopment

The central government is also pushing for projects that would entail significant amounts of new jobs – to help alleviate severe employment pressures – though they have not specified which infrastructure projects are most likely to be jobs-heavy.

More generally, the macro planner and 11 other ministries released a list of preferred spending areas back in February, which included:

- Promoting the development of offshore wind power in coastal provinces
- Upgrading large coal-fired power plants
- Kicking off energy-saving and carbon reduction projects in steel, non-ferrous metals, building materials, and petrochemicals
- Promoting the refurbishment of old ships
- Guiding telecom operators to accelerate 5G construction
- Promoting projects that use China's Beidou satellite network
- Accelerating the construction of national-level data hubs
- Supporting investment in the domestic production of iron ore and copper
- Promoting the utilization of scrap steel and non-ferrous metals, waste paper, and other renewable resources
- Speeding up planning and approvals for solar, wind, energy-saving, and carbon reduction projects

While the above list includes some items that fall somewhat outside the infrastructure remit, it will likely act as a general guide for local officials looking to get considerable spending out the door in a very short period.

Some important caveats

While the overall size of the potential Q3 stimulus out of China is significant – at close to 2% of GDP – there are some more qualitative concerns about local governments' ability to deploy this cash in a timely fashion.

These factors may undercut the impact of the stimulus push on economic growth in H2 2022 and, therefore, the trajectory and speed of recovery.

Recall that key domestic economists are projecting H2 growth of around 6.7% as the best-case scenario.

- Importantly, such a scenario would require the full and almost flawless execution of the coming stimulus funded over the past two months.
- And that's not to mention the potential for another wave of COVID outbreaks roiling China, disrupting infrastructure construction and logistics in multiple regions – something that we consider to be of fairly high probability.

The first issue that could undercut the smooth execution of the stimulus plan is a lack of shovel-ready projects. This has been a challenge for over a year and was a key reason that the RMB 3.65 trillion quota of SPBs for 2021 was not fully issued – local governments just didn't have enough good projects to spend the money on.

We assess that this is still a significant challenge for local governments – who often prefer to spend SPB money on projects with quick returns, like shantytown redevelopment, as opposed to those that the central government currently prefers, like water conservancy.

- That said, it appears that the central government has relaxed standards for SPBs to some extent – which may lead to some wasteful spending but should nonetheless help get money out the door faster than would otherwise be the case.

The RMB 800 billion allotted for infrastructure loans through the policy banks faces the same dilemma – with policy bank officials publicly pointing out how difficult it will be to get this money lent, especially at a time of weak loan demand.

- What's more, policy banks are even more constrained than local governments in the types of projects they can fund – and must remain firmly in line with stated government spending priorities.
- Additionally, policymakers have constrained borrowing by off-book local government financing vehicles (LGFVs), which have traditionally been major borrowers from the policy banks – so it's unclear who the policy banks will look to lend to.

On top of these concerns, many local governments remain cash-strapped due to the weak economy and lack of revenue from depressed land sales. As such, some of the SPB money will likely be (illegally) diverted to finance bread-and-butter local government expenditures – such as salaries and social services.

Finally, it is simply unclear how successful the infrastructure investment push will be without a pickup in property spending.

- Officials remain firm that the property market won't be used as a tool to boost short-term growth as it has regularly been in the past – but doubts remain as to how well an infrastructure-heavy investment stimulus can work absent a parallel boost from property.

The upshot of all of this is that while officials have effectively set the stage for a surge in infrastructure investment by getting a significant amount of funding in place, there is still plenty of execution risk for getting that money into the economy.

While Chinese officials and domestic economists remain focused on projecting the best-case scenario for the economy over the next six months, investors will need to keep close tabs on the actual level of infrastructure investment in the coming weeks to gauge the economy's likely trajectory.

In our view, the reason this is so critical is that if the investment drive is much weaker than officials anticipate – and than the large amount of available funds would indicate – then China's upstream industrial producers could quickly move into a destocking cycle – especially in metals and other key commodities.

- The supply-driven nature of China's rebound from COVID-related lockdowns in late May and June has meant that upstream inventories have risen rapidly in recent weeks – and players in the steel and iron space, in particular, are now considering price cuts and aggressive moves toward destocking.

The risk, then, is if China's stimulus undershoots in the next couple of months, the country could become a major contributor to a global disinflationary trend much sooner than many investors currently expect.