Trivium China Markets
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Why China's fiscal bazooka is firing blanks

- Chinese policymakers' effort to transition away from monetary and credit-led stimulus toward direct on-budget fiscal channels to support the economy is hitting roadblocks.
- Fiscal expenditure so far this year has significantly lagged the target for 2020 set in the May budget, with central officials becoming increasingly vocal about the need to speed up spending.

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Key takeaways

- Chinese policymakers' effort to transition away from monetary and credit-led stimulus toward direct on-budget fiscal channels to support the economy is hitting roadblocks.

- Fiscal expenditure so far this year has significantly lagged the target for 2020 set in the May budget, with central officials becoming increasingly vocal about the need to speed up spending.

- Despite the slow progress made so far, policymakers are doubling down on their efforts to put their planned fiscal bonanza into play. This also includes quasi-fiscal spending, with indications that policy banks are starting to ramp up lending, and even commercial state-owned banks being directed to undertake quasi-fiscal lending to finance urbanization projects.

- If policymakers succeed in their ambitions, fiscal spending will rise substantially in the final five months of the year: to hit expenditure targets local and central government spending in the August to December period will need to be RMB 4 trillion more than it was last year. But given the problems Beijing has faced in unblocking this spending so far this year, this is a big if.

- Moreover, the impact on the wider economy from this spending will likely be limited. Fiscal expenditure is being channeled into areas like education, 5G, and healthcare, and not simply being splurged on infrastructure. Investment in these areas has less of a knock-on effect for other sectors and provides less of an immediate boost to the wider economy.

- If all goes to plan, investors can expect a moderate fiscal boost to growth in the coming months, but not a rising-tide-lifts-all-boats situation. Rather than betting on the traditional stimulus destination of infrastructure or a renewed surge in aggregate economic activity in China, investors would do better to follow the money into specific areas like healthcare and telecommunications.

- Going forward, investors need to monitor this closely. The fiscal data coming out of China doesn't get a lot of attention relative to the credit numbers, but this is where the focus should be for the remainder of the year. If fiscal expenditure continues to lag behind Beijing's target, officials may need to resort back to monetary means to support the economy.

What's going on

Over the past two years, Chinese policymakers have made a concerted effort to transition away from monetary and credit-led stimulus toward direct on-budget fiscal channels to support the economy, but this shift is currently proving tricky. Having turned on the fiscal stimulus taps, so far this year all that has come out has been a trickle.

While local and central governments are budgeted to increase expenditure (across both the general public budget and the government-managed funds budget) by 13% y/y in 2020, in the first seven months of the year spending rose by just 2%.

That leaves a massive shortfall to make up in the final months of 2020. Indeed, to meet the full-year target, government spending will need to increase 27% y/y in the last five months of the year. Such a surge would represent RMB 4 trillion in additional spend compared with the same period last year.

There are signs that policymakers are now trying to bring this fiscal bonanza into play.

Fiscal expenditure rose substantially in July. Spending from the general public budget increased 18% y/y, and expenditure in the government-managed funds budget (the deficit of which is financed through issuance of local government special purpose bonds and special treasury bonds) rose 7% y/y. In total, spending was up 14% y/y, compared with the 1% y/y rise in H1 2020.

The government is also putting increased pressure on local authorities to accelerate fiscal spending, especially from funds that have been directly transferred to prefecture and county governments as part of the new special transfer payment mechanism. At this week's State Council meeting, Premier Li stressed that officials should "promptly channel the allocated funds to market players and people's livelihood" and indicated that "steps will be taken to redress any tardiness in fund allocation or utilization."

Policymakers are also now pushing quasi-fiscal channels more aggressively in order to boost growth.

Policy banks appear to be ramping up lending. We infer policy bank lending by looking at the difference between loan issuance at the Big Four state-owned lenders versus the category of "large state-owned banks," which includes the Big Four plus Bank of Communications (BOCOM), the Postal Savings Bank, and the three policy banks. Lending at these entities has risen sharply y/y in recent months **[FIG 1]**).

Further evidence of an increase in policy bank loans is seen in the frenzy of fund raising at these banks. Net bond financing – the main source of funding for policy banks given that they do not take deposits – has jumped since May **[FIG 2]**.

Beijing is also now leaning on other state-owned lenders to undertake quasi-fiscal lending. The NDRC last week directed six banks – four state-owned commercial banks and two policy banks – to open credit lines for county-level towns in order to fund urbanization efforts in those areas

FIG 1: Net new loans at policy banks, BOCOM and Postal Savings Bank

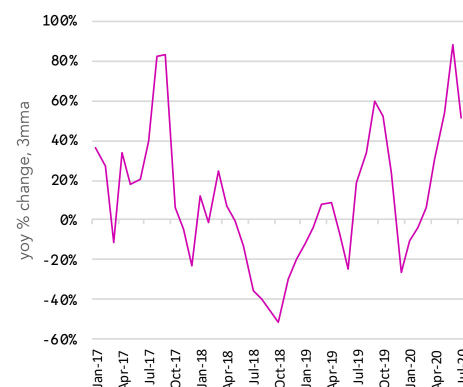
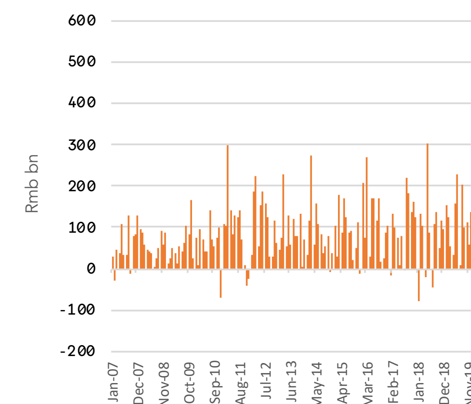


FIG 2: Policy banks net bond financing



Bullish signal?

This looks bullish. The RMB 4 trillion needed increase in fiscal spending in order to hit spending targets, and a continued acceleration in policy bank loans, should provide a boost to economic growth through the latter part of the year.

We have some doubts, however.

For one thing, the increase in policy bank lending and the RMB 4 trillion spending shortfall that needs to be made up by the end of the year, are both, to some extent, the product of policy failures.

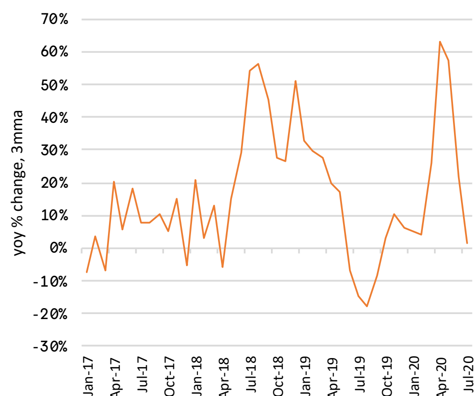
Policy bank loans are rising as lending growth at commercial banks shrinks **[FIG 3]**. It seems likely that the increase in policy bank lending and the push to get some state-owned commercial banks to fund urbanization is, at least in part, a move to make up for the lending pullback at other financial institutions. As a consequence, overall loan growth is likely to remain stable – rather than rising substantially – into year-end.

The push on the fiscal front meanwhile is arguably the result of local officials dragging their feet on spending in the first half of the year, rather than an intentional backloading of expenditure. We have written before about how the fears of being held responsible for making bad investments related to special purpose bonds is constraining that particular program.

This raises questions as to how successful the central government will be at unlocking additional fiscal spending during the remainder of the year.

The new special transfer payment mechanism, which bypasses provincial governments in the disbursement of fiscal funds, may not provide the panacea for streamlining spending that policymakers first hoped. Indeed, this week's State

FIG 3: Net new loans at commercial banks



Council meeting pointed to a certain level of frustration over the slow pace at which these funds are being spent, which suggests that removing the provincial government bottleneck may not have done much to accelerate the pace of expenditure. And while half of the RMB 2 trillion in funds to be allocated via this new payment mechanism are coming from special treasury bond issuance – which was only just completed in June and July – the other half is meant to have come from funds raised via local government general bonds, which have been issued since the beginning of the year. Indeed, RMB 459 billion of the RMB 980 billion quota for 2020 was used in Q1, so this money should have been deployed early and to great effect in the initial days of China's recovery from the COVID-19 shutdown – but that doesn't appear to have been the case.

Another concern is the multiplier effect of this fiscal spending.

Policymakers have been clear that they do not want to stimulate the economy via a 2009-esque infrastructure binge. Instead Beijing wants to channel funds into a relatively diverse range of areas: so-called "new infrastructure," as well as increased spending in sectors like healthcare.

The data for fixed asset investment so far this year backs this up. The increase in infrastructure investment (transport, water conservation, and utilities) has been relatively modest, while other areas – education, telecommunication, and healthcare – have all seen a more substantial rise **[FIG 4]**.

While spending in these areas has clear benefits to the Chinese economy in the long term, it provides less of an immediate boost to growth than a strong upswing in infrastructure spending would. This is partly because investment in these "newer" areas provides less of a knock-on effect for growth in other sectors – unlike infrastructure investment, which benefits upstream industries such as steel and cement.

The weaker short-term boost to overall growth also means that this spending will do less to bolster corporate and consumer confidence, further limiting the cumulative effect of such investment.

It is also questionable how effective direct transfers to struggling consumers and corporates (which special treasury bond proceeds will reportedly be used for) will be. These transfers are more likely to have a relief effect than to encourage a substantial increase in spending among recipients.

At best, therefore, the year-end fiscal push will provide a muted boost to growth that falls short of creating a rising-tide-lifts-all-boats situation. As such, rather than betting on the traditional stimulus destination of infrastructure – or a renewed surge in aggregate economic activity in China – investors would do better to follow the money into specific areas like healthcare and telecommunication.

More broadly, investors should also be conscious of the real question mark over whether policymakers can realize their ambition to dial back monetary stimulus and rely more on fiscal spending to support the economy. There are many difficulties in scaling up the latter to the extent required, given the lack of shovel-ready projects to invest in and local authorities' risk-adverse approach to fiscal spending due to the dire consequences if investments sour.

Investors need to monitor this closely. The fiscal data coming out of China doesn't get a lot of attention relative to the credit numbers, but this is where the focus should be for the remainder of the year. If fiscal expenditure continues to lag behind Beijing's target, officials may need to resort back to monetary means to support the economy.

FIG 4: Fixed asset investment