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China's fiscal easing

Infrastructure investment to lead the way

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Economics - China

- Fiscal spending fell short of expectations in 2021, resulting in weak growth in infrastructure investment
- This year, more fiscal stimulus will likely be reintroduced to shore up economic growth
- We expect a rebound in infrastructure investment in 2022 on the back of improvement in both funding and project pipelines

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A tighter 2021. Overall fiscal spending was notably tightened in 2021, resulting in weak infrastructure investment growth of only 0.4% versus 2020. Even as total fiscal revenue exceeded the budgeted level, total fiscal spending fell short of expectations. We estimate that China's broadly defined fiscal stance has likely come in at around 5% of GDP, 2.5ppt lower than expected and notably lower than 8.4% in 2020. Meanwhile, we note that inefficient use of local government special bonds (LGSBs) failed to generate a rebound in infrastructure investment despite an expanded issuance quota. There has been a surplus of more than RMB2trn in the government-managed fund each year in the last two years, suggesting that some of the proceeds of LGSBs were left unused.

The reasons behind the fiscal austerity. Robust GDP growth in the first half of last year reduced the necessity for expansionary fiscal spending and prompted Beijing's stricter management of local government debt. The priority of local authorities' budget spending remained on virus containment last year instead of infrastructure investment. Moreover, we see two key issues impeding the more efficient use of LGSB proceeds last year: (1) insufficient preparation in terms of project pipelines and deficient inspection with regard to project feasibility before approval; and (2) local authorities were unable to assign unused special bond proceeds to other projects, as proceeds are strictly attached to specific projects.

A better year ahead. In 2022, we expect a more expansionary fiscal stance and a modest recovery in infrastructure investment growth to 5% for the full year. We forecast a stable official budget deficit at 3.2% of GDP and a higher quota for LGSBs of around RMB4.0trn, up from an average of about RMB3.7trn in 2020 and 2021. A ramp-up in LGSB issuance in late 2021 and front-loading of RMB1.4trn quota in Q1 2022 can help offset the shock from weak land sales on the fiscal health of local authorities and provide sufficient funding for infrastructure projects. In addition, Bejing's overall easing stance will create looser credit conditions for infrastructure financing and encourage local authorities to take on more leverage. On the project side, there have been a series of positive changes to LGSB management that can help distribute and use this year's issuance quota more efficiently while also ensuring project quality. We believe issues such as slow special bond issuance and inefficient use of proceeds can be alleviated in 2022.

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Fiscal easing on the way

- Infrastructure investment remains one of the most forceful countercyclical policy measures in Beijing's toolkit
- Frontloading of special bond issuance can offset the impact of weaker land sales on the fiscal health of local authorities and …
- … loosening monetary conditions can support infrastructure funding from other channels

2021: Fiscal austerity led to weak infrastructure investment

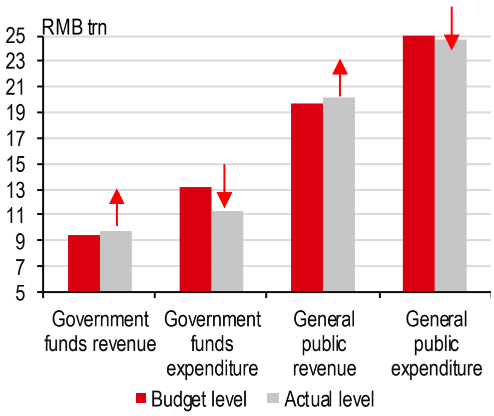
Broadly-defined fiscal deficit came in notably lower than the budgeted level

Fiscal stance tightened in 2021

Despite the generous fiscal bill delivered in March 2021, China's fiscal stance was notably tightened in 2021. Combining the general public budget and the government-managed fund, total actual fiscal revenue exceeded the budgeted level by around RMB839bn, but fiscal spending fell short of the budget by as much as RMB2.1trn in 2021 (see Chart 1). This means the broadly defined fiscal deficit as a percent of GDP is likely to be around 2.5ppt lower than we expected – i.e. the actual fiscal deficit was around 5% of GDP, down significantly from 8.4% in 2020.

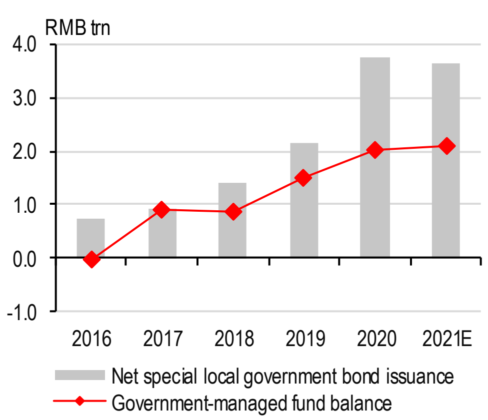
Breaking down the fiscal spending by usage, fiscal austerity was broad based with public capital spending on infrastructure the largest drag. Public spending on infrastructure is mainly recorded in the fiscal budget through two items – general public budget spending on infrastructure and government-managed fund spending (except spending on land reservation). As shown in Chart 3, both of these two items have shrunk on an annual basis, putting a drag on overall fiscal spending growth. Other than that, general public budget spending on people's livelihoods and government-managed fund spending on land reservation maintained positive growth, but at a much softer pace than in previous years.

Chart 1: Fiscal revenue exceeded the budget in 2022, but fiscal spending fell short



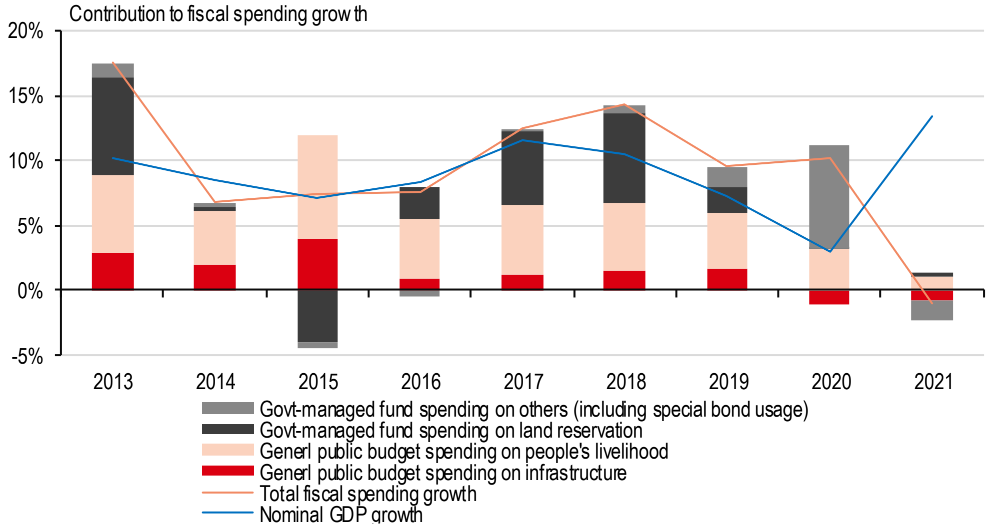
Source: Wind, HSBC

Chart 2: Government-managed fund surplus rose alongside rising net LGSB issuance



Source: Wind, HSBC

Chart 3: Fiscal spending on infrastructure-related items



Source: Wind, HSBC

Generous special bond quota failed to deliver a recovery in infrastructure investment

In recent years, the local government special bond (LGSB) quota has become a key financing channel for public investment on infrastructure after Beijing tightened restrictions of local governments' issuance of hidden debt. However, while Beijing expanded the LGSB quota from RMB1trn in 2017 to around RMB3.7trn in each of the last two years, it has so far failed to deliver a meaningful recovery in infrastructure investment, as shown in Chart 4.

We find that a large amount of special bond proceeds has been left unused in the past two years

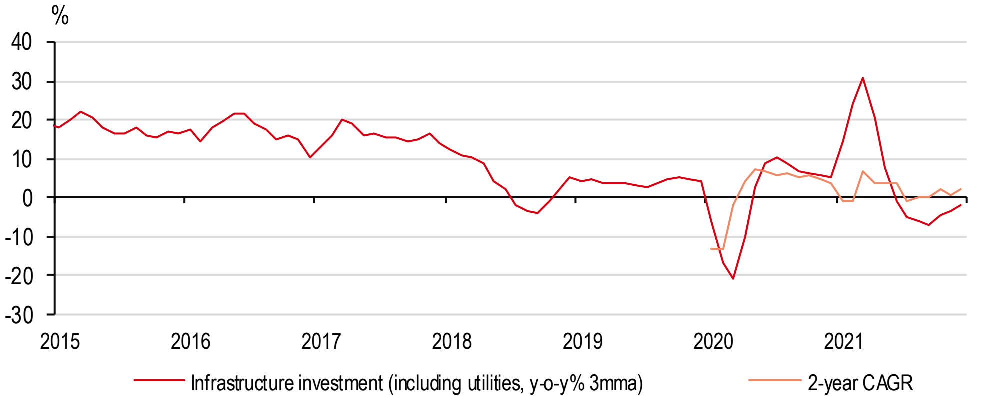
The key issue here is that a large amount of special bond proceeds has been left unused in the past two years. As shown in Chart 2, alongside rising LGSB issuance, the government-managed fund surplus has also more than doubled in recent years. Our analysis shows that the bulk of this surplus is unused special bond proceeds. This carry-over of more than RMB2trn per year points to inefficient use of special bond proceeds by local governments.

Key factors behind the fiscal austerity

There are several reasons behind the rather disappointing level of fiscal stimulus in 2021, in our view. Firstly, robust growth in the first half of 2021 supported strong fiscal revenue growth and at the same time reduced the necessity for expansionary fiscal spending.

Secondly, as virus containment remained a priority for local authorities in 2021, more of their fiscal spending was likely tilted towards virus control with less spent on infrastructure investment.

Chart 4: Infrastructure investment growth has remained subdued since 2018



Source: CEIC, HSBC

Beijing has called for better oversight of local authority budgets

Thirdly, Beijing has called for better oversight of local authority budgets and spending and tighter monitoring of debt. In October, the State Council named and shamed eight local government projects in four western provinces for their loose debt policies, telling local officials to "strictly follow fiscal discipline" (SCMP, October 2021). This has likely further incentivised a more risk-off sentiment among local authorities.

Lastly, we have observed two key issues impeding the more efficient use of special bond proceeds last year. First is insufficient preparation in terms of project pipelines. Audit reports from a number of local audit departments in 2021 identified this as a key reason for large amounts of special bond proceeds being left unused in 2020. Local authorities and related central government departments – mainly the Ministry of Finance and National Development and Reform Commission (NDRC) – may have experienced problems such as insufficient time for project planning and deficient inspection on project feasibility before approval. Another issue is that local authorities could not assign unused special bond proceeds from old projects to other projects, as special bond proceeds were strictly attached to specific projects. This inevitably resulted in the inefficient use of special bond proceeds.

2022: Funding and project pipelines are still the focus

Fiscal spending on infrastructure investment is set to pick up

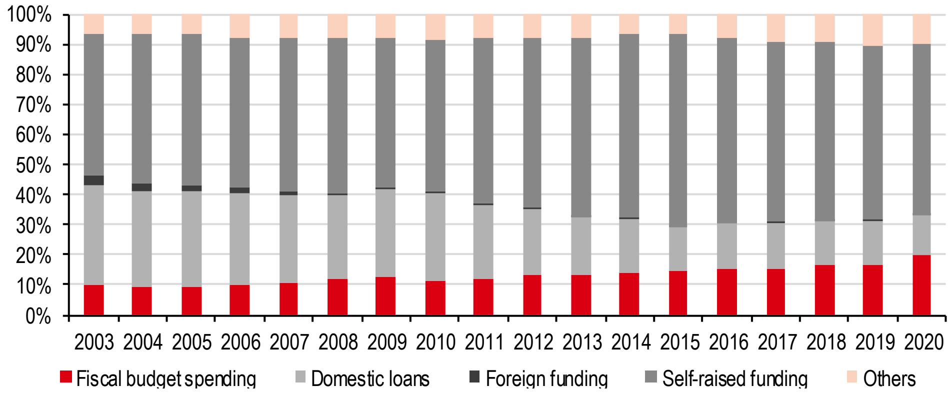
Whether infrastructure investment can rebound in 2022 has become an increasingly important question for the economy. Beijing has pledged to beef up policy easing to counter mounting growth headwinds. Infrastructure investment is no doubt one of the most forceful countercyclical policy measures in Beijing's toolkit. But some people still question whether both central and local governments are indeed prepared to lift investment, or it is going to be déjà vu with much said but little action, as has been the case for the last two years.

To answer this question, there are two main factors to consider – funding conditions for infrastructure investment and project pipelines. Fiscal budget spending, which makes up slightly below 20% of total infrastructure investment, is set to rise alongside a more generous budget bill (see Chart 5 for a breakdown of funding channels for infrastructure investment).

We expect a stable official budget deficit at 3.2% of GDP but a higher quota for LGSBs of RMB4.0trn – versus an average of about RMB3.7trn in 2020 and 2021 – of which about RMB1.4trn has been frontloaded prior to the National People's Congress in March 2022.

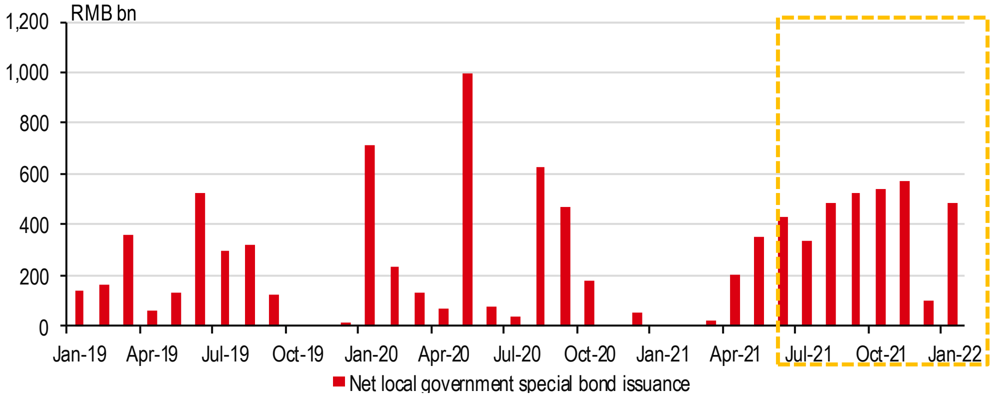
Moreover, an acceleration of special bond issuance in late 2021 also added to the funding for infrastructure projects in early 2022 (Chart 6). Although local governments' land sales revenue recorded a contraction of 6% y-o-y, or RMB335.8bn, in H2 2021 – a trend which may continue for some time – we believe the ramp-up in special bond issuance early this year can offset the impact of weaker land sales on the fiscal health of local authorities.

Chart 5: Breakdown of funding channels for infrastructure investment



Source: CEIC, HSBC

Chart 6: LGSB issuance has speeded up since mid-2021, and the momentum is likely to continue in early 2022 on the back of a frontloaded quota of RMB1.4trn



Source: CEIC, HSBC

Loosening monetary conditions can support infrastructure funding from other channels

Meanwhile, loosening monetary conditions can support infrastructure funding from other channels. After two rounds of 50bp across-the-board reserve requirement ratio (RRR) cuts and a 10bp cut in the 7-day reverse repo rate and 1-year medium-term lending facility rate, the 1-year loan prime rate (LPR) has dropped by 15bps in recent months and 5-year LPR by 5bps, suggesting that domestic credit conditions have eased. Infrastructure projects are likely to have easier access to bank lending and self-raised funding (including local government financing vehicles and public-private partnership, etc.) under such circumstances. These two channels together accounted for around 70% of infrastructure investment in 2021.

There have been a series of positive changes to LGSB management

In addition to looser funding, we believe there is also better preparation for project pipelines at both the local and central level this year, based on the following positive changes:

- The NDRC and Ministry of Finance announced a negative list of special bond projects, which make it clear the areas where LGSBs should not be used. This list will likely enhance efficiency of project investigation and improve the quality of projects in the pipeline.
- As Beijing rolled out new regulations to measure the performance of special bond projects last June, we believe the allocation of the new quota among provinces and cities this year will improve as it will be based on the performance of projects by each region last year. Provinces that were able to better plan and more efficiently use their special bond quota will likely gain more support this year. To address the issue of unused proceeds, Beijing now also allows local authorities to move unused proceeds from one project to another one. But there will also be penalties for regions that make large and frequent adjustments on special bond usage. Their quota for LGSB issuance in the following year will be reduced.
- Local authorities have a longer time to prepare for project pipelines this year and central government departments also have sufficient time for investigation. This should ensure the quality of projects being proposed to Beijing and facilitate faster implementation once projects are approved. This round of project preparation started in July, about two months earlier than in previous years. Meanwhile, the NDRC had three months (September to November) to investigate and approve projects for this year, while in previous years this was usually required to be completed in a month.

Lastly, there is Beijing's clear shift in policy focus

Lastly, there is Beijing's clear shift in policy focus – from de-risking and de-leveraging to supporting growth amid mounting growth headwinds. This should encourage local authorities to be more willing to take on leverage to support infrastructure investment, a clear difference from last year's risk-off sentiment. In light of all these promising changes, we believe issues such as slow special bond issuance and the inefficient use of proceeds can be alleviated in 2022.

As we think both funding and project pipelines will likely improve in 2022, we hold a relatively constructive view on infrastructure investment this year. That said, we also see some uncertainties that may pose downside risks. Firstly, local government financing vehicles (LGFVs) that have long been a key financing channel for infrastructure projects are facing renewed volatility in 2022. Although the overall proportion of off-balance-sheet financing in total infrastructure funding has been shrinking in recent years, it can still have a sizeable impact on local government's investment capacity. Beijing reiterated the importance of controlling local government debt risks at the Central Economic Work Conference. As a result, HSBC credit analysts think regulators will at some point conduct a stress test by allowing the first default of an LGFV public bond, which is likely to trigger volatility in the credit market and impede financing for infrastructure projects.

Moreover, should economic data show signs of a faster-than-expected recovery in early 2022, the issuance of special bonds and growth of infrastructure investment may slow down in the second half of the year, as Beijing remains prudent about maintaining a stable macro leverage ratio. This would be similar to 2019, when Beijing shifted towards a neutral policy stance soon after economic data showed signs of a rebound from the initial shock of the pandemic.

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