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# China Policy Watch

## What to expect next

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Economics - China

- Policymakers are turning more proactive: RMB1trn issuance of treasury bonds will likely prompt 50bp of RRR cuts
- Key policy events in Q4: National Financial Work Conference and Central Economic Work Conference
- Addressing the local government debt situation and long-term growth drivers are likely to be in focus


**Jing Liu**
**Chief Economist, Greater China**
The Hongkong and Shanghai Banking Corporation Limited

**Lulu Jiang (Reg. No. S1700523070001)**
**Economist, Greater China**
HSBC Qianhai Securities Limited

**Erin Xin**
**Economist, Greater China**
The Hongkong and Shanghai Banking Corporation Limited


### Policymakers are becoming more proactive

Beijing is taking a firm stance on supporting growth as seen with the recent issuance of RMB1trn of sovereign bonds. The debt will be used to fund infrastructure projects aimed at disaster prevention and mitigation. This should have a positive effect on growth, though the effect may be more back-end loaded into next year.

The recent fiscal policy changes, with the fiscal deficit breaking the 3% threshold, may also signal a regime shift towards more proactive fiscal policy with a focus on holistic budget management. The bond issuance is reminiscent of previously issued "long-term construction bonds", which were continuously included in the general budget and rolled out over multiple years. Moreover, this round of bond issuance also shifts more responsibility to the central government where it has sufficient space to increase leverage.

Meanwhile, the increase in bond supply on account of the new sovereign bonds, already budgeted ones, and increase in local government refinancing bonds will tighten up liquidity. To facilitate the bond issuance, the PBoC is likely to cut RRR by 50bp by year-end 2023.

### Structural growth will be in focus at the upcoming policy meetings

As China's recovery continues to chug along, more focus will be put on medium- and long-term growth. We expect these to be the focus at the upcoming key policy meetings, which are likely to be held in Q4: National Financial Work Conference and Central Economic Work Conference. The official dates are yet to be confirmed.

The National Financial Work Conference may come first: Bloomberg has reported it will be held on 30-31 October (Bloomberg, 23 October). This conference will likely focus on financial reform and risk resolution. In particular, it is expected to unveil the final plan of institutional reform, including the key personnel appointments. It may also roll out details of the local government debt restructuring plan, which will likely include a mix of liquidity measures to address funding stress (which is recently seeing more policy support), as well as a structural solution. Meanwhile, we also expect the focus to be on providing more funding for growth drivers like technology and innovation development, as well as green development.

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# Turning more proactive

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## Additional RMB1trn treasury bond issuance

**Unusual move, eyeing 2024 growth**

On 24 October, China's legislature, the Standing Committee of National People's Congress (NPCSC) approved an additional RMB1trn sovereign bond issuance. This is an unusual move, given that China is set to achieve its "around 5%" growth target this year (Bloomberg: 5.0%), after the stronger-than-expected Q3 GDP growth data and continuous improvement in various economic activity data.

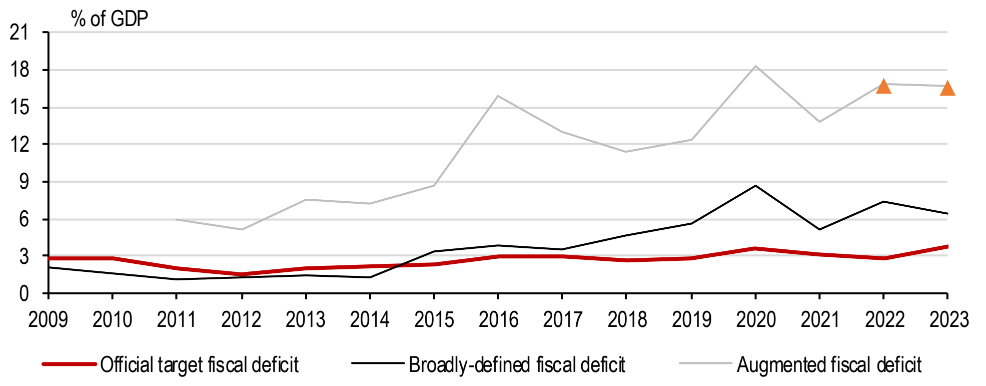
It's more about 2024 growth. On the same day, the NPCSC also passed a bill to allow local governments to front-load 60% of their 2024 special purpose bond (LGSB) quota. If we assume the new LGSB quota will come in at around RMB3.5trn to RMB4trn in 2024, this could mean potentially RMB1.75trn to RMB2.4trn of LGSB issuance early next year. Together with RMB500bn of proceeds from the RMB1trn treasury issuance planned to be utilised in 2024, there could be some RMB2trn to RMB3trn of spending powder for the government before the National People's Congress approves the 2024 budget during the Two Sessions in March. A strong performance in Q1 will boost the overall growth for 2024. Right now, the market expects slower growth in 2024 (Bloomberg: 4.5%); however, with the recent development some, including the former deputy governor of the PBoC Mr. Zhu Min, believe GDP will grow at c5% (Bloomberg, 25 October).

**Budget deficit rises to 3.8% – a regime shift?**

With this issuance, the target budget deficit is raised to 3.8% of GDP for 2023 from the previous 3.0%. This is the highest in decades, even higher than in 2020 (targeted at 3.6%, actual at 3.7%) during the COVID-19 outbreak. The red line of a 3% budget deficit ratio has been carefully observed since the reform and opening up, with only a few exceptions (Chart 1). In the face of the pandemic, raising this ratio "significantly" above 3% triggered quite some debate (Xinhua, 24 March 2020).

However, breaking the 3% red line might mean a shift towards a holistic budget management rather than a narrow focus on fiscal budgets. Indeed, Chinese governments actually run four accounts, fiscal budget, government-managed funds, state-administered SOE funds, and social security funds, with the previous two accounting for the majority of the on-balance sheet budgetary balances. For government-managed funds, revenues include proceeds from land sales and issuance of special bonds, as well as various levies, such as tolls and lottery tickets, while their spending mainly consists of capex, including infrastructure projects. The broadly defined fiscal deficit, when incorporating government-managed funds, is more volatile than the official deficit – especially when off-balance sheet accounts, such as local government financing vehicles (LGFVs), are included (Chart 1). For the first few quarters in 2023, there was a 21.3% contraction y-o-y in land sale proceeds, so the government net borrowing ends up being softer than in 2022, though the official fiscal deficit paints a different picture.

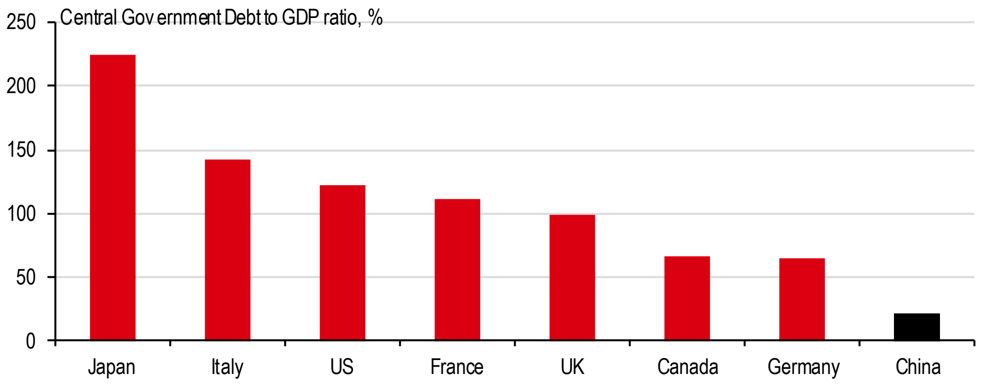
**Chart 1. Government net borrowing larger than target deficit in recent years**




Note: The broadly defined fiscal deficit is the combined deficit from two accounts of the general fiscal budget and government-managed funds. The augmented fiscal deficit is estimated by the IMF, including balances from all four on-balance sheet accounts, as well as off-balance sheet accounts, such as government-guided funds and LGFVs. The 2022 and 2023 figures are forecasted by the IMF in its 2022 Article IV report.
Source: CEIC, IMF, HSBC estimate

Another aspect of the potential regime shift may be related to which sector to leverage. This time, proceeds from the RMB1trn treasury issuance will be transferred to local governments to use, while the debt is on the central government's balance sheet. As a matter of fact, the central government's debt-to-GDP ratio is 21.5% as of Q2 2023, the lowest among major economies. We also argue in *How to turn over a new leaf (II)* (30 August) that local government debt restructuring may also benefit from the central government taking on more leverage to swap higher cost LGFV debt, a best practice in infrastructure financing for more centrally relevant projects with substantial positive externalities.

**Chart 2: China's central government has lower leverage than G7 economies**




Note: Data as of Q2 2023, except for Canada and the UK (Q1 2023).
Source: CEIC, HSBC

### The beginning of proactive fiscal policy

If history carries wisdom, the recently approved RMB1trn treasury bonds appear more like "long-term construction bonds" (长期建设国债), which made their debut in 1998 amid the Asia Financial Crisis. They were also issued as additional treasury bonds and increased the budget deficit (an ad hoc format). Following that, such bonds were issued in 1999 and 2000 also in an ad hoc format, then "institutionalised", aka budgeted during the NPC's two sessions, in the following years until 2007. The description of fiscal policies also changed from "moderately tight" (适度从紧财政政策) to "proactive" (积极财政政策).

We see a parallel of the current situation to late 1990s, in terms of the timing of a potential structural reform, as well as the change of the growth model. A more proactive fiscal policy might fit in well at the current juncture.

**Table 1: Summary of long-term construction bonds**

| Year | Month | Categories | Issuance, RMBbn | Official deficit before | | Official deficit after* | |
|---|---|---|---|---|---|---|---|
| | | | | RMBbn | % of GDP | RMBbn | % of GDP |
| 1998 | Aug | Long-Term Construction bond | 100 | 46 | 0.5% | 96 | 1.1% |
| 1999 | Mar<br>Aug | Long-Term Construction bond | 50<br>60 | 150.3 | 1.7% | 180.3 | 2.0%* |
| 2000 | Mar<br>Jul | Long-Term Construction bond | 100<br>50 | 229.8 | 2.3% | 279.8 | 2.8%* |
| 2001 | Mar | Long-Term Construction bond | 150 | 259.8 | 2.3% | No change to official deficit | |
| 2002 | Mar | Long-Term Construction bond | 150 | 309.8 | 2.5% | No change to official deficit | |
| 2003 | Mar | Long-Term Construction bond | 140 | 319.8 | 2.7% | No change to official deficit | |
| 2004 | Mar | Long-Term Construction bond | 110 | 319.8 | 2.3% | No change to official deficit | |
| 2005 | Mar | Long-Term Construction bond | 80 | 300 | 1.6% | No change to official deficit | |
| 2006 | Mar | Long-Term Construction bond | 60 | 295 | 1.4% | No change to official deficit | |
| 2007 | Mar | Long-Term Construction bond | 50 | 245 | 1.0% | No change to official deficit | |
| 2008 | Mar | Long-Term Construction bond | 30 | 180 | 0.6% | No change to official deficit | |
| 2023 | Oct | Sovereign bond | 1000 | 3775 | 3.0% | 4775 | 3.8% |

Note: *Does not align with final fiscal deficit for the year
Source: Gov.cn, CEIC, HSBC

### Accommodative monetary policy to follow: 50bp cuts before end-2023

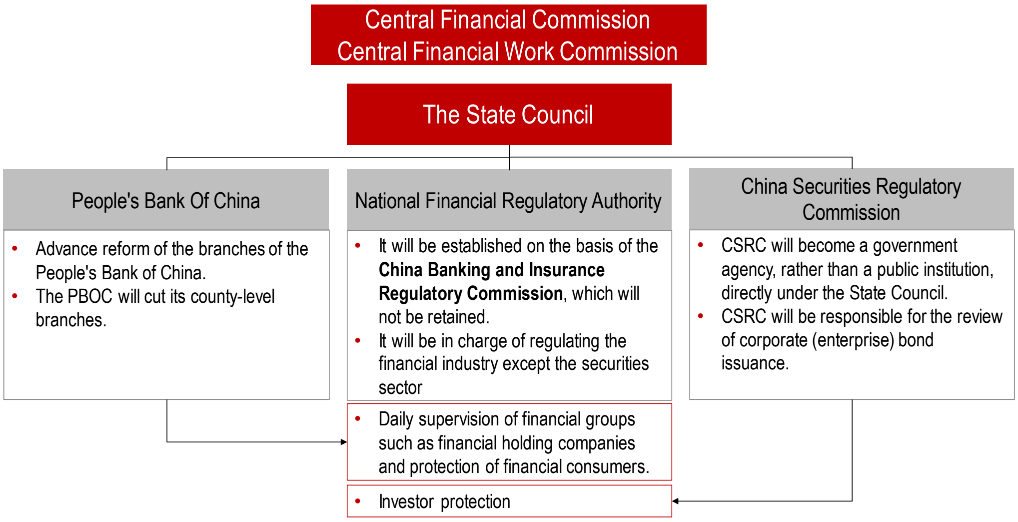
We now forecast another RRR cut of 50bp before end-2023. Taking into consideration the RMB1trn treasury bond issuance, there will likely be at least an additional RMB2trn government bond issuance in Q4. An increase in the bond supply will add pressure to liquidity towards year-end 2023. Though short-term liquidity injections via OMO or MLF would help relieve the problem, a RRR cut or a rate cut could release long-term funding to the banking sector. Given the monetary policy divergence with the Fed, the PBoC will likely favour a quantitative liquidity injection.

## National Financial Work Conference

Bloomberg reported that the National Financial Work Conference will be convened on 30-31 October. This conference is held twice a decade, usually setting key financial policy priorities for the next five years. Looking back at the previous five financial work conferences, key focus areas include financial reform, preventing and resolving financial risks, financial services to support the real economy and financial opening.

For this year, financial supervisory reform, local government debt restructuring as well as providing financing resources for new growth drivers will likely be the focus. The conference is expected to unveil the final plan of institutional reform, including key personnel appointments at the newly created party-level super-regulators, the Central Financial Commission and the Central Financial Work Commission (Chart 3), as well as the chairperson of the CSRC.

**Chart 3: The new financial regulatory system**




Source: Gov.cn, HSBC

The creation of super-regulators at the Central Committee level is said to better streamline the implementation of policy and improve the coordination across relevant departments. This will allow better control and supervision over financial risks. This also marks a transition from a segmented regulatory model to something framed as “goal-oriented” regulation by Mr. Li Guo, Dean of the Peking University Law School (China Law Review, 29 May 2023). With problem solving as the orientation, the new regulatory model focuses on three objectives: the stability of the financial market, the soundness of financial institutions, and standardisation of business conduct. The draft “Financial Stability Law”, now under review by the National People’s Congress (Xinhua, 7 September 2023), aims to complement the institutional reform of financial regulation by setting clear responsibilities of central and local regulatory bodies, providing a unified rulebook, strengthening market-based bankruptcy mechanisms, and reducing the “too-big-to-fail” scenarios.

Relatedly, the conference is likely to provide details of the ‘comprehensive package’ as mentioned in the July Politburo meeting. A mix of liquidity measures to address financing gaps as well as structural measures will be needed. Already we have seen some movements through local government refinancing bonds (cRMB1trn in October), as well as directives for banks to roll over and adjust terms on local government lending (Reuters, 17 October 2023). This will help to keep the ball rolling, but more support is likely needed to comprehensively address the issue, the detail of which is worth paying close attention to, especially with respect to the distribution of responsibilities among various stakeholders, including governments, LGFVs, banks, and others.

Additionally, as China adjusts its economic growth model, more emphasis will be placed on higher productivity areas, such as technology innovation and green development. There will likely be an emphasis providing more financial support both on the public side, as well as encouraging more private sector involvement. This can include opening up more financing channels, such as through primary markets (e.g. PE and VC funding), providing targeted financing tools as well as policy incentives to encourage a speedier transition. Manufacturing upgrading and technology development are likely to see more targeted policies to encourage R&D spending and support early-stage funding. We also see green financing having significant potential to grow, though there will likely need to be further clarity on things like taxonomy (especially as it pertains to transition industries), as well as development in the carbon pricing market.

**Table 2: Summary of previous National Financial Work Conferences**

| | 1st<br>17-19 Nov 1997 | 2nd<br>5-7 Feb 2002 | 3rd<br>19-20 Jan 2007 | 4th<br>6-7 Jan 2012 | 5th<br>14-15 Jul 2017 |
|---|---|---|---|---|---|
| Background | 1997 Asian financial crisis (AFC); high NPLs in state-owned banks | China joined the WTO; high NPLs in state-owned banks; shareholding reform | Bank shareholding reform; rapid increase of FX reserves | 2008 Global Financial Crisis; European debt crisis; rapid increase of LGFV debt | Structural transition of China's economy from "high growth" to "new normal" |
| Financial supervision and reform | Establish Central Financial Work Commission (CFWC) to supervise the financial system after the AFC;<br>establish the China Insurance Regulatory Commission (CIRC) and the China Securities Regulatory Commission (CSRC) | Abolish CFWC, restructured the PBoC to establish the stand-alone bank regulator China Banking Regulatory Commission (CBRC) | Improve financial supervision capabilities | Improve supervision of systemically important financial institutions | Establish the Financial Stability and Development Committee at the State Council to strengthen macro-prudential regulation; Unified Asset Management rule to tackle shadow banking activities and regulatory arbitrage |
| Capital market reform and development | Abolish credit plan, banks free to lend according to commercial considerations | Banking reform | Restructure the Agricultural Bank of China, transform the China Development Bank into a commercial institution | Interest rate liberalisation reform; deepen financial institution reform | Establish multi-level capital market system; improve direct financing, enhance inclusive finance |
| Prevent and resolve risks | Establish four Asset Management Companies to dispose of bad loans | Set up Central Huijin Investment Co., Ltd. to direct shareholding reform of state-owned banks | Establish China Investment Co., Ltd. (CIC) | Prevent and resolve local government debt risk; establish deposit protection system | Promote deleveraging (especially for SOEs) and strictly control over the incremental growth of local government debt |

Source: Gov.cn, HSBC

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