China Fiscal Stimulus

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— China announced a RMB 10 trillion debt swap program on the last day of the National People’s Congress (NPC) meeting; however, investors were not impressed, as they are seeking hints of consumption-boosting stimulus.
— The announced measures such as the current property destocking programs and the cash-for-clunkers programs might not be sufficient for China to achieve its ambitious growth target in the short to medium term.
— Structural changes in the social security system are likely necessary to create a positive wealth and income effect over the longer term.
— While the downside risk of China equities appears limited due to the government’s commitment to supporting the economy, the upside potential also looks uncertain at the moment without details on consumption-boosting stimulus. Unless we see effective fiscal policies to stabilize the economy, the Chinese equity market could remain range-bound.

China announced a RMB 10 trillion debt swap program on 8 November to relieve some of the debt burden on local governments. The scale of the debt swap program was higher than market expectations, which were RMB 6 trillion, as reported by Reuters a few days before the National People’s Congress (NPC) meeting. However, one week after the announcement, the Hang Seng Index (HSI) dropped by 6.3%, while the CSI 300 index fell by 3.3%. This suggests that the debt swap program alone has failed to impress investors who have been looking for hints of consumption-boosting stimulus. With a Trump presidency becoming a reality, it may make sense for Beijing to hold off until there is more clarity on potential U.S. policy changes after Trump takes office. However, the longer it takes, the more likely investors will lose patience. All eyes are now on China to see what kind of fiscal policies Beijing will announce in the coming months to address its three major crises amid anticipated increases in trade tensions, which could further undermine China’s economic growth. This article will discuss and evaluate the effectiveness of potential fiscal policy tools that China could use to alleviate local government debt, destock its property market, and stimulate consumption, all of which are interlinked.

Local Government Debt Swap Program

Beijing announced on 8 November that up to RMB 10 trillion worth of funds will be provided to local governments to refinance local government financing vehicle (LGFV) debt onto the public balance sheet through 2028. The debt swap program involves lifting the local government debt ceiling and allowing them to issue longer-dated special government bonds to finance high-cost, short-tenor LGFV debt. While this program could ease refinancing pressure and improve the debt structure, significant structural fiscal risks remain. The International Monetary Fund (IMF) estimated that RMB 60 trillion in LGFV debt was outstanding as of 2023. Although the announced RMB 10 trillion debt swap program could mitigate the immediate risks of large-scale LGFV debt defaults that could spill over into the broader financial system, it would only substitute about 16% of the riskiest outstanding LGFV debt. Additionally, while some systemic risks could be reduced by moving LGFV debt onto local governments’ balance sheets, this does not enhance their ability to service the debt. The resolution of the local government debt crisis will ultimately depend on the ability of local governments to generate sufficient fiscal revenue, which is closely tied to the performance of the wider economy. The debt swap program itself only helps indirectly by allowing local governments to mobilize more resources on economic growth, but it does not provide any direct support to improve aggregate demand.

Property Market Destocking

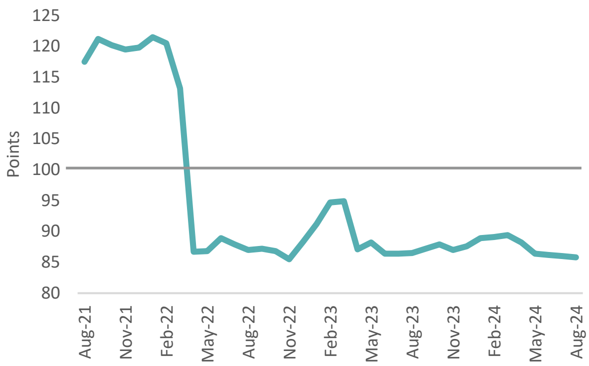
It is widely recognized that property constitutes approximately two-thirds of household wealth in China. Consequently, the decline in home prices following the collapse of the property sector has significantly affected consumer confidence and spending, primarily due to the negative wealth effect. To stabilize home prices, Reuters reported that up to RMB 4 trillion in bonds may be issued to finance regional governments' purchases of idle land and completed homes, aimed at providing affordable housing for citizens. Additionally, the removal of VAT and the land appreciation tax is being considered to stimulate property market transactions.

These proposed policies appear similar to the previously announced real estate rescue package, albeit on a much larger scale. In May 2024, the People's Bank of China (PBOC) established a RMB 300 billion relending facility to provide cheap funding for local state-owned enterprises (SOEs) to purchase finished homes and convert them into affordable housing. Earlier, in January 2023, the PBOC launched a loan support program for rental housing purchases in eight pilot cities, with a total quota of RMB 100 billion. Despite their low costs, these initiatives have largely been ineffective due to a fundamental mismatch between the supply of property inventory and the demand for affordable housing. In third- and fourth-tier cities, where there is a significant oversupply of properties, demand for housing remains modest. As a result, local governments and state-owned enterprises have limited economic incentives to engage in these destocking programs, aside from aligning with the political agenda. There seems to be no difference this time around.

Short Term Consumption Stimulus Expected

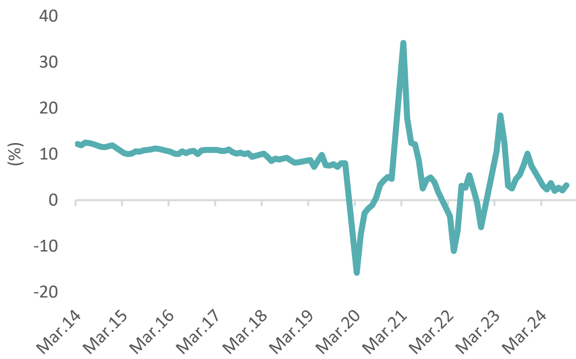
With consumer confidence at a near-record low (Chart 1) and retail sales struggling to return to pre-COVID levels (Chart 2), boosting consumption is seen as crucial to reversing the deflationary trend. However, the announced measures have not provided sufficient boost in consumer confidence.

Chart 1: China Consumer Confidence 2021 – 2024 August



Source: National Bureau of Statistics of China, as of August 2024.

Chart 2: China Retail Sales YoY: 2014– 2024 September



Source: National Bureau of Statistics of China, as of September 2024.

The trade-in program for durable goods has been in place since April 2024. To encourage electric vehicle (EV) sales, China doubled the EV subsidy in July 2024. Additionally, there has been a noticeable rise in the use of consumption vouchers in various forms across China. While these measures may appear to be quick fixes to help China achieve its 5% growth target, their effects are likely to be temporary and muted, as they risk merely frontloading purchases and shifting demand from unsubsidized to subsidized goods. Indeed, even after the introduction of the cash-for-clunkers program, retail sales growth has struggled to return to pre-COVID levels. Consequently, the market has been expecting more consumption stimulus from the central government.

Expectations include further employment support, such as relief for employers' social security contributions and assistance for startups. With youth unemployment rising to 18.8% in August, subsidies for hiring graduates, particularly in state-owned enterprises (SOEs) and the public sector, are anticipated. However, public sector support may inadvertently crowd out private sector employment.

The Institute of Finance & Banking, a think tank linked to the State Council, has proposed establishing a stock market stabilization fund by issuing RMB 2 trillion in special treasury bonds. This fund aims to stabilize the stock market by actively participating in blue-chip stocks and exchange-traded funds (ETFs). Alongside property market stabilization measures, this approach could help mitigate the negative wealth effect that has been undermining consumer confidence and spending. However, this initiative appears to be merely an extension of the implicit ETF buying by the "national team" investors in China, who in aggregate is estimated to be holding approximately RMB 3.5 trillion worth of domestic ETFs[1]. Only time will tell whether the additional RMB 2 trillion stock market stabilization fund could generate sufficient momentum for the stock market.

Long Term Structural Change to the Social System Needed

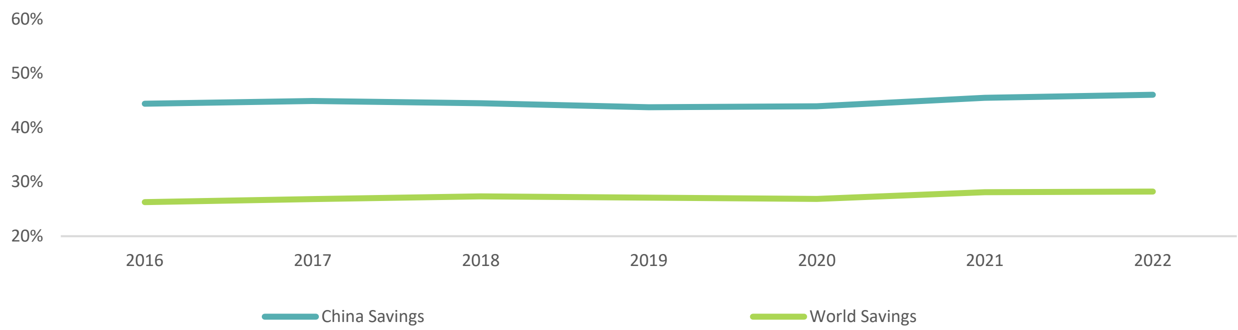
Weak consumption in China stems from the fact that Chinese people have one of the highest saving rates globally. To meaningfully improve consumer confidence, structural changes in the social system are needed to reduce saving rates and ultimately unlock consumption potential in China.

On the social front, China needs to enhance its social security net. In 2022, China's gross savings were approximately 46% of GDP, compared to 28% globally (Chart 6). This disparity reflects a tendency towards precautionary savings for healthcare, education, housing, and retirement due to inadequate social welfare. Therefore, improving the social security net could potentially reduce saving rates by reducing the need to save for these precautionary expenses.

- **Social welfare**: (i) raise government spending on healthcare, elder care, and childcare, (ii) increase childbirth subsidy, (iii) provide demand-side subsidy on medical insurance.
- **Pension reform**: KPMG suggested that possible pension reforms include: (i) increasing the Pillar 1 asset investment by allocating more of these assets to the National Council for Social Security Fund (NCSSF). Currently, around 25% of the Pillar 1 assets are invested, while the majority of the rest are sitting in bank deposits; (ii) making the enterprise annuity scheme mandatory; and (iii) expanding tax incentives to promote participation in Pillar 3 pensions[2].

The inadequate social safety net in China stems from the deeply entrenched hukou system, which deprives more than half of the urban population of equal access to public services and urban housing. Therefore, the leadership may consider accelerating hukou system reform to integrate rural migrants into urban economies and boost consumption. However, this is easier said than done. The hukou system has long been used by local governments for population control and maintaining social order. An hukou reform would require an upgrade of the capacity of urban infrastructure—ranging from education and healthcare to transport and housing—raising concerns about the cities' ability to absorb the influx of new demand. The complexity lies in aligning local interests with national goals, as well as addressing the deeply embedded social inequality in China. Still, we believe that enhancing social security is key to reducing saving rates and unlocking domestic consumption potential.

Chart 3: China and World Gross Savings and Household Consumption (% Of GDP)



Source: World Bank, World Bank national accounts data, and OECD National Accounts data files, as of December 31, 2022.

Size of the stimulus

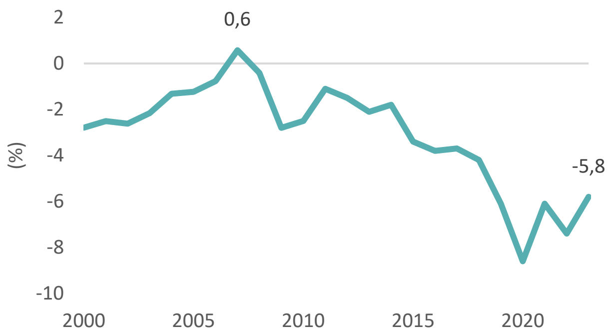
The size of the fiscal stimulus matters, as only a large-scale fiscal stimulus package could pull China out of the deflationary spiral and meaningfully revitalize its economy to reach the annual growth target. No concrete numbers have been announced yet, but some indications can be drawn from historical examples. Back in 2008, China unleashed a stimulus package equal to 13% of its GDP to support the economy. If Beijing feels the same sense of urgency to boost the economy this time, a stimulus package of up to RMB 16 trillion (13% of 2023 GDP) is possible.

However, a package of such scale is highly unlikely because China's fiscal condition today is much tighter than it was before the 2008 Global Financial Crisis (GFC). Pre-GFC, China had a fiscal surplus of 0.6% of GDP in 2007, while it had a fiscal deficit of -5.8% of GDP in

[1] HSBC estimate, as of June 30, 2024.
[2] KPMG, as of June 30, 2023.

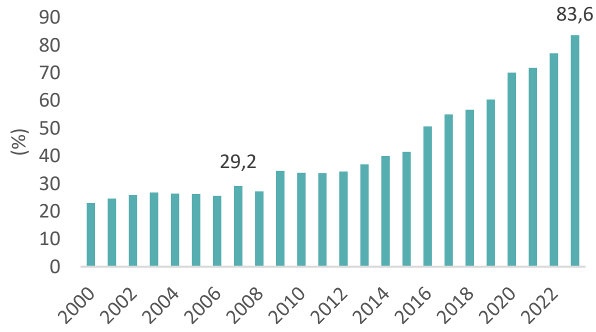
2023. Government debt, accounting only for central and local government debt, has also risen from 29.2% of GDP in 2007 to 83.6% in 2023. Fidelity estimates that China's gross national debt exceeds 300% of GDP when taking into account LGFV debt, corporate debt, and household liabilities[3]. Launching a stimulus program of 13% of GDP, even if implemented over the next 3-4 years, could add 3.3% to 4.3% to the fiscal deficit-to-GDP ratio and 13% to the debt-to-GDP ratio over the next few years, making China one of the most fiscally vulnerable countries globally. If the scale of the fiscal stimulus package approaches or exceeds RMB 16 trillion (including the RMB 10 trillion debt swap program), it would demonstrate Beijing's commitment to rejuvenating the economy and could be very positive for the market from a sentiment standpoint.

Chart 4: China Fiscal Balance to Nominal GDP 2000 - 2023



Source: Trading Economics, as of December 31, 2023.

Chart 5: China National Debt to Nominal GDP 2000 – 2023



Source: Trading Economics, as of December 31, 2023.

Key to Escape Japanification: Scale, Efficiency and Consistency

The risk of the Japanification of China has been a consistent concern for investors. With China's CPI in October slowing further to 0.3% year-on-year, the likelihood of falling into a deflationary trap appears more plausible. If Japan's experience offers any lessons, a large-scale and efficient stimulus program – one with a high multiplier effect – implemented consistently over multiple years is crucial, as there is no shortcut to escaping the deflationary spiral.

All eyes are now on China to see what fiscal policies Beijing will announce in the coming months to address its economic challenges. While the downside risk appears limited due to the government's commitment to supporting the economy, the upside potential also looks uncertain at the moment without details on consumption-boosting stimulus. Unless we see effective fiscal policies to stabilize the economy, the Chinese equity market could remain range-bound. For the time being, domestic stocks with positive earnings momentum and high-dividend banking stocks should provide a relatively attractive risk/return trade-off in the Chinese markets.

Glossary

A **local government financing vehicle (LGFV)** is a funding mechanism by a local government in China. It usually exists in the form of an investment company that borrows money to finance real estate development and other local infrastructure projects.

The **International Monetary Fund (IMF)** is a major financial agency of the United Nations.

The **trade in program for durable goods** is an expansive policy in China across automobiles, home appliances and real estate to encourage the replacement of outdated goods with newer and more advanced options.

Hukou is a system of household registration used in mainland China.

[3] Fidelity International, as of January 25, 2024.

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