Making Sense of China’s Fiscal Dollars and Cents

Executive Summary
The precarious U.S. fiscal outlook is a frequent topic of concern among financial market participants. This fear often stems from both short- and long-run considerations. In the short-term, there are worries that the sizable budget deficit in the United States will limit the government’s ability to engage in expansionary fiscal policy during the next recession. In the long-run, there are concerns about how ever-rising debt levels will potentially crowd out both public and private investment, weighing on economic growth.

These challenges are well documented, and we have written on them at length in other reports. It is important to keep in mind, however, that the United States is not the only major economy to face fiscal hurdles. In this report, we take a deep dive into the public finances of the world’s second largest economy, China. China’s fiscal position is opaque, marked by blurred lines between the public and private sectors, data limitations and decentralized power dynamics across the various levels of government. While this makes an apples-to-apples comparison between the United States and China somewhat difficult, a few important macro trends do seem evident.

At first blush, China’s fiscal position appears quite enviable when compared to the United States, with a much lower “official” government debt-to-GDP ratio and a smaller deficit. However, a deeper dive reveals a more worrying and uncertain outlook for several reasons. China’s deficit has clearly widened in recent years, and the prospect of additional fiscal stimulus in the near-term suggests further widening might lie ahead. Furthermore, an “augmented” deficit measure produced by the International Monetary Fund (IMF) suggests true net borrowing by the general government is closer to 10-11% of GDP. Deficits of this magnitude are much less consistent with fiscal sustainability and suggest less capacity for fiscal easing than initially meets the eye.

In the near term, China already has and likely will continue to ease fiscal policy in response to slowing economic growth. This should help limit the slowdown in the Chinese economy in the coming quarters, all else equal. But, the trend in public finances is headed in the wrong direction at the moment. The Chinese economy is slowing for both cyclical and structural reasons, and the “augmented” budget deficit continues to widen. If growth and the budget deficit continue to diverge over time, China could face plenty of fiscal and economic challenges. Though the drivers and specifics would in some ways be different than in the United States, the general contours would look familiar: slower growth, an aging population and historically high government debt levels. While this is not an immediately pressing problem, it presents yet another challenge for Chinese policymakers who are striving to structurally reform their economy while keeping economic growth from slowing too sharply in the years to come.
China’s Fiscal Situation: A Deeper Dive

Fiscal policy in China is conducted in a perhaps surprisingly decentralized fashion. Even though in theory provincial and local authority is derived from the central government, in practice Chinese policymakers at the subnational level have historically played a large and somewhat autonomous role in everything from infrastructure spending to social welfare policy. This quirky form of federalism in China has led to an unusual imbalance between central and subnational government budget balances. Even though subnational governments only account for about half of government revenue, they account for about 85% of government spending. Transfers from the central government to the subnational governments are supposed to close this gap, but in practice, and particularly since 2008, subnational governments have resorted to borrowing to meet their needs.

Until recently, however, there were strict prohibitions on formal subnational borrowing, so that much of the debt-financed spending that occurred was done off-balance sheet, particularly through local government financing vehicles (LGFVs). In short, local governments have utilized LGFVs to circumvent the formal limits on subnational borrowing, leading to a situation where de facto public borrowing is taking place outside the scope of official, on-balance sheet government statistics.

In an effort to broadly reform the fiscal landscape in China, policymakers enacted a new budget law in 2014 that permitted subnational governments to borrow through more formal channels, subject to annual limitations. Broadly speaking, this borrowing is intended to help replace the LGFVs’ role in financing local projects and infrastructure spending. In addition to “opening the front door” to more borrowing, policymakers strived to “close the backdoor” by tightening rules on off-balance sheet borrowing and explicitly bringing some previously classified off-balance budget activity on balance sheet. This broad-based reform played an important role in the widening of the officially reported deficit numbers for the general government (Figure 1).

However, not all off-balance sheet borrowing was recognized by the Chinese government as a result of the 2014 reform, and there remains considerable debate about to what extent local authorities are still utilizing off-balance borrowing via LGFVs and other measures. As a result, the IMF has continued to publish an “augmented deficit/debt” measure. The idea behind this augmented measure is that it offers a more complete picture of the true liabilities incurred by all levels of government in China. By this metric, which the IMF acknowledges comes with considerable uncertainty, China’s general government deficit is quite high at nearly 11%, and its debt-to-GDP ratio is roughly 72%, almost double the official measures (Figure 2).

Figure 1

Chinese Government Budget Balance
General Government, Percent of GDP, 2018 Preliminary

Source: International Monetary Fund and Wells Fargo Securities

Figure 2

Chinese Gov. Debt: Alternate Measures
Percent of GDP, Shaded Area = IMF Projections

Source: International Monetary Fund and Wells Fargo Securities

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When viewed through this lens, China has much less spare fiscal capacity than initially meets the eye. Even though nominal GDP growth in China is nearly 10% at present, the sizable deficit is such that the IMF projects the augmented debt-to-GDP ratio will reach 92% by 2023. Perhaps even more worryingly, these projections date from July 2018, so additional fiscal stimulus in China amid a slowing economy may not be fully factored into those projections (more on that later). As a final point, it is worth noting that the idea of an “augmented” debt measure is really about which sector of the economy is on the hook for the liability, as opposed to a question about the total amount of leverage in the economy. China has a well-documented debt problem in its non-financial corporate sector, which accounts for the bulk of debt in the Chinese economy (Figure 3). However, some of that non-financial corporate debt may in practice be liabilities of the government via the LGFVs and other off-balance sheet borrowing. Given that China’s government may have a much larger deficit and debt load than initially meets the eye, does this broader assessment of China’s fiscal and budget activities mean that the government will not have the capacity to stimulate the economy if needed?

**Figure 3**

Source: Bank for International Settlements and Wells Fargo Securities

**China’s Fiscal Outlook: Short-run and Long-run Implications**

For now, even allowing for this broader perspective on fiscal and budget activities, we do not view the budget deficit in China as an obstacle to further near-term stimulus. Although the IMF’s augmented measure of China’s general government deficit is quite large relative to most developed economies, China’s still-solid pace of nominal GDP growth helps offset some of the budget pressure. Furthermore, maintaining social stability is a top priority for the Chinese government, and steadily rising living standards via continued economic growth is viewed as a means to achieve this end. Part of the reason subnational governments incurred so much off-balance debt in the first place was to help hit regional growth targets in the post-2008 period.

Over the past year, the Chinese government has already implemented several fiscal measures to help cushion China’s growth slowdown. Just as the distinction between China’s official and augmented budget balances is somewhat opaque, the distinction between the total fiscal stimulus announced and the cumulative individual measures is also murky. Chinese authorities have implemented and announced budget measures in a piecemeal fashion during the current stimulus episode, and it is not altogether clear to what extent, if at all, stimulus in one sector is being offset by cost savings elsewhere. That said, below we highlight some of the tax and spending plans that have been announced or discussed by Chinese authorities over the past year or so.
The Chinese fiscal stimulus includes large tax cuts and spending increases.

2018 Budget Measures: What We Know
The broad contours of China's announced 2018 fiscal stimulus included approximately CNY1300 billion of tax cuts (about 1.5% of GDP) and CNY550 billion in spending measures (about 0.6% of GDP).

<table>
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<tr>
<th>Tax and Revenue Reductions Announced</th>
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<tr>
<td>March 2018</td>
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<td>Premier Li Keqiang pledges <strong>CNY800 billion</strong> in tax cuts for companies and individuals.</td>
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<td>Finance minister Xiao Jie added that China planned an additional <strong>CNY300 billion</strong> reduction in administrative fees and operating charges, bringing the total expected stimulus to <strong>CNY1.1 trillion</strong>.</td>
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<td>October 2018</td>
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<td>Finance minister Liu Kun announces that total tax cuts for the year are expected to exceed <strong>CNY1.3 trillion</strong>.</td>
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Key Announced Details of Tax Cuts
- **Effective 1 May 2018**
  - Value Added Tax (VAT) rates reduced and annual turnover threshold for small VAT payers increased. Estimated annual cost: **CNY400 billion**
- **Effective 1 July 2018 and 1 November 2018**
  - Tariff reductions on autos and consumer goods, including clothing, footwear, home appliances, fish, seafood and healthcare goods. Further tariff reductions on 1,585 products, including machinery, paper, textiles and construction materials. Estimated annual cost: **CNY60 billion**
- **Effective 1 October 2018 and 1 January 2019**
  - Increased income thresholds for collecting income taxes, and tax deductions on expenses for children’s education, home mortgage interest, housing rent and serious disease treatment. Estimated annual cost: **CNY320 billion**
- **Effective 1 January 2019**
  - Further tariff reductions on 700 products, the third round of tariff reductions announced in 2018.

Key Announced Details of Spending Increases
- **March 2018**
  - China’s finance ministry announced a **CNY550 billion increase in special purpose bond issuance**, to CNY1350 billion from CNY800 billion in 2017. The bonds are sold by local government to finance items such as highways, railroads or other construction projects.
- **August 2018**
  - China’s finance ministry told local government to accelerate special bond sales, to complete 80% of planned bond sales by end-September, with the remaining sales to take place mainly in October.


Potential Additional 2019 Budget Measures
While the precise details of fiscal stimulus measures for 2019 have yet to be determined, early indications are that China's fiscal stimulus could be even larger this year, potentially including **CNY1500 billion in tax cuts and revenue reductions (about 1.7% of GDP)** and **CNY800 billion in spending measures (about 0.9% of GDP)**. Our sense is that these measures would be cumulative rather than additive, meaning that it would be CNY1500 billion in tax cuts in total over 2018-2019 rather than CNY1300 billion in tax cuts in 2018 and then another CNY1500 billion on top of that in 2019. That said, we acknowledge the opaqueness of China’s fiscal policymaking, meaning there is some uncertainty around the exact timing and size of these tax cut rollouts. While more granular details will likely be known surrounding annual planning meetings scheduled for March, the announcements and initial media reports so far include the following:
To repeat, due to the incremental nature of China’s stimulus measures, and the fact that some offsetting savings measures have likely not been as well publicized, it is challenging to gain a fully comprehensive look into what has and will be enacted in China. Nonetheless, there are still some interesting takeaways. For the 2018-2019 stimulus, there is a fairly balanced split between tax cuts and spending increases. That is in contrast to prior large scale stimulus episodes, especially 2008-2009, which were much more weighted towards large-scale spending projects. This is consistent with a structural goal in China of slowly becoming less-reliant on investment spending and becoming more reliant on consumption to drive economic growth. Additionally, we believe that so far the total fiscal stimulus in 2018 and 2019 remains well below that seen in 2008-2009 (when China’s augmented budget deficit worsened by around 7.5% of GDP). Perhaps the biggest takeaway is that China has made clear that, despite some fiscal challenges, it will continue to gradually crank up the stimulus as needed to help ensure that the economy does not slow more in the near term than desired by Chinese policymakers. Indeed, monetary policy stimulus has been just as forthcoming over the past year or so.

Is the scale of China’s fiscal stimulus sustainable on an ongoing basis? In our view, large scale stimulus is likely achievable over the course of the current slowdown and during the next global recession, whenever that may occur. Even using the augmented measures, the debt-to-GDP ratio for the general government of China is below that of the United States, and as prior episodes (specifically 2009) indicate, there is precedent for a sharp deterioration in China’s budget deficit to support economic growth. Taking a longer-run view, however, some challenges appear likely to emerge. First, nominal GDP growth in China is likely to continue to slow in the coming years as an aging population and slowing productivity growth put downward pressure on potential GDP growth. This in turn will make it more challenging to keep deficit- and debt-to-GDP ratios from rising, all else equal. Second, as most Western economies developed, over time they gradually saw spending on social welfare (such as education and health care) rise as shares of their economies. China’s government spends a far smaller share of its spending on social welfare (such as education and health care) rise as shares of their economies.

Additional spending on these programs relative to the OECD average and its emerging market peers. Should government spending on these types of programs rise as China’s economic development continues, this would create additional fiscal strain, all else equal.

Additionally, China aims to transition to a more consumption-based economy as previously mentioned, but at present households have relatively low debt levels and high savings. High household saving rates help to finance borrowing in other domestic sectors, such as the non-financial corporate and government sectors. But, for China to become more reliant on personal

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4 See Figure 5 in the report cited in footnote 1.
consumption, households will probably need to become a bit more profligate. With higher household debt levels and/or lower saving rates, the economy will probably need less corporate and government borrowing, or more significant foreign capital inflows, to finance aggregate domestic borrowing.

While foreign ownership of Chinese government debt is still low, it has risen sharply in recent years, with foreign holdings of Chinese government bonds now around 8% of government bonds outstanding (Figure 4). Recent inflows in particular have been strong, in part a reflection of increased renminbi asset holdings by global foreign exchange managers (Figure 5) and China’s inclusion in the Bloomberg Barclays Global Aggregate Bond Index, to be phased in starting in April 2019. If China’s bond market were also incorporated in other major global indices, increased foreign financing may be somewhat supportive of funding stimulus and government borrowing more broadly in the coming years.

However, China’s budget deficit is still overwhelmingly domestically financed and unrestricted capital flows into and out of China are not yet a full reality. Until this changes, foreigners will likely only be financing a relatively small share of China’s government borrowing. At the end of the day, domestic financing of government deficits will remain key, with Chinese households the key component of that domestic financing.

Figure 4

Chinese Government Bond Holdings

Source: International Monetary Fund, Bloomberg LP and Wells Fargo Securities

Conclusion: China Faces Its Own Fiscal Demons

Pulling it all together, what are the key takeaways for China’s fiscal situation? First, a quick glance at the official data would suggest China has ample fiscal capacity to provide short-term economic stimulus without threatening the long-run public finances of the country. A deeper dive, however, reveals that the Chinese government’s deficit/debt burden is likely much higher than initially meets the eye. In the near term, China can and probably will continue to ease fiscal policy without excessive difficulty. But, the trend in public finances is headed in the wrong direction at the moment. The Chinese economy is slowing for both cyclical and structural reasons, while the “augmented” budget deficit continues to widen. If growth and the budget deficit continue to diverge over time, China could face plenty of fiscal and economic hurdles. Though the drivers and specifics would be different than in the United States, the general contours would look familiar: slower growth, an aging population and historically high government debt levels. While this is no means an immediate problem or a crisis-inducing issue, it presents yet another challenge for Chinese policymakers who are striving to keep economic growth from slowing too sharply in the years to come.