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CF40 Policy Brief

Three Concerns for Economic Recovery

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Abstract: More and more researchers believe that the current round of economic recovery is entering a new phase with stronger momentum and greater magnitude. However, performances of capital markets do not seem to be so optimistic. **Now the key is whether the policy support is strong enough to deal with the possible challenges in the future and bolster the recovery.**

There are at least three concerns that must be taken into account when assessing the effectiveness of policy efforts. The current economic recovery is characterized by a wave-like advance, and a very important reason is the lack of strong endogenous recovery momentum. At this stage, China can and needs to adopt bolder policy measures and should make more targeted responses to the three hidden concerns.

The English version is post-edited machine translation. In case of any discrepancy or ambiguity between the English and Chinese versions, the Chinese version shall prevail.

I. ECONOMIC RECOVERY HAS ENTERED A NEW PHASE

With the release of August data on China's key macro indicators, the market has initiated a new round of discussions around the momentum of China's economic recovery. The monthly yoy growth of key macro indicators such as industrial value added, total retail sales of consumer goods, manufacturing investment, price level, and infrastructure investment all showed marginal improvement compared with July. Since September, many high-frequency data have also continued to show marginal improvement, including the sales area of commercial houses in 30 medium and large cities, the rate of operation in all types of industries, the G7 logistics index, and box office revenue, many of which have increased from the previous month.

Given such data performance, more and more researchers believe that the current round of economic recovery is entering a new phase with stronger momentum and magnitude. However, the feedback from the capital market does not seem to be so optimistic. After the release of the August macro data, stocks, commodities and exchange rates all experienced a round of short-term decline. There are indeed many factors affecting asset prices, and the pricing mechanisms of different assets are different. But with all the major macro data showing marginal improvement, such asset price performance seems to imply that the capital market has not widely accepted the estimate of accelerated economic recovery.

If now is the starting point of a new round of accelerated economic recovery, what is the key driver? Currently, there are two possible explanations.

The first explanation is that economic recovery is driven by endogenous dynamics. The recovery in some areas, such as service consumption, has continued. In addition, the growth of manufacturing investment and infrastructure investment has remained at a certain level without a sharp decline, which underscores the resilience of the economy. However, given that the business sector has hardly experienced effective market clearing in the past three years and the household sector is also facing the problem of weakened long-term expectations and reduced asset valuations, it is not clear where exactly endogenous momentum is coming from and through what mechanism. This explanation can hardly explain the weakening momentum of the economic recovery in the second quarter.

The second explanation is that policies to stabilize growth have begun to play a role in supporting the accelerated recovery. Since August, all policies have played a much stronger role than in the second quarter. Among them, the monetary policy includes rate cut and reserve ratio cut and fiscal policy involves accelerated bond issuance and increased refinancing bond issuance. Against the backdrop of significant changes in the real estate supply and demand, real estate policies have also seen more pronounced optimization and adjustment in August, triggering the widest market attention. Among them, the two policy optimizations that improved market sentiment the most were the wide implementation of "recognize a house but not mortgage" in first-tier cities and the reduction of interest rates for most of existing mortgages.

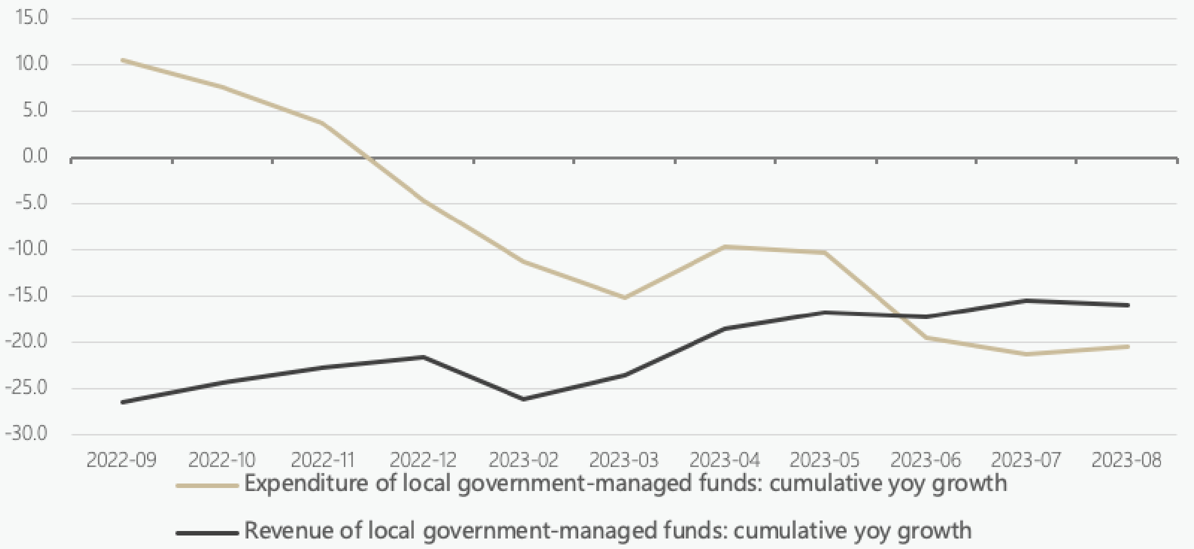
Looking ahead, **whether the policy support will be strong enough to meet future challenges and drive economic recovery will determine the trajectory of China's economy.** In our view, there are at least three concerns that must be taken into account when assessing the effectiveness of policy efforts. If these three concerns are ignored or bypassed in favor of a direct discussion of policy effects, it might lead to an obvious misjudgment.

II. CONCERN 1: FISCAL REVENUE MIGHT FACE PERSISTENT DOWNWARD PRESSURE

Despite the better reading of many indicators, fiscal revenue has not shown marginal improvement, reflecting the continued pressure on fiscal balance. In August, China's fiscal revenue grew at a rate of -4.6% compared with the previous year, turning negative for the first time this year; the revenue of national government-managed funds grew at a rate of -18.5% yoy and the revenue of local government-managed funds growing at a rate of -18.8% yoy. The general public budget can be replenished by the issuance of national bonds and general bonds. However, for local governments, revenue pressure has been clearly transmitted to the expenditure side. From January to August, the cumulative year-on-year growth of expenditure of local government-managed funds was -20.5%, which exceeded the cumulative growth rate of revenue of local government-managed funds (-16%) (See Figure 1).

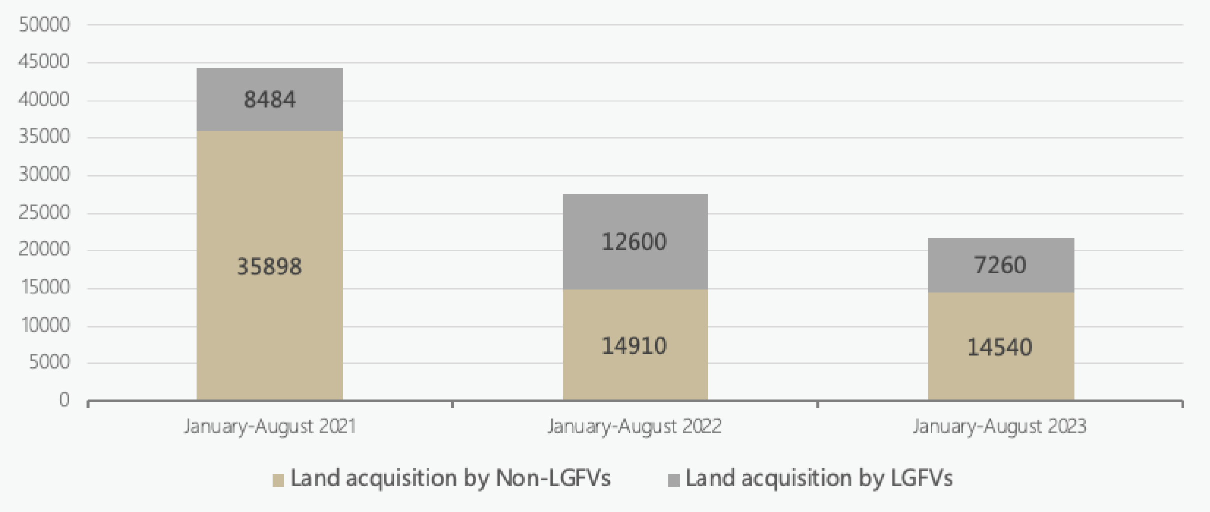
Into the fourth quarter, there is also continued strain on local revenue. The main reason for the concern comes from changes in the land market. Over the past two years, the most significant factor contributing to the decline in local fiscal revenue has been the contraction of the real estate market, particularly the decline in government proceeds from sales of state-owned land-use rights. However, there has also been a structural change in the decline of proceeds from sales of state-owned land-use rights this year. As shown in Figure 2, the Chinese government's proceeds from sales of state-owned land-use rights in January-August 2023 were significantly lower than the same period last year, **mainly because the scale of land acquisition by local government financing vehicles (LGFVs) was plunging while the scale of land acquisition by non-LGFVs (i.e., real estate enterprises) was basically the same as that of the same period last year.** This situation is in stark contrast to the situation in 2022 when real estate enterprises systematically withdrew from the land market while LGFVs entered the market on a large scale to acquire land in order to stabilize land sales revenue. The reason why LGFVs began to widely withdraw from the land market after June this year is that since June the State Council has paid more attention to the resolution of local hidden debt and stepped up the regulation of LGFVs, which made LGFVs unable to borrow money from banks and other financial institutions to acquire land.

Figure 1: The decline of government expenditure started to exceed that of government revenue (%)



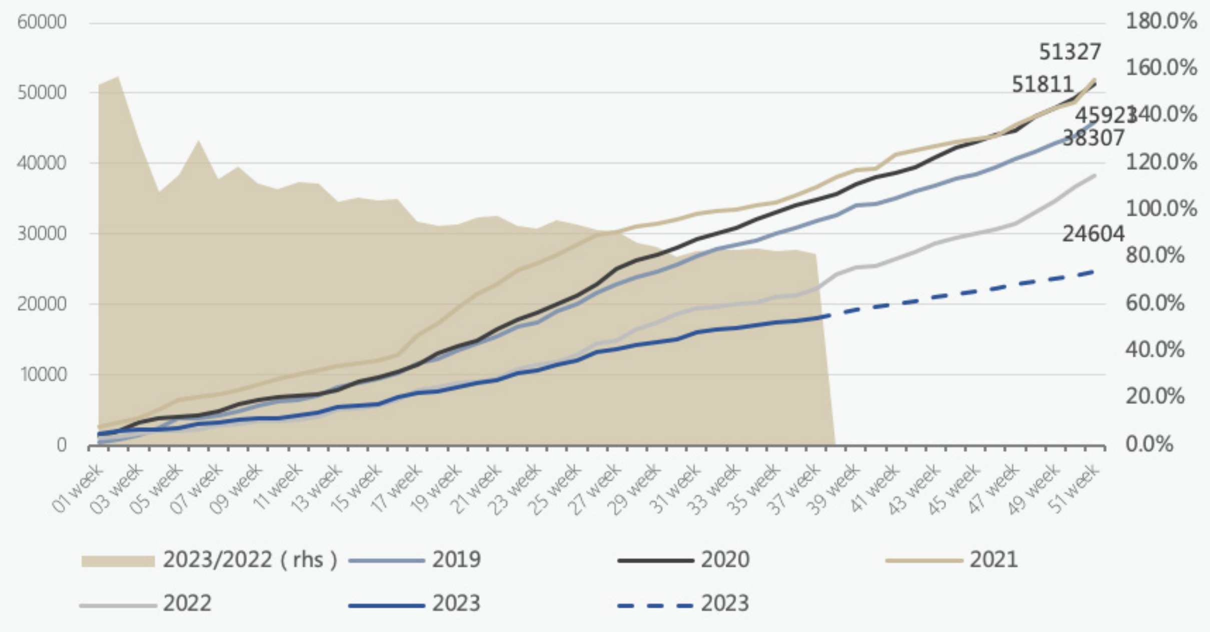
Source: wind

Figure 2: The structure of proceeds from sales of land-use rights has changed (100 million RMB)



Source: Guangfa fixed income investment fund

Figure 3: Government proceeds from sales of state-owned land-use rights might decline sharply yoy (100 million RMB)



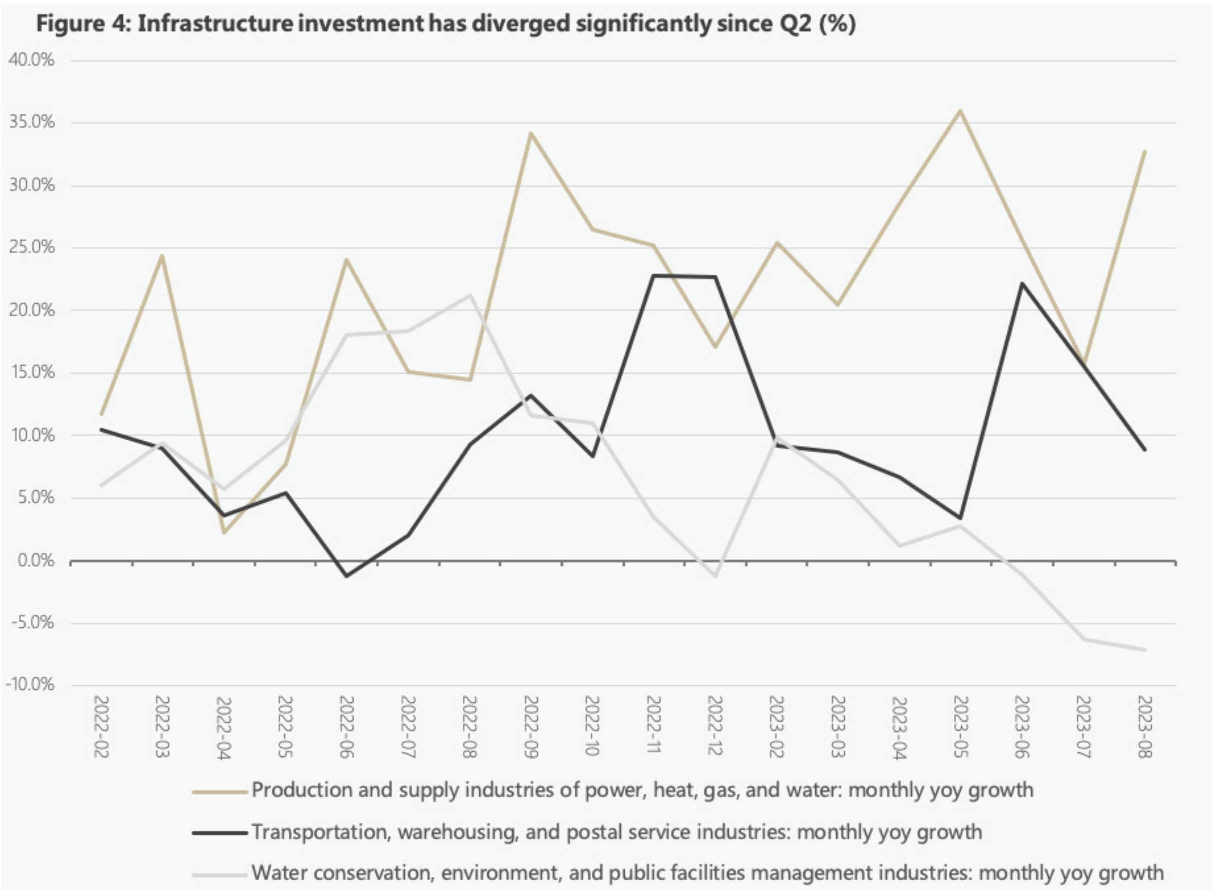
Sources: wind; author's own calculations

Based on this scenario, local governments may face an ongoing revenue shortfall in the fourth quarter. As shown in Figure 3, since June, proceeds from sales of state-owned land-use rights in 100 medium and large cities have been lower than the same period last year and the trend performance in this period seems to be linear and stable. If we make a simple linear extrapolation based on the data since June, the result is that the proceeds from sales of state-owned land-use rights of 100 medium and large cities in 2023 will be about 2.46 trillion yuan, 1.37 trillion yuan less than that of last year, with 800 billion yuan shortfall year-on-year in the fourth quarter.

Local fiscal revenue is directly related to the sustainability of infrastructure investment which is still resilient for the moment. As shown in Figure 4, since the second quarter, infrastructure investment has diverged significantly, with investment in the electricity industry (including production and supply industries of power, heat, gas, and water) growing significantly higher than the other two major industries. In August, investment in the electricity industry grew as high as 32.7% yoy, while investment in the water conservancy, environment and public facilities management industries grew at - 7.1% yoy. Investments in water conservancy, environment, and public facilities management industries are mostly municipal projects, which are closely associated with the local government fiscal balance. **Hence, going forward, whether infrastructure investment could remain stable depends on which of the two forces is stronger.**

III. CONCERN 2: THE SHARP DECLINE OF GOVERNMENT BOND ISSUANCE AND THE RESTRAINT OF "RESOLVING DEBT" POLICY MIGHT LEAD TO CREDIT CONTRACTION

Since 2023, China's private sector has been reluctant to increase leverage and there is a clear lack of incentive to expand credit. Meanwhile, the ahead-of-schedule issuance of government bonds (treasury bonds, local government general bonds and local special bonds) coupled with the increased financing of LGFVs from banks both in effect stabilized credit expansion.



Sources: wind; author's own calculations

Looking ahead, the trajectory of stabilizing credit expansion, whether through ahead-of-schedule bond issuance or LGVFs' borrowing from banks, is uncertain. As shown in Figure 5, as of September, China's treasury bonds have completed 75% of the full-year issuance plan, faster than the same period in the past three years. In the first three quarters, the issuance progress of China's local government bonds (general bonds plus special bonds) has been close to 90% of the annual issuance plan. Based on the budget at the beginning of the year, the remaining net financing quota for the three types of government bonds combined in the fourth quarter is only about 1.36 trillion yuan. As can be seen in Figure 6, the net government bond financing scale of 1.36 trillion yuan in the fourth quarter is significantly smaller, both compared with the previous quarter or the same period in history.

What deserves more attention is a series of possible impacts of the policy of debt resolution. In the previous practice of resolving local government hidden debt, there is an important working principle that has never changed, that is, "curbing new debt and resolving existing debt". On July 24, the Central Political Bureau meeting further proposed to "effectively prevent and resolve the risk of local debt, and formulate and implement a package of debt resolution programs". Subsequently, a series of regulatory policies that target LGFVs' debt issues began to be implemented, which will directly inhibit the credit creation ability of LGFVs.

On the one hand, according to the current regulatory requirements, the only rationale for the vast majority of LGFVs to issue bonds is to create new debt to repay the old. Therefore, the credit expansion of LGVFs in the fourth quarter might be quite limited. From January to September, the cumulative corporate net financing reached around 1.7 trillion yuan, of which 1.2 trillion yuan of net financing came from LGFVs based on the statistics of Wind. **In other words, nearly three-quarters of corporate bond financing in the first three quarters of this year is actually LGFV financing.** The contraction of LGFV bonds will not only decrease the scale of financing but also means that China's credit bond market is shrinking, which may be more worthy of attention.

On the other hand, the newly added local government hidden debt is no longer LGFV bonds but bank loans to LGFVs. Although we can't know how much of the loans are actually given to LGFVs, we can get a glimpse of the reality from the structure of bond financing. Based on the above-mentioned ratio of debt issuance, if we assume that half of the corporate loans were given to LGFVs (which is likely to be an underestimate), then LGFVs accounted for $7 trillion of the cumulative $14 trillion new corporate loans from January to August. If the following policy of debt resolution is to bring all the debt of most LGFVs into the scope of regulation, including bank loans, then LGFVs would find it much more difficult to obtain loans from banks and their ability to create new loans will also weaken dramatically.

IV. CONCERN 3: EVEN IF HOME SALES REBOUND, IT WILL NOT IMMEDIATELY BOOST NEW CONSTRUCTION AND LAND SALES

The highlight of this round of policy adjustments is the optimization of real estate policy. However, so far, the market has not formed a common expectation of whether real estate sales can stabilize and rebound after the policy adjustment. According to the high-frequency data, after the policy adjustment, there has been a relatively obvious marginal improvement in the sales area of new commercial housing in 30 medium and large cities. The first-tier cities, in particular, have witnessed an obvious rebound almost back to the same period in 2021 (see Figure 7). Many studies on China's long-term housing demand suggest that the potential demand for housing in

China will be around 1 billion square meters per year over the next three to five years, with optimistic estimates suggesting that it could reach 1.2 billion square meters. Based on the estimates, the current real estate sales seem to be "overshooting". As shown in Figure 8, based on the -20% year-on-year growth rate of annual sales area, the residential sales area in 2023 is estimated to be about 910 million square meters. If the growth rate is -15%, the residential sales area in 2023 is 970 million square meters, still slightly below the long-term potential demand level. **Therefore, whether it is a temporary improvement in demand due to policy optimization, or the impact of long-term potential demand, stabilization or even a rebound of real estate sales is a completely understandable result.**

Figure 5: The pace of bond issuance is much faster than the same period in the past 3 years (%))

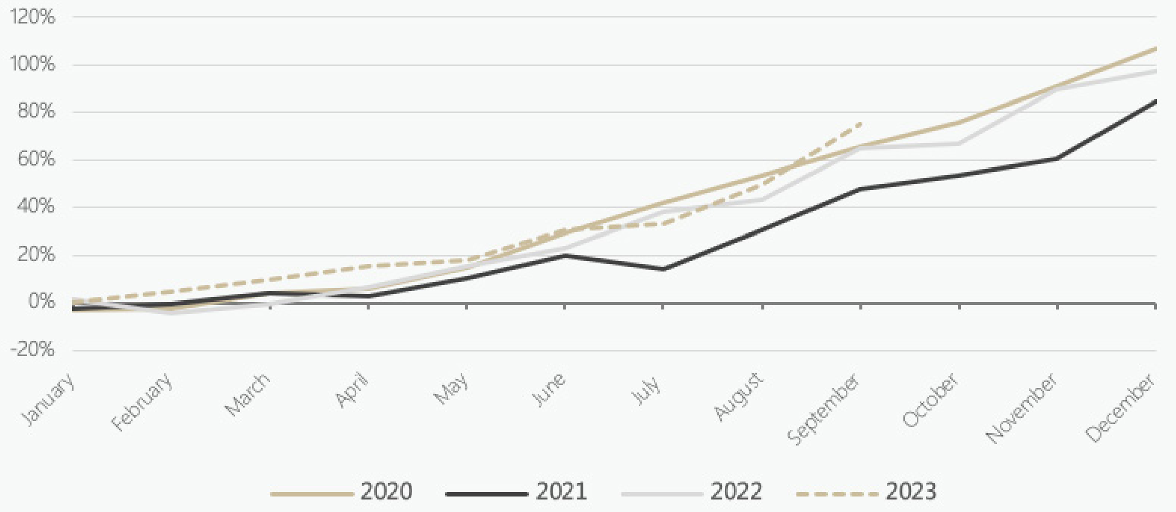
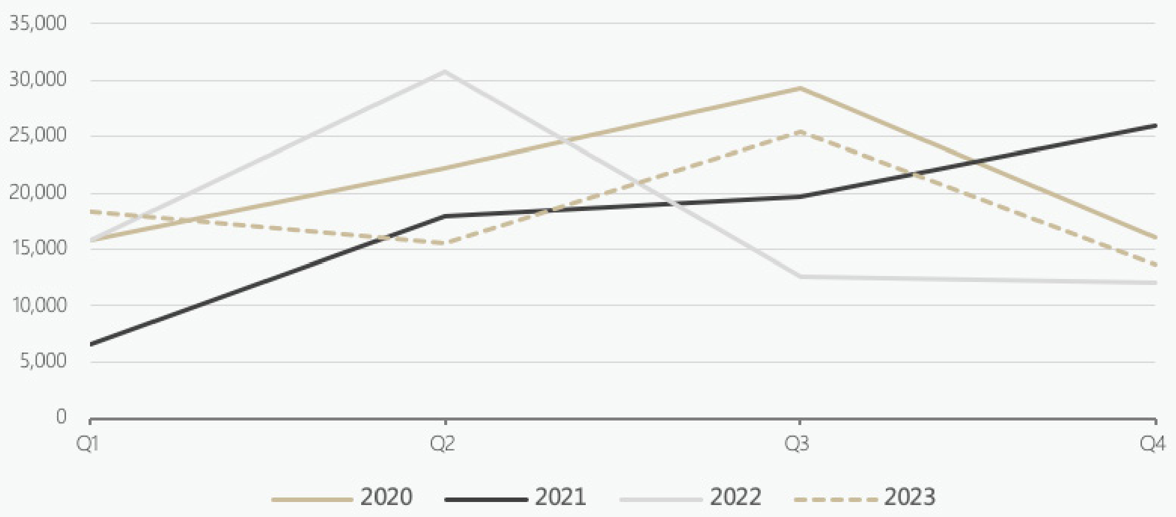


Figure 6: Net government bond financing would significantly contract in Q4 (100 million RMB)



Sources: wind; author's own calculations

Figure 7: Sales area of commercial houses in first-tier cities significantly improved after policy adjustment

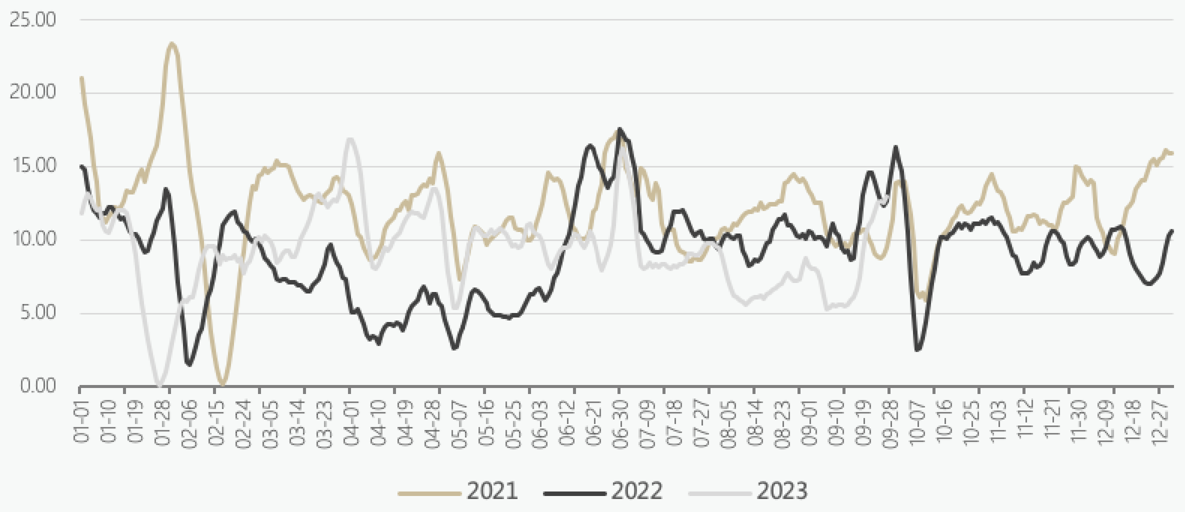
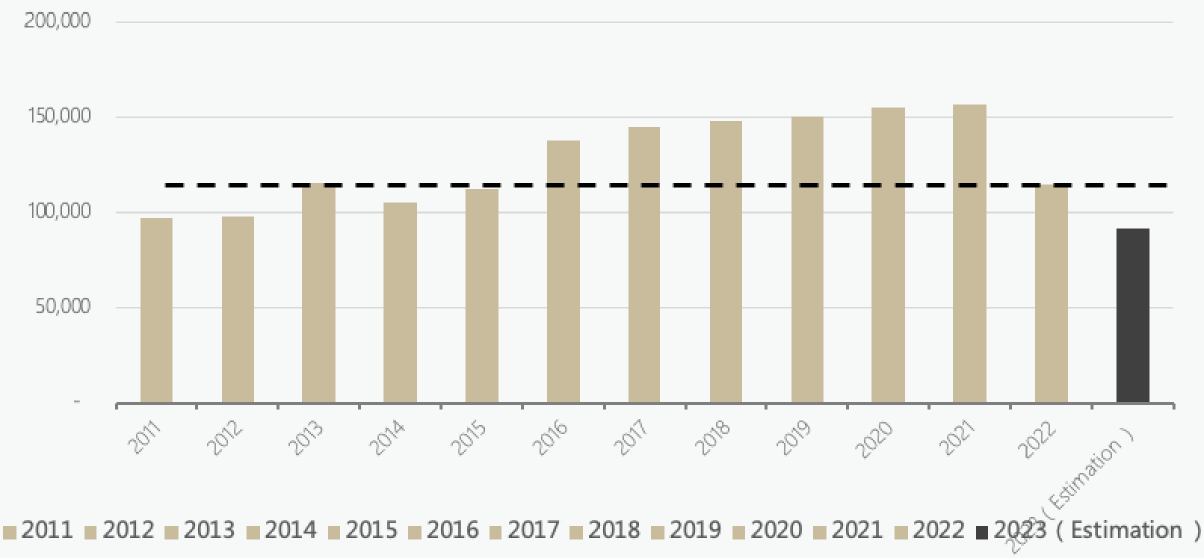


Figure 8: Sales area of commercial houses (ten thousand square meters)



Sources: wind; author's own calculations

However, even if real estate demand can be stabilized and real estate sales area can be stabilized and recover, the implications are very different from the past. In the previous rounds of real estate cycles, the reason why we should focus on real estate sales is that sales rebound is the starting point of the real estate cycle, and sales rebound will lead to the rebound of new construction and land acquisition of real estate companies. This transmission mechanism depends on two prerequisites, one is that the behavior of real estate enterprises follows the logic of "determining production according to sales prospects", and the second is that real estate enterprises have relatively stable financing channels.

Now these two preconditions do not hold anymore. On the one hand, “to ensure delivery of housing projects” is now the first priority of all real estate companies, and the behavioral logic of “determining production according to sales prospects” no longer exists. This also explains why the decline in new construction areas is much larger than the decline in real estate sales in the past two years. At present, only state-owned real estate companies and LGFVs are still active in the land market, whereas private real estate companies have stopped purchasing land-use rights. On the other hand, almost all private real estate companies are mired in debt, and most financing channels have been completely closed. From January to September this year, the net financing of real estate companies in the bond market was negative, and the balance of bank loans to real estate development decreased by 200 billion yuan in the second quarter compared with the first quarter.

Therefore, even if real estate sales can stabilize and rebound to boost marginal improvement in the cash flow of real estate companies, the real estate companies only have two choices: either accelerate the completion of housing projects or repay debt. It will take a long road for the improved sales to be transmitted into increased land acquisition and new construction, with limited effect on stimulating the economy in the short term.

V. CONCLUSION AND IMPLICATIONS

At present, China’s economic recovery is characterized by a wave-like advance, and a very important reason is the lack of strong endogenous recovery momentum. At this stage, China can and needs to adopt bolder policy measures and should make more targeted responses to the above-mentioned three hidden concerns.

First, local governments should be allowed to frontload the special bond issuance quota of next year to fill the potential gap of local government fiscal balance in the fourth quarter so as to avoid the further decline of general government expenditure growth and stabilize credit growth in Q4. Meanwhile, it is also necessary to pay attention to whether debt resolution will bring about credit contraction, as well as its impact on local governments’ revenue and expenditure.

Second, the benchmark interest rate should be reduced further. Since September, the market interest rates began to rise, with the rate of ten-year treasury bonds up by 10 bp than the end of August, which in effect increased the cost of debt financing. At this time, a further reduction in the benchmark interest rate can reduce the cost of issuance of replacement bonds; LGFVs can also cut interest expenses by issuing new bonds by to repay the old debt. Meanwhile, lower financing costs also help stimulate credit demand in the private sector and boost the economy’s endogenous momentum of credit expansion when combined with real estate policy and other macro policies.

Third, it is still necessary to further introduce a package of policy measures to stabilize the real estate sector. The central bank can encourage commercial banks to make full use of the “loans to guarantee the delivery of housing” as a structural monetary policy tool and encourage large banks to lead commercial banks to provide financing support for private real estate companies as soon as possible, in order to help private real estate companies to establish a normalized financing mechanism. At the same time, special bonds could also be used to acquire the guaranteed delivery housing projects which can be converted into affordable housing after the completion of the projects.

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