Economic and Policy Highlights Following the Two Sessions[1]

Robin XING[2], CF40 Member

Abstract: *This year's economic growth target conveys the government's intention to guide expectations and stabilize confidence, but it will not be an easy task. The contraction of local government financing vehicles (LGFVs) and the decrease in land transfer revenue will restrict to some extent how expansionary broad fiscal policy can be. To offset the tightening effects of deleveraging in the real estate and LGFV sectors and to bring the inflation rate and nominal GDP growth back to more satisfactory levels, a net fiscal expansion of about 7-8 trillion yuan is needed over the years 2024-2025, with a focus on social security and welfare investment.*

Monetary policy should play a supporting role and coordinate with fiscal policy. Compared to Japan's monetary policy moves when the country entered a prolonged period of deflation in the 1990s, China's current round of monetary policy operations is more appropriate. Looking ahead, if the central government issues more national bonds, whether the monetary authority needs to help through innovative tools is worth studying.

In terms of policy direction, the focus should not return to investment-led stimulus but should shift more towards supporting consumption. In addition to the short-term trade-in subsidies for consumer goods, social security reform is a more meaningful long-term measure, which could unleash consumption willingness by increasing social security spending in medical care, public housing, and education for new citizens, including migrant workers.

To treat "both symptoms and root causes" of risks in key areas such as the real estate market, it is necessary to address how to increase affordable housing and to solve the current problem of oversupply in the real estate market. If the authorities can purchase a portion of commercial housing and convert it into affordable housing, it will help alleviate the short-term real estate liquidity crisis and increase social security benefits for new citizens, including migrant workers.

One of China's advantages is that the balance sheet of the central government and the overall government balance sheet, including state-owned assets, are relatively healthy. This allows for market-oriented reforms of state-owned enterprises aimed to improve ROE, strengthen dividend ratios, and bring more dividends to shareholders such as the social security fund to fill the fiscal gap. Enhancing the returns from state-owned assets and reforming state-owned enterprises may be a necessary part of China's fiscal reform.

1 This article is an interview conducted by the CF40 Research Department with the author. It was initially published on March 7, 2024, on CF40's WeChat official account.

2 The author is Chief China Economist of Morgan Stanley.

I. Fiscal Policy Needs to Step Up to Achieve the Ambitious Economic Growth Target

Q1: How do you interpret the 2024 GDP growth target? How easy or difficult it is to realize an "around 5%" growth target?

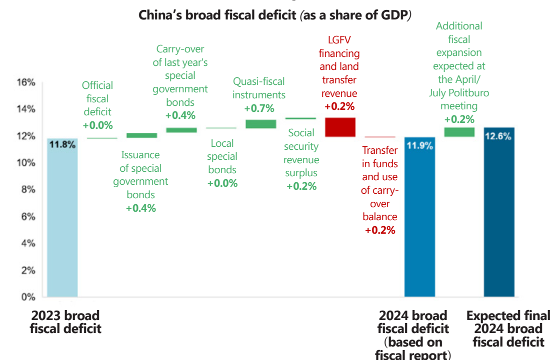
Xing: I think the growth target is set quite high. International organizations and institutions forecast China's economic growth to be around 4.5% in 2024, and their expectation for the long-term potential growth rate may be even more conservative. By setting the target at around 5%, the authorities hope to guide market expectations, dispel external narratives of a downturn in China's medium and long-term growth potential, and convey confidence. This intention is good, but the key is implementation, which requires supporting policy measures.

Q2: Regarding fiscal policy, the government work report proposed a fiscal deficit rate of 3%, but the report also proposed issuing ultra-long-term special government bonds for several consecutive years, starting with 1 trillion yuan this year. What is your assessment and suggestion on the fiscal stance?

Xing: The government work report at this year's Two Sessions appears to suggest a rather restrained and moderate fiscal plan. The official deficit rate of 3%, and the 1 trillion yuan of ultra-long special national bonds and 3.9 trillion yuan of local special bonds combined (as a percentage of GDP) are basically flat compared to last year. Of course, there is 1 trillion yuan of government bonds issued but not used in 2023. While the funding raised through the bonds will be transferred over to this year and have certain positive impact, it should also be noted that this year's off-balance-sheet finance may still tighten by about a trillion yuan, i.e., the financing of LGFVs and local governments' land transfer balance will continue to contract, so the overall strength of the broad fiscal policy remains to be seen (Figure 1).

Since the economic growth target is quite ambitious, it may be necessary to re-evaluate the situation in the middle of the year and further strengthen fiscal policy. There can be multiple times in a year when the decision-makers adjust economic policy, and there will be at least 2-3 more Politburo meetings on economic work this year. If the economy encounters more challenges in the first half of the year, fiscal policy can be further strengthened. The announcement of an additional 1 trillion yuan of government bonds in October last year was a discretionary move to step up efforts.

Figure 1: Considering the Tightening of LGFVs and Land Finance, the Broad Fiscal Deficit Has Not Expanded



Source: Morgan Stanley

II. Monetary Policy Should Play a Supporting Role Given Limited Room for Interest Rate Cuts

Q3: The government work report stated that "prudent monetary policy should be flexible, appropriate, precise, and effective," and it also proposed to "enhance the intrinsic stability of the capital market." What's your interpretation of these statements? How do you view the direction and stance of the monetary policy for 2024?

Xing: We've seen a series of policy moves aimed at supporting the capital market recently, such as slowing down the pace of IPOs, mobilizing the "national team", or long-term funds, to rescue the stock market, strengthening regulation to protect investor interests, and severely punishing illegal and noncompliant activities. These have had a certain effect, and the market is gradually bottoming out.

However, overall, the stock market is still a barometer of the economy, and the synergy of various macro policies may be more conducive to sustained improvement in financial market confidence. Therefore, whether the subsequent improvement in confidence can be sustained depends on whether there is room for fiscal policy to continue to expand, in order to break the negative feedback loop of lower prices and higher debts; monetary policy should play a supporting role and coordinate with fiscal policy. If greater fiscal stimuli, such as issuing more government bonds, are adopted, the People's Bank of China could help the market absorb the bond issuance by reducing reserve requirements and injecting liquidity.

As for interest rate cuts, there is some policy room this year, but not much space for direct stimulation. On one hand, over the past two to three years, China has already eased its monetary policy to a certain degree. Last year, everyone was comparing China and Japan, and I believe that compared to Japan's monetary policy moves in the 1990s when the country entered a prolonged period of deflation and the "lost decades", China's current monetary policy operations are more appropriate, especially in terms of real interest rate adjustments.

From 1990 to 1995, the Bank of Japan was hesitant about using tools such as interest rate cuts to ease monetary policy, fearing that lowering rates too much might create another real estate bubble. The indecision at that time led to a situation where, during five to six years of significant downturn in real estate and huge deflationary pressures on the economy, Japan's real interest rates remained nearly 200 basis points higher than the real GDP growth, which is inconsistent with the historical experience that relatively low interest rates are needed when an economy is deleveraging.

We compared the data of countries that have successfully achieved a soft landing after deleveraging in the past 100 years with those that have not and instead suffered significant economic and monetary system shocks. One lesson we drew from the analysis is that if an economy wants to achieve a soft landing when it deleverages, interest rates need to be maintained at relatively low levels. A real interest rate about 200 basis points lower than the real GDP growth rate is helpful for deleveraging. A high real interest rate environment, where GDP growth cannot keep up with interest payments, will increase leverage rather than decreasing it.

China's current round of monetary policy operations have kept the real interest rate level below the real GDP growth rate since 2021, by about 100 basis points on average. Recently, because of the low price level, the real interest rate is not significantly lower than the real GDP growth rate, and the central bank has responded with further rate cuts, such as the recent 25 basis points reduction to the 5-year LPR.

On the other hand, some views suggest reducing the interest rate to near 1 or 0, but significant interest rate cuts face practical constraints. One is that the Federal Reserve has been raising interest rates to deal with surging inflation during the past three years, and the interest rate spread between China and the US imposes certain constraints on the exchange rate. In simple terms, China faces the "impossible triangle," if we want to stabilize the exchange rate, interest rates may not be able to drop too much. Second, the net interest margin of China's banking sector has declined in recent years. If we want the banking sector to help absorb some debt risks, including those of LGFVs, banks need to maintain a certain margin and profit space. Further large reductions in loan interest rates will likely weaken bank profitability, affecting their ability to digest risks in the long term.

Considering that US monetary policy will reach a turning point—we expect the Federal Reserve may begin cutting rates this summer, opening the curtain for a downward trend in US interest rates over the next two years, China will have some room for interest rate cuts, which is expected to be around 20 basis points.

III. Innovation in Monetary Policy Tools is Worth Studying

Q4: The government work report pledged to "continue to implement a proactive fiscal policy and a prudent monetary policy and strengthen the innovation and coordination of policy tools." What are your expectations and hopes for the innovation of policy tools?

Xing: To achieve coordinated easing of fiscal and monetary policies, the basic operation is to issue bonds on the fiscal end, and flatten liquidity fluctuations through appropriate monetary maneuvers. In this regard, there are more innovative tools, such as Quantitative Easing (QE), i.e., direct purchases of government bonds by the central bank, which has been implemented in the United States and Japan.

For China, there is still some room for traditional monetary policy tools, and it has not yet reached the point where it needs to implement QE to achieve its monetary policy objectives under zero interest rate. The law governing the People's Bank of China does not support this, and if such innovation were to be realized, it might involve amendments to the law in the future. However, in the long term, it would be a good idea to look into whether some innovative monetary policy tools can be adopted to help the central government issue bonds on a larger scale.

The current nominal economic growth, which includes the real GDP growth rate plus the inflation rate, faces certain pressure, and businesses and investors are more concerned with nominal growth. Therefore, the key is to restore the inflation rate to a reasonable level of 2%-3%, which would be conducive to a sustainable rebound in market confidence.

According to our calculations, a net fiscal expansion of about 7-8 trillion yuan over the years 2024-2025 is required to offset the tightening effects brought about by deleveraging in the real estate and LGFV sectors, break the negative feedback cycle of low prices and high debts, and bring the inflation rate and nominal GDP growth rate back to more satisfactory levels.

A net fiscal expansion of 7-8 trillion yuan means that the scale of central government bond issuance needs to be further expanded. Therefore, in this process, we could also devote some research attention to whether monetary authorities can innovate tools to help the central government issue bonds on a larger scale, to support adequate fiscal expansion.

IV. Shift away from the Old Ways of Investment-led Stimulus and Rely on Social Security Reforms to Unleash Consumption Willingness

Q5: Regarding expanding domestic demand, the report suggested to "integrate the strategy of expanding domestic demand with efforts to deepen supply-side structural reform, and better coordinate consumption and investment, so as to more effectively drive economic growth." What do you think this arrangement means for China's efforts to expand domestic demand and stabilize growth this year? What suggestions do you have for boosting consumption and investment?

Xing: The government work report's expression is quite balanced and attention should be paid to how specific policies are implemented.

Although stimulating aggregate demand is urgent, we should not return to the old ways of investment-led stimulus. In the past rounds of economic downturns, economic stimulus focused on boosting investment in real estate and infrastructure, which kept the proportion of investment in China's GDP at a high level.

Under the current trend of population decline and aging, the capital output ratio is not what it used to be. According to our calculations, before 2010, China could produce one unit of GDP with every 2-3 units of capital investment. Today, this ratio—the Incremental Capital-Output Ratio (ICOR)—has risen to 10, several times higher. In this case, if we continue to adopt investment-led stimuli, the return on investment will further deteriorate.

Therefore, the current policy focus should shift more towards stimulating consumption. Cash and consumption vouchers can have immediate impacts, but not very feasible in China. A more feasible measure is to provide short-term trade-in subsidies for consumer goods, especially smart home appliances, new energy vehicles, and electronic products, which has already been proposed by the central government. Another more meaningful measure is social security reform. By increasing social security spending for new citizens including migrant workers in medical care, public housing, and education, it can unlock the consumption willingness of these household sectors.

According to the International Monetary Fund (IMF), due to the large impact on low-income families with a high marginal propensity to consume, the short-term fiscal multiplier effect of such social welfare transfers reaches 1.4, even higher than the fiscal multiplier of 1 from direct government infrastructure investment.

Q6: You believe that policy focus should shift towards consumption. However, considering last year's high consumption growth rate, some views hold that there is limited room for maintaining high consumption growth this year, hence some prefer investment-led growth. What is your view on this?

Xing: I think we need to adopt systemic thinking to understand the main challenges facing China's economy, the solutions, and how to avoid new risks when dealing with these challenges.

An investment-led stimulus policy, even if it supports high-end manufacturing, green energy transition, and other strategically important areas, is still essentially a supply-side policy that aims to generate more production capacity. In this regard, we also need to consider whether the global market can absorb so much of China's capacity amid the current geopolitical landscape. Therefore, if we focus solely on investment, it may indeed stimulate the economy in the short term, but it may bring more challenges in the long run. Meanwhile, the situation of insufficient consumer demand will not be well addressed in the process of increasing production capacity.

As we suggested, facing insufficient consumer demand and unstable expectations, strengthening social security and welfare investments for the new citizen groups can help release consumption potential, which not only aligns with the implementation of the concept of common prosperity in the medium and long term but also helps to reduce the risk of new excess capacity. In other words, the method kills two birds with one stone.

V. Is It Possible to Purchase A Portion of Commercial Housing and Convert It into Affordable Housing?

Q7: Regarding the risks in key areas such as real estate, the government work report proposed to "treat both the symptoms and the root causes" and has made plans from two aspects: prudently and orderly handling potential risks and improving the long-term mechanism for risk prevention and control. What specific suggestions do you have for implementing the "treatment of both symptoms and root causes" of real estate risks? How do you view the state of the real estate market this year?

Xing: You mentioned the expression "treating both the symptoms and the root causes." The policy towards real estate has further improved in recent months, including the whitelist system and regulatory encouragement for more support from the banking sector to help ensure the delivery of housing projects. I believe these are part of "treating the symptoms," mainly addressing the current liquidity and sales issues faced by developers.

"Treating the root causes" refers to a sustainable new development model, including more housing supply from affordable housing. To address both symptoms and root causes, we need to figure out how to increase affordable housing while also addressing the existing oversupply issue in the real estate market. Therefore, if the authorities could purchase a portion of commercial housing and convert it into affordable housing, this would help alleviate the short-term real estate liquidity crisis and increase social security benefits for new citizens, including migrant workers.

Some worry about moral hazard, but this may require systemic thinking. Based on lessons learned from the United States and Japan in dealing with the slump in real estate and financial markets, it can be observed that worrying too much about moral hazard without timely intervention might lead to a negative feedback cycle of low prices and high debts, which could have a more adverse effect on long-term growth potential.

There was a similar debate in the United States after the 2008 financial crisis about whether to bail out the banking sector; Japan's hesitation in the 90s regarding real estate and banking issues was partly caused by the lack of consensus and excessive concern over moral hazard. In hindsight, the United States adopted large-scale rescue policies without being overly concerned about moral hazards, which led to a rapid recovery, and today, it seems that the potential for economic growth in the United States has not been too adversely undermined and has recovered fairly well. In contrast, Japan's hesitation led to the "lost decades."

Regarding this year's real estate market trend: from the sales side, the first and second quarters might still see negative growth year over year, but the sales will possibly stabilize in the latter half of the year. After all, real estate sales have undergone significant adjustments from 2021 to the present. Based on our calculations of China's future normal urbanization and renovation space, there might still be some rigid demand in the real estate market, and the current actual sales level is already close to the equilibrium level.

The biggest issue is whether we can adopt more targeted policies to avoid further overshooting risks caused by a negative feedback loop.

VI. Increase State-Owned Enterprises' Dividends

Q8: Following the Central Economic Work Conference at the end of last year, the government work report once again proposed to "plan a new round of fiscal and tax system reform." What are your prospects or expectations for this?

Xing: It is important to recognize the challenges China faces, such as population aging and the downturn in the real estate market, which will put pressure on fiscal revenues and expenditures, necessitating timely strategic preparation and bold reforms.

Currently, in the process of resolving local debt, for some provinces with relatively serious debt issues, it's not only about helping them mitigate their debts but also preventing them from raising large amounts of new debts for economic development, etc. This means that the role of local governments has changed significantly compared to the past decades. They need to transition from actively mobilizing various resources to raise debt for infrastructure and intervene in economic development, to acting as service-oriented governments to improve the business environment.

In the future, population aging could exacerbate the social security funding gap. Considering the need to implement social security benefits for new citizens, including more than 200 million migrant workers, more fiscal revenue is obviously needed. So how can we fill the funding gap?

This requires recognizing China's strengths. One of China's advantages is that the balance sheet of the central government and the overall government balance sheet, including state-owned assets, is relatively healthy, which is a quality many countries do not possess. The central government not only has a low level of debt but also owns a large amount of state assets, especially shares in state-owned enterprises. Facilitating better market-oriented reforms of state-owned enterprises, improving Return on Equity (ROE), and increasing dividend ratios to bring more dividends to shareholders, such as the social security fund, are important sources for filling the fiscal gap.

We have estimated that increasing the dividend rate of state-owned enterprises to around 40% could fill the gap created by the decline in land transfer revenue and

local fiscal revenue. This would give us more leeway when facing the fiscal transformation in the next decade or so, amid population aging and increased social security spending. Therefore, enhancing the returns from state-owned assets and reforming state-owned enterprises may be a necessary part of China's fiscal reform.

In fact, in regions such as the Nordic countries, the Middle East, and Southeast Asia, many economies with sovereign assets rely on the income from these assets to sustain fiscal revenue and provide better national welfare.