

Delicate balance
between growth and
risk prevention-
Takeaway from the
2019 "two sessions"



Executive summary

Premier Li Keqiang clearly took the potentially slower economic growth in 2019 into consideration as he delivered the Government Work Report. In addition to revising down the official target for economic growth, economic policies also turned more supportive with the key feature of government tax and fee cuts. Meanwhile, monetary easing will be limited to addressing the liquidity demand from the real economy, as excessive financial leverage remains a concern. Instead of returning to massive stimulus, policy has shifted its focus to nurturing strategic industries and expanding market access for foreign investors.

Target in 2019: boosting growth while keeping risks at bay

The 2019 Government Work Report (“Work Report”) was delivered by Premier Li Keqiang on the first day of the National People’s Congress (NPC) on 5 March¹. In contrast to the report last year, which was primarily focused on structural reforms when economic growth was more resilient, the Premier clearly considered the challenges against China’s economy this year. Admitting that China’s economy is entering “a more complicated situation”, the report highlighted the need to stabilize the economy in six areas: finance, trade, foreign capital, investment, expectations, and most importantly, employment.

Fig 1: 2019 official government target

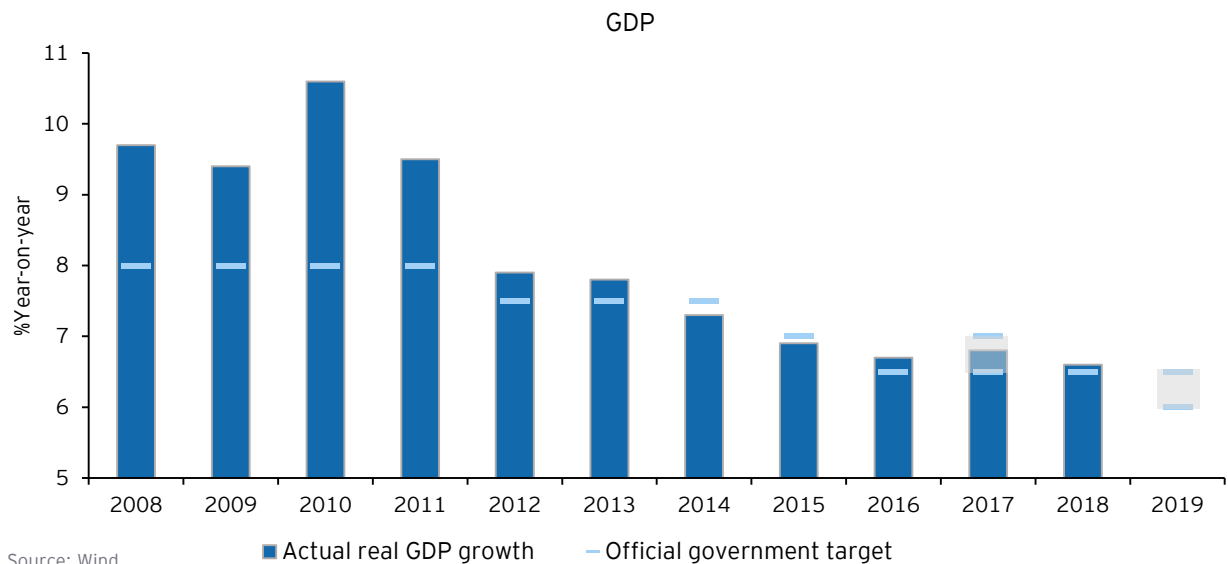
| Target | 2019 | 2018 | 2017 | 2016 |
|--|--------------|------------|------------|------------|
| GDP (%Year-on-year) | 6.0-6.5 | Around 6.5 | Around 6.5 | 6.5-7.0 |
| CPI (%Year-on-year) | Around 3.0 | Around 3.0 | Around 3.0 | Around 3.0 |
| Urban job creation (m persons) | ≥ 11 | ≥ 11 | ≥ 11 | ≥ 11 |
| Urban surveyed unemployment rate (%) | Around 5.5 | ≤ 5.5 | - | - |
| Urban registered unemployment rate (%) | ≤ 4.5 | ≤ 4.5 | ≤ 4.5 | ≤ 4.5 |
| Energy consumption per unit of GDP (%) | Around -3 | ≥ -3 | ≥ -3.4 | ≥ -3.4 |
| Fiscal deficit (% of GDP) | 2.8 | 2.6 | 3.0 | 3.0 |
| Local government special bond (RMB b) | 2,150 | 1,350 | 800 | 400 |
| Tax and fee cut (RMB b) | Around 2,000 | 1,100 | 550 | 500 |
| Railway investment (RMB b) | 800 | 732 | 800 | ≥ 800 |

Source: Government Work Report

The Work Report revised down China’s official growth target for 2019 from 6.5% year-on-year in 2018 to a range of 6.0-6.5% year-on-year, a three-decade low. It also pledged to keep China’s growth within a reasonable range through more proactive policies, all the while giving markets a bigger role for the economy to achieve high-quality growth and keeping the overall financial leverage risk in check.

¹ http://www.gov.cn/premier/2019-03/05/content_5370734.htm (in Chinese only)

Fig 2: The official real GDP growth target in 2019 has been adjusted to 6.0-6.5% year-on-year



Tax and fee cuts to shore up the economy

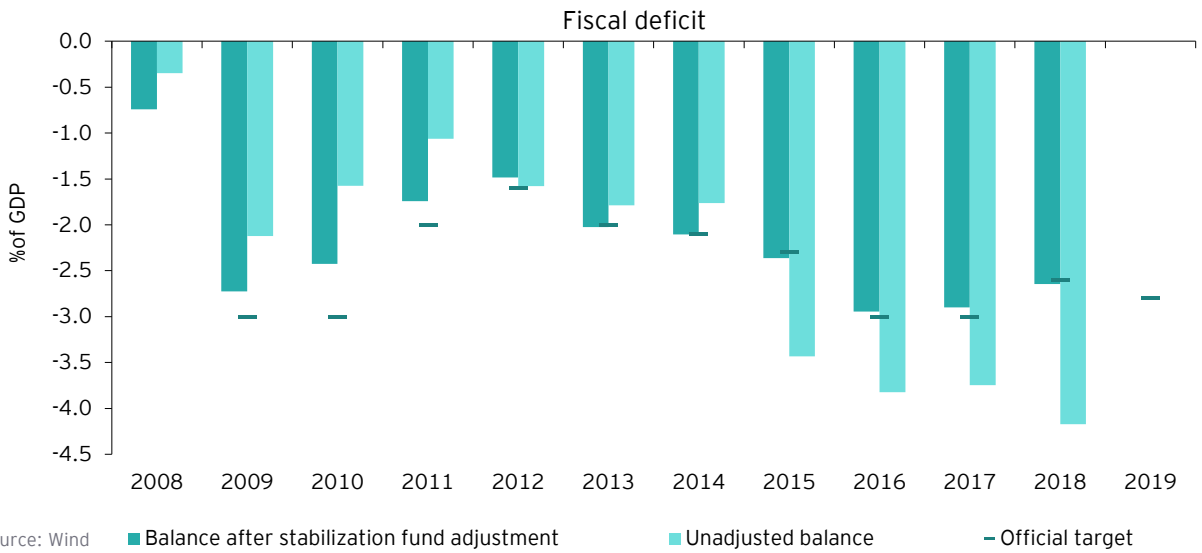
To achieve the growth target, the key feature of policy easing is government tax cuts and fee reductions. The Work Report planned to reduce corporate burden by nearly RMB 2t, way above the RMB 1.3t in 2018, through both tax cuts and employer social insurance contributions paid on behalf of workers. Specifically, the value-added tax (VAT) for manufacturers will be lowered from 16% to 13% and for transportation and construction industries from 10% to 9%. Tax reform will also proceed to simplify the VAT system and reduce the number of tax brackets from three to two. As a result, fiscal revenue for all government levels are going to be tightened this year.

The fiscal deficit target has only been raised to 2.8% of GDP from 2.6% in 2018. Nevertheless, easing could be expanded through two channels. First, China's budget accounting allows it to draw untapped funds from previous years through budget stabilization funds so it can reduce year-to-year volatility and report an actual deficit in line with the target.

Second, Liu Kun, Minister of Finance, also noted² that profits turned in by designated state-owned financial institutions and enterprises will increase; transfer payment from the central Government to local governments will also increase; other non-necessary expenditures such as government car purchase and overseas trips will be tightened further; and local governments are requested to put various dormant funds and assets to good use through multiple avenues, thereby making use of fiscal resources efficiently.

² <http://www.gov.cn/zhuanti/2019qglhzb/live/20190307a84237.html> (in Chinese only)

Fig 3: The actual fiscal deficit could be larger with adjustment from stabilization funds



Meanwhile, infrastructure investment will likely pick up, albeit only moderately, targeting at projects that are addressing pressing economic and social needs and to support major initiatives such as the Belt and Road Initiative (BRI) and the Greater Bay Area (GBA). Infrastructure investment will in part be funded by the new issuance of special purpose local government bonds, which is going to rise to RMB 2.15t from RMB 1.35t last year. In order to maximize the impact of the new bond issuance, the Ministry of Finance noted that the time frame for bond issuance has been advanced earlier this year through special approval from the NPC, and the average bond maturity of the newly issued bonds has been extended for an extra year to match the underlying project cycle better and prevent unnecessary repayment pressure.

Fig 4: Slower infrastructure investment since 2018

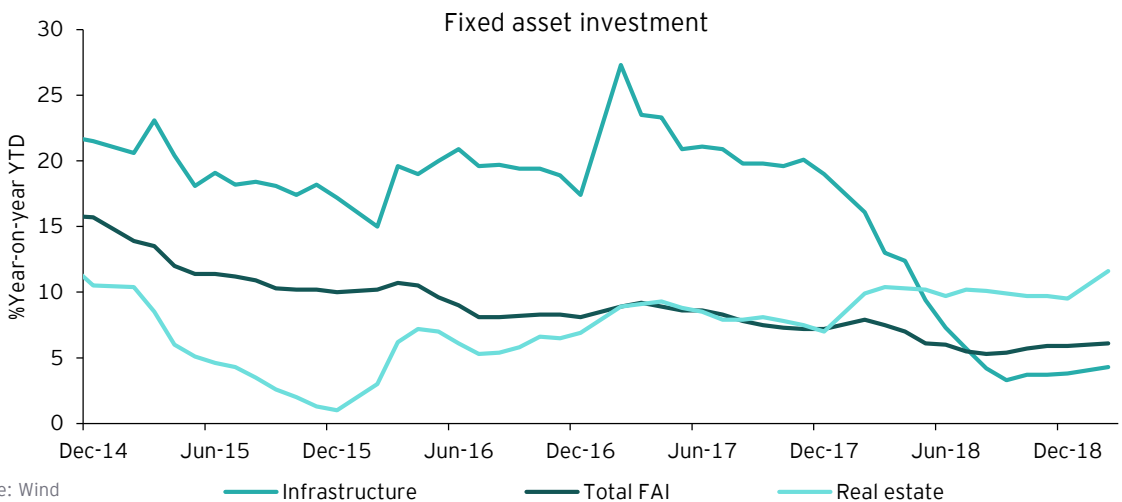
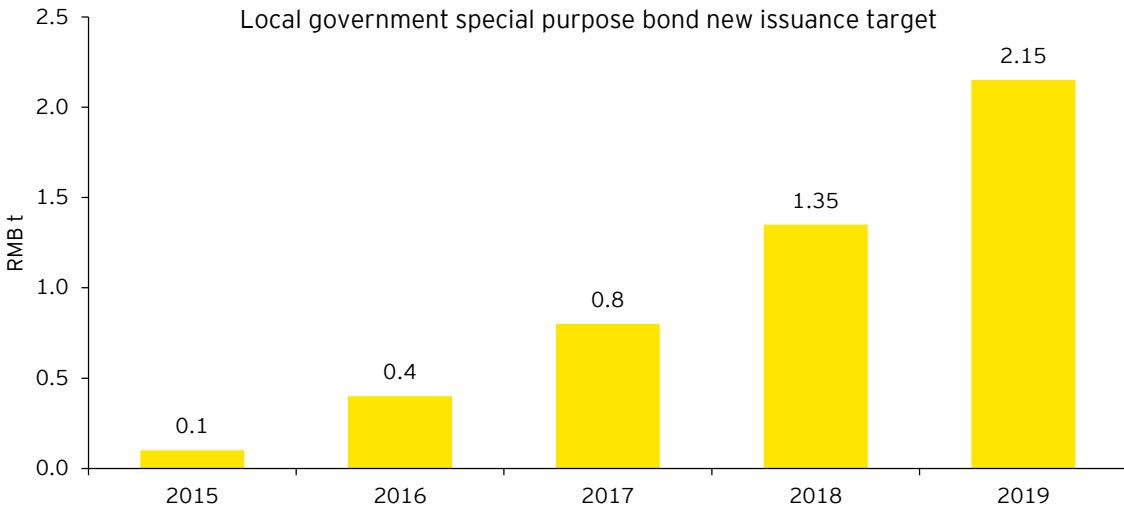


Fig 5: Local government special purpose bond issuance to increase by RMB800b this year

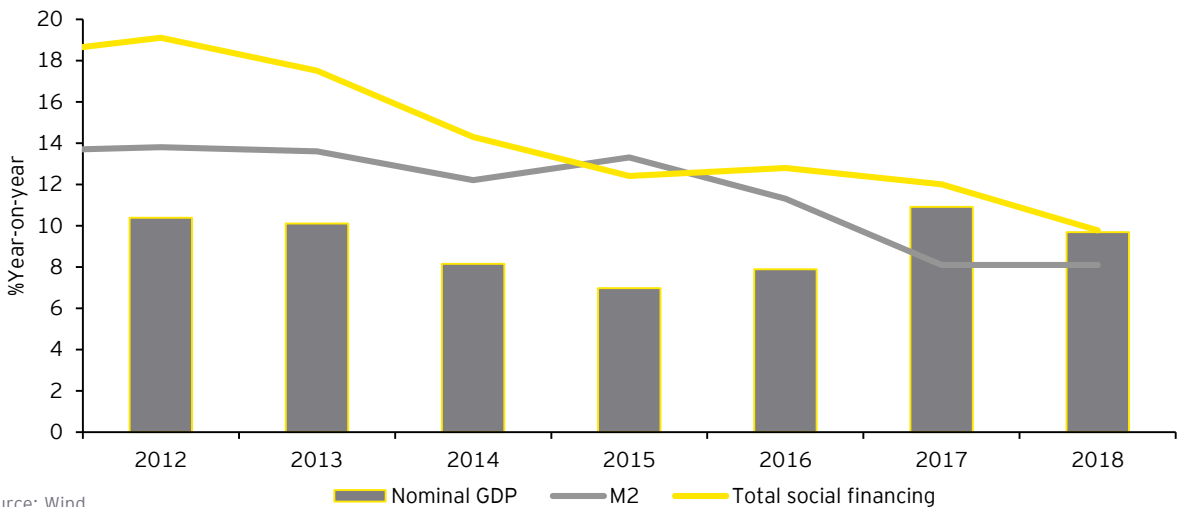


Source: Wind

Targeted monetary policy serves real demand

The Work Report also highlighted that monetary policy will be carried out with precision. With massive easing explicitly ruled out in the Report, the policy is targeted at spurring genuine economic demand. Specifically, the Report expected the growth rates of money supply (M2) and total social financing (TSF) to match with the pace of nominal economic growth. It suggested that continued efforts will be made to prevent excessive growth in shadow banking that was a concern for the financial market in the past.

Fig 6: Growth rate of M2 and total social financing have become more in line with GDP growth since 2017

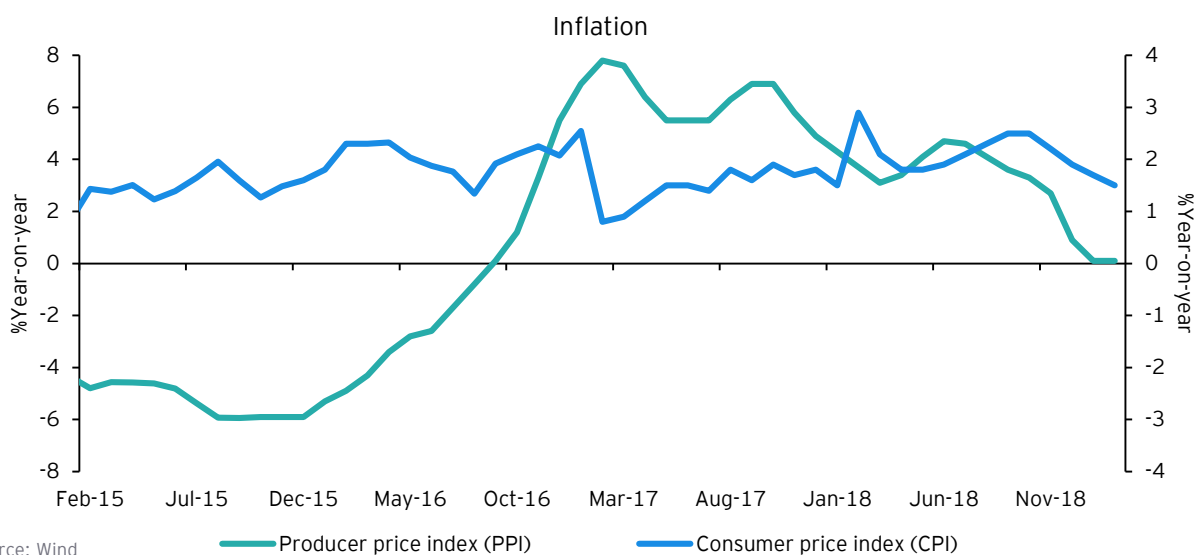


Source: Wind

To alleviate the difficulty for the real economy to obtain bank financing, the Work Report demanded that the leading state-owned banks to extend 30% more loans to small and micro enterprises in 2019. Guo Shuqing, Chairman of the China Banking and Insurance Regulatory Commission (CBIRC), elaborated during a NPC press meeting³ that the target is achievable through well-crafted guidelines that could potentially use big data to facilitate lending to those enterprises, many of which lack collateral and credit history, possibly at a lower cost.

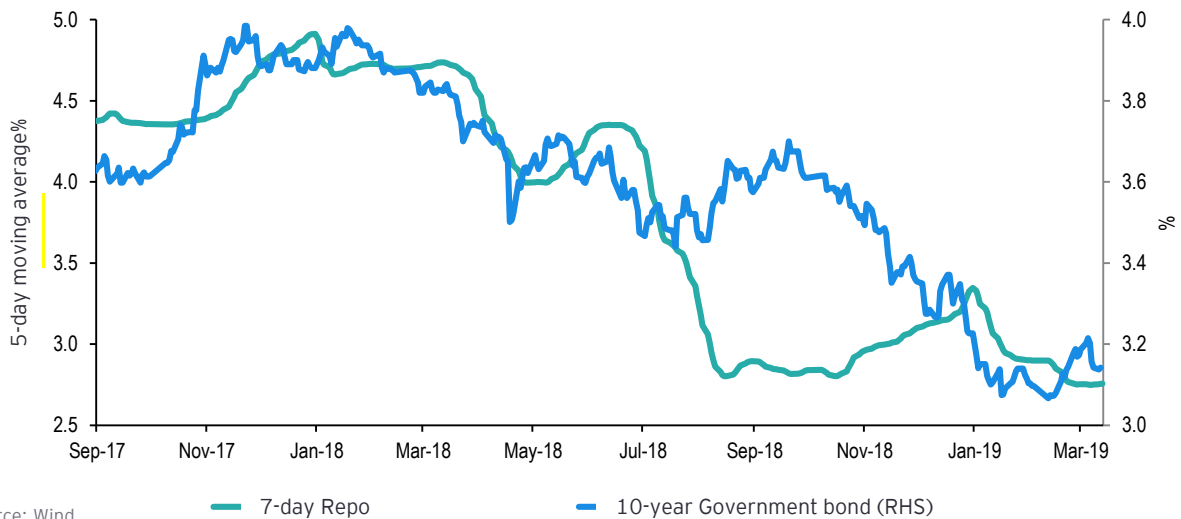
In addition, the Report made clear that the Government should be prepared to use quantity and quality monetary tools such as reserve-ratio-requirements (RRR) and interest rate to keep financing cost low. As such, although the People's Bank of China (PBoC) has other options to bring down market interest rates, the possibility of the first benchmark rate (one-year lending) cut since 2015 has increased, especially when China's subdued inflation is put into consideration.

Fig 7: Subdued inflation increases the possibility of benchmark interest rate cut



³ <http://www.cebnet.com.cn/20190305/102554763.html> (in Chinese only)

Fig 8: The PBoC has brought down market risk-free interest rate since end-2017



Source: Wind

In addition to bank lending, the Work Report also pledged to promote direct financing through bond and equity issuance in the financial market. Fang Xinghai, Vice Chairman of the China Securities Regulatory Commission (CSRC), announced on 7 March⁴ that the new science and technology innovation board at the Shanghai Stock Exchange is now open to listing application. The more lenient requirements at the board will hopefully provide a new channel for upcoming technology businesses to receive direct funding from the capital market.

Nurturing strategic industries for sustainable high-quality growth

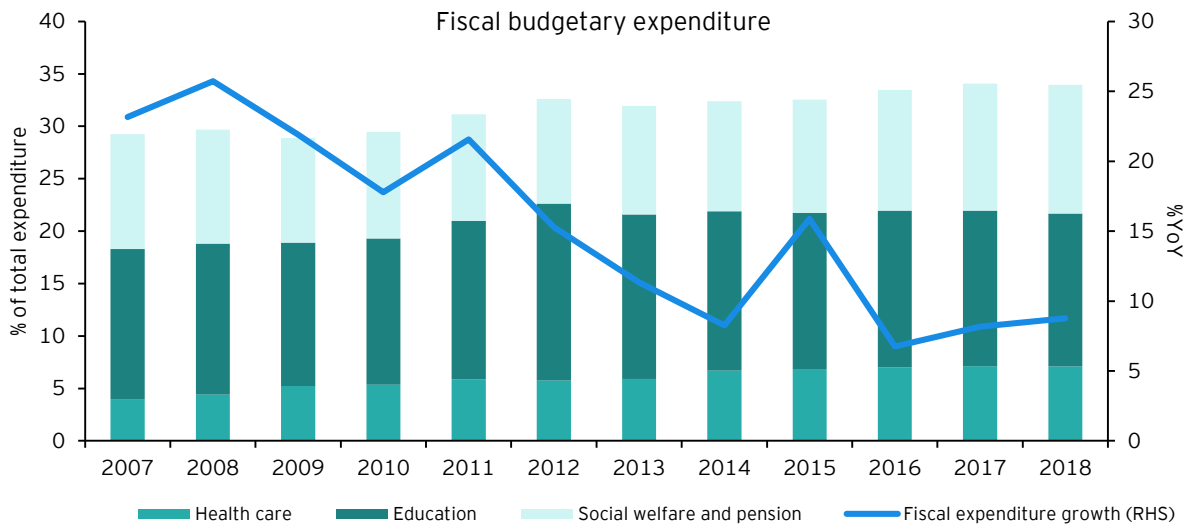
Sustainable high-quality growth has to be achieved through the development of strategic new industries. In the Work Report, the focus is on 1) technology, innovation, and entrepreneurship; and 2) domestic demand particularly through consumption.

First, the Work Report reiterated the importance of making China a strong nation in manufacturing. This is expected to be achieved through: upgrading traditional industries; high-quality growth of the advanced manufacturing sector; technology and innovation; strengthening information infrastructure such as increasing the speed and lowering the cost of broadband connection; more support on fundamental science and technology research; and entrepreneurship incentives. Measures such as tax cuts for manufacturers and small-businesses will also be enhanced to encourage the development of high-quality manufacturing and boost innovation.

⁴ <http://money.people.com.cn/n1/2019/0308/c42877-30964306.html> (in Chinese only)

Second, the Report stated that economic resilience is achieved through strong domestic demand. In particular, the Government will continue to boost domestic consumption through: comprehensive implementation of individual income tax cut; offering better education, health care, pension, and social insurance; and nurturing the development of high-quality personal service industries in the private sector such as community elderly care and childcare. He Lifeng, Chairman of the National Development and Reform Commission (NDRC), said in a press conference⁵ that the NDRC will announce further measures to boost domestic demand in areas such as the recycling of old automobile and home appliances after the NPC.

Fig 9: Fiscal spending on welfare could further boost consumption



Source: Wind

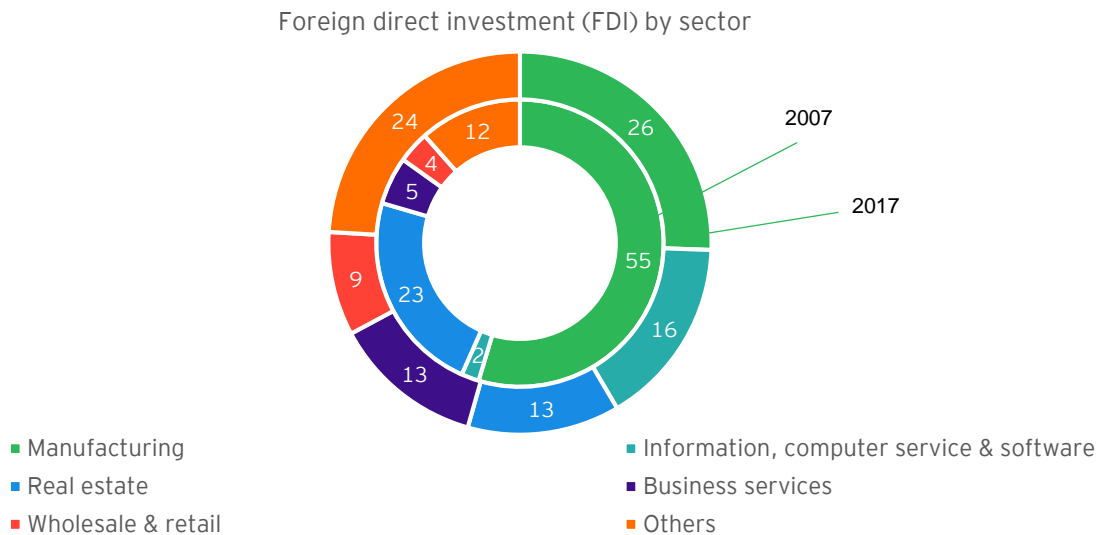
Refocus on foreign trade and investment

The Work Report also pledged to improve market access for foreign trade and investment, and create an open environment in which Chinese and foreign enterprises could compete on equal grounds.

⁵ <http://www.gov.cn/zhuanti/2019qglhzb/live/20190306a74816.html> (in Chinese only)

According to the NDRC, the negative list of industries for foreign participation will be shortened further in 2019, and more industries will be open to wholly foreign-funded companies. Meanwhile, it will also expand the list that welcomes foreign investment to encourage foreign investors to take a more conducive role in China's industrial upgrade and new industry development. In areas such as new energy, advanced manufacturing and information technology, foreign investors may enjoy zero tariff on imported equipment, favorable policy on land use, and reduced corporate income tax at 15% for projects in the Western Region of China. Separately, the CBIRC also noted on Tuesday⁶ that Beijing could "absolutely" reach an agreement with the United States on opening up its financial sector.

Fig 10: FDI shifted from manufacturing to services



Source: Wind

The NPC also passed China's first unified legislation on foreign investment. The law protects foreign investment rights through clear stipulation on intellectual property rights and forbids forced technology transfers through administrative means. Foreign companies will also be treated as equals with Chinese companies before and after they enter China, such that they will face the same opportunities offered to their Chinese counterparts, from receiving policy support, raising funds in the A-share market, setting industry standard, to participating in government procurement bids.

⁶ <http://m.news.cctv.com/2019/03/05/ARTIXWPMZh8HQ5ygdM1DM2rN190305.shtml>
(in Chinese only)

Private investors allowed control over some SOEs

According to Xiao Yaqing, Chairman of the State-owned Assets Supervision and Administration Commission (SASAC)⁷, 2019 is a critical year for China's state-owned enterprise (SOE) reform, with ambitious targets in 1) changing the focus of supervision from asset to capital; 2) rationalizing the organization structure and decision-making hierarchy; 3) the pilot scheme in state-owned capital investment company; 4) contractualizing the board of directors and professional management arrangement; and 5) strengthening the incentive system for SOE management.

Specifically, the Work Report planned to select the fourth batch of SOEs to take part in the pilot reform this year and to actively promote private-sector participation in the reform. Lian Weiliang, Vice Chairman of the NDRC, noted in the NDRC press conference that more than 100 SOEs will participate compared to 50 in the first three batches since 2016. The SASAC sketched out plans for state investment and management companies akin to those of Singapore. Under this system, state capital investment companies will focus on long-term investment in selected industries with strategic importance, while state capital management companies will operate like private equity companies that seek capital returns from diversified assets investment. This could improve efficiency and sharpen the delineation between business and the state, addressing one of the common concerns in the reform.

In addition, the NDRC later elaborated that the SOE reform will focus on actively promoting mixed ownership reform, such that private investors will be allowed to take a controlling stake in SOEs in competitive sectors, while the practice of hiring professional managers instead of appointing bureaucrats for the operation of SOEs has been written in the Work Report for the first time. These measures could create incentive for enterprises to increase efficiency and profitability.

⁷ <http://www.gov.cn/zhuanti/2019qglhzb/live/20190309e19739.html> (in Chinese only)

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