CHINA: SHARP CONTRACTION IN FISCAL REVENUE EXPECTED IN 2022

MORE DEBT FINANCING IS REQUIRED FOR FURTHER STIMULUS

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SUMMARY

› The recent covid lockdowns and persisting property-sector weakness have led to a significant contraction in the Chinese government's fiscal revenue, which could fall short of its forecast by Rmb3.4-3.9 trn (about 3.0–3.4% of Chinese 2021 GDP) in 2022.

› A more constrained fiscal position may limit the rollout of additional government stimulus measures in the near term.

› There are various tools that the Chinese government can resort to in order to fill this funding gap. Some are easier to apply than others. But no matter which method it chooses, more debt financing is inevitable.

The Chinese government has clearly stepped up policy support to mitigate the sharp economic deceleration resulting from its 'zero covid' policies. There are heightened hopes of additional fiscal stimulus to boost GDP growth towards the official target of 5.5% for this year. According to our estimate, however, the covid lockdowns and the persistent weakness in the property sector have led to a sharp decline in the Chinese government's fiscal revenue so far this year, which could limit its ability to roll out more stimulus in the near term. Additional fiscal stimulus will require the government to significantly increase debt financing.

A bird's eye view of Chinese government revenue

Chinese government revenue consists of two main components: in-budget fiscal revenue and off-budget government-managed funds. In-budget fiscal revenue mainly consists of taxes, including value-added tax (VAT), corporate income tax, personal income tax, property-related taxes and so on, which together account for around 85% of in-budget revenue. The remaining 15% is from other non-tax sources such as administrative fees. The off-budget government-managed funds mainly come from land sales revenue, which accounts for about 90% of income in this category.

Overall, land sales and property-related taxes represented a significant 37% of total Chinese government income in 2021 (*Chart 1*).

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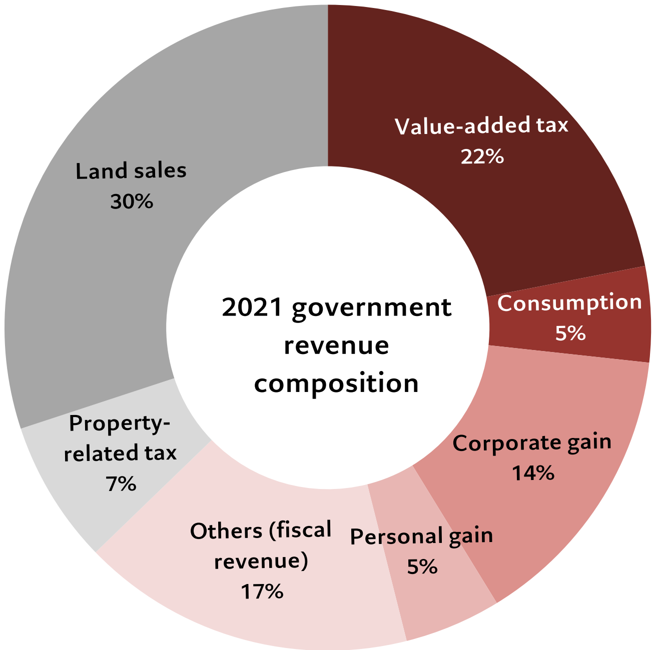
CHART 1: BREAKDOWN OF CHINESE GOVERNMENT'S CONSOLIDATED REVENUE



Source: Pictet Wealth Management, Wind as of June 2022

Chinese fiscal revenue will likely contract sharply in 2022

The covid-induced lockdowns and the slump in the property sector (which started in 2021) have led to a sharp deceleration in the Chinese economy since March, hurting government fiscal income hard.

In the first four months of 2022, the Chinese government's in-budget fiscal revenue contracted by 4.8% compared to the 2022 annual target of 3.8% growth announced at the National People's Congress (NPC) in March. The slump was particularly significant in April (-41.3% y-o-y), due to the widespread lockdown measures introduced in response to the Omicron wave and VAT refunds sent to businesses as part of a government rescue programme (*Chart 2A*).

Off-budget revenue contracted even more sharply, by 27.6% year on year (y-o-y) in the first four months of the year, with land sales being the main drag (-29.8% y-o-y) as the property market continued its downward spiral. The still-acute liquidity problems faced by many property developers weighed heavily on land transactions (*Chart 2B*). Limited household mobility and consumer demand amid prolonged covid restrictions have likely added to developers' financial stress.

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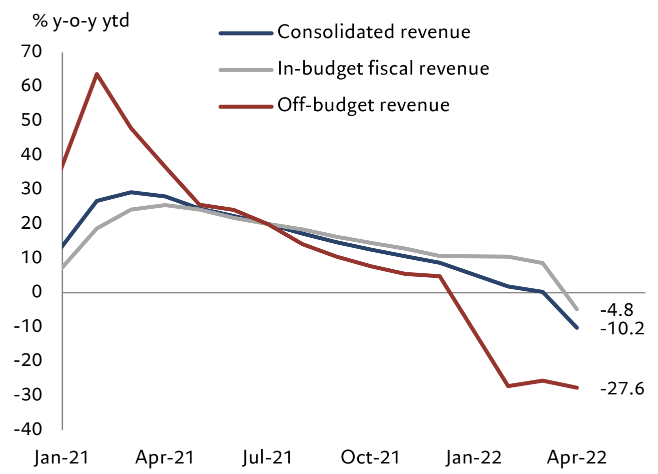
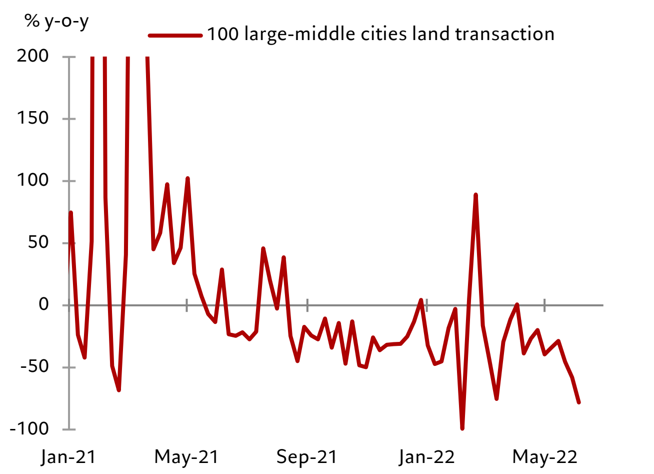
CHART 2A: GROWTH IN CHINESE GOVERNMENT REVENUE



Source: Pictet Wealth Management, Wind as of June 2022

CHART 2B: GROWTH IN LAND TRANSACTIONS IN 100 MAJOR CITIES



Source: Pictet Wealth Management, Wind as of June 2022

Given the sharp contractions in its two major income sources (i.e. taxes and land sales revenue), we estimate the Chinese government's actual fiscal revenue in 2022 could fall significantly below its annual target, possibly by Rmb3.4 trn (about 3.0% of Chinese GDP in 2021). This assumes a 20% full-year decline in land sales (in value terms). Government revenue could decline by Rmb3.9 trn (equivalent to about 3.4% of 2021 GDP) if land sales contract by 25% *(Table 1)*.

TABLE 1: ESTIMATED FISCAL REVENUE SHORTFALLS COMPARED TO GOVERNMENT BUDGET FORECASTS

RMB bn	Government Target	*Assume 20% drop in land sales (value)*		*Assume 25% drop in land sales (value)*	
		Projection	Shortfall	Projection	Shortfall
In-budget revenue	21.0	19.5	-1.5	19.5	-1.5
Off-budget revenue	9.4	7.5	-2.0	7.0	-2.4
Total revenue	**30.5**	**27.0**	**-3.4**	**26.6**	**-3.9**

Source: Pictet Wealth Management, Wind, Ministry of Finance as of June 2022

Further stimulus requires significant increase in government debt financing

In response to the slump in growth, the authorities have clearly stepped up policy support. A Rmb300 bn bond to fund additional railway construction and a Rmb200 bn bond issue to support the aviation industry has been followed by a Rmb800 bn increase in policy banks' lending quota to support infrastructure investment. Altogether, Rmb1.3 trn of new money has been injected into the economy in recent weeks.

However, the measures announced so far may not be enough to overcome the damage that the latest lockdowns have inflicted on the economy. We estimate that to boost the

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economy so that it has a chance of approaching the official 5.5% annual GDP target, additional spending of at least Rmb2.5-3.0 trn will be needed. Yet the drop in government tax receipts will hamper further stimulus.

However, we think there are still some tools at the government's disposal to fill the fiscal funding gap *(Table 2)*. In the very near term, the government will likely resort to more borrowing by state-owned entities (such as policy banks), which can be relatively easily done without having to obtain the approval by the NPC. Special bond issues or an outright increase in the budget deficit could be considered to boost stimulus further, but these require the NPC's authorisation and thus would take longer to implement. However, given the severity of the economic deceleration, we believe these options could well be on the agenda in the second half of this year.

TABLE 2: POTENTIAL TOOLS TO FILL THE FISCAL REVENUE GAP

Tools	Remarks	Additional measures already announced
Increase policy banks' lending quota	• Does not need approval from the NPC • Similar mechanism was utilised in the RMB3.6trn shantytown renovation programme (2015-2018)	RMB800 billion
Support state-owned enterprises (SOEs) to increase borrowing	• Does not need approval from the NPC • Encourage SOEs to take on more debt and speed up spending on infrastructure	RMB 300 bn for railway construction RMB 200 bn for aviation industry
Issue "central government special bonds (CGSBs)" or other special types of bonds	• The Ministry of Finance (MoF) needs to submit an application 30 days ahead to the NPC for approval • In 2020, the NPC approved RMB1.0trn in CGSBs to contain covid-19 and provide financial relief	-
Raise the fiscal deficit ratio	• The MoF needs to submit an application 30 days ahead to the NPC for approval • An unlikely option due to lengthy approval process	-
Allow local government funding vehicles (LGFVs) to take on more debt	• Does not need the NPC's approval • Channel to fill local government funding gap resulting from falling land sales • But any big easing of regulations on LGFV borrowing is unlikely given Beijing's concerns about local governments' high leverage	-

Source: Pictet Wealth Management, Wind, Ministry of Finance as of June 2022

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