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# Mizuho Economic Outlook & Analysis

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April 23, 2019

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## *Will the effects of China's economic stimulus measures materialize?*

*Evaluation of Jan-Mar quarter real GDP and analysis of policy effects*

### < Summary >

- ◆ Though the real GDP growth rate stopped declining for the first time in one year in the Jan-Mar quarter of 2019, largely underpinned by expanded housing investment and a greater external demand contribution from lower imports, infrastructure investment expected to have policy effects turned negative
- ◆ The effect of economic support measures on increasing the growth rate in 2019 is estimated to be +1.1%pt based on inter-industry relations table . According to this estimate, the government is keenly aware that the growth rate will drop to around +5% without stimulus measures
- ◆ Although policy effects are expected to appear in the second half of the year and later, there is a possibility that local infrastructure planning may be delayed due to the normalization of local government debt, and rising debt rates at private enterprises may also hinder investment expansion

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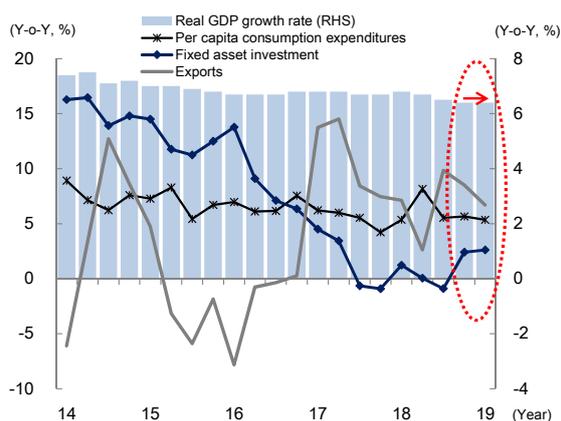
## 1. Temporary halt in fall of real GDP growth rate, but biased toward temporary factors such as lower imports & real estate investment

In the Jan-Mar quarter of 2019, China's real GDP growth was flat at +6.4% y-o-y against the previous year (Oct-Dec qtr: +6.4% y-o-y) and the growth slowdown continuing three quarters in a row since the Apr-Jun quarter of 2018 has ended for the moment (**Chart 1**). However, a breakdown shows that the growth rate was propped up largely by temporary factors, and downward pressure on the economy remains strong<sup>1</sup>.

Looking at the contribution of demand factors, domestic demand had final consumption of +4.2%pt (Oct-Dec qtr: +4.6%pt) and gross capital formation at +0.8%pt (Oct-Dec qtr: +1.3%pt), so both had lower contributions. Although the contribution from external demand expanded to +1.5%pt (Oct-Dec qtr: +0.5%pt) in support of growth, imports began to decline, and export growth has contracted for two consecutive quarters on the back of a global economic slowdown centered on manufacturing.

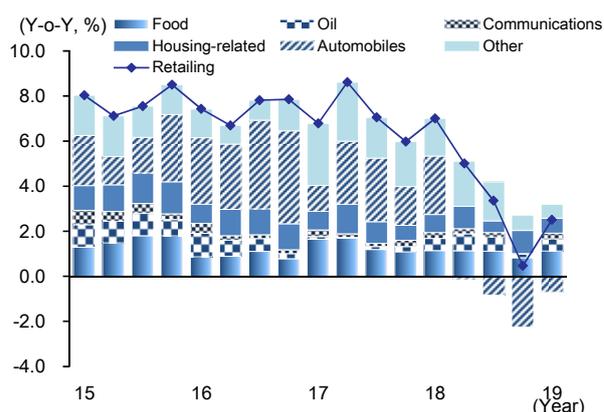
Based on an examination of the details of domestic demand using key indicators (estimates provided by Mizuho Research Institute), the real growth rate of per capita consumption expenditures shrank to +5.4% y-o-y (Oct-Dec qtr: +5.7% y-o-y), which is consistent with the lower contribution of final consumption to the growth rate. On the other hand, the real growth rate for total retail sales of consumer goods excluding services consumption expanded to +6.9% y-o-y (Oct-Dec qtr: +6.0% y-o-y). Looking at a breakdown of retail sales above a certain size, a smaller decline in automobiles and a bigger plus from communications equipment helped to lift retail sales (**Chart 2**). The volume of automobile sales was -5.1% y-o-y in March (Feb: -13.7%

**Chart 1: Real GDP growth rate and key indicators**



Note: Consumption expenditure per capita and fixed asset investment are real values. Exports are denominated in nominal dollars.  
Source: Made by MHRI based upon National Bureau of Statistics of China and China's General Administration of Customs

**Chart 2: Real retail sales**



Note: Realized via the CPI corresponding to each item.  
Source: Made by MHRI based upon National Bureau of Statistics of China

<sup>1</sup> Even at the April 2019 China Politburo meeting, the evaluation was that "economic management in the first quarter was stable overall and better than forecast" but that "economic management was still facing many difficulties and challenges, and the external economic environment is tense overall."

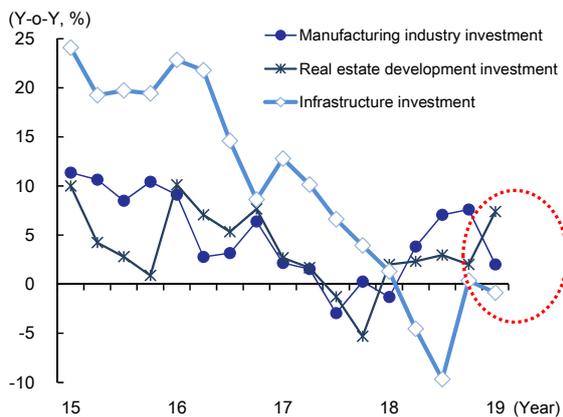
y-o-y), representing a slight recovery from the severe period of six months of continuous monthly y-o-y double-digit declines since September 2018, and signals that the downward pressure following the end of the tax cut for small cars has eased somewhat.

The real growth rate of investment in fixed assets saw a modest increase of +2.6% y-o-y (Oct-Dec qtr: +2.4% y-o-y). This resulted from growth in real estate development investment rising sharply by +7.4% y-o-y (Oct-Dec qtr: +2.0% y-o-y), while infrastructure investment growth expected to have policy effects was again negative at -0.9% y-o-y (Oct-Dec qtr: +0.4% y-o-y) (Chart 3). The growth in manufacturing investment dropped to +2.0% y-o-y (Oct-Dec qtr: +7.6% y-o-y). The contribution from inventories may have declined as the growth in fixed asset investment increased whereas the contribution from total capital formation declined.

The rapid expansion in Jan-Mar quarter real estate development investment is believed to reflect the progress of construction projects in 2018, but it is unlikely that this will lead to sustainable expansion as new projects are already in decline<sup>2</sup>. The value of land transactions, which is usually a leading indicator of development investment, has also been falling below the previous year's level (Chart 4). However, March housing prices (the average for 70 cities) were +11.3% y-o-y, the highest level since September 2010. Because of an emerging sense that the real estate market is overheating, the possibility of renewed willingness by developers to develop real estate requires cautious attention.

As described above, the growth rate for the Jan-Mar quarter remained unchanged because of support coming from a decline in imports and an expansion of real estate development

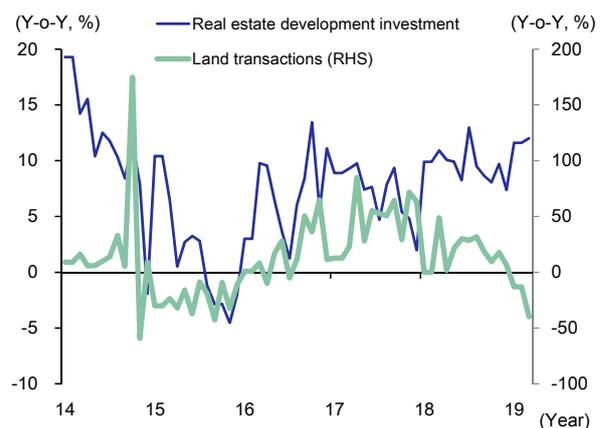
**Chart 3: Manufacturing, real estate development & infrastructure investment**



Note: Converted into real terms by a weighted-average deflator for each index series of fixed asset investment prices according to the ratio of investments in construction, machinery and others.

Source: Made by MHRI based upon National Bureau of Statistics of China

**Chart 4: Real estate development investment & land transactions**



Source: Made by MHRI based upon National Bureau of Statistics of China

<sup>2</sup> According to the National Development and Reform Commission's "2018 National Fixed Assets Investment Development Trend Monitoring Report and 2019 Investment Climate Outlook" (February 26, 2019), real estate project investment planning surged in 2018. The execution of these construction projects may cause a sharp increase in real estate development investment in the Jan-Mar quarter of 2019, but it was noted that new projects are decreasing.

investment, while the effects of support measures could not be clearly identified. In addition, the March surge in industrial production to +8.5% y-o-y (February: +5.3% y-o-y) is seen by the National Bureau of Statistics as influenced by the production drag caused by the Chinese New Year holidays in 2018 and the application of purchase deductions before the VAT tax cuts in April. However, it is believed that such temporary factors will disappear in April and production growth will again slow down. It is unlikely that the expansion of real estate development investment and the significant positive contribution from external demand as a result of the decline in imports in the Jan-Mar quarter will last, so the growth rate from the Apr-Jun quarter onward is expected to slow again.

## 2. If the policy effects have a steady impact, the growth rate can get a 1.1%pt boost

So, when will the economic support measures outlined at the National People's Congress (NPC) appear and what growth rate can be expected in the future?

First, let's examine the growth rate boosting effect. The policies outlined at this year's NPC to support the economy included (1) increasing infrastructure investment, (2) reducing taxes and reducing social insurance premiums and (3) promoting the purchase of durable goods (**Chart 5**). The scale of implementation for this consists of in the case of (1) mainly expanding the annual issuance of local special purpose bonds to 2.15 trillion yuan (2018 was 1.35 trillion yuan) and in the case of (2) increasing cost savings to 2 trillion yuan (2018 was 1.3 trillion yuan). On the other hand, the scale in the case of (3) has not been clarified, and the formulation of specific measures has been mainly left to local governments. Therefore, at the moment only (1) and (2) are possible candidates for generating quantitative effects, and their marginal increase ((1) is +0.8 trillion yuan and (2) is +0.7 trillion yuan compared with 2018) of 1.5 trillion yuan combined constitutes

**Chart 5: Major economic support measures in 2019**

	Scale
① Infrastructure investment expansion (local special projects bonds issuance)	2.15tr yuan
② Tax reductions, social insurance reduction	2tr yuan
- Value-added tax out (April --)	800bn to 1tr yuan
Manufacturing industry: 16% → 13%, transportation & construction industries: 10% → 9%	
- Social (pension) insurance premium reduction (May --)	800bn yuan
- Small-scale micro enterprise corporate income tax reduction (Jan --)	200 bn yuan
For companies with sales of 100,000 yuan/month or less, taxable income is 25% up to 1m yuan, 50% for 1-3m yuan	
- Individual income tax reduction (Jan --)	100bn yuan
③ Consumption promotion measures such as durable goods	Undetermined

Note: An estimated breakdown of the scale of tax reductions and cost reductions based upon information from China-based research institutes (news media).

Source: Made by MHRI based upon various reports from China's Ministry of Finance

**Chart 6: Effects of economic support measures (estimated)**

<b>Marginal increase in economic support measures</b>	<b>1.5tr yuan</b>
① Infrastructure investment	0.8tr yuan
② Cost reductions	0.7tr yuan
<b>New demand</b>	<b>1.0tr yuan</b>
① Infrastructure investment	0.8tr yuan
② Increase in investment thru cost reductions 700bn yuan (cost reduction amount) * α	0.2tr yuan
α = operating surplus / added value (= 0.25)	
<b>Value added induced amount</b>	<b>1.0tr yuan</b>
<b>GDP boosting effect</b> (2018 nominal GDP ratio)	<b>+1.1%pt</b>

Note: Estimated according to the 2012 Inter-industry relations table. The consumption propensity used in the secondary ripple effect was the average consumption propensity in 2018.

Source: Made by MHRI

the basis of support for China's annual growth rate in 2019.

Using inter-industry relations table, within the 1.5 trillion yuan, the full amount of the infrastructure investment portion in regard to (1) and part of the portion for cost reductions in regard to (2) can be regarded as a new demand<sup>3</sup>. When estimating the value-added induced amount that is included up to the effect of the increase in income (secondary ripple effect) brought about by inducing production through this new demand, China's growth rate receives a policy push of 1.1%pt (1.0 trillion yuan) (**Chart 6**). If this is the intended result, it means the government has set a growth rate target of 6.0 to 6.5%, whereas without support measures the growth rate is expected to fall to around +5% in 2019. Although it is necessary to have a wide range of estimated results, we can see that China has recognized a severe economic situation behind the fact that a total of more than 4 trillion yuan of subsidy measures were launched.

Next, when will the effects of these support measures become manifest? Value-saving tax cuts and social insurance reductions, which are the main features of cost reductions, will be implemented from April onward, and even if all goes well it is reasonable to look at the latter half of 2019 as the time when the effect of boosting the real economy is realized, such as improvements in profitability due to lower costs leading to investment. In fact, based on reactions this author heard during a visit to China in March, the second half of the year was most often noted as the period of the onset of supporting effects (leading to the economy bottoming out). Also, according to a recent survey of China-based economists, 53% believed that China's economy will hit bottom in the Jul-Sep 2019 quarter or later (not including those economists who answered that the economy bottomed in the Jan-Mar quarter of 2019)<sup>4</sup>.

### **3. Local government debt normalization, rising private enterprise debt rates may impede the emergence of support effects**

There are several factors that will make it difficult for the support effects in the current economic stimulus package to appear. First, one factor that may block the expansion of infrastructure investment is the possibility that local infrastructure plans will be difficult to arrange under the situation of the normalization of local government hidden debt. With respect to infrastructure investment, certain policies have already been taken. For example, the issuance of local special project bonds has been accelerated since the summer of 2018 and investment promotion measures have been launched in nine areas including escaping poverty, railway and

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<sup>3</sup> Given tax reductions and social insurance reductions, the income of companies accordingly grows, and that amount is diverted to investment to be considered as new demand. Regarding the ratio to be diverted to investment, we assume that all of the newly created value-added amount distributed to corporate income is diverted to investment and we used the total intermediate use of enterprise surplus/added-value amounts from inter-industry relations table. Regarding the cuts to personal income tax, since the scale of tax cuts based on the January 2019 measure (the introduction of a specific item additional deduction) is less than the measure implemented as of October 2018 (raising the minimum taxable income), in our estimates only the effects of corporate tax cuts were considered. However, since tax effects from October 2018 will continue until September 2019 against the previous year, the scale of actual income tax cuts in 2019 will surpass 2018.

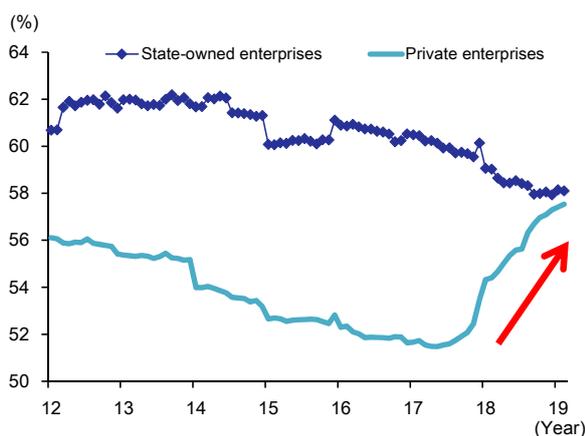
<sup>4</sup> The Economic Observer, "1Q 2019 Survey of Economists" (<http://www.eeo.com.cn/2019/0411/353110.shtml>)

water transport and the environment in line with the October "guiding opinions on promotion and maintenance of reinforcing weakness in the infrastructure sector" (the State Council). However, though actual infrastructure investment returned to positive year on year for the first time in three quarters in the Oct-Dec quarter of 2018, it is at a standstill as indicated by the earlier mention of the Jan-Mar quarter again being minus.

The National Development and Reform Commission has pointed out that the causes of stagnant investment are that the small scale of infrastructure investment preparation projects results in delaying project progress and that the project proposals of each province have been significantly scaled down<sup>5</sup>. At the National Financial Work Conference held in July 2017, a policy was set to strictly control the expansion of local administrative debt. As a result, it is believed that local governments have strengthened their ability to rein in excessive investment projects. Major risk prevention is one of the top policy priorities for 2018 to 2020, and there is no change in the policy to deal with the problem of hidden local government debt that could trigger financial instability. Since it takes considerable time at the planning stage to carry out infrastructure investment predicated on the backing of appropriate funding levels, it is presumed that this has led to the stagnation of local project proposals.

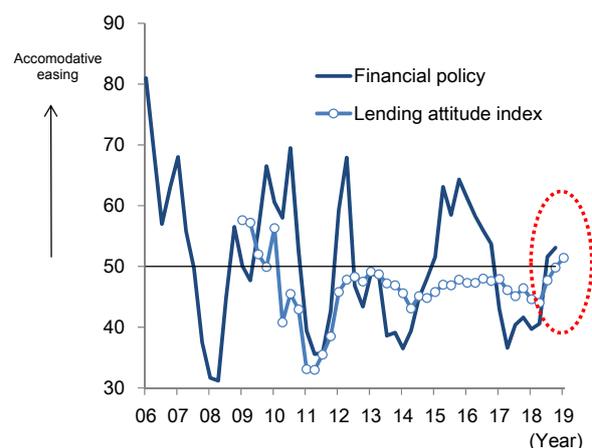
In addition, in regard to tax reduction and cost reduction measures, there is a possibility that these will not lead to expanded investment while the financial situation of private and small-scale micro enterprises worsens. The asset-liability ratio of private enterprises (industries) has risen sharply since 2018 and continued to rise after entering 2019 (Chart 7). Under these circumstances, even if corporate profits improve as a result of cost reductions, it seems that many

**Chart 7 Asset-debt ratio of companies (Industrial)**



Source: Made by MHRI based upon the People's Bank of China

**Chart 8 Banking business index**



Note: Debt/assets. Seasonally adjusted values made by Mizuho Research Institute.

Source: Made by MHRI based upon National Bureau of Statistics of China

<sup>5</sup> Refer to the information in note 2.

companies are unlikely to direct funds toward expanded investment.

#### **4. Conclusion**

Summarizing the above, it is the decline in imports and the apparently temporary expansion of real estate development investment that has supported the growth rate in the Jan-Mar quarter. While the economic slowing down trend is expected to continue for the time being, policy effects are expected to reach full effect in the second half of 2019. As regards the support measures, the scale of which can be confirmed via the NPC, if we estimate the effects using inter-industry relations table under certain assumptions the increase in GDP will be 1.1%pt. However, it seems that local infrastructure plans are less likely to be formulated due in part to the normalization of local government hidden debt, and under the continuing rise in the asset-liability ratio of private enterprises the improvement of profitability through cost reductions is less likely to lead to increased investment. Thus, for these and other reasons it is a fact that there are factors that prevent the manifestation of the support effects of economic policy. If economic support effects cannot be realized as expected or further economic downturns occur, such as a recurrence of US-China tensions, it will be necessary to add more measures to achieve the growth rate target, and there is a concern that efforts at reform, such as the problem of local debt normalization, will be delayed.

On the other hand, by taking measures to improve the financing of privately-owned and small-scale micro enterprises, the financial environment is becoming accommodative, with the bank lending attitudes rapidly improving by March (**Chart 8** on the previous page). Concerns over speculation are also emerging, such as in regard to continued rising real estate prices. At the April meeting of the State Council Politburo, references to real estate as "something for living, not an object of investment speculation" were revived, suggesting that the authorities are increasingly alert. It is difficult to balance increasing the effectiveness of easing policies in support of the economy with warnings about corresponding side effects.