MOODY'S
INVESTORS SERVICE

ISSUER IN-DEPTH
16 March 2018

Rate this Research

Analyst Contacts

Martin Petch +65.6311.2671
VP-Sr Credit Officer
martin.petch@moodys.com

Serena Wang +65.6398.8334
Associate Analyst
serena.cc.wang@moodys.com

Marie Diron +65.6398.8310
MD-Sovereign Risk
marie.diron@moodys.com

Alastair Wilson +44.20.7772.1372
MD-Global Sovereign Risk
alastair.wilson@moodys.com

Government of China

Fiscal impulse larger than headline deficit but likely tighter spending in broader public sector

On 5 March, China (A1 stable) released its 2018 budget and fiscal outcomes for 2017. The government is targeting a deficit of 2.6% of GDP in 2018, smaller than 2.9% of GDP in 2017. Our estimates indicate the fiscal impulse in 2018 will be 4.4% of GDP, around the same as the authorities budgeted for last year,[1] after taking into account special bond issuance by local governments[2] and excluding various fund transfers.[3]

The overall fiscal impulse remains sizeable, supporting GDP growth and leading to a gradual increase in government debt. At the same time, regulatory tightening of off-balance-sheet contingent liabilities continues. Our assessment of China's fiscal strength, which incorporates both on-balance-sheet debt and off-balance-sheet contingent liabilities, is unchanged.

» **Fiscal impulse is larger than deficit target implies** Our analysis indicates that the actual fiscal impulse from the general government after adjustments will be greater than the headline deficit target, at 4.4% of GDP. This is about the same as the fiscal impulse that we estimated for 2017 based on last year's budget, and is larger than the actual outturn.

» **Government to take on more spending responsibilities as regulatory tightening continues** The increase in local government special bond issuance comes as new debt issuance by local government financial vehicles has been easing, likely related to regulatory tightening in the sector. We expect that containing the risks related to local government debt will remain a key policy focus of the authorities.

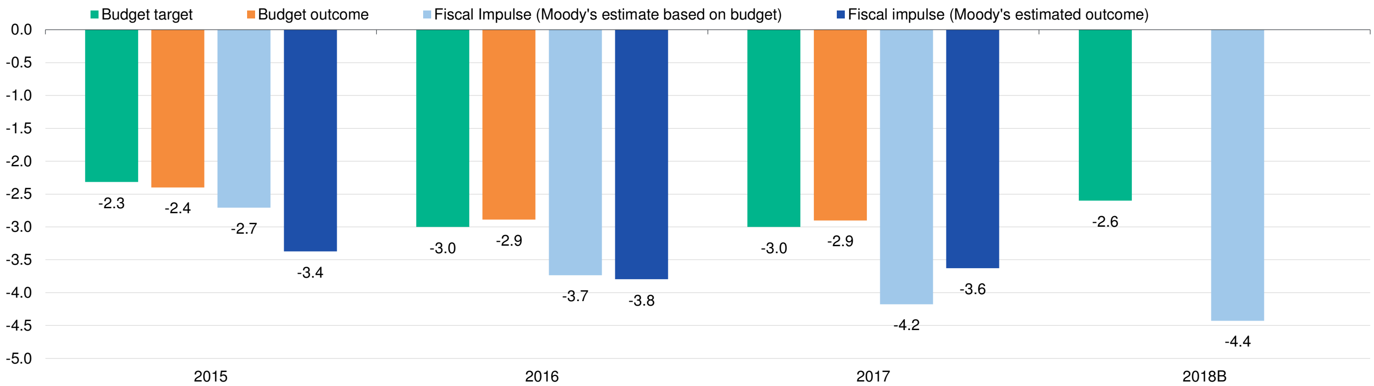
» **Key fiscal reform to tackle revenue-spending imbalances between central and local government** The budget advances plans for a clearer differentiation of responsibilities and spending between central and local government, with the drafting of a reform framework. Another government focus this year will be on property tax, which will be assigned as a potential revenue source for local governments.

Fiscal impulse is larger than deficit target implies

China's government has set a budget deficit target of 2.6% of GDP for 2018, 0.3 percentage point lower than last year's outturn (see Exhibit 1). This is the first time since 2012 that the authorities have lowered the deficit target and reflects solid growth which has supported a steady increase in total revenues. Key fiscal measures include reducing fees and taxes for companies and individuals, and increased spending on social welfare, environmental protection and poverty alleviation.

Exhibit 1

Fund transfers keep reported deficits on target, while maintaining a larger fiscal impulse
(% of GDP)



Sources: Ministry of Finance, Moody's Investors Service

However, our analysis indicates that the actual fiscal impulse from the general government after adjustments[4] will be greater than the headline deficit target, at 4.4% of GDP. This is about the same as the fiscal impulse that we had estimated for 2017 based on last year's budget and larger than the final outturn (3.6% of GDP).

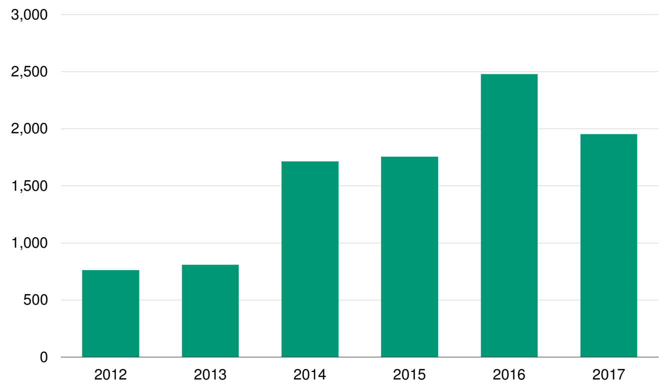
Driving this larger fiscal impulse are plans for local governments to issue CNY1.35 trillion in special bonds, a significant increase from CNY800 billion last year. The aim of the additional funding is to support the smooth implementation of ongoing projects, as Premier Li Keqiang highlighted in his government work report. The total local government debt limit is CNY21 trillion in 2018, up from CNY18.8 trillion in 2017.

Government to take on more spending responsibilities as regulatory tightening continues

The increase in local government special bond issuance comes as new debt issuance by local government financial vehicles (LGFVs) has been easing, likely related to regulatory tightening in the sector. Over the past year, the authorities published multiple policy guidelines[5] to reinforce the budget law, which prohibits local governments from providing debt guarantees[6], and strengthens the regulatory enforcement and control of local government debt risk. For instance, Document 50, published in May 2017, reiterated that LGFV debt does not constitute an obligation of local governments, and that local governments cannot directly provide financing from their budgets to support any corporate debt. In 2017, total LGFV onshore bond issuance shrank by about 20%, after surging by 40% in 2016, according to the Wind Economic Database (see Exhibit 2). Total LGFV bonds outstanding in 2017 correspondingly ticked down to 8.3% of GDP from 8.4% in 2016 (see Exhibit 3).

Exhibit 2

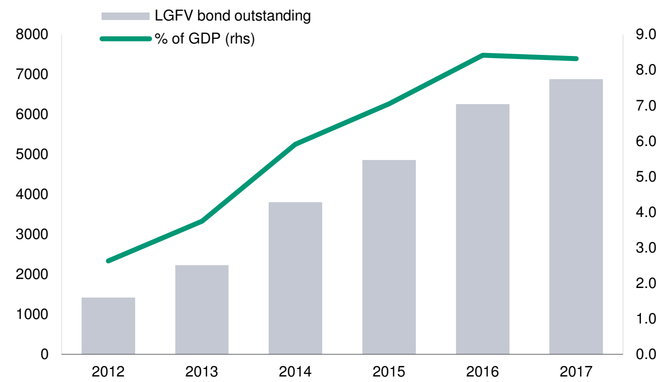
LGFV bond issuance declined in 2017 amid regulatory tightening (CNY billion)



Source: Wind Economic Database

Exhibit 3

LGFV bonds outstanding increased more slowly than GDP last year (CNY billion - left axis; % of GDP - right axis)



Source: Wind Economic Database

Meanwhile, total liabilities of state-owned enterprises (SOEs), another key source of contingent liabilities for the Chinese sovereign, grew at a slower pace than in previous years, although the level of these liabilities remains elevated at around CNY100 trillion, or 120.6% of GDP, as of December 2017.

Looking ahead, we expect that containing the risks related to local government debt will remain a key policy focus of the authorities. Indeed, the recently published Document 194 mandated further regulatory requirements for corporate bond issuance, and reiterated that governments should not use public-private partnerships as a platform to finance out-of-scope projects. And, in contrast to last year's budget, which called for increasing the efficiency of government investment funds, this year's budget highlights the need to strictly control the establishment of such funds.

Overall, the authorities' measures and the budget projections point to ongoing fiscal stimulus on- and off-budget (through local government special bond issuance) by the government, combined with scrutiny of off-balance-sheet liabilities.

As such, we have revised our direct government debt to GDP forecast for this year to 37.3%, rising from 36.2% in 2017, based on the latest fiscal outturn data. We previously expected a smaller, 0.8 percentage point, increase in debt to GDP from 2017 to 2018.

The shift from indirect to direct government debt does not change our view that China's fiscal strength is "Very High (-)", as it takes into account both direct and contingent debt.

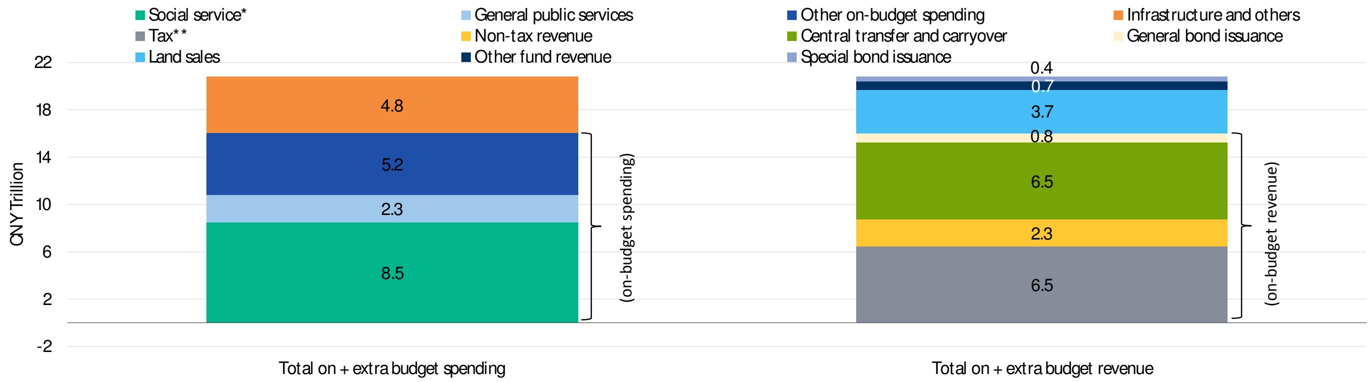
Key fiscal reform to tackle revenue-spending imbalances between central and local governments

The latest budget advances plans for a clearer differentiation of responsibilities and related spending between central and local government, with the drafting of a reform framework. This sets a basis to address sustained imbalances between the revenue capacity and expenditure responsibilities of local government. These are often linked to local social responsibilities not financed by the central government. The government will focus on addressing revenue-spending imbalances in areas such as education, health care, transportation and environment protection this year.

On-budget revenues collected from taxes and transfers from the central government do not fully cover the overall fiscal spending responsibilities and development needs of local governments. This has been the key incentive for local governments consequently reliant on land revenues to support investment spending needs (see Exhibit 4).

Exhibit 4

Local governments' spending is not fully covered by their on-budget fiscal revenue
(CNY trillion, 2016)



* Social service includes spending on education, housing, health care, urban-rural social administration, social safety and education.
** Tax revenue includes VAT, business tax, land related tax, corporate income tax, individual income tax, and other tax revenues.
Source: China Ministry of Finance, Moody's Investors Service

While there is no clear timeline yet, another government focus this year will be property tax, which will be assigned as a revenue source for local governments. This could widen the revenue base for local governments, if implemented effectively, and help them to alleviate borrowing pressures through off-balance-sheet channels containing potential sovereign contingent liabilities.

Moody's related publications

Sector In-Depth

- Governments of China and India: Investment in renewable power will bring long-run credit benefits; March 2018
- Cross-Sector - China: Debt-equity swaps provide liquidity relief, but some liabilities remain in system; February 2018
- State-owned enterprises (SOEs) - China: Leverage will continue to decline gradually for most rated SOEs through 2018; January 2018

Sector Comment

- Regional & Local Governments - China: Recent data restatements cast doubt on RLGs' ability to support state-owned enterprises; February 2018

Outlook

- Sovereigns - Asia Pacific: 2018 outlook stable as upturn in growth balances high leverage; January 2018

Contributors

Authors

Serena Wang

Martin Petch

Research Writer

Natasha Brereton-Fukui

Endnotes

1 See Fiscal Impulse Larger than Deficit Implies; Credit Impact Depends on Sustainability of Growth, April 2017

2 Special local government bond issuance is outside of the general public budget and is used to fund specific welfare projects by local governments.

3 We exclude China's reported fiscal revenue and expenditure incorporating fund transfers to and from the Central Budget Stabilization Fund, central and local government funds, and central government state-owned capital operations to measure the overall fiscal impulse.

4 Adjustment factors mainly include fund transfers to and from the Central Budget Stabilization Fund, central and local government funds, and central government state-owned capital operations, and proceeds from local government special bond issuance.

5 See Sector Comment: China's Stricter Regulatory Framework for Regional and Local Government Financial Management is Credit Positive, May 2017

6 With the exception of loans from foreign governments or international economic organizations.

REPORT NUMBER 1115981