China Macro Brief

Recalibrating the impact of COVID-19 & the needed fiscal relief

Eva YI
Analyst
SAC Reg. No.: S0080515050001
SFC CE Ref: AMH263
eva.yi@cicc.com.cn

Hong LIANG
Analyst
SAC Reg. No.: S0080513050005
SFC CE Ref: AJD293
hong.liang@cicc.com.cn

Friday evening (March 27), the politburo meeting revealed the plan to expand the general government deficit, issue special Treasury bond, and meaningfully lift the quota of local government special construction bond[1]. As part of our recent forecast revision, we have factored in much larger impact from the escalation of COVID-19 outbreak overseas, and therefore a sizable expansion of the fiscal relief program[2]. In this note, we refresh our framework on the different impact on growth from "passive" vs. "voluntary" fiscal deficit expansion (i.e. the fiscal impulse), and walk our readers through the algebra question of "how much fiscal deficit expansion may be required to bring 2020 GDP growth back to 5% YoY?"

The impact from the COVID-19 pandemic on China's growth continues to ramp up, now at est. 7-8 ppt of GDP, with a notable "shock" from the anticipated "sudden stop" of external demand in 2Q-3Q 2020. As we have discussed in previous research[3], continued escalation of COVID-19, especially if US slips into recession and financial market contagion spreads, constitutions a "bear case scenario". In this case, we foresee 3-4ppt impact on China's GDP from the external demand slowdown. The recent development of COVID-19 and the global financial market points to the materialization of the bear case, more specifically:

- **Domestic epidemic control efforts in 1Q2020 may have shaved off annual GDP by 3-3.5ppt,** after further calibration based on the Jan-Feb economic data. Nominal retail sales growth declined by 20% YoY in Jan-Feb, while real retail sales growth may have recorded larger contraction considering CPI at +5.3% YoY in the first 2 months of the year. Furthermore, real industrial value-added declined by 13.5% YoY in the first 2 months of the year, while nominal FAI contracted by 24.5% YoY. Considering an average capacity utilization rate of ~90% in January, 45% in February, and ~75% in March according to our CICC PAT[4], March industrial production growth is unlikely to return to positive territory, considering the single-digit percentage point improvement of capacity utilization vs. the Jan-Feb average. Thereby, we revised down our 1Q2020 real GDP growth forecast to -9.3% YoY. Considering the 6.4% YoY GDP expansion in 1Q2019 and a 22% share of 1Q in annual GDP, we arrived at ~3.3ppt "impact" of the domestic COVID-19 outbreak on *annual* GDP growth.
- **The escalating pandemic overseas may dampen China's annual GDP Growth by another 3-4 ppt**. As we have detailed in previous research, a global recession scenario may lead to a 3-4ppt dent in China's GDP growth. Judged from the current trajectory of the COVID-19 outbreak in US, EU, and Asia (Figure 1), global activity growth may see a larger contraction in 2Q2020 than in the worst quarter during 2008-2009 GFC. High frequency indicators of domestic traffic, service consumption and international exchange all point to a deeper S-T impact on activity growth from the pandemic than the GFC – e.g. global hotel occupancy is now running at only 26%, vs. ~50% during the worst month in GFC; airlines have cut flights by more than 40% in 1 month, restaurant dining has completely stopped, a phenomena never seen in modern history, and etc. (Figure 2-3).

Related reports

- Macroeconomy | Both profit & revenue recorded notable YoY contraction (2020.03.27)
- Macroeconomy | China bans entry of foreign citizens, US jobless claim spikes (2020.03.27)
- Macroeconomy | US 3D avg. new cases >10,000, large scale fiscal stimulus expected (2020.03.26)
- Macroeconomy | Fiscal revenue sharply declining; fiscal deficit significantly expanding (2020.03.25)
- Macroeconomy | Econ. activity froze in US & EU; Hubei to gradually lift travel bans (2020.03.25)
- Macroeconomy | CMI points to rapidly weakening external demand (2020.03.25)

[1] http://www.gov.cn/xinwen/2020-03/27/content_5496366.htm
[2] See China Macro Thematic, *Cutting growth forecast amidst escalating global COVID-19 pandemic*, published on Mar 23, 2020 and China Macro Brief, *Quantifying the Loosening Impulse post COVID-19*, published on Mar 15, 2020
[3] See China Macro Thematic, *Estimating the impact of COVID-19 on growth in China*, published on Mar 13 2020 and China Macro Thematic, *Cutting growth forecast amidst escalating global COVID-19 pandemic*, published on Mar 23, 2020
[4] See China Macro Thematic Report, *"Quantifying" the progress of nation-wide production resumption | Introducing the CICC Daily Production Activity Tracker (PAT)*, published on Feb 23, 2020

In this context, we have downgraded our 2020 GDP forecast to 2.6% YoY, after taking into consideration a 6-7ppt expansion of China's "broadly-defined" fiscal deficit. Otherwise put, our forecast of GDP growth may have been lower, without the assumption of a sizable expansion in broadly-defined deficit. More specifically:

1. **Our estimate points to a 3-4ppt expansion of "cyclical" deficit for the combined total of general gov't budget balance and gov't fund /local gov't budget balance – i.e. the "passive" fiscal expansion that does *not* generate positive "fiscal impulse".** As illustrated by Figure 4-5, based on the historical elasticity for the fiscal revenue vs. real growth & price indicators[5], we have simulated the path of general gov't revenue and gov't funds revenue growth before and after the COVID-19 impact (not considering "voluntary" deficit expansion from tax relief programs after the outbreak). The fiscal revenue for both the central and the local gov'ts will shrink as corporate profitability and land sales growth deteriorates. More specifically, the COVID-19 outbreak and the plunge in PPI may shave 2.4ppt off from the general (central) gov't income (Figure 6), and cause another 1.1ppt decline of gov't fund (local gov't) revenue (Figure 7). Under the assumption of the similar pace of expenditure growth as in 2019, we have arrived at the passive "cyclical" deficit expansion of ~2.1ppt for the central gov't, and ~1.4ppt for the local gov'ts (Figure 8).

2. **Consequently, under our baseline assumption, ~3ppt of the fiscal deficit expansion constitutes "voluntary" deficit expansion**, i.e. one that generates positive fiscal impulse to support economic growth.

3. **The ~3ppt of fiscal impulse may help offset around 4ppt of the negative impact from the global "COVID-19 shock", leaving growth 3-4ppt lower than pre-COVID-19 levels** in our baseline forecasts – this set of deduction is predicated on the a fiscal multiplier of just above 1X, similar to the level in the US. It is worth noting that within this set of forecast, we have factored in a recovery of GDP growth to an average of 5.5% YoY in 2Q-4Q2020, which is not by any account a "bearish" outlook in the context of the once-in-a-century pandemic.

As detailed in our recent research, the expected 6-7 ppt expansion in "broadly defined" fiscal deficit may be financed by expansion of bond issuance by both gov't and quasi-gov't entities, as well as mobilizing idle fiscal reserves[6]. More specifically, on the expansion of government financing, we expect the general budget deficit to be expanded, special treasury bond issuance to be summoned, local government bond quota to be topped up, and policy bank bond quota to be scaled up. Meanwhile, we cannot rule out the launch of a specialized bond program dedicated to providing longer term capital for pandemic relief [7](See Figure 9 for a breakdown of the "broadly-defined" government financing channels). Meanwhile, in regards to the fiscal reserve mobilization, we see possibilities on the following fronts: 1) total social security contribution (SSC) relief announced so far may add to >Rmb 1 trillion in broadly defined fiscal deficit, recorded under the SSF balance[8], which is separate from the general government and government fund budget. Expediting the reallocation of SOE assets to SSF will likely help facilitate the SSC relieve, or even more SSC rate cuts; 2) mobilizing the housing fund will likely help replenish household cash flow without adding to overall leverage; 3) activating fiscal reserves may help add to the total fiscal impulse. In addition, potential transfers from SOE profitability to the real economy may amount to 0.5-1ppt of GDP in quasi fiscal relief as well[9].

(Continues next page)

[5] China's VAT system dictates that tax revenue growth is highly sensitive to changes in output prices

[6] See China Macro Thematic, *Cutting growth forecast amidst escalating global COVID-19 pandemic*, published on Mar 23, 2020 and China Macro Brief, *Quantifying the Loosening Impulse post COVID-19*, published on Mar 15, 2020

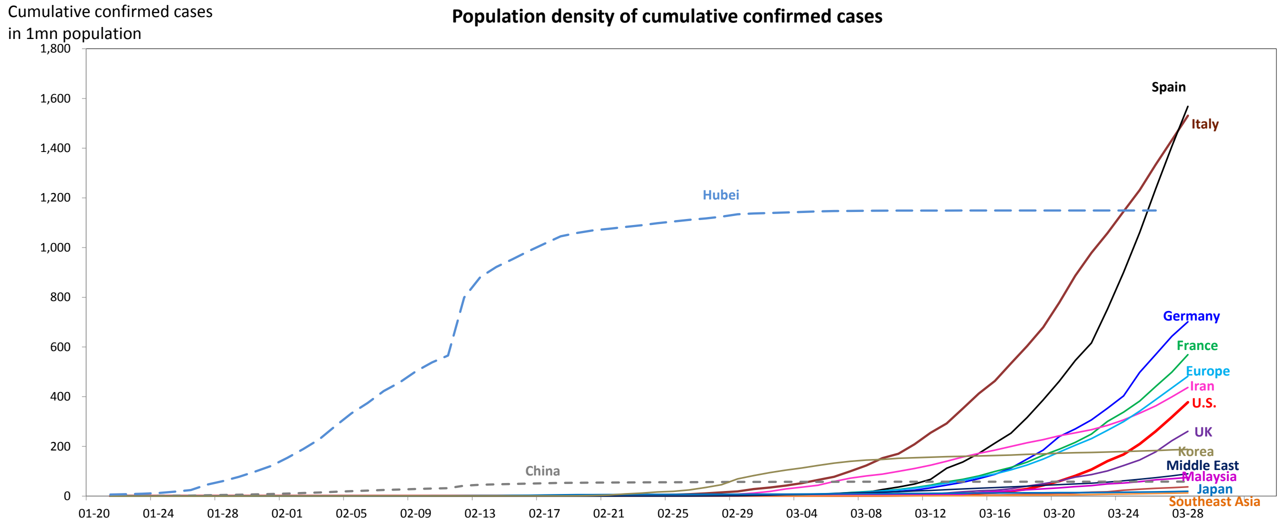
[7] See China Macro Brief, *Reading the policy signals from the March 27 politburo meeting*, published on Mar 29, 2020.

[8] For the detailed breakdown, please refer to China Macro Brief, *Quantifying the Loosening Impulse post COVID-19*, published on Mar 15, 2020

[9] This is part of the "1998 playbook of fiscal easing. These "transfer" include short-term policies to lower rent, utilities, and high-way tolls; extending low-cost credit lines / waiving delinquency fees for the SMEs; and etc. For detailed calculation of the potential size of SOE transfers, please refer to China Macro Brief, Quantifying the Loosening Impulse post COVID-19, published on Mar 15, 2020

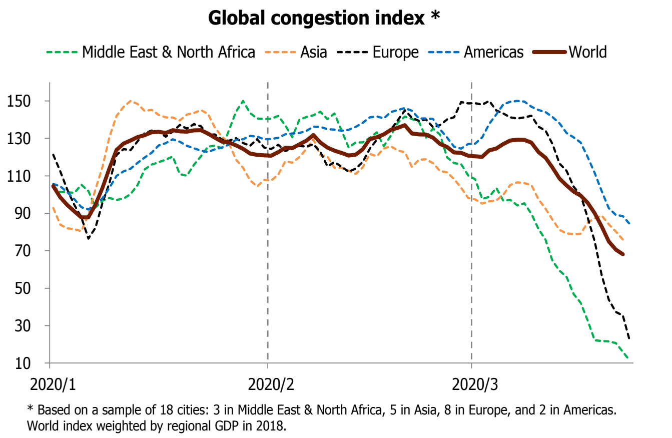
Meanwhile, lifting annual growth back to >5% YoY level may require broadly-defined fiscal deficit expansion of ~9ppt, with ~5-6ppt in voluntary deficit expansion or positive fiscal impulse. We see this as a more bullish case than our central scenario at this point. Again, assuming a fiscal multiplier of just above 1, a 5-6ppt in positive fiscal impulse may help lift growth by 6-7ppt, offsetting most of the 7-8ppt negative "shock" from the pandemic as we have estimated. However, a 9 ppt fiscal expansion, while not entirely impossible considering the global backdrop, may render China's relief package one of the most generous so far – Germany proposed a fiscal package of ~3% of GDP last week, and the US has drawn up a fiscal stimulus package of ~6% of GDP after netting out bank loans[10]. However, since China has already managed to drastically reduce the overall economic impact of COVID-19 by highly-effective epidemic control measures, we maintain the fiscal relief package in the amount of 6-7ppt of GDP as our "central case" for now. However, if the scale of the fiscal relief turns out to be larger than our current forecast, *and* the COVID-19 outbreak overseas is effectively reined in by 2Q2020, then China growth may see a stronger-than-expected recovery.

Figure 1: The global COVID-19 pandemic has spread and escalated rapidly outside of China



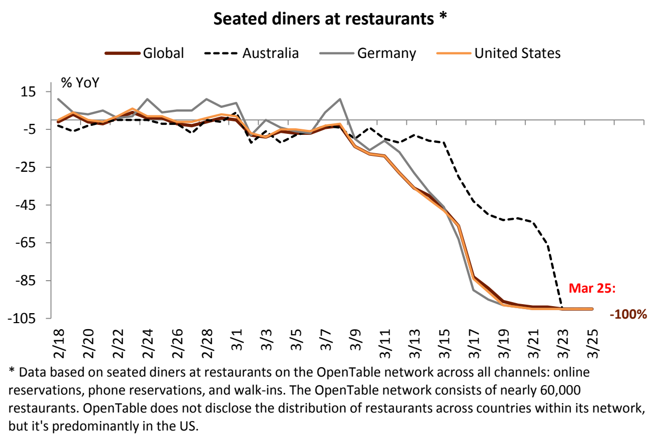
Source: ECDC, Wind Info, CICC Research

Figure 2: domestic business activities grinded to a half globally



Source: Google Maps, CICC Research

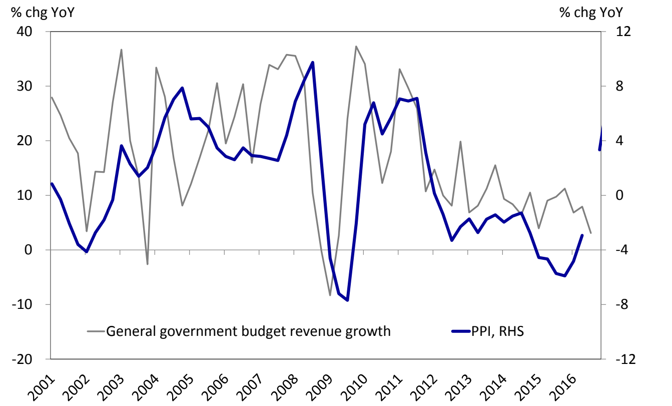
Figure 3: restaurant dining in major cities came to an "full stop"



Source: Opentable, CICC Research

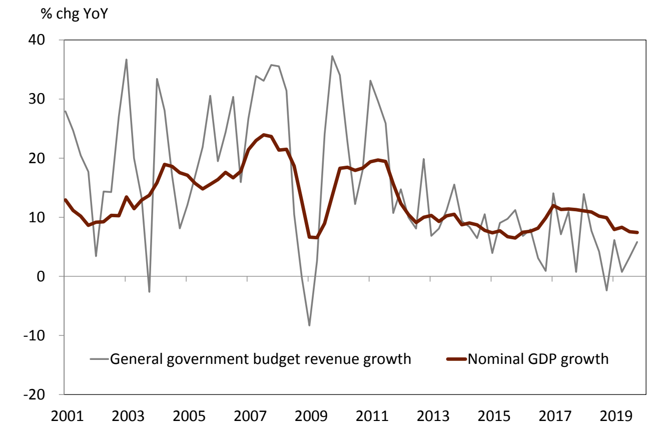
10 https://www.ft.com/content/9575e856-6ed3-11ea-9bca-bf503995cd6f

Figure 4: government revenue growth is highly sensitive to changes in output prices



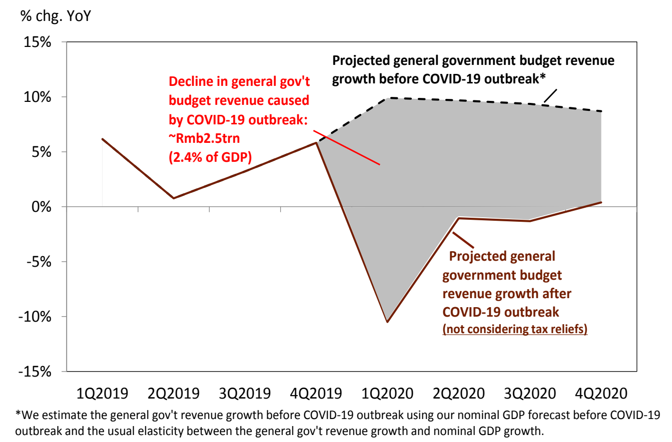
Source: CEIC, CICC Research

Figure 5: fiscal revenue growth correlates with that of GDP



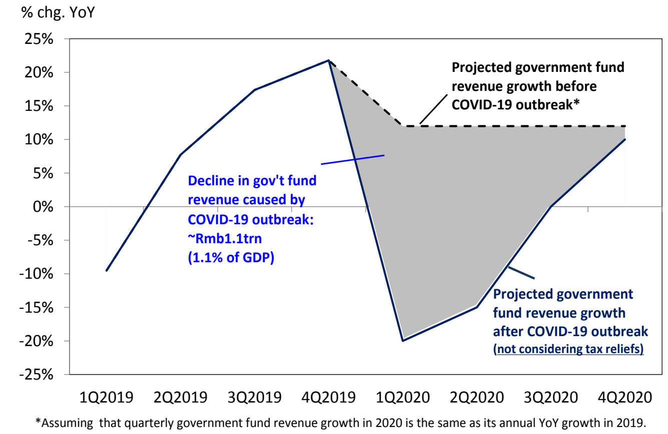
Source: CEIC, CICC Research

Figure 6: general (central) government balance: with or without COVID-19



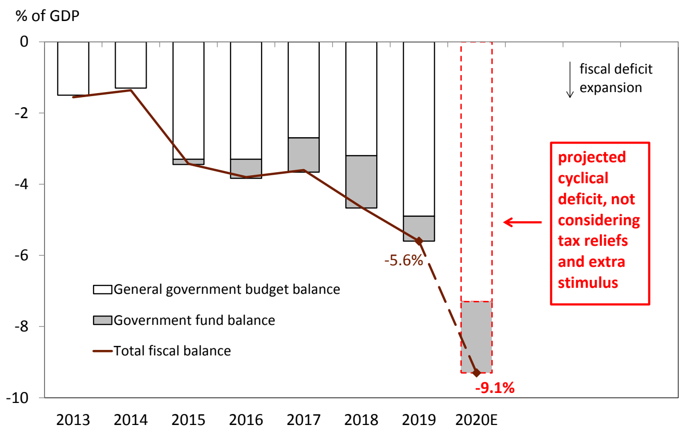
Source: CEIC, CICC Research

Figure 7: government fund I(local government) balance: with or without COVID-19



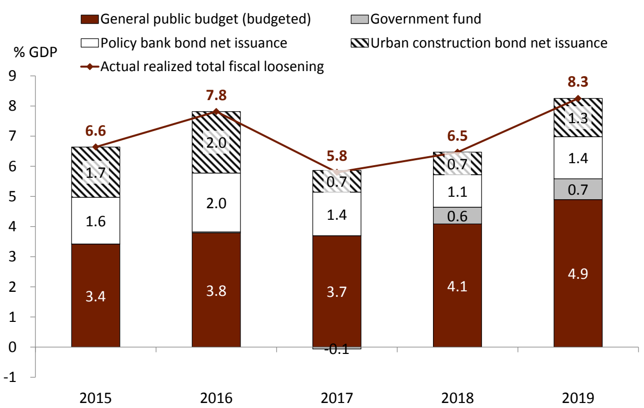
Source: CEIC, CICC Research

Figure 8: projected "cyclical" fiscal balance expansion may reach 3-4 ppt (without considering tax relieves)



Source: CEIC, CICC Research

Figure 9: the composition of broadly-defined government financing



Source: CEIC, WIND Info, CICC Research

Important legal disclosures

General Disclosures

This report has been produced by China International Capital Corporation Hong Kong Securities Limited (CICCHKS). This report is based on information available to the public that we consider reliable or the information of market survey , but CICCHKS and its associated company(ies)(collectively, hereinafter "CICC") do not represent that it is true, accurate or complete. The information and opinions contained herein are for investors' reference only and do not take into account the particular investment objectives, financial situation, or needs of any client, and are not an offer to buy or sell or a solicitation of an offer to buy or sell the securities or the financial products mentioned. Under no circumstances shall the information contained herein or the opinions expressed herein constitute a personal recommendation to anyone. Investors should make their own independent evaluation of the information contained in this research report, consider their own individual investment objectives, financial situation and particular needs. CICC does not provide tax, accounting, or legal advice to our clients, and all investors are advised to consult with their tax, accounting, or legal advisers regarding any potential investment. Neither CICC nor its related persons shall be liable in any manner whatsoever for any consequences of any reliance thereon or usage thereof.

The performance information (including any expression of opinion or forecast) herein reflect the most up-to-date opinions, speculations and forecasts at the time of the report's production and publication. Such opinions, speculations and forecasts are subject to change and may be amended without any notification. At different periods, CICC may release reports which are inconsistent with the opinions, speculations and forecasts contained herein.

The analysts named in this report may have from time to time discussed with our clients, including CICC salespeople, traders, and other professionals, or may discuss in this report, trading strategies that reference catalysts or events that may have a near-term impact on the market price of the securities or the financial products discussed in this report, which impact may be directionally counter to the analysts' published price target expectations for such securities or the financial products. Any such trading strategies are distinct from and do not affect the analysts' fundamental rating for such securities or the financial products as described herein.

CICC's salespeople, traders, and other professionals may provide oral or written market commentary or trading ideas that may be inconsistent with, and reach different conclusions from, the recommendations and opinions presented in this report. Such ideas or recommendations reflect the different assumptions, views and analytical methods of the persons who prepared them, and CICC is under no obligation to ensure that such other trading ideas or recommendations are brought to the attention of any recipient of this report. CICC's asset management area, proprietary trading desks and other investing businesses may make investment decisions that are inconsistent with the recommendations or opinions expressed in this report.

Unless stated otherwise, any performance data quoted represents past performance. Past performance is not a indicator of future performance. No representation or warranty is made that any returns indicated will be achieved. Certain assumptions may have been made in this analysis which have resulted in any returns detailed herein. Changes to the assumptions may have a material impact on any returns detailed.

To the extent this material is provided to any recipient, this material is provided solely on the basis that the recipient has the capability to independently evaluate investment risk and is exercising independent judgment in evaluating investment decisions in that its investment decisions will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations.

This report is distributed in Hong Kong by CICCHKS, which is regulated by the Securities and Futures Commission. Queries concerning CICC Research from readers in Hong Kong should be directed to our Hong Kong sales representatives. The CE numbers of SFC licensed authors of this report are disclosed by the authors' names on the cover page.

This report is distributed in Singapore only to accredited investors and/or institutional investors, as defined in the Securities and Futures Act, by China International Capital Corporation (Singapore) Pte. Limited ("CICCSG"), which is regulated by the Monetary Authority of Singapore. By virtue of distribution by CICCSG to these categories of investors in Singapore, disclosure under Section 36 of the Financial Adviser Act (which relates to disclosure of a financial adviser's interest and/or its representative's interest in securities) is not required. This report is not intended for and should not be distributed or passed on, directly or indirectly, to any other person in the jurisdiction of Singapore. Recipients of this report in Singapore should contact CICCSG in respect of any matter arising from or in connection with this report.

This report is distributed in the United Kingdom by China International Capital Corporation (UK) Limited ("CICCUK"), which is authorised and regulated by the Financial Conduct Authority. The investments and services to which this report relates are only available to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. This report is not intended for retail clients. In other EEA countries, the report is issued to persons regarded as professional investors (or equivalent) in their home jurisdiction.

This report will be made available in other jurisdictions pursuant to the applicable laws and regulations in those particular jurisdictions.

Special Disclosures

CICC does and seeks to do business with companies covered in CICC Research. As a result, investors should be aware that CICC and/or its associated persons may have a conflict of interest that could affect the objectivity of this report.

V190710
Editing: Ying ZHANG

China International Capital Corporation Limited
28th Floor, China World Office 2, 1 Jianguomenwai Avenue, Beijing 100004, P.R. China
Tel: (+86-10) 6505 1166
Fax: (+86-10) 6505 1156

United States

CICC US Securities, Inc
32th Floor, 280 Park Avenue
New York, NY 10017, USA
Tel: (+1-646) 7948 800
Fax: (+1-646) 7948 801

United Kingdom

China International Capital Corporation (UK) Limited
25th Floor, 125 Old Broad Street
London EC2N 1AR, United Kingdom
Tel: (+44-20) 7367 5718
Fax: (+44-20) 7367 5719

Singapore

China International Capital Corporation (Singapore) Pte. Limited
6 Battery Road,#33-01
Singapore 049909
Tel: (+65) 6572 1999
Fax: (+65) 6327 1278

Hong Kong

China International Capital Corporation (Hong Kong) Limited

29th Floor, One International Finance Centre
1 Harbour View Street Central, Hong Kong
Tel: (+852) 2872 2000
Fax: (+852) 2872 2100

Shanghai

China International Capital Corporation Limited – Shanghai Branch
32nd Floor Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, P.R. China
Tel: (+86-21) 5879 6226
Fax: (+86-21) 5888 8976

Shenzhen

China International Capital Corporation Limited – Shenzhen Branch
72th Floor,PingAn Finance Center
5033 Yitian Road, Futian District
Shenzhen, 518048, P.R. China
Tel: (+86-755) 8319 5000
Fax: (+86-755) 8319 9229

CICC
中金公司