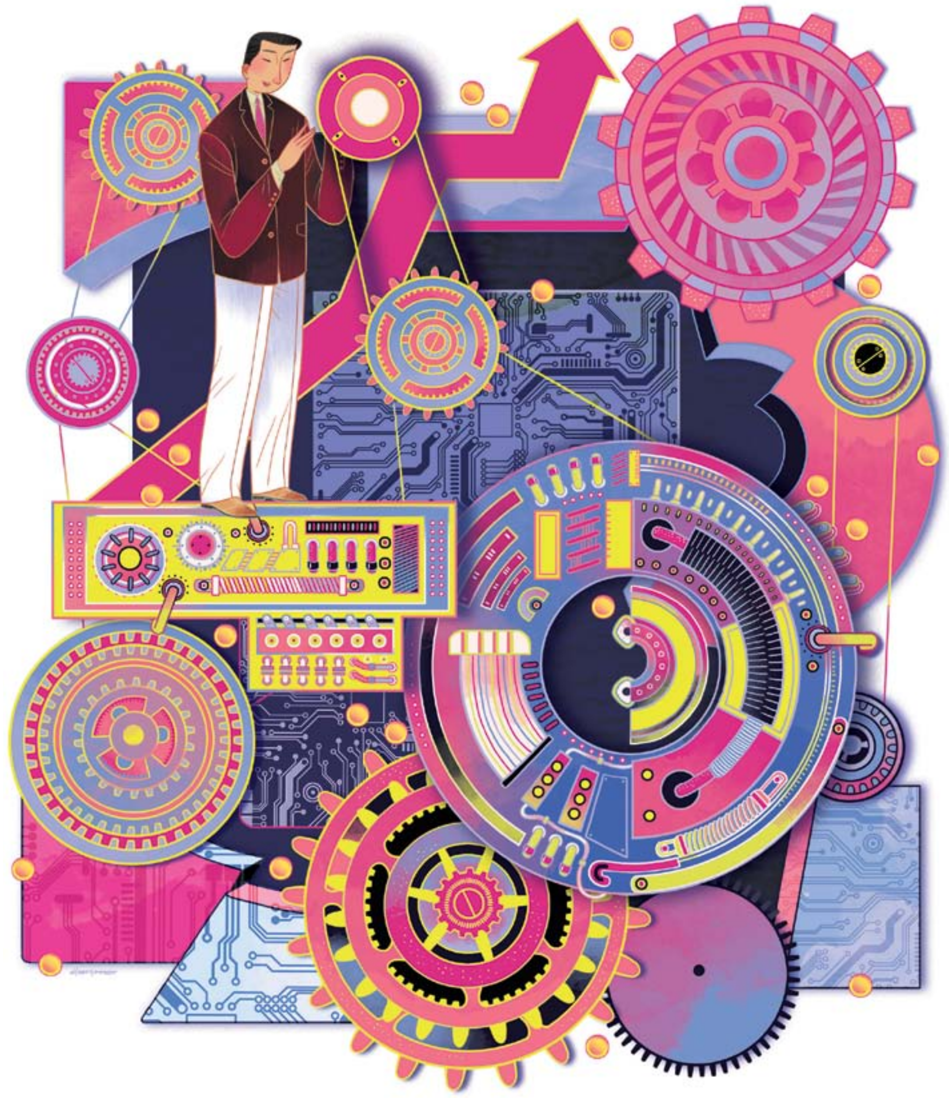
TWO SESSIONS

COMMENT

Quality growth amid deleveraging

Government Work Report suggests a de-emphasis of the GDP target, tolerance of economy's moderating expansion



LI MIN / CHINA DAILY

By HU YIFAN

In the Government Work Report he delivered to the National People's Congress, China's top legislature, on the opening day of its annual session on March 5, Premier Li Keqiang laid out policy priorities for 2018 and the longer-term reform agenda.

The GDP growth target has been set at "around 6.5 percent" for 2018, similar to 2017. Li did not mention "higher if possible in practice", suggesting the government is de-emphasizing the GDP target to be more tolerant of the ongoing growth moderation. We (at UBS Global Wealth Management) expect GDP growth to reach 6.6 percent in 2018, slowing from 6.9 percent in 2017 on a cooling property market, declining infrastructure investment and continuous deleveraging efforts.

The government has removed the fixed asset investment target for the first time in recent years; it was 9 percent last year (7.2 percent actual). Planned investment in transportation infrastructure has fallen to 2.53 trillion yuan ($400 billion) from 2.6 trillion yuan in 2017 (3.1 trillion yuan actual). The retail sales growth target has been set at "around 10 percent", the same as last year (10.2 percent actual).

The urban new job creation target remains at 11 million and the registered urban unemployment rate below 4.5 percent, both unchanged from 2017. The government has also introduced a new unemployment target, the surveyed urban unemployment rate, which includes migrant workers, and set it at 5.5 percent (it was 5 percent by the end of last year).

The fiscal deficit target has been lowered to 2.6 percent of GDP, from 3 percent in 2017, mainly due to "rising fiscal revenues on the steady economy", Li explained.

The planned issuance of special local government bonds for existing projects has been increased to 1.35 trillion yuan this year from 800 billion yuan in 2017.

On the other hand, the Government Work Report emphasizes the need to control implicit local government debt through local government financing vehicles (LGFV) and public-private partnership (PPP) projects. This implies the continuation of an active fiscal policy as a buffer amid slowing economic growth, and the strict supervision and control of off-balance-sheet local government debt.

The Work Report contains further tax reform announcements, including tax cuts worth 800 billion yuan to support corporate investment and household consumption. For corporations, value-added tax rates for manufacturing and transportation sectors will decline, tax deductions for equipment purchases will rise, and the tax threshold for small businesses will increase. For households, the tax threshold of personal income (currently 3,500 yuan per month) will rise, and tax deductions for medical and education expenses are to be introduced. Fiscal spending to improve social security and reduce poverty, too, will increase.

On the other hand, the legislative process for property tax will be accelerated, as doing so could be an effective measure to increase holding costs to control speculation, stabilize the government's fiscal position and improve equality. While implementing a property tax nationwide could happen in the long term, we expect a property tax pilot project to be launched in more first- and second-tier cities within the next one to three years.

"Three battles" — risk containment, poverty reduction and environmental protection — have been reemphasized in the Work Report. Risk containment has been named as the top task, as the government strives for stability amid economic transition to high-quality development. Deleveraging and regulatory tightening is therefore set to continue to prevent systemic risks.

For the first time in recent years, the Work Report does not specify money supply (M2) and total social financing (TSF) growth targets. It does mention that the rates should be "largely similar to 2017," meaning about 8.2 percent for M2 and 12 percent for TSF, reflecting the government's commitment to finding a balance between keeping broad liquidity stable and continuing to deleverage, in our view.

We therefore expect a mild increase in funding costs and a mild slowdown in credit growth. The 2018 consumer price index inflation target has been set at 3 percent, unchanged for the past three years. We see it at 2.7 percent, up from 1.6 percent last year, on higher food prices and rising service costs.

A "macro leverage" target, referring to the debt/GDP ratio, has been introduced in the Work Report and indicates as remaining largely stable. Deleveraging has been in addition to the policy agenda since the second quarter of 2017, given the rapidly rising debt-to-GDP ratio. The Work Report also calls for a streamlined and more efficient regulatory framework, led by the Financial Stability and Development Committee of the State Council, China's cabinet.

Announced regulatory tightening measures have expanded from traditional financial institutions to Internet financing and the real economy. Major highlights include:

- Further regulatory tightening for financial institutions

Financial supervision will focus on financial products and functions under the new streamlined framework. Supervision of banks will emphasize shifting their off-balance-sheet business, including wealth management products and negotiable certificates of deposit, back to the balance sheet, as well as limiting interbank financing, their channel business and investment in non-standard products. New regulations on brokers and trusts will focus on controlling asset pool products, increasing net capital requirements and improving transparency. Increased regulations on insurers will include bans on universal insurance sales and non-standard products.

- Strengthened Internet financing regulations

Internet financing in China has grown to become a 12 trillion yuan market (as of 2017) over the past five years, but this growth has been accompanied by rising defaults, frauds and scandals. The government's tone on Internet financing in Government Work Reports has thus evolved from "promoting healthy development of Internet financing" in 2014 and 2015, "regulating Internet financing development" in 2016, and "staying alert to Internet financing risks" in 2017, to "strengthening comprehensive regulations on Internet financing" in 2018. Regulatory measures on peer-to-peer, crowdfunding and third-party payments have been announced and circulated.

- Real economy leverage ratios capped

Surging State-owned enterprise (SOE) and local government debts have driven the rise of "macro leverage". The government has reiterated the restructuring of SOEs and the closure of zombie companies, highlighting measures such as capacity reduction, the introduction of strategic partners, incentive plans, public listings and debt-equity swaps. Further emphasis has been laid on stricter control on LGFV borrowing and PPP participation, as well as more transparent and responsible management of inter-temporal government budgets.

The Government Work Report, which marks the 40th anniversary of China's "reform and opening-up" policy, reiterates the need to further open up the market to foreign investors. The government remains committed to speeding up market opening-up in extended fields, including further opening up the manufacturing sector, and starting to open up telecommunications, healthcare, education and new-energy vehicle sectors; easing or removing restrictions on foreign shareholdings in the financial sector, including banking, securities, futures and asset management; granting tax deferrals to overseas investors for their reinvestment profits made in China; lowering import tariffs on automobiles and certain consumer goods; and establishing more free trade zones nationwide.

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