FLASH NOTE

CHINA: FISCAL POLICY TURNS MORE PROACTIVE

INCREASED FISCAL SPENDING AND TAX CUTS TO MITIGATE DOWNSIDE RISK

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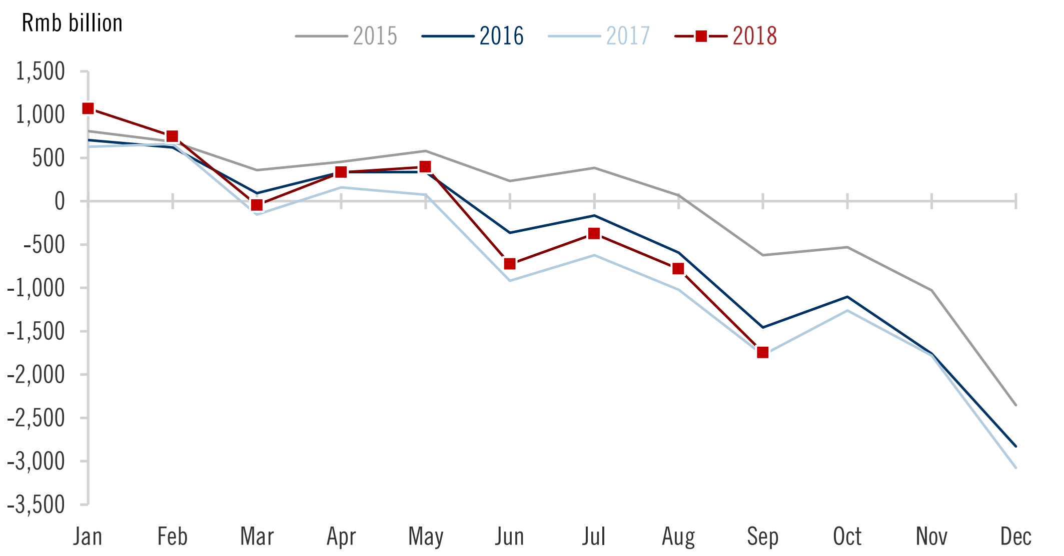
SUMMARY

- As the economy continues to decelerate, the Chinese government is ramping up fiscal policy. Since June, the government's fiscal spending has picked up significantly, but remains fairly modest compared to previous years.
- The government is also resorting to supply-side tools such as tax cuts to stimulate the economy. Recently, the Chinese government announced further plans to cut the personal income tax burden from 1 January 2019. The potential increase in household disposable income due to the tax cuts announced so far could boost household consumption by 0.9% in 2019 and nominal GDP growth by 0.3%.
- Looking forward, we expect tax cuts to be extended to the corporate sector as well, in particular value-added tax (VAT) and corporate income tax.

The Chinese government is ramping up fiscal policy to offset downward pressure on the economy. In addition to the usual tool of increasing fiscal spending, the government is also resorting to tax cuts. We expect these measures to help mitigate the downside risks to growth, especially as monetary policies have limited capacity to stimulate an economy with already elevated debt levels and undergoing deleveraging.

In the first five months of the year, China's fiscal policy was on the tight side, with government spending failing to keep pace with the rapid increase in tax revenues. As a result, there was a cumulative fiscal surplus of nearly Rmb400 billion by the end of May, significantly higher than in 2017 (Rmb76 billion). But since June, fiscal spending has picked up significantly, with the cumulative fiscal deficit at end-September the same as at the same date last year (*Chart 1*).

CHART 1: CUMULATIVE FISCAL BALANCE OF THE CHINESE GOVERNMENT



Source: PWM - AA&MR, National Bureau of Statistics of China

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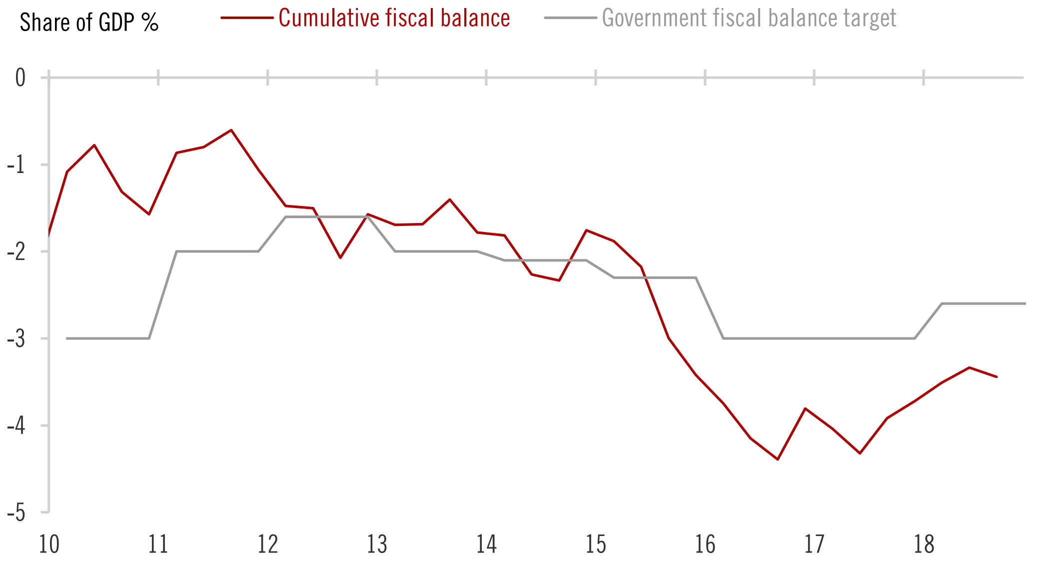
However, in terms of share of GDP, the amount of fiscal spending is still fairly modest compared to the previous two years. As of Q3 2018, China's fiscal deficit was equivalent to 3.4% of nominal GDP, much smaller than the peaks reached in 2016-2017 (*Chart 2*). The constrained increase in fiscal spending is reflected in the sharp decline in infrastructure investment growth year to date. Even as fiscal spending has picked up, infrastructure investment has continued to decelerate. In the first nine months of the year, infrastructure investment grew by only 3.3% year-over-year (y-o-y), compared to 7.3% at the end of June and 19% at the end of 2017.

CHART 2: CHINESE FISCAL DEFICIT AS A PERCENTAGE OF GDP AND GOVERNMENT TARGET



Source: PWM - AA&MR, National Bureau of Statistics

In our view, the fairly modest increase in fiscal spending so far reflects the government's preference for "quality growth" over "quantity growth". After years of rapid increases in investment of highways, high-speed rail, airports, power plants and so on, the number of potential projects that make obvious economic and social sense has declined. In addition, in a typical Chinese infrastructure investment project, fiscal money is usually used to kick off the project, with the remainder still financed by credit. Given the on-going deleveraging campaign (particularly focused on the shadow banking sector, on which many local governments rely heavily), it is hard to envision another wave of massive infrastructure investment anytime soon.

In this context, the government is resorting to supply-side tools such as tax cuts to stimulate the economy. It has already lifted the tax-free income threshold from RMB3,500 per month to RMB5,000 (effective since 1 October 2018), which could reduce households' tax payment by roughly RMB320 billion per year. More recently, the Chinese government has announced further plans to cut the personal income tax burden from 1 January 2019. In the latest proposal, six additional tax-deductible items are to be introduced, covering expenses on education, medical payments, mortgage interest, housing rents and support for the elderly. It is estimated that these measures could lead to additional tax savings of about RMB116 billion per year for Chinese households (*Chart 3*). We estimate that the potential increase in household disposable income due to the tax reforms announced so

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far could boost household consumption by 0.9% in 2019 and nominal GDP growth by 0.3%.

CHART 3: CHINA'S LATEST PERSONAL INCOME TAX REFORMS

Reform items	Changes	Effective date	Estimated tax savings (RMB bn)
Tax-free threshold	Lift from RMB3,500 / month to RMB5,000 / month	1-Oct-18	**320**
Additional deductible items		1-Jan-19	**116**
Children's education	RMB12,000 per child per year		17.5
Continued education for adults	RMB3,600-4,800 per year		1.4
Treatment of major illness	Max of RMB60,000 per year		23.3
Mortgage interest for first home	RMB12,000 per year		14.9
Housing rents	RMB9,600-14,400 per year		46.3
Elder parent support	RMB12,000-24,000 per year		12.6
			436

Source: PWM - AA&MR, Ministry of Finance of China, Nomura

Looking forward, we expect tax cuts to be extended to the corporate sector as well, with reductions in VAT and corporate income tax. These measures, in conjunction with increasing fiscal spending, could help mitigate the downside risks facing the Chinese economy due to escalating trade tensions with the US.

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