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Markets in High Resolution

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China Stimulus: More Smoke & Mirrors

My cat's insane. Cooped up in the house all day, one of those little red laser dots bouncing on the wall sets him into a manic frenzy.

In this story, "infrastructure stimulus" is the little red dot. Chinese equity investors are my cat.

The latest "little red dot" is the loosening of requirements for the usage of proceeds from "special purpose bonds," which has generated a flurry of narrative-support from Wall Street's army of China touts. Alas, **like "fiscal stimulus," this is just more smoke and mirrors**.

Special Purpose Bonds are akin to "revenue bonds" in the U.S. muni market – they finance specific projects which, in theory, will throw off cash flow with which to service the bonds. Prior to Tuesday's announcement, local governments were required to post minimum capital of 20% for infrastructure and allowed to borrow the remaining 80%.

Now, according to Bloomberg,

> *The **Ministry of Finance will allow local authorities to use some of the proceeds from special bond sales as part of the capital for qualified major projects**, and encourage banks to offer loans to projects funded by the instruments.*

Local governments will now be able to borrow 100% of the expense for qualifying infrastructure projects. Meanwhile the notice makes clear that "*provincial governments will take the full repayment obligation for special bonds sold, while project companies will repay the funding raised from financial institutions*." In other words, the Special Purpose Bond morphs from a "revenue bond" to a "general obligation bond."

The quota for special bond issuance for 2019 is set at RMB 2.2T, up from RMB 1.8T last year, so **there is no plan as of yet to blow out the issuance of these products**. If special bond issuance relieves local governments of the need to supply equity capital, there could potentially be RMB 2.2T more infrastructure investment than there would otherwise have been **if banks pony up an extra RMB 2.2T in credit**. The special bond proceeds simply roll down the capital structure from debt to equity. You only get more shovels in the ground if extra debt is added, presumably by banks.

Ergo, as always, **it comes back to the aggregate financing data**. If there is more total credit issuance there will be more shovels stuck in the ground. But **the change in policy towards special bond proceeds tells us nothing about the prospects for total credit flow**.

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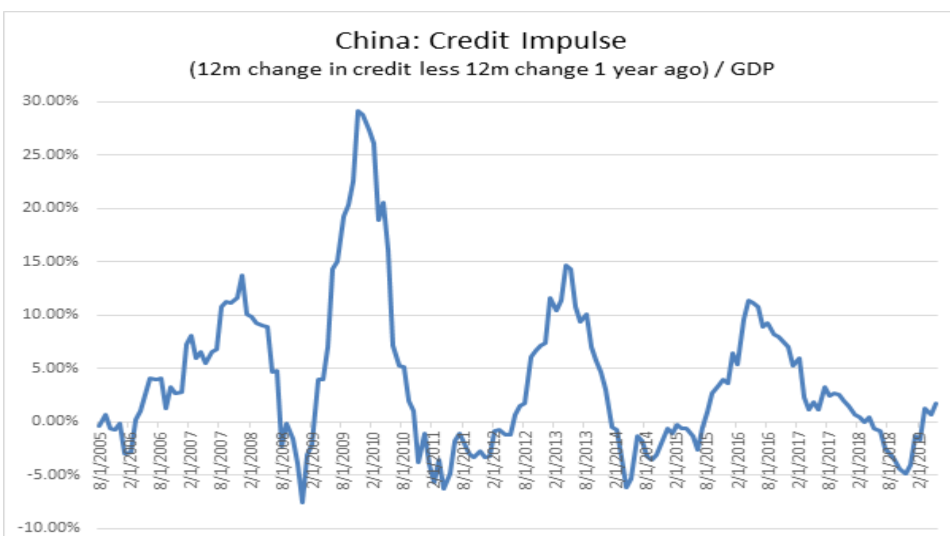
China dumped the credit data last night, so let's have an updated look at some metrics:

My preferred measure of total credit (Total Social Financing less equity issuance plus all government bond issuance) grew by 12.4% y/y. That's up from late-2018 lows at 11.2% but **these growth rates are not near to reaching the bar the market has set for "stimulus."**

The credit impulse (2nd derivative of credit outstanding relative to GDP) is now slightly positive, but they will have to pump far more aggressively to produce anything approaching the power of previous stimulus programs.



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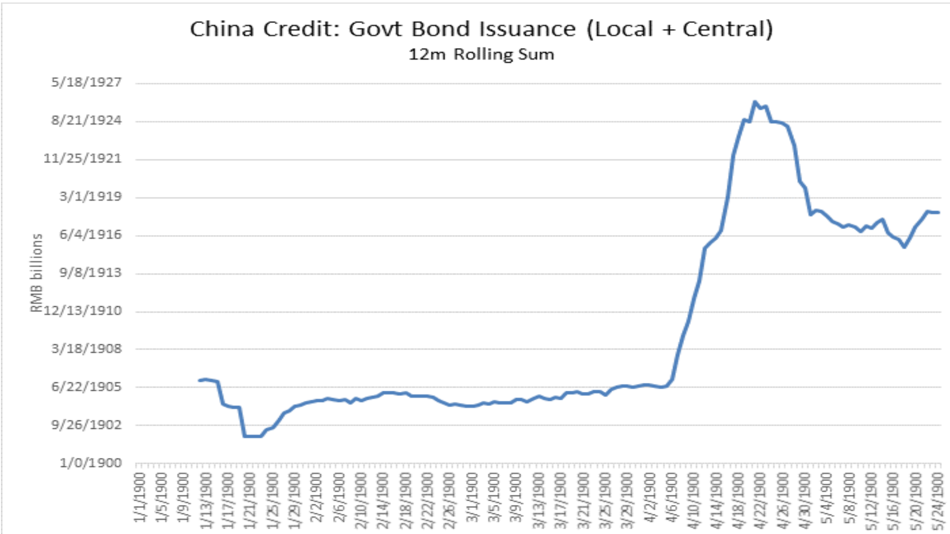
What about "fiscal stimulus?" There's little sign that its actually happening. The clearest way to monitor fiscal easing is via the issuance of bonds by central and local government. As I've pointed out previously, China already shot the "fiscal easing" bullet in 2015-16.



If China is not increasing the issuance of government bonds then **tax cuts are either A) not actually happening or B) being funded out of expenditure cuts**.

How could tax cuts not be happening? "The mountains are high and the emperor is far away" as they say. From China News Service (5/27/19)

> *Premier Li Keqiang called for full implementation of tax cuts and fee reductions to better stimulate market vitality and consolidate economic growth during an inspection trip in Shandong province.*
>
> *The tax and fee cuts are crucial measures to coping with complicating circumstances and to withstanding new downward pressure on the economy, the premier said while visiting Weichai Group, a manufacturer in Weifang, on Friday.*
>
> *It is important to ensure that all sectors see their tax burdens lowered...*
>
> *Li also called for local authorities to fully implement the tax and fee reductions and to maintain balance between fiscal revenues and expenditures.*
>
> ***He cautioned that they should not bend rules in ways that increase burdens on businesses to alleviate the pressure on government finance**.*

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Clearly, there are some problems with "local non-compliance" on net tax reductions. Pressure on local finances is probably also the motivation for the policy change regarding "special bonds"

From the WSJ report on the Special Bond policy:

> *Local governments had already accelerated their bond issuances early this year but a lack of capital has failed to jump start investment, analysts have said.*

That's not because local governments don't love infrastructure projects. It's because they're badly cash-constrained.

Conclusions

The market has been obsessing over "stimulus" for the better part of a year now, yet there remains little sign of it in the data.

I continue to believe that **Chinese policymakers view the risks of aggressive credit stimulus as outweighing the rewards**.

Aggressive credit stimulus would be:

- An immense embarrassment for Xi Jinping
- Highly problematic for the RMB
- An obvious economic dead end
- At high risk of failure due to badly damaged systemic credibility
- Foolish with limited prospects for a natural economic upturn on the horizon (you don't start a "long march" with an all-night bender)

"China stimulus" thus far is largely smoke and mirrors.

Like my crazy cat, Chinese equity investors may never stop jumping at the little red dot. But they're never gonna catch the damn thing.