CHINA Insights

OCBC Bank

NPC takeaways

Tuesday, March 05, 2019

Highlights:

- **Slower growth but not too slow as China steps up investment.**
- **Main upside surprise from the tax and social contribution cut. Fiscal policy to play a bigger role.**
- **Not necessary bad for bond investors as social contribution shortfall can be financed by the possible injection of state assets.**
- **Chance of a benchmark interest rate cut is higher, but no urgency to cut now as monetary condition has eased since 4Q18.**

China's Premier Li Keqiang delivered his 2019 government work report this morning. Most of the key targets are in line with market and our expectations. The main upside surprise was from the CNY2 trillion tax and social contribution cut target to lower the burden for business, higher than last year's actual CNY1.3 trillion tax cut. In addition, it seems that a benchmark interest rate cut is no longer unthinkable to support the financial sectors to channel the liquidity to the real economy.

Slower but not too slow

As widely expected, China lowered its growth target for 2019 to 6-6.5% from around 6.5% in 2018. Despite the slower growth target, China keeps its job market target, such as 11 million urban job creation and 5.5% surveyed unemployment rate, unchanged. This is the sign of bottom line thinking.

Meanwhile, China also increased its investment expenditure to support the growth. Fixed investment in railway project will be increased to CNY800 billion from last year's CNY732 billion. On central government level, budget for fixed asset investment will be increased by CNY40 billion to CNY577.6 billion.

On money supply growth, although China did not give a quantified target for M2 and aggregate social financing growth same as last year, the 2019 work report tweaked the language saying that China's M2 and social financing growth should match the nominal GDP growth. Noting that China's nominal GDP grew by about 9.7% in 2018. This implied that the ideal M2 growth in 2019 may be at 8.5-9% range, higher than the actual 8.1% in 2018. A stronger credit expansion is supportive of growth.

As mentioned by Premier Li in the speech, China needs a good result to celebrate 70th anniversary of the founding of the People's Republic of China this year. As such, we think China will not hesitate to step up more policy supports to provide the floor to the growth.

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Fiscal policy to play a bigger role

Premier Li did not disappoint market on fiscal policy. Although China's 2.8% fiscal deficit target is largely in line with expectation, the estimated CNY2 trillion tax and social contribution cut still surprises market on the upside. VAT for manufacturing sector will be lowered by 3% to 13% while VAT for transportation and construction sectors will be lowered by 1% to 9%.

China's bond investors have been jittery recently due to concerns about shift of monetary policy and higher fiscal deficit. Nevertheless, we think this round's higher than expected tax cut may not be necessary bad for bonds as the projected CNY2 trillion cut includes both tax cut and social contribution reduction. Social contribution shortfall could be financed by the injection of state assets rather than new borrowing.

Chance of a benchmark interest rate cut is higher

Although Premier Li has reiterated that China will not flood the economy with the excessive liquidity, the chance of a benchmark interest rate is higher in our view after Premier Li said in today's speech that China will use tools of reserve requirement ratio and interest rate to guide financial institutions to expand their credit support to the real economy. In addition, Premier Li also said China wants to lower the real interest rate.

China has refrained from touching its benchmark interest rate since 2015 due to constraints from the higher housing prices and de-leverage campaign. However, given China has shifted its focus to smooth the transmission mechanism from easing money to easing credit, a benchmark interest rate is no longer treated as a merely simulative tool but a possible tool to support the lending to the real economy.

Nevertheless, we think there is no urgency for China to cut its benchmark interest rate as China's easing monetary policy has taken effect and monetary condition in China has eased since 4Q 2018. PBoC reported a 31bps decline of weighed average loan rate in the last quarter of 2018 in its 4Q monetary policy report. In addition, loans priced below benchmark interest rate increased to 16.27% up from 9.59% in July, signalling easing monetary condition.

Chart 1: Weighted average interest rate to the real economy declined by 31bps in 4Q 2018.

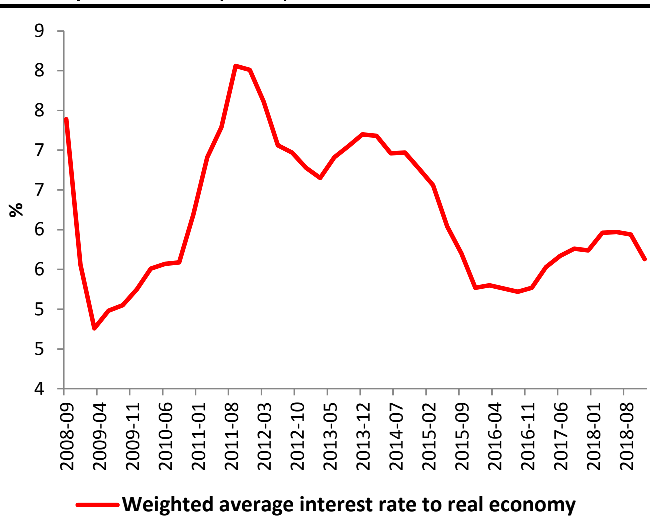
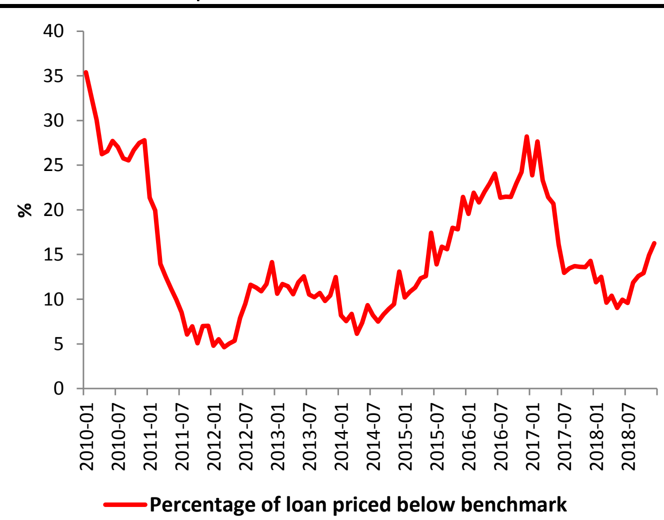


Chart 2: Monetary condition has eased from 4Q18 with More loans were priced at below benchmark



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