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China's 'all-out' infra push

A new twist on an old playbook

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Economics - China

- Infrastructure investment is back to help bolster the slowing economy, but this likely isn't the start of another super cycle
- Projects from shanty town renovation to 5G await funding, and they could boost growth and productivity
- Still, Beijing wants to ensure financial stability so won't want to re-leverage; we also detail the three key funding sources

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Can infrastructure spending rescue the economy? As China faces multiple economic headwinds, a new theme is rapidly emerging: the return of investment-driven growth. Multiple high level meetings in Beijing have called for an "all-out" infrastructure push. We believe this could help to drive a recovery, and we expect infrastructure investment to rise by c5% this year – far faster than the past two years.

The old playbook is back, but will the old problems return too? Many wonder if there will be a replay of the construction boom post the Global Financial Crisis, which included a raft of new roads, airports and bridges and which was criticised by some for building up debt levels and crowding out more productive investment. Infrastructure investment has long been a popular counter-cyclical macro stabilisation tool. It also has the potential to boost productivity and economic growth in the longer term, but only as long as there are quality projects to work on and there is sufficient funding.

Are there any infrastructure projects left to build? Yes. China ranks just 36th in overall infrastructure quality so there is still room for improvement, especially in terms of transportation services and water infrastructure. New infrastructure investment is even more urgently needed – both in the green and digital arenas.

Is there sufficient funding available and could that increase financial risk? We look at various funding sources and make three conclusions: 1) **Special bonds** are the most promising funding source as they have the potential to have RMB4.2trn more funds to dispense than 2021 this year. 2) Although counter-intuitive, **land-sale revenue**, which is down this year and continues to slide, has the potential to be a source of funding for local governments; we provide a Land Finance 101 tutorial to show how local governments can tap into accumulated revenue for land-related expenditure, such as funding for shanty-town renovation. And 3) funding from **local government financing vehicles** is unlikely to provide a material lift as Beijing's 'red line' on containing local government debt risk remains unchanged. New funding sources are being explored. On 1 June, the State Council told policy banks to establish additional infrastructure credit lines of RMB800bn (CCTV, 1 June), and pilot infrastructure REITs, a new equity financing channel, have the potential to expand substantially over time.

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China's infrastructure push

- President Xi called for an 'all-out' infrastructure push at the Central Committee for Financial and Economic Affairs meeting in late April
- Infrastructure investment was a key growth driver post GFC and it should shine again in 2022, but the push likely won't be as dramatic
- China has plenty of infrastructure investment needs, but Beijing remains cautious on local government debt risk when it comes to financing

Infrastructure investment to rescue the economy

Facing mounting economic headwinds, infrastructure investment appears set to play a significant role in driving the economic recovery in China. But are there actual investment needs after a construction boom that has lasted for years? How does this square with China's pursuit of a structural change away from the old construction-led model? Are there enough funding sources? Will there be financial stability concerns down the road? We aim to shed some light on these hotly-debated questions in this report.

Omicron wave has dealt another blow to economic growth
Omicron flare-ups in China have changed the course of the economic recovery. Unsurprisingly, economic activity saw a broad-based slowdown, or even contraction, in March and April, especially in retail sales and services.

The flare-ups and the corresponding containment measures have put pressure on businesses that depend on offline activity. There are more pronounced logistics disruptions this time too. Even online retail sales of goods contracted 1% y-o-y in April, partly because the postal and courier industry handled 11.9% fewer parcels than the same time in 2021 (State Post Bureau of the PRC, 16 May). With daily new cases decreasing nationwide and Shanghai beginning its phased reopening, the worst may be over. But to achieve this year's real GDP growth target of "around 5.5%", Beijing likely needs to step up stimulus.

The call for an infrastructure push started in 2021, but momentum picked up in 2022
We have argued that the investment-driven growth rebound will be a key theme this year and that infrastructure investment, therefore, will be crucial. On 26 April, President Xi called for an "all-out" effort to strengthen infrastructure construction at the Central Committee for Financial and Economic Affairs meeting (*Xinhua*, 26 April). On 23 May, the State Council Executive Meeting highlighted infrastructure investment as an important policy lever when announcing a series of 33 measures to stabilise the economy. On 25 May, Premier Li Keqiang urged swift action at the national teleconference for government officials.

But the call for an infrastructure push isn't new. It dates back to the Politburo meeting on 30 July 2021 and has been repeatedly emphasised at high-level meetings. Still, infrastructure investment has grown slowly until recent months.

So how is this year different from 2021? Both the national and local governments are more willing to spend on infrastructure as the focus shifts from de-risking/de-leveraging to stabilising growth. Local governments also now have more ammunition with bigger budgets and the accelerated issuance of local government special bonds (LGSBs). There are also signs that the tight scrutiny over local government debt is relaxing temporarily while new channels of funding, such as infrastructure REITs (Real Estate Investment Trusts), are being explored too (more discussions below). Taken together, we expect infrastructure spending to rise by c5% y-o-y in 2022, much faster than the growth rates of the previous two years (0.9% in 2020 and 0.4% in 2021) and the pre-pandemic level in 2019 (3.8%) with momentum likely to be carried well into 2023.

Will the 'all-out' infrastructure push exacerbate China's structural problems?
Now that China is seeming to return to its old playbook (i.e. construction-led growth), how can Beijing balance short-term and long-term targets, i.e. orchestrate a recovery while achieving a transformation to high-quality development and strengthening long-term financial stability?

These concerns stem from the RMB4 trillion stimulus package that was rolled out post the Global Financial Crisis in 2008 and the imbalances that may have been caused afterwards. Although it was successful in boosting the economic recovery, it is often criticised because: 1) the construction-centric model may have assigned too much capital to infrastructure and housing development, crowding out potentially more productive investment, such as in manufacturing and lowering the investment efficiency;[1] and 2) the subsequent debt-fuelled growth path potentially raised financial risks, such as through burgeoning levels of implicit local government debt and shadow banking activities.

For the first argument, the jury is still out over whether infrastructure investment was insufficiently productive. Back in 2008, China ranked 58th in overall infrastructure quality, according to the World Economic Forum.[2] The massive investment post the GFC has helped to bridge that gap, enabling China to leap to the 36th position in 2019.[3]

Other than the noticeable improvement in infrastructure quality, such as road connectivity and railway density, infrastructure also boosts productivity in other sectors. For example, the World Bank conducted a comprehensive evaluation of China's high-speed rail (HSR) projects. It concluded that China's HSRs have shortened travel times, rebalanced regional growth, reduced greenhouse gas emissions and, hence, delivered a higher economic rate of return – considering all the positive externalities – than the financial rate of return (8% and 6%, respectively, as of 2015).[4]

Given that infrastructure investment may already have delivered a relatively large productivity boost to the overall economy, some may argue that China, thus, no longer needs a further aggressive push after years of significant construction. For example, China has been one of the fastest-growing countries in terms of transport infrastructure spending over the past decade, and constantly ranks first in terms of transport infrastructure spending as a share of GDP (Chart 1).[5] If indeed there isn't an authentic investment need, then the infrastructure push may end up crowding out more productive investments. We discuss this in detail in the next section.

The second concern over financial stability is echoed by China's financial regulators. In 2017, Beijing launched a deleveraging campaign that has continued except for a pause in 2020 due to the outbreak of COVID-19. According to the China Banking and Insurance Regulatory Commission (CBIRC), the deleveraging campaign successfully reined in the disorderly expansion of shadow banking by slashing its size to RMB39.14trn in 2019 from a peak of RMB51trn in 2016.[6] Financial regulators have upheld their prudent stance. So how will the infrastructure projects be financed without loading up on too much leverage?

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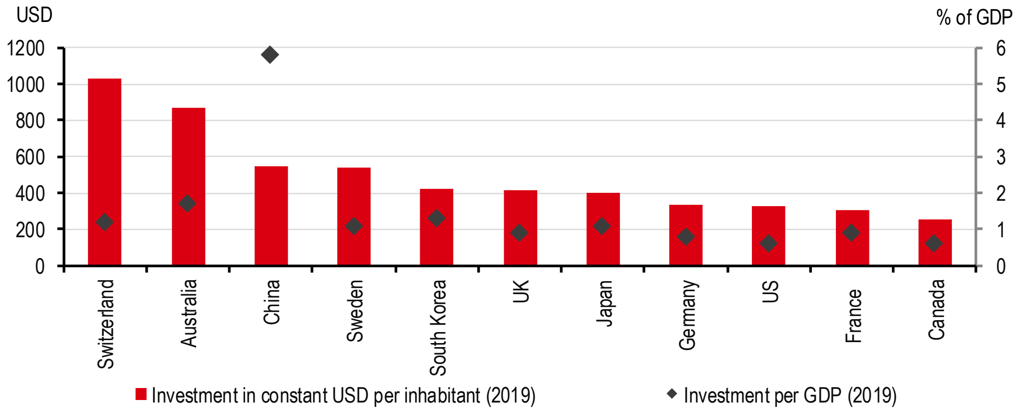
[1]Brandt, Loren, John Litwack, Elitza Mileva, Luhang Wang, Yifan Zhang, and Luan Zhao; World Bank Policy Research Working Paper 9298, *China's productivity slowdown and future growth potential,* June 2020.
[2]World Economic Forum; *The Global Competitiveness Report 2008-2009*, Geneva, Switzerland, 2008.
[3]World Economic Forum; *The Global Competitiveness Report 2019*, Geneva, Switzerland, 2019.
[4]World Bank Group; *China's High Speed Rail Development*, Washington D.C., the United States, 2019.
[5]International Transport Forum; "Inland transport infrastructure investment share of GDP remains stable in OECD," 15 June 2021.
[6]CBIRC; *China Shadow Banking Report*, December 2020.

Chart 1: China ranked first in inland transport infrastructure investment share of GDP



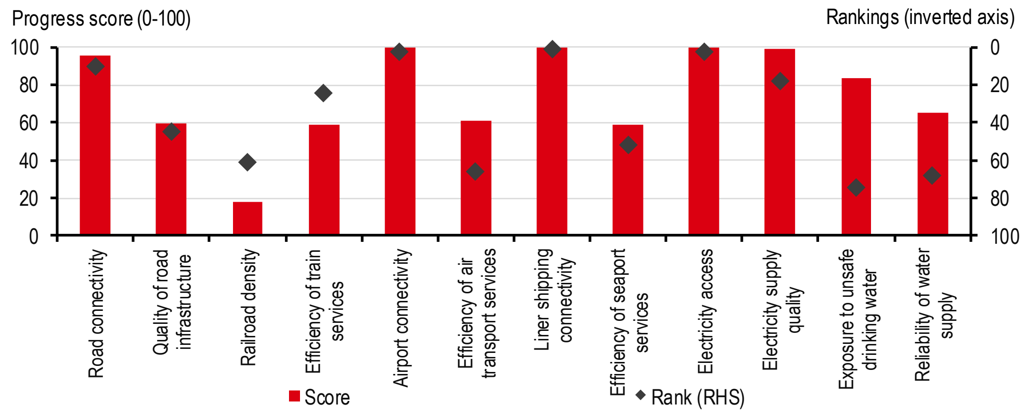
Source: International Transport Forum (2021), HSBC

Are there enough quality infrastructure projects?

Economic theory – as well as practice around the world – highlights infrastructure spending as an important countercyclical macroeconomic stabilisation tool. If there are concrete needs for infrastructure investment, then doing so can offset an economic downturn, absorb labour market slack and boost long-term productivity and growth.

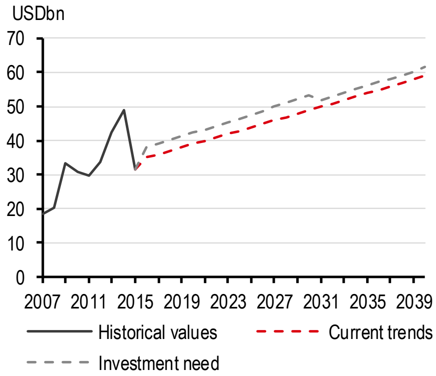
After years of massive infrastructure investment, China has upgraded its infrastructure substantially. But is the economy now 'saturated'? Well, China still ranks only 36th in overall infrastructure quality (Chart 2), leaving still ample room for improvement, particularly with respect to the efficiency of transportation services and water infrastructure (Chart 3).

Chart 2: China ranked 36th in overall infrastructure quality in 2019



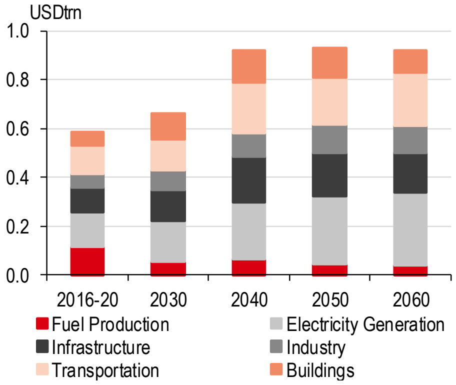
Source: World Economic Forum (2019), HSBC

Chart 3: Vast investment still needed to enhance water infrastructure…



Source: Global Infrastructure Hub, HSBC

Chart 4: …and for green infrastructure too

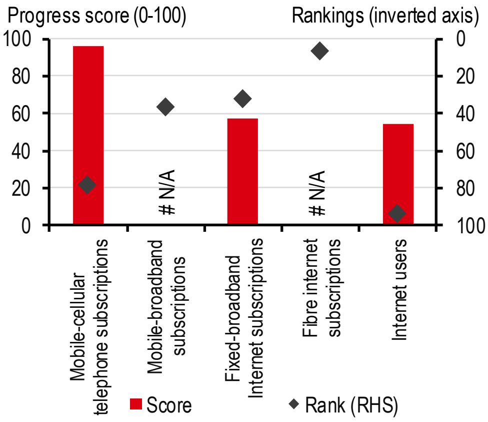


Source: IEA (2021)

Furthermore, the definition of infrastructure has expanded beyond traditional projects to green and digital infrastructure. In the green infrastructure arena, we have written on the RMB200trn in investment to decarbonise the economy as well as how carbon pricing can accelerate private participation in green investment. The need for green infrastructure investment appears urgent (Chart 4), and mega projects, such as renewable energy bases, have kicked off. In the digital infrastructure arena, China has launched mega cross-regional projects such as "processing eastern data in the west" (东数西算). These initiatives can boost less-developed inland Central and Eastern regions and leverage advances in the Eastern region. In addition, the 5G network is expected to usher in an unprecedented new era of productivity and creativity. The impact is set to be spread across multiple sectors and is estimated to be an aggregate USD220bn by 2030 (Chart 6).[7]

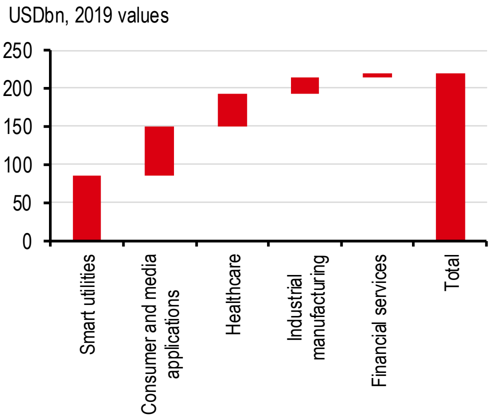
Both traditional and new infrastructure projects were mentioned broadly when President Xi called to "comprehensively strengthen infrastructure" and build a "modern network of infrastructure" at the Central Committee for Financial and Economic Affairs meeting in late April. At the State Council Executive Meeting on 23 May, Premier Li Keqiang said priority would be given to mega infrastructure projects, including water conservancy, transportation, shanty-town renovation and energy projects. This highlights the areas in which some of the greatest investment needs appear to lie.

Chart 5: Digital infrastructure still has room for improvement…



Source: World Economic Forum (2019), HSBC

Chart 6: …and creates a positive spill-over impact: how 5G will boost China's GDP by industry by 2030



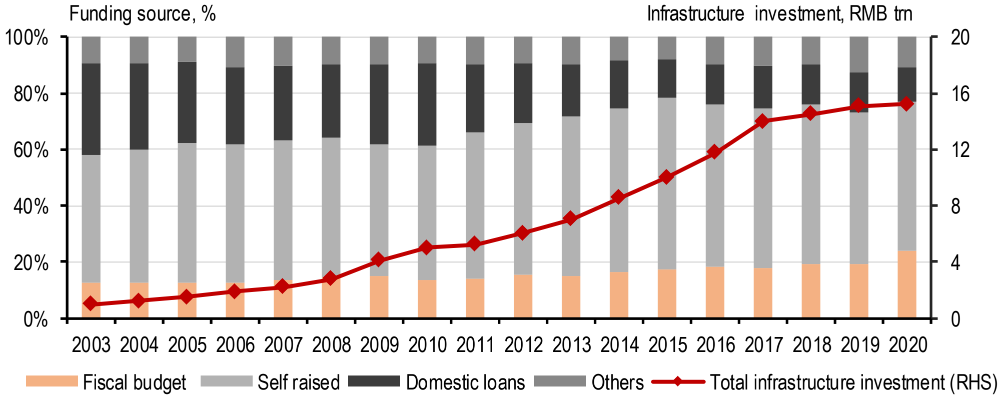
Source: PwC (2021)

[7]PwC; *The global economic impact of 5G: China report: Powering your tomorrow*, 2021.

Is there sufficient funding support?

How will these projects be financed? Although the LGSB quota is often seen as the size of pay cheque available for infrastructure spending, it is neither exclusively used for infrastructure projects nor the main source of infrastructure funding. For example, in Q1 2022, about two-thirds of the proceeds from LGSB issuance were for infrastructure investment while the rest went to social housing and social projects, such as education, elderly care, etc. Self-raised funds by local governments, including government-managed funds (with the majority coming from land-sale revenue) and funds raised by LGFVs, contributed over 50% of the financing for traditional infrastructure projects (Chart 7). However, these funding sources are faring differently now.

Chart 7: Breakdown of infrastructure funding by source: the majority is self-raised



Note: Decomposition of funding sources is based on investment in water conservancy, the environment and public utility management, transportation, and postal services.
Source: Wind, HSBC

Conclusion

Infrastructure investment will be an important growth driver this year. We expect it to grow c5% y-o-y in 2022, beating the pre-pandemic pace of 3.8% in 2019. But another super infrastructure cycle as seen post-GFC is unlikely. Beijing has learned a lesson from the high price it eventually paid when it needed to rein in leverage and will likely to any extent possible avoid falling into the same trap of re-leveraging and building up financial risk.

This year, LGSB issuance will provide strong funding support, particularly with front-loaded issuance. The State Council has also added more ammunition with RMB300bn in railway bonds and RMB800bn in infrastructure credit lines from policy banks. Despite the seemingly depressed land-sale revenue, we expect land finance – especially with local governments tapping into past years' excess revenue – to provide solid funding for shanty town renovation. LGFV financing is unlikely to be the magic pill this time around as Beijing is still trying to contain local government debt risk. Over time, a new way of equity financing through infrastructure REITs has the potential to generate much-needed infrastructure funding without pushing up local government leverage. Other new funding channels are also worth exploring.

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