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RISK&OPPORTUNITIES

SG Economics and Sector Research

China's Mission Impossible

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Our new publication RISK&OPPORTUNITES offers a deeper-dive into some of the more structural aspects of topical issues in the economic debate. In tandem, we have also launched ECONOMICSFORALL, with the first editions offering a general introduction to, respectively, the Minsky moment and the economic implications of robotics.

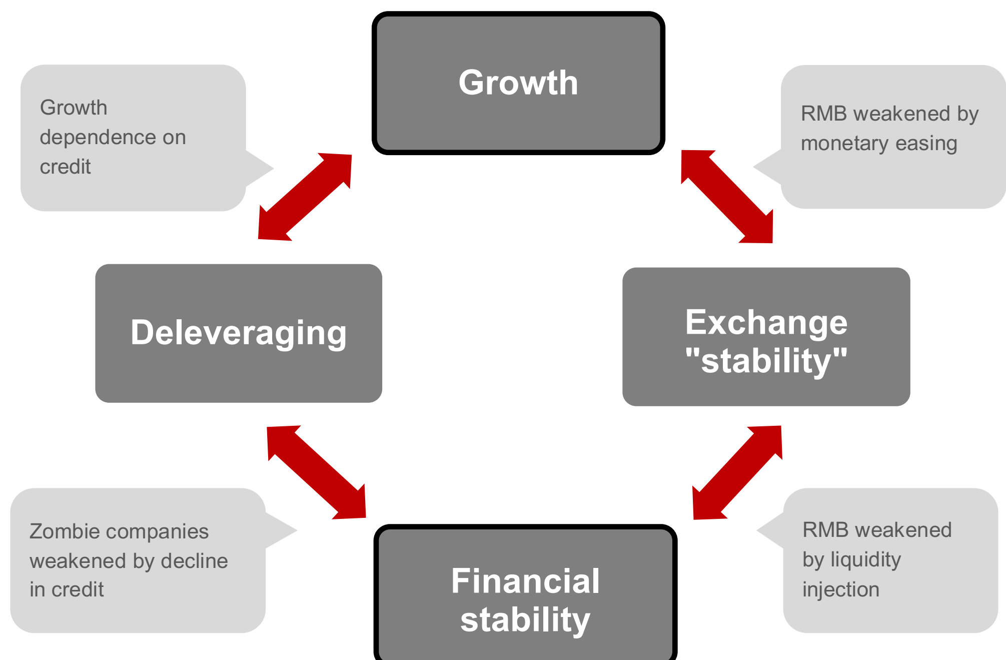
Thank you for your readership!

Economics and Sector Research

Chinese economic policy pursues four, at times conflicting, goals: growth, financial stability, exchange stability and deleveraging. Albeit that this is not new, the context is now much more restrictive and although measures have been announced favouring growth and reforms, there is mounting concern that policymakers will have to make some hard choices.

We believe that the direction of economic policy will lean towards growth and financial stability while pausing the other two, although not fully abandoning these goals. This implies, at least over the next two years, a gradual weakening of the RMB and a pause in the deleveraging process. We expect Chinese growth to gradually slow to around 5% in 2022.

Goals and contradictions



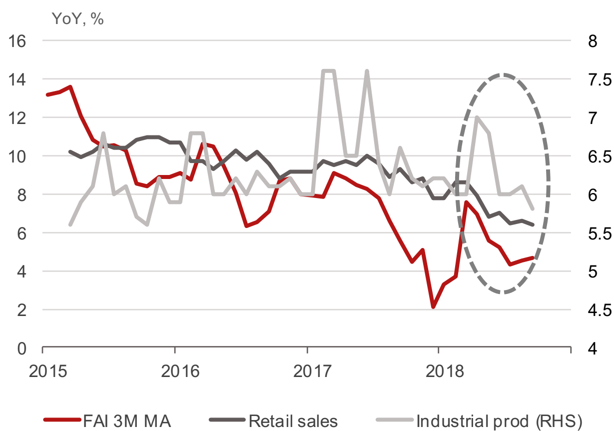
Source: SG Economics and Sector Research

Goals of economic policy

Economic indicators show that the Chinese economy is slowing, from consumption to investment. Top of the list of headwinds are the trade tension with the United States that introduced both tariffs and significant uncertainty. The PMI for export orders has fallen below 50 (contraction zone) even though customs data have not shown slowing signs yet. And, although the share of exports in GDP has declined slightly over the last decade, to 20% today, exports continue to make significant contribution to the Chinese economy through investment and job creation.

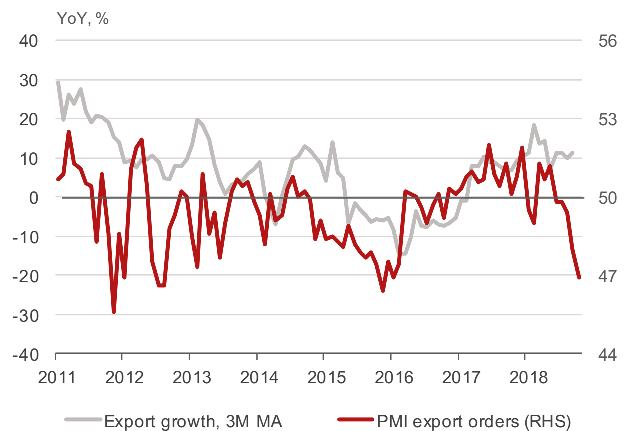
The IMF recently lowered its growth forecast for China from 6.4% to 6.2% in 2019. We also forecast 6.2% for next year, but see an increasing risk that growth will falls faster than expected. Several measures to buffer the headwinds have been announced by the Chinese authorities and while helpful, these will not fully offset the headwinds.

Slowing economic activity



Sources: NBS, SG Economics and Sector Research

Jeopardized export outlook



Sources: NBS, SG Economics and Sector Research

The RMB has depreciated 10% against the US dollar since April 2018, becoming one of the weakest emerging currencies against the greenback. Faced with the depreciation risk, the PBoC introduced measures to mitigate this pressure. In early August, it imposed a 20% reserve requirement ratio related to foreign exchange derivatives transactions, which increases the cost of betting on RMB depreciation; in late August, it reintroduced the counter-cyclical factor to maintain the daily fixing at a relatively stable level. Although more exchange rate flexibility is in line with the PBoC-led reform, China's central bank seems keen to avoid too much depreciation, which could increase capital outflow pressure. In addition, the current account surplus – which usually makes a structural contribution to capital inflows – has near vanished, entailing less support for the RMB.

On the financial side, credit risk is visibly on the rise, a consequence of too rapid credit expansion with practices that are more attentive to the type of ownership rather than to the company's intrinsic quality. Given a debt-to-GDP ratio of 260%, financial stability is thus a constant focal point and deleveraging is a clear goal, but pursuing it comes at a cost to near-term economic growth.

Avoiding a hard landing, avoiding too sharp a depreciation of the RMB, maintaining financial stability and continuing deleveraging are four important goals that the Chinese authorities

aim for. If each of the goals seems necessary, following the four objectives simultaneously is mission impossible because of the inevitable contradictions that this implies.

Contradictions

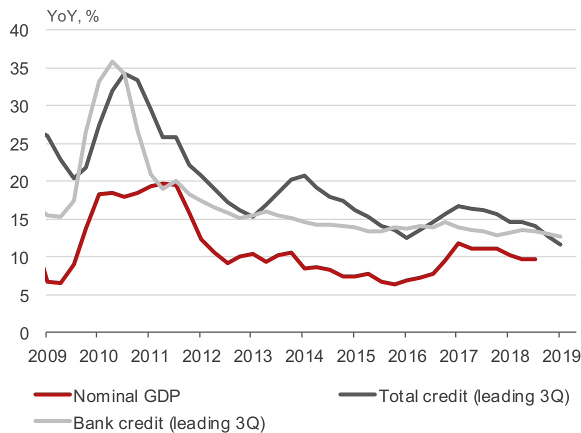
Contradiction N°1. Growth vs. Deleveraging

Economic growth in China is closely linked to that of credit. Over the last two years, credit growth, especially non-bank lending, has slowed sharply with the sharp contraction in shadow banking. The sectors dependent on these sources of financing were the most heavily impacted, for example, infrastructure investment has been declining since June. Pursuing deleveraging therefore implies a slowdown in growth, all else being equal.

Contradiction N°2. Growth vs. Exchange rate “stability”

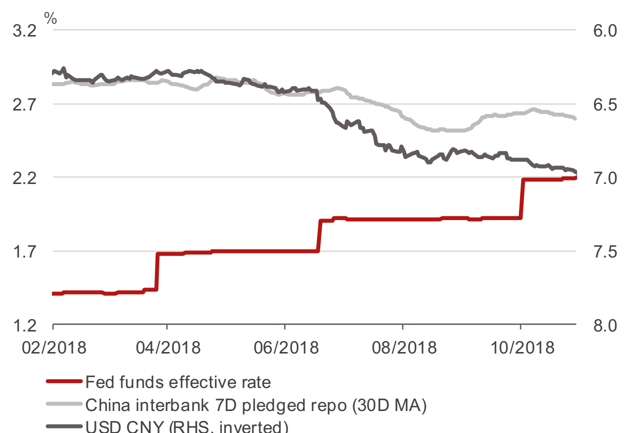
To avoid a hard landing, monetary policy has been eased. Interbank interest rates are easing, reducing the differential to the United States. In turn, this divergence of monetary policies adds depreciation pressure to the RMB. Throwing in the current uncertainties, and not least the intensification of trade tension with the United States, only adds to the depreciation pressure and may even cause markets to over-react. To rapid a depreciation of the RMB is clearly something the Chinese authorities wish to avoid.

Nominal GDP growth led by credit



Sources: PBoC, SG Economics and Sector Research

RMB depreciation caused by monetary divergence



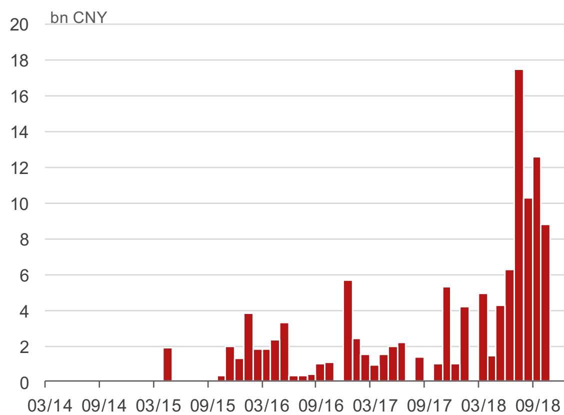
Sources: PBoC, Fed, SG Economics and Sector Research

Contradiction N°3. Deleveraging vs Financial stability

The debt of the Chinese economy has risen by more than 100pp of GDP since 2008. While good news for short-term growth, this rapid debt expansion also entails risks and Chinese policymakers have clearly sought to moderate the expansion in recent years. Non-bank credit growth, in particular, has slowed since 2017. However, while deleveraging and financial stability are consistent goals in the medium and long term, they may prove contradictory in the short term. In fact, as access to credit is rationed as consequence of deleveraging policies, zombie companies may no longer be able to renew loans and thus face foreclosure. If the deleveraging rhythm is poorly measured, defaults can become large enough to cause bank liquidity stress (especially small ones) as the quality of their balance sheet deteriorates, causing stress in the financial system.

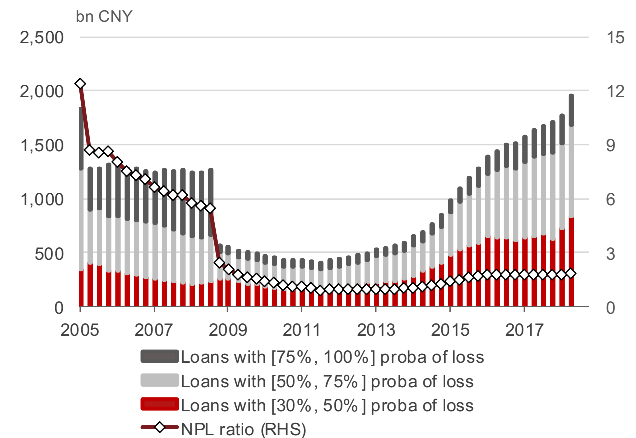
These two goals should thus be balanced with great caution as they come into conflict when the credit risk becomes high. For now, the official rate of non-performing loans is stable. However, since the beginning of the year, bond defaults have multiplied.

Surge in defaulted bonds



Sources: Bloomberg, SG Economics and Sector Research

Still stable non-performing loans ratio



Sources: CBIRC, SG Economics and Sector Research

Contradiction N°4. Exchange "stability" vs Financial stability

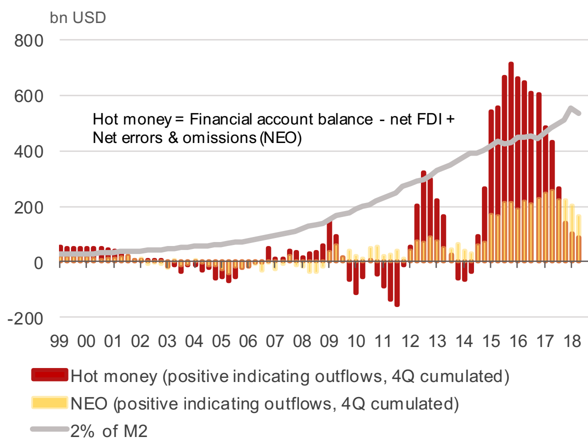
As mentioned above, default risk increases as companies are cut off from credit. In response to the growing risk to financial stability, the Chinese authorities are expected to ease financing conditions as a preventive measure. Meeting the need for liquidity to preserve financial stability, however, weakens the fundamentals of the RMB, leading to pressure to depreciate and greater exchange rate volatility. However, the foreign exchange reserves as a weapon of defence are weaker than in the past in the event of strong outflow pressure, and this despite the presence of exchange controls.

Although capital controls have been effectively tightened, capital outflows can still be significant in absolute terms. In 2008-2009, 2012-2013 and 2015-2016 outward financial outflows and net errors and omissions marked peaks amounting to a small portion of broad money (2% or more)[1]. But since 2014, foreign exchange reserves have decreased while a potentially larger amount of capital can leak out of the country due to increasing domestic liquidity. Therefore, the PBoC's ability to intervene via foreign exchange reserves is mitigated. This is illustrated by the decline in the ARA ratio[2] – the IMF metric Assessing the Reserves Adequacy (ARA). It is today equal to 0.85, falling below 1 in 2017; a ratio between 1 and 1.5 is considered adequate.

Financial stability is thus potentially a contradictory goal to that of exchange rate stability, especially since the latter has become more difficult to defend for the PBoC.

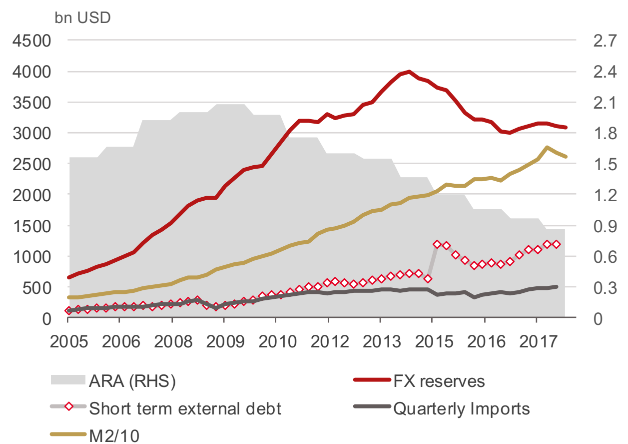
[1] Jonathan Anderson, October 2018.
[2] The metric considers the reserves coverage of broad money, short term external debt and imports.

Increasing amount of "hot money"



Sources: PBoC, SG Economics and Sector Research

Ebbing FX reserves adequacy



Sources: IMF, PBoC, SG Economics and Sector Research

Conclusion: Policy priority leaning towards growth and financial stability

Summing up, the context has become more restrictive in China, complicating the balancing act of the four goals outlined above:

- The capital account has become more open. Wanting both the autonomy of monetary policy and a relative stability of the exchange rate becomes more challenging.
- Monetary creation is no longer the result of the accumulation of FX reserves since 2015/16. Money supply continues to grow rapidly while foreign exchange reserves have fallen. Defending the value of the RMB by currency intervention is still possible but less credible than before, and not least if there are leaks in the capital controls.
- The debt ratio is already high. After surging from 140% of GDP in 2008 to 260% of GDP currently, the debt pile results in: limited leeway for credit growth, weaker credit quality and increased necessity of deleveraging given implicit credit risk.
- Trade tension with the United States casts uncertainty over growth prospects.

These increasingly apparent conflicts amongst the stated goals, have caused mounting scepticism despite announcements by the Chinese authorities to reassure the markets; the RMB is still under pressure and the stock market has yet to significantly recover.

The Chinese authorities will have to make choices and we see the policy priority moving towards financial stability and growth, while a higher tolerance is given to RMB depreciation. We note in this context that passive portfolio inflows[1] can partially offset outflows for a certain period. As for deleveraging, this remains a medium and long-term goal, but will likely be paused for now. We nonetheless do not see a significant stimulus policy, nor a rebound in activity in the coming quarters. Chinese growth is expected to gradually decline, and to come closer to 5% in 2022.

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[1] The inclusion of China's stock and bond markets in global indices leads to inflows from passive (index) portfolio management. This would partially compensate for outflows during inclusion implementation period.

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