



MACRO
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Decoding China's Economic Arrival



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MACRO OUTLOOK

Steady As She Goes on Deleveraging



KEY TAKEAWAYS FOR 2H2018

- The recent Politburo meeting on July 31 reaffirmed Beijing's priority of containing China's debt, focusing on state sector and local government deleveraging.
- Beijing will primarily use administrative measures, and to a lesser extent financial regulation, to contain financial risk for the rest of 2018.
- While monetary policy will continue to be modestly accommodative, the deleveraging agenda—that is, curtailing shadow banking and local off-budget borrowing—will remain intact and continue to put a drag on growth in the medium term.
- As long as state firms' and local governments' finances are solid, Beijing will hold back on stimulus, stay the course on deleveraging, and accept lower growth.

As US-China trade tensions have escalated, the general consensus has overwhelmingly shifted toward the view that “Beijing is returning to stimulus mode again,” implying that Chinese policymakers are ready to postpone or even reverse its ongoing deleveraging effort. In light of the State Council's recent [dovish signals](#), such a view has only gained more traction.

But those State Council signals are at odds with the core message of the [July 31 Politburo meeting](#) that President Xi Jinping chaired. What came out of that meeting is clear: the overall direction of deleveraging and financial tightening will remain unchanged. Nonetheless, there will be some notable changes in economic policy for the remainder of the year.

Before forecasting the medium term policy trajectory, it's worth revisiting what happened in the first half of 2018, especially the “triple tightening” approach Beijing used for deleveraging (monetary policy, financial regulation, and administrative measures). Each of these policies and its impact will be briefly assessed, which will be used as the basis for examining likely policy outcomes for the rest of the year.

THE “TRIPLE TIGHTENING” OF 2017 TO 1H2018

Aggressive Interest Rate Hike Led to Slower Growth

To deter reckless borrowing and rising leverage, the People’s Bank of China (PBOC) engineered an aggressive interest rate hike in Q42017. In the fourth quarter, the one-year risk-free borrowing rate (as measured by the one-year China Development Bank bond yield) increased by 70 basis points. To put this in perspective, the US Federal Reserve, in its current rate hike cycle, has not raised borrowing cost by more than 25 basis points per quarter.

The higher borrowing cost encouraged savings and discouraged spending and investment, which contributed to the overall slowdown of economic growth in the first half of 2018. As a result of weaker demand, inflation had been falling faster than interest rate cuts since the beginning of 2018 (PBOC has been behind the curve), which means the *real* borrowing cost had actually been increasing over this period (see Figure 1).

Figure 1. Real Borrowing Cost Remained High Through June 2018



Note: The interest rate is measured by the one-year CDB bond yield. The difference between the bond yield and inflation can be seen as a measure of the *real* borrowing cost. Unless otherwise specified, inflation is measured by the GDP deflator because it is a more comprehensive measure than CPI or PPI.

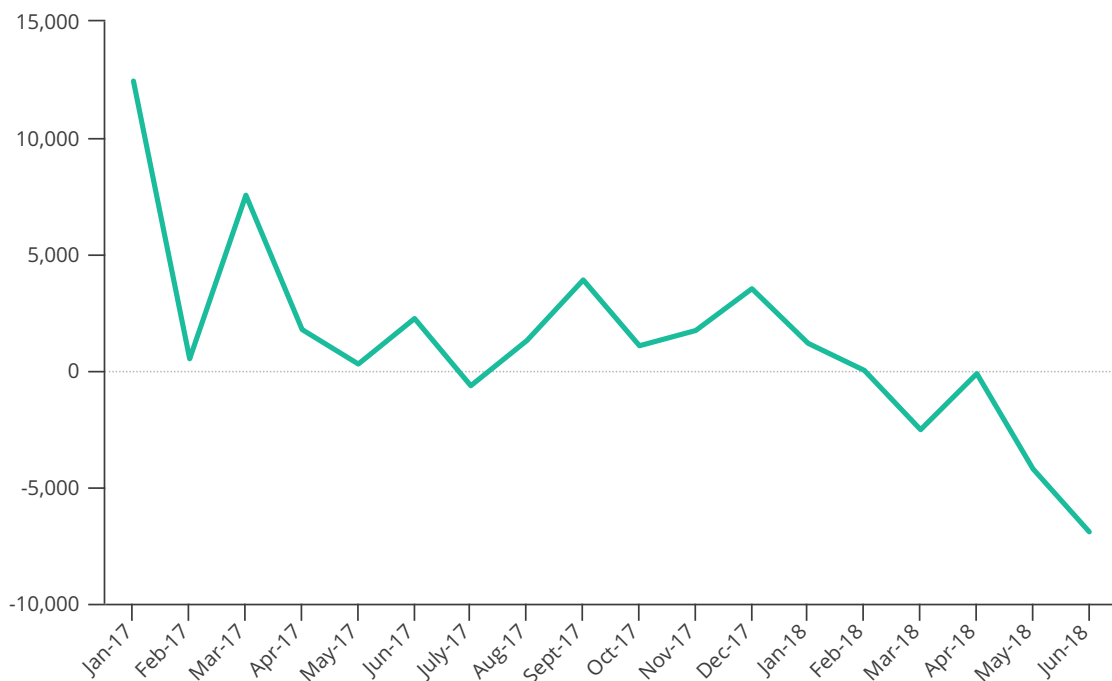
Source: Wind.

Second, China's higher interest rate in 1H2018 compared to other major economies attracted capital inflows, which in turn led to currency appreciation. The rapid appreciation of the Chinese yuan in early 2018 was largely responsible for China's [first current account deficit](#) in 20 years.

Clamping Down on Shadow Banking

Not only did PBOC raise the interest rate, the central government had also been squeezing shadow bank lending since late 2017. In particular, a high-level regulatory document from November 2017, according to [MacroPolo's ReformPedia](#), triggered the rapid shrinking of shadow banking (see Figure 2). [Curtailing shadow banking](#), which was an important driver of credit expansion in the past decade, not only reinforced the credit scarcity created by the interest rate hike, but also hit risky borrowers particularly hard because it was usually their only channel to obtain credit. Although Chinese banks now have plenty of funds to lend, they are still wary about making loans to risky borrowers. As a result, risky borrowers have been hung out to dry.

Figure 2. Shadow Bank Financing Collapsed in 2018 (in 100 million yuan)



Note: The chart shows monthly change in outstanding shadow bank financing, measured as the sum of trust loans, entrusted loans, and undiscounted bankers' acceptances.

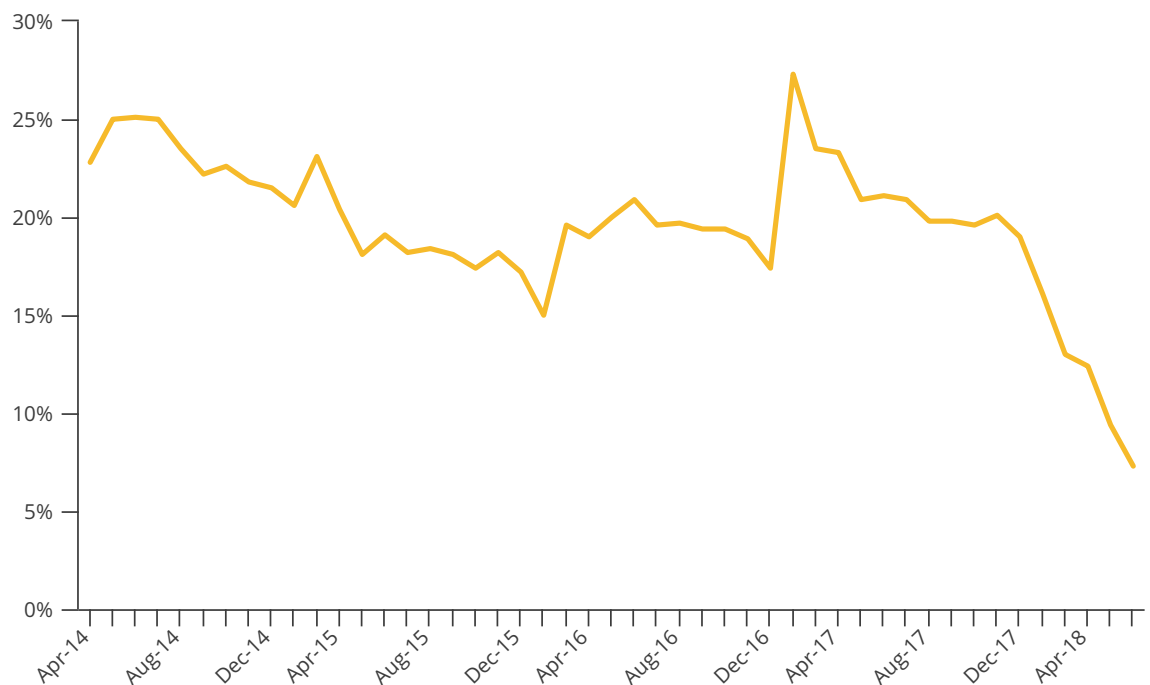
Source: PBOC.

Containing Local Government Debt

In addition to the interest rate hike and dealing with shadow banks, Beijing also had to address massive local government off-budget borrowing. Because local governments tend to be intrepid and creative in exploiting loopholes around central mandates, Beijing relied on draconian administrative measures to get local governments to quit their borrowing habits cold turkey.

But eliminating off-budget borrowing channels also affects on-budget expenditure. This is because for many local investment projects, usually only 25% are financed through on-budget financing, with the rest coming from off-budget borrowing. Therefore, local governments' difficulty in borrowing off-budget will delay on-budget expenditure as well. This can be seen clearly in the collapse of infrastructure investment, which has been mostly funded by local governments (see Figure 3).

Figure 3. Infrastructure Investment Growth Plummeted in 1H2018



Source: National Bureau of Statistics.

REST OF 2018: STEADY ON DELEVERAGING, TOLERATE WEAKER GROWTH

Against this backdrop of triple tightening in the first half, let's turn to unpacking the recent policy signals and their implications for the macroeconomic outlook for the rest of 2018.

The Meaning of Deleveraging

Upon a cursory look, the message from the Politburo meeting seems contradictory, emphasizing both deleveraging and growth. But this can be reconciled by clarifying just exactly what Beijing means by “deleveraging” in the current context.

Top policymakers are well aware that they've gotten a lot of flak from businesses and investors, as well as local governments, for tightening policies that have dried up credit. The complaints have grown since the beginning of 2018, so the Politburo meeting's emphasis on deleveraging is meant to signal that amid grumbling among the masses, the central government is holding the line. In other words, Beijing isn't going to do what's popular—opening up the credit spigot again—but rather doing what it deems necessary for China's economic stability. Indeed, the July Politburo meeting readout notably included Beijing's renewed vow to uphold deleveraging, which was *not* included in both the April Politburo meeting readout and the December 2017 Central Economic Work Conference.

Even though the emphasis on deleveraging remains fixed, the central government appears ready to tweak its approach around the edges. Based on the [readout](#) of the latest State Council Financial Stability Commission meeting, deleveraging in 2H2018 and beyond will be targeted rather than across the board. At least for the time being, deleveraging has been tweaked to mean “structural deleveraging.”

From Triple Tightening to “Double” Tightening

What this means in the second half is that deleveraging will mostly rely on administrative measures targeted at state-owned enterprises (SOEs) and local governments. Meanwhile, the existing financial measures will remain but will not be further tightened, and monetary policy will become more accommodative and be more in line with inflation trends. In other words, Beijing is simply moving from its triple threat on tightening to just a “double” threat.

This change in approach is due to a couple factors. SOE and local government debt have risen to the top of the deleveraging priority list, but neither local governments nor SOEs

are very sensitive to interest rate hikes. Therefore, monetary policy is rendered largely ineffective in deterring state players' borrowing behavior but does have an impact on the overall economy.

In this context, it makes sense to abandon monetary policy as one of the preferred tools of deleveraging. This has resulted in a much more accommodative monetary policy as of late, and the PBOC will likely stay the course for the remainder of the year. After rapid easing of monetary policy in July, by August 10, the one-year risk-free borrowing cost is close to overall inflation, implying a real interest rate of around zero that is much more accommodative than the 1% real interest rate in 1H2018. Similarly, on the currency front, the Chinese yuan has [depreciated](#) to its mid-2017 level.

A more accommodative monetary policy does not necessarily mean that credit growth will increase. In fact, credit growth will likely remain subdued because of the continued clampdown on shadow banking. Even in the absence of additional regulations, the shadow banking sector will continue to shrink in size under the existing policy environment. If Chinese banks remain reluctant to lend to high-risk borrowers, then the disappearance of shadow banking won't be offset by increased lending through formal channels.

If monetary policy will be ditched and financial regulation will stay the course, then that leaves administrative measures in the driver seat of deleveraging efforts. The current restrictions on local government off-budget borrowing will be implemented with the same intensity, or may even be ramped up given the more accommodative monetary policy. For instance, Beijing may further scrutinize state bank lending to SOEs and local governments to make sure they're behaving in prudent fashion.

As I explained previously, since containing local debt is imposed through an administrative mandate from the center, it will be very hard to fine-tune without essentially abandoning it altogether. The clear message of zero tolerance of new local government off-budget borrowing will be maintained. In fact, immediately after the Politburo meeting, Minister of Finance Liu Kun penned an essay affirming [Beijing's resolve](#) of containing off-budget borrowing.

Moreover, now that Liu He, the chief architect of China's deleveraging campaign, has been put in charge of SOE reforms, state sector deleveraging is expected to proceed at the same intensity over the medium run. In early August, Beijing published [a new directive](#) mandating the acceleration of SOE deleveraging.

Not Another Round of Investment-Driven Stimulus

As far as “supporting growth” is concerned, the Politburo meeting’s readout emphasized “investment stabilization.” But this does not mean another round of credit fueled investment binge, as many seem to have interpreted it. In fact, there are two reasons to believe that investment growth will continue to be slower than GDP growth in the foreseeable future.

First, “investment stabilization” likely means preventing a further decline in investment growth, rather than gunning for another v-shaped recovery of investment. The National Development and Reform Commission (NDRC), the agency in charge of approving investment projects, offered more clarity in its second half work conference. The NDRC stated its goals for investment and consumption as “stabilizing” and “expanding,” respectively. In other words, Beijing prioritizes expanding consumption over investment. This difference in language clearly illustrates Beijing has no intention to raise the contribution of investment to growth, but only to prevent it from falling further.

Second, as the oversight on local government off-budget borrowing will remain intense, local investment isn’t likely to return to double-digit growth. In particular, even if on-budget investment will be more proactive, it will not be enough to offset the decline of off-budget investment. Since China’s off-budget fiscal deficit is more than 30% larger than the on-budget deficit, simply enlarging the central budget deficit cannot make up for the shortfall from off-budget fiscal spending. (Off-budget deficit is calculated as the sum of *net cash from financing* for all bond-issuing local government financing vehicles.)

In sum, there is likely to be an acceleration of fiscal spending toward investment in 3Q2018, but investment growth will still lag GDP growth and likely to stabilize at a lower level for the rest of 2018. Although Beijing has announced a flurry of investment projects lately, it should be interpreted within the broader context of rapidly falling investment growth, which reached a new low in July. The promotion of investment will mostly be offset by the tightening of local government debt. In addition, because investment is no longer Beijing’s preferred tool for supporting growth, proactive fiscal policy will increasingly take the form of tax cuts. For example, Beijing plans to cut income tax this October, which is aimed at supporting household consumption rather than investment.

HOW MUCH GROWTH SLOWDOWN CAN BEIJING STOMACH?

Ultimately, the macro outlook depends on how much growth slowdown Beijing is willing to accept, which, in turn, is contingent on the performance of the state sector and local governments. As long as these two sectors are in good shape, Beijing will not pursue aggressive stimulus.

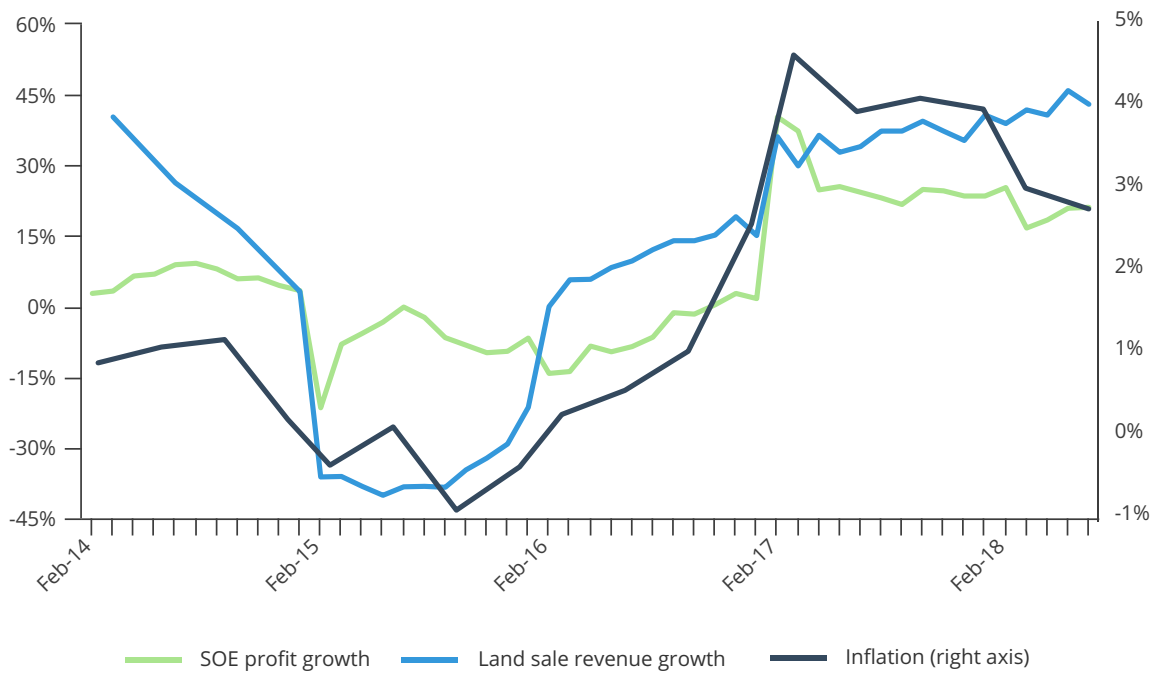
Not only are state firms and local governments economically important, they are the two main political constituencies for the Chinese Communist Party. Since SOEs and local governments together account for about two-thirds of China's debt and bank lending, their financial performance and their ability to service their debt have an enormous impact on the extent and severity of China's financial risks. Therefore, it's important to take a closer look at these two economic and political stakeholders.

Inflating Their Way to Sound Performance

So far, the financial conditions of SOEs and local governments seem to have been little affected by weakening economic growth. State firm profits have been growing at double-digit rates since the start of the year. When it comes to land sales, which account for about one-third of local government revenue, they have been growing at [more than 30%](#) this year.

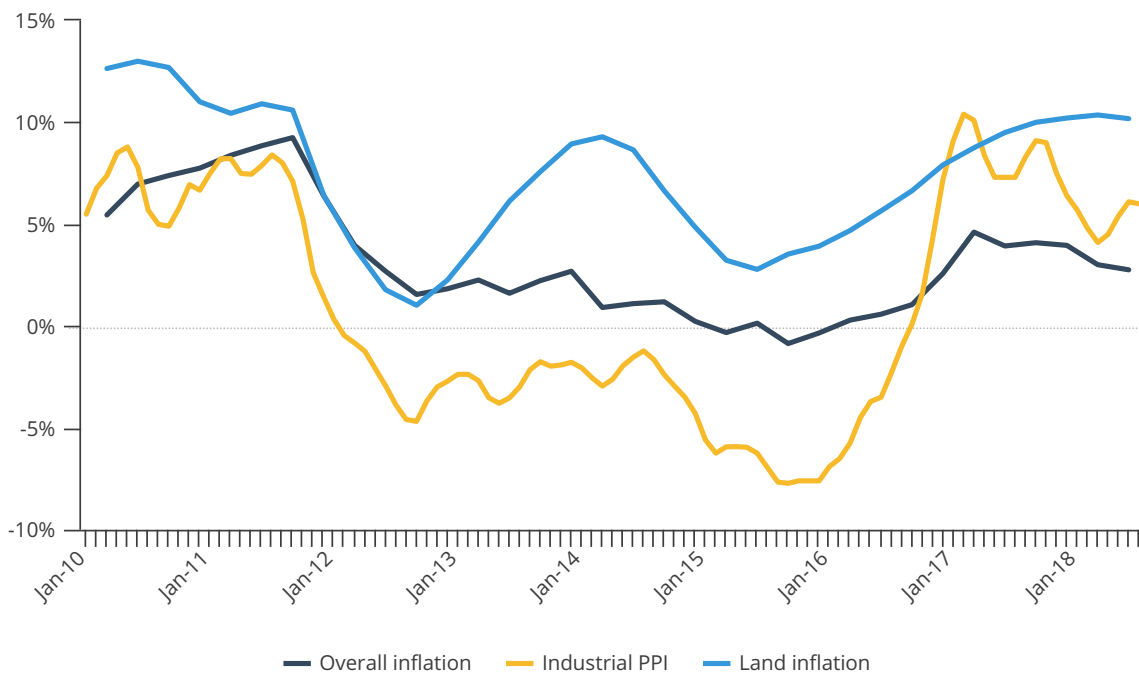
However, the financial performance of SOEs and local governments are historically strongly correlated with inflation (see Figure 4). Their recent solid performance is largely the result of high inflation since 2016, especially the price of industrial goods (SOEs' main products) and land (local governments' main asset) (see Figure 5).

Figure 4. SOE Profits and Local Government Land Sales Depend on Inflation



Source: Wind.

Figure 5. Industrial and Land Prices Have Rebounded Since 2016

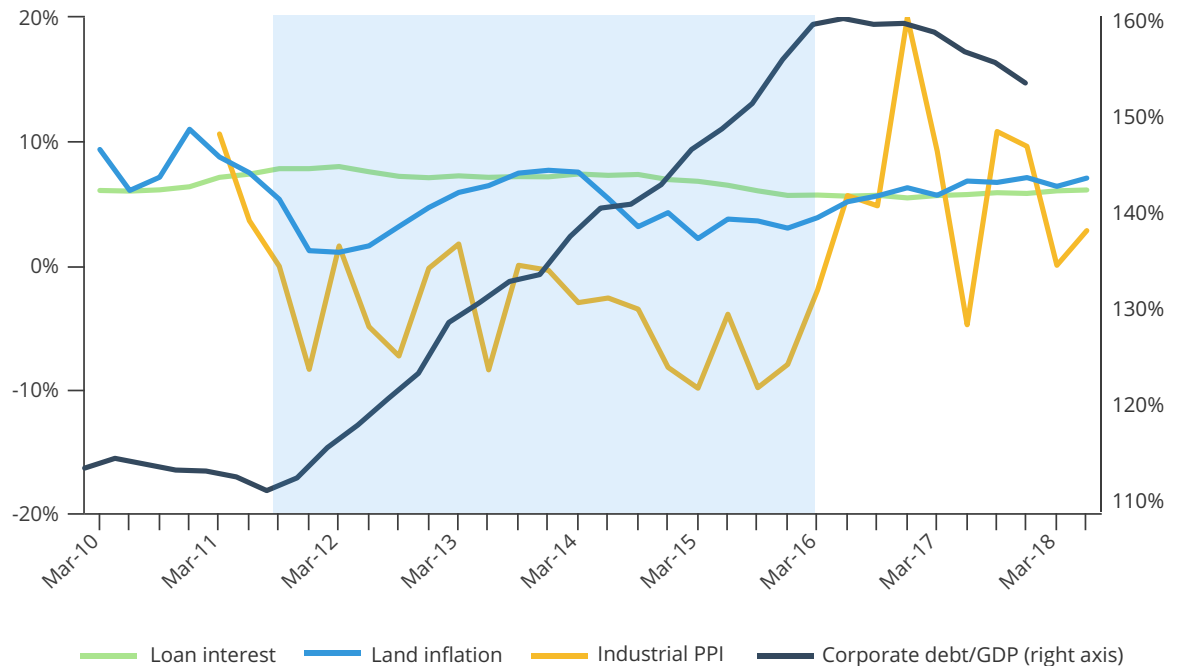


Source: Wind.

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High inflation also helps both SOEs and local governments to better cope with their piles of debt. That is, whenever inflation runs above the interest rate, the debt burden declines overtime and vice versa (see Figure 6).

Figure 6. Debt Increases Rapidly When Interest Rate Is Higher than Inflation



Note: Corporate debt is used as a proxy for total SOE and local government off-budget debt as they account for the majority of the growth of China's corporate debt in the past decade. Corporate debt/GDP is calculated by subtracting equity/GDP from BIS' credit to non-financial corporate/GDP ratio. Both industrial PPI and land price growth are calculated as quarterly changes at the annual rate. The blue area represents rapid accumulation of debt. Sources: NBS, BIS.

What Happens When Inflation Turns to Disinflation?

Of course, the current healthy performance of the state sector and local governments may quickly evaporate amid signs that inflation is weakening, particularly as the industrial producer price index (PPI) has been tapering off since the start of this year. So does the current PPI stagnation mean Beijing will deploy stimulus to boost demand for SOE products?

Not necessarily. Rather than using stimulus to create temporary demand, Beijing can bolster industrial prices by shutting down excess capacity—measures it is already taking as part of the so-called “supply-side reforms.” For example, facing a coal glut in 2016, Beijing

organized a coal production cartel and mandated all their coal mines to operate at only 75% capacity to support prices. In fact, the latest Politburo meeting has ordered an acceleration of supply-side reforms, which means continued focus on eliminating wasted capacity rather than stimulating demand.

In contrast to the deflationary period of 2014-2016, the current higher industrial PPI and land prices—a result of both supply-side reform and a housing market that’s overheating again—are benefitting both SOEs and local governments, thus providing Beijing some cushion to cope with the economic slowdown. The inflation picture, in the absence of a stimulus, also explains why Beijing is less desperate to shore up growth this time. At least for now, “supporting growth” means accepting slower growth and ensuring a soft landing, so long as these conditions hold and the two main political constituents are faring well.

China’s growth is certainly weaker, but it isn’t worrisome enough to trigger a new round of investment-driven stimulus. And even if SOEs’ performance falters, Beijing has tools other than credit to support them. Over the medium run, the scope and pace of deleveraging will be more dependent on the conditions of SOEs and local governments than on the growth outlook.