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Decoding China's Economic Arrival



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MACRO OUTLOOK

Don't Hold Your Breath for China's Stimulus

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KEY TAKEAWAYS FOR 2019

- Beijing's general policy stance in 2019 will see more continuity with 2018 than divergence. Although stimulus measures will be taken, they will be targeted at preventing a further slide in growth rather than lifting growth above a certain level.
- Structural constraints on launching an aggressive stimulus, as well as economic policymakers' reluctance on policy easing, means that Beijing intends to accept a lower growth target.
- Concerns about a near-term sharp contraction or potential recession are likely misplaced. Any stimulus measures will be front-loaded in 1H2019 ahead of the 70th Anniversary of the founding of the People's Republic of China in the fall.
- The front-loading of stimulus means pro-growth efforts will taper off in 2H2019, leading to a sharper slowdown toward the end of year. As such, those expecting another bout of Chinese stimulus to bolster global growth will likely be disappointed.

Concerns about the Chinese economy intensified in the second half of 2018, as the US-China trade war weighed on markets and signs of a precipitous slowdown emerged. But much of the economic decline, particularly in 4Q2018, owes as much to the impact of domestic fiscal and monetary policies as it does to the trade war.

Fiscal support was prioritized as the main tool for juicing growth in 2018. But the jolt never truly arrived, or when it did, it was too little and too late. Meanwhile, the central bank was unwilling to step in to support growth in the absence of fiscal measures, focusing instead on de-risking the financial system that consequently led to monetary tightening. This double whammy put significant downward pressure on the Chinese economy in 4Q2018.

There will be broad continuity with this policy mix in 2019, with fiscal spending in the starting line-up of bolstering growth, and monetary policy ready to come off the bench. But in practice, stimulus measures will likely disappoint, as they were in 2018.

Cognizant of the fact that its ability to support growth is limited, Beijing is expected to tolerate lower growth of about 6% in 2019. To achieve this growth, Beijing will concentrate fiscal measures in 1H2019 to arrest the current downward trajectory, but allow policy support to deplete in the second half. As long as the slowdown is gradual and orderly, Beijing appears prepared to accept this outcome.

The absence of an aggressive stimulus, however, has a silver lining. That is, credit growth will continue to be subdued and financial tightening will persist, reinforcing the continued progress on deleveraging. This means the debt/GDP ratio, currently at [250%](#), will continue to stabilize.

The bulk of this outlook will revisit the main factors that led to the rapid slowdown in 4Q2018, particularly why both fiscal and monetary stimulus was weaker than many had hoped. Because of the expected continuity in policy stance and constraints, a thorough retrospective is important to understanding why a robust stimulus won't be in the cards in 2019. The final section will look forward in 2019, focusing on three questions: 1) China's growth path; 2) Beijing's growth target; 3) The likely policy mix to achieve those goals.

We will update this base case throughout the year in the event of major policy changes and other unexpected exogenous shocks, such as an escalation and/or a conclusion of the trade war.

THE 2018 SLOWDOWN: A TRIFECTA OF FACTORS

Even as the trade war escalated and signs of an economic slowdown emerged in the second half of 2018, Beijing held back on any significant stimulus, as I previously predicted in [“Steady As She Goes.”](#) In particular, despite speculation of reversing course, Beijing kept the screws tight on local government off-budget borrowing and shadow banking activities.

Still, I underestimated the People’s Bank of China’s (PBOC) determination in financial de-risking, which created an overly restrictive monetary environment in 2H2018 that affected growth more than would’ve been the case otherwise. Instead of maintaining a neutral stance, the PBOC further tightened monetary policy in 4Q2018. This occurred in the context of already weak fiscal support to the economy. So it is no surprise that the Chinese economy lost steam quickly by the end of the year.

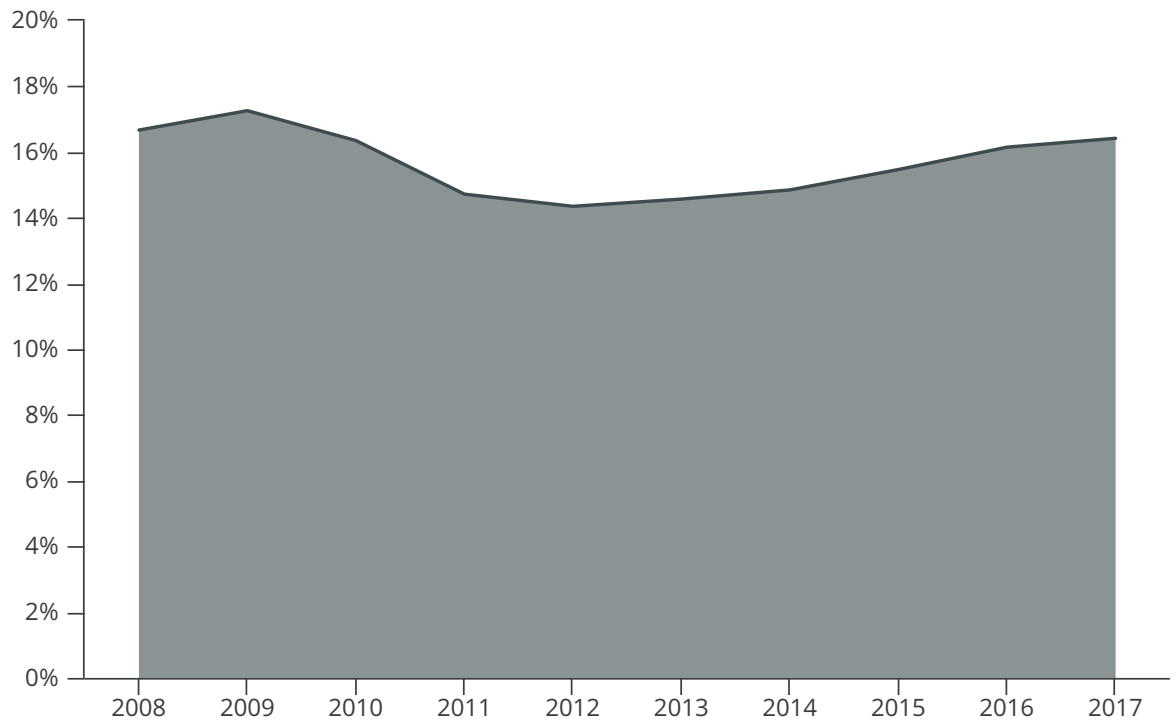
In short, what happened since September 2018 was the trifecta of trade tariffs, inadequate fiscal firepower from the Ministry of Finance (MoF), and a consistently hawkish PBOC. The 10% tariff on \$250 billion of Chinese exports weakened domestic demand more than fiscal support was able to offset, which was reflected in both slower growth and lower inflation. And as inflation fell, the PBOC chose not to adjust the nominal interest rate, so the real interest rate effectively rose as a result. This confluence of factors put significant downward pressure on economic growth.

Who Was Really in Charge of Providing Stimulus?

During the 2018 summer, when it became apparent policy intervention was needed to bolster growth, the PBOC and MoF engaged in a [public spat](#) over who should be responsible for the stimulus. Both had good reasons to pass the buck to the other.

For the central bank, loosening the monetary spigot ran the risk of undermining the ongoing financial de-risking effort, which is a top priority for the central government. The finance ministry, on the other hand, preferred a balanced budget rather than running a large deficit that had to be financed in the future. Indeed, the central government’s obsessive fiscal prudence has meant that its debt level has been kept very stable, even during the global financial crisis (see Figure 1).

Figure 1. Central Government Debt as % of GDP



Source: Wind.

But the escalating trade war throughout the summer meant that Beijing needed a pro-growth strategy. So in July 2018, top leaders decided that fiscal policy should be the primary instrument for supporting growth, meaning that MoF was now in the driver's seat. This decision effectively meant that Beijing sided with PBOC's argument that financial de-risking was too important to sacrifice for short-term growth gains.

Even though the decision to rely primarily on fiscal coffers to juice growth was wise, given China's myriad financial vulnerabilities, in practice it was not nearly as effective as policymakers had anticipated.

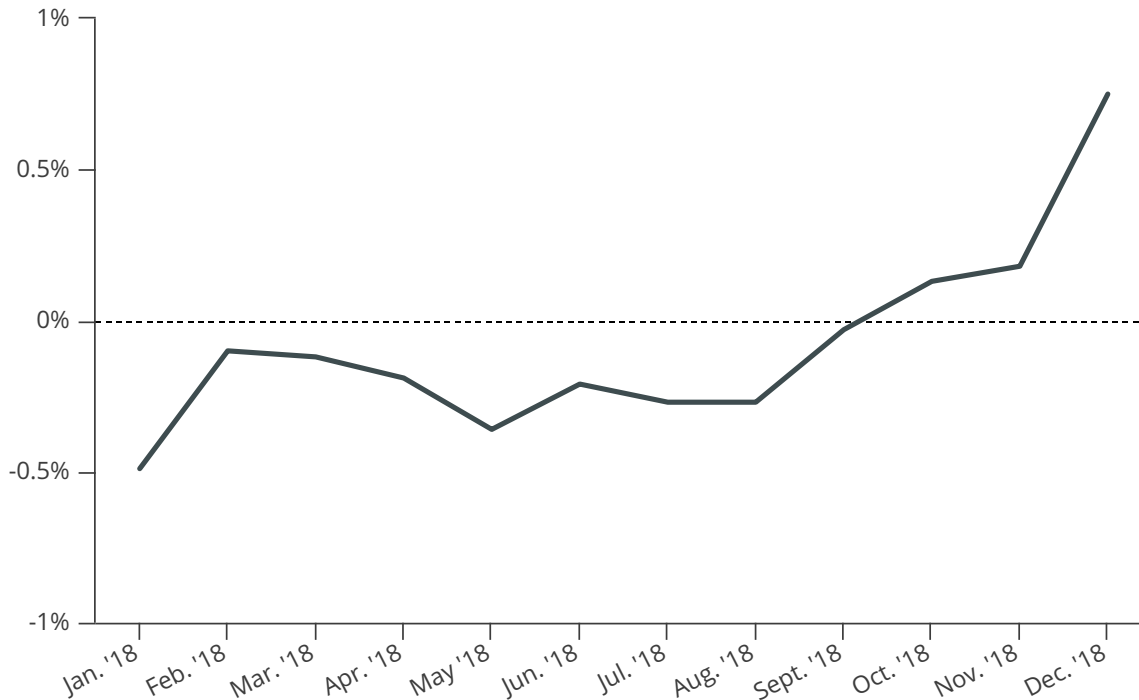
Let's take a look at each of these areas—from fiscal spending and interest rate to financial regulation—in detail to understand how structural constraints and poor bureaucratic coordination dragged down growth.

The Fiscal Boost That Never Came

For most of 2018, both on-budget and off-budget spending was contractionary, with only marginal improvements in 2H2018. That improvement came from on-budget deficit

spending, which had a modest effect (see Figure 2). However, the boost came at the very end of 2018 and was likely smaller than the headline figure suggested.¹ Therefore, on-budget spending was too little, too late.

Figure 2. Fiscal Deficit Contribution to Growth (% of GDP)

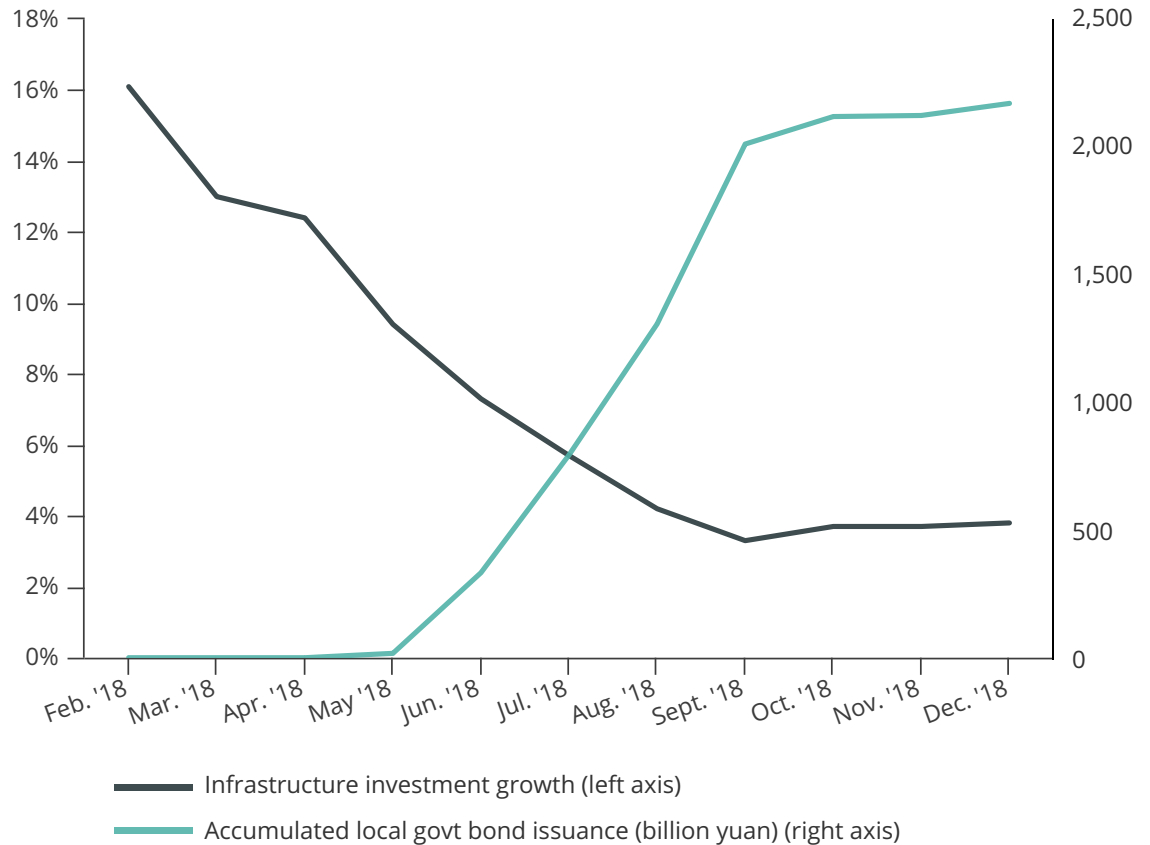


Note: Positive reading suggests that fiscal expenditure is contributing to growth.

Source: Wind.

Off-budget fiscal expenditure via local government financing vehicles (LGFVs) also remained weak throughout 2H2018. Although LGFV figures for 4Q2018 are not yet available, off-budget spending can be inferred from estimating infrastructure investment growth. This is because the majority of infrastructure investment is typically financed by local government off-budget borrowing. As is apparent, year-on-year infrastructure investment growth stabilized at a historical low of about 4% at the end of the year, significantly lower than GDP growth. More significant, infrastructure growth was weak despite a surge in local government borrowing (see Figure 3). This suggests much of the new borrowing was used to service debt rather than for new investment.

Figure 3. Infrastructure Investment Fell Despite Increased Local Government Borrowing

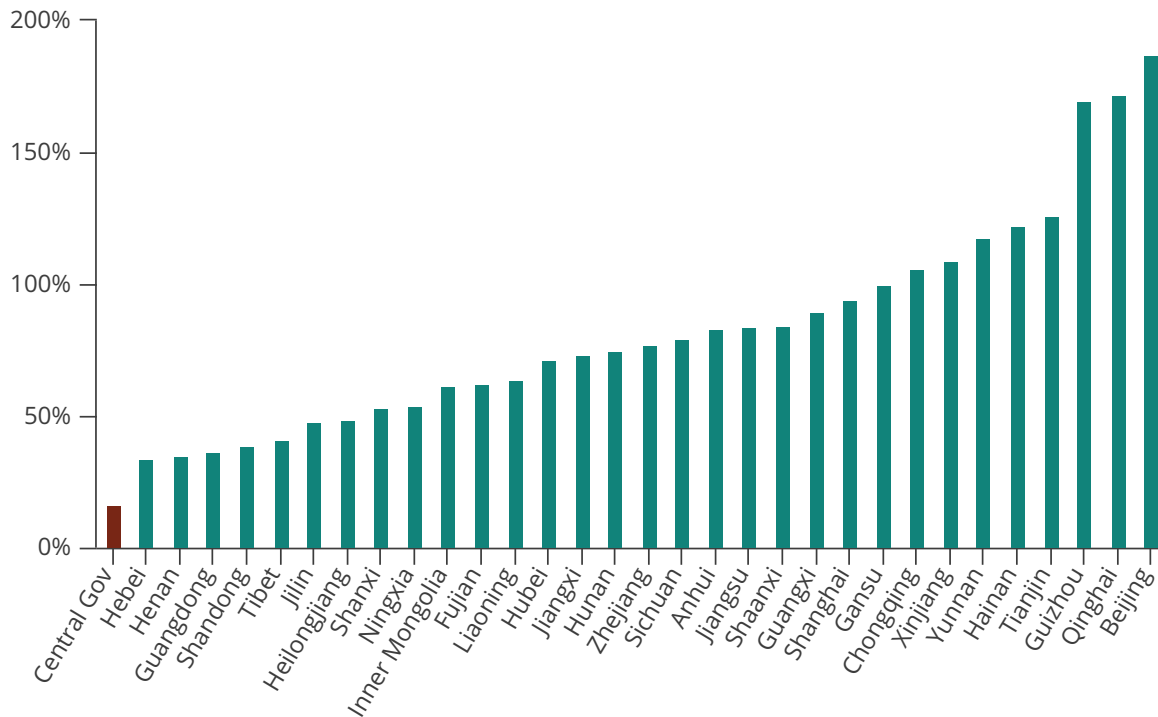


Source: Wind.

There are three reasons why the fiscal stimulus didn't come sooner. First, it was practically difficult to increase deficit spending in the latter part of the year, because the initial 2018 deficit target was set even lower than the 2017 deficit. This suggests Beijing didn't anticipate the need for fiscal support in 2018 and was likely caught off-guard by the trade war and rapid slowdown.

Second, relying on heavily indebted local governments to do the heavy lifting means that the actual stimulus was probably smaller than what was announced. Since local governments have significantly higher levels of debt than the central government, they simply have less room to ramp up spending and are generally unwilling to increase their deficit levels (see Figure 4).

Figure 4. Central Government Debt Much Lower Than Provincial Governments (% of GDP)



Note: Local government debt is calculated as the sum of local government on-budget debt and LGFV debt. All figures are for 2017.

Source: Wind and author calculations.

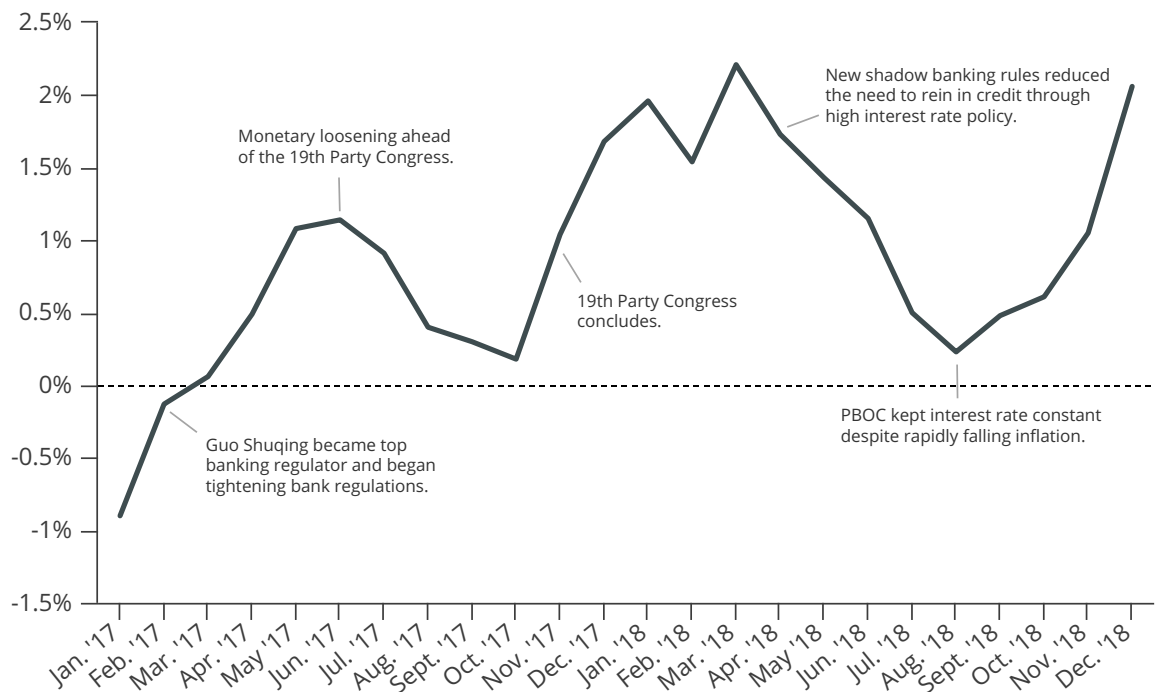
For instance, local governments in 2018 borrowed 264 billion yuan (\$39 billion), or 0.3% of GDP, less than they were allowed. To put this in perspective, total fiscal spending's contribution to 2018 growth was only 0.8% of GDP. Had local governments borrowed to their fullest extent, fiscal spending's contribution to growth could have increased by almost 40%.

Third, the fierce battle to discipline off-budget spending seemed to have meaningfully changed local officials' attitude and behavior toward managing debt. Previously, local officials seemingly had an insatiable appetite for debt because it was common practice to hide off-budget spending, leaving their successors to clean up any mess. But now, local officials have gotten the message and will be held accountable for life for the borrowing approved under their tenure. In the Xi Jinping era, this sort of behavior modification through relentless campaigns seemed to have produced certain outcomes.

PBOC Further Crashed the Growth Party

Throughout 4Q2018, not only was the PBOC reluctant to support growth, it actually did the opposite by effectively tightening through maintaining high interest rates. That is, the PBOC kept the nominal interest rate constant in the face of rapidly falling inflation, which led to a significant rise of the real interest rate. Throughout the fourth quarter, CPI dropped by around 60 basis points, while PPI saw an even steeper decline, dropping from 3.6% to 0.9%. This meant that amid disinflation, PBOC's policy drove real interest rate up by at least one percentage point for the overall economy (see Figure 5).

Figure 5. Rising Real Interest Rate in 4Q2018 (%)



Note: Real interest rate is calculated as nominal interest rate minus inflation. Inflation is measured by an average of CPI and PPI, while nominal interest rate is determined by the yield of one-year AAA bank bonds.

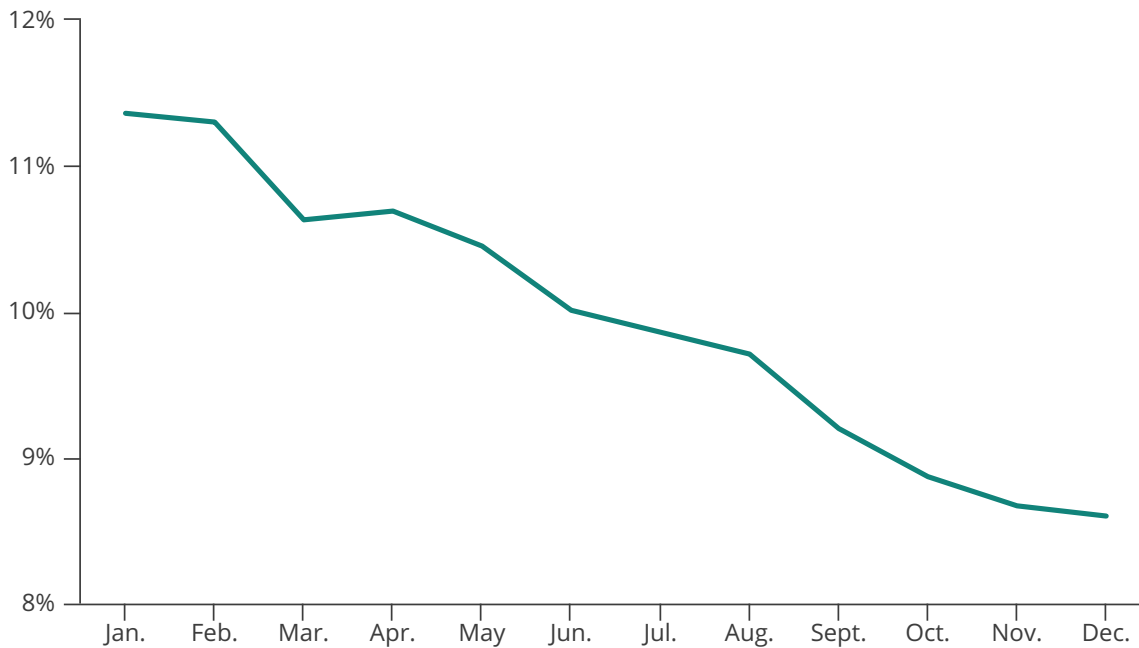
Source: Wind.

As the real interest rate was rising, tariffs were being imposed on \$250 billion worth of Chinese goods, about 10% of total exports. Given the potential shock from the trade war, the PBOC should have guided the real interest rate lower (i.e. cut nominal rate by more than the fall of inflation) to keep growth at its potential level. At a minimum, the real interest rate should have been kept constant (i.e. cut the nominal interest rate at the same pace as the drop in inflation). But instead, the real interest rate increased after trade tensions escalated.

Financial Tightening Persisted

Even as the PBOC kept interest rates high, it doled out credit to the private sector, targeting small and medium enterprises. But the overall effort was to no avail, as credit growth continued to decline through 4Q2018 (see Figure 6). Some of this can be attributed to the continued contraction of shadow banking. More important, the lackluster credit growth was a result of the higher cost of credit. Indeed, the real cost of capital had risen significantly in the fourth quarter, especially for industrial sectors.

Figure 6. Weak Private Sector Credit Growth in 4Q2018 (%)



Note: Private credit is measured as total social financing excluding local government bonds and bank write-offs.

Source: Wind.

There are two possible explanations for PBOC's inaction in the face of rapidly weakening growth. First, the central bank may have chosen to remain on the sidelines as a way to exert pressure on the finance ministry to do more, since fiscal firepower was still limited up until December. If PBOC had stepped in with monetary easing, that would have taken some pressure off of MoF.

Second, the central bank's preoccupation with supporting the exchange rate may have led it to be behind the curve in lowering interest rates. During 4Q2018, the yuan/dollar exchange rate almost dipped below 7, which is widely seen as a key psychological threshold. In his

recent [speech](#), PBOC Governor Yi Gang insisted that the bank's guiding principle on interest rate policy should be primarily focused on domestic factors, but also admitted that exchange rate concerns had handcuffed monetary policy to some extent.

LOOKING FORWARD: DON'T EXPECT CHINESE STIMULUS TO BOOST GLOBAL ECONOMY

The trifecta that led to the 2018 slowdown—local governments' inability and unwillingness to significantly increase their deficit spending, Beijing's fiscal conservatism and unwillingness to accrue central government debt, and PBOC's reluctance to stimulate the economy—are likely to persist into 2019.

This does not bode well for a strong stimulus in 2019, which largely aligns with the core message from the [Central Economic Work Conference](#) (CEWC) in December. That message focused on “stabilizing aggregate demand/稳定总需求,” which implies weaker policy support than the stronger language of “increasing aggregate demand/扩大总需求” in 2015 and 2016.

Nonetheless, there will be some *marginal* improvements in 2019 for several reasons.

For one, Beijing won't be caught off guard this year and will adopt a more accommodative fiscal policy from the get-go, rather than having to adjust course toward the end of the year. Even as the central government adopts a more realistic appraisal of fiscal spending in 2019, local governments' inability and unwillingness to borrow will likely persist. This means a significant increase in central budget deficit (at least 1% GDP) will be needed to compensate for weak local fiscal spending.

Whether Beijing would be willing to abandon its fiscal conservatism remains to be seen, though *Caixin* has reported that the central government is contemplating setting its 2019 [revenue target to zero](#). If this turns out to be true, then that would be an upside surprise on sustaining growth.

Second, Beijing has instructed PBOC to be more active. Shortly after the conclusion of the CEWC, the central bank finally began its long-overdue interest rate cut. The market interest rate, as measured by central government bond yields and bank borrowing cost, has declined by around [40 basis points](#) since late December 2018.

Despite the recent easing signal, PBOC's internal antipathy towards easy credit holds. In the past, PBOC has repeatedly tried to rein in credit, but because of the lack of political support, all previous efforts eventually faltered. Now that the political environment has aligned with PBOC's hawkish stance on credit, it seems unlikely that the central bank will squander the strongest political support it has had in over a decade. As such, PBOC's recent easing should not be interpreted as a fundamental shift in monetary policy. The central bank will likely continue to limit its easing and maintain tight monetary policy overall.

Growth Should Stabilize in 1H2019

All of this means that pro-growth support will disappoint for 2019 overall. But Beijing should still be able to stabilize growth at about 6% by front-loading stimulus measures in 1H2019.²

The rationale for front-loading is simple: do not underestimate major anniversaries as action-forcing events. Just as in 2017, the year of the 19th Party Congress, 2019 will celebrate the 70th anniversary of the founding of the People's Republic of China in October. Indeed, to maintain robust growth ahead of the Party congress in 2017, Beijing [packed fiscal spending](#) equivalent to 0.5% of GDP into the first three quarters of the year, which led to a fiscal drain late in the year that contributed to the weak growth leading into 2018.

Beijing seems to have adopted this same trick again in 2019, as it has allowed local governments to begin borrowing in January, rather than waiting until March like in previous years. This means that similar to the fiscal cycles in 2017, policy support will also peak around 3Q2019 and weaken in the final quarter.

Beijing Is Fine with a Lower Growth Target

Ultimately, these factors [point to](#) Beijing having to accept a lower growth target in 2019. Although the target will not be officially revealed until the National People's Congress in March, there is ample evidence from the provincial level to help forecast it. Except for a few outliers, most provinces have already lowered their 2019 target by 0.5% from their actual 2018 growth rate. This suggests the national level growth target is also likely to be reduced by around 0.5% to around 6%. Most likely, this year's growth target will take the form of a range between 6%-6.5%.

It is also worth highlighting that, as I explained [previously](#), the GDP target is now less binding than it was just a few years ago. To the extent that Beijing does stimulate, it will be driven more by the desire to prevent a growth freefall rather than deliberately pushing growth above a certain level, as in the Wen Jiabao era of “protect the eight (保八)”. In other words, Beijing will accept, rather than fight, a slowdown as long as it is gradual and not disruptive.

Endnotes

[1] It is worth noting that December 2018 fiscal expenditure usually does not correspond with real expenditure, but simply means that money earmarked for future spending is still sitting in government bank accounts. So the actual on-budget spending in 2018 was likely significantly less than the headline number.

[2] Although the 4Q2018 headline year-on year growth rate was 6.4%, this probably overstated the real growth in light of the downward revision of 4Q2017 GDP. The more accurate measure is the annualized quarter-on-quarter rate of 6%.