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Decoding China's Economic Arrival



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MACRO OUTLOOK

Houze Song

Beijing Will Juice the Economy and Stick To Long-Term Objectives



KEY TAKEAWAYS FOR 2Q2019

- In the near term, Beijing will focus more on stimulus in response to weak growth fundamentals but also pursue structural reforms in parallel.
- The current monetary tightening reflects the central bank's struggle to balance supporting growth with deleveraging. But the tightening will be short-lived and unlikely to last beyond May, particularly if the trade war meaningfully escalates yet again.
- To achieve sound growth ahead of the 70th anniversary of the founding of the People's Republic of China—a politically important event—there will likely be both fiscal and monetary loosening toward the end of the second quarter.
- This still means stimulus will be front-loaded and M-shaped, with peaks in March and June, but taper off after the anniversary in October when growth is expected to slow.

Market sentiment on the Chinese economy has been somewhat schizophrenic over the last few months. At the start of 2019, it was widely believed that the Chinese economy would see a hard landing because the stimulus was too little and too late. But when stimulus measures in fact stabilized growth around March, the market's cheers quickly gave way to fretting over how another bout of stimulus would undermine the deleveraging effort.

Investor concerns were amplified by the People's Bank of China's (PBOC) tightening of liquidity since late March. Then when the April Politburo meeting on the economy concluded, markets widely read the outcome as Beijing intending to prioritize structural reforms over growth, which would mean a reversion to austerity.

But the latest fear of growth plummeting, yet again, may be overblown. Rather, more significant stimulus measures will likely arrive by late May, making the stimulus "M-shaped" in the first half, with the first peak in 1Q2019. Should the trade war actually escalate, Beijing could loosen sooner. But our base case remains that a trade deal is more likely than not in the near term. As such, even if US tariffs are raised, it will likely be temporary and have marginal impact on China's economy in 2Q2019. Given this assumption, the outlook does not consider the trade war a meaningful variable.

These factors do not mean, however, that Beijing is forfeiting its deleveraging effort and going all-in on stimulus. It continues to face a set of constraints—limited room to stimulate, weak fundamentals, and balancing long- and short-term considerations—that will determine what it is willing and able to do for the remainder of 2019.

Weak fundamentals and limited policy space mean the economic recovery will be a lengthy process. Meanwhile, Beijing can't afford to postpone long-term structural reforms until the economy is nursed back to full health. Amid a table full of suboptimal choices, the most optimal option for Beijing is to pursue structural reforms in parallel with targeted and occasional stimulus to prevent growth from falling through the floor. These constraints, as well as their implications on the economy, will be examined in this outlook.

THE THREE CONSTRAINTS

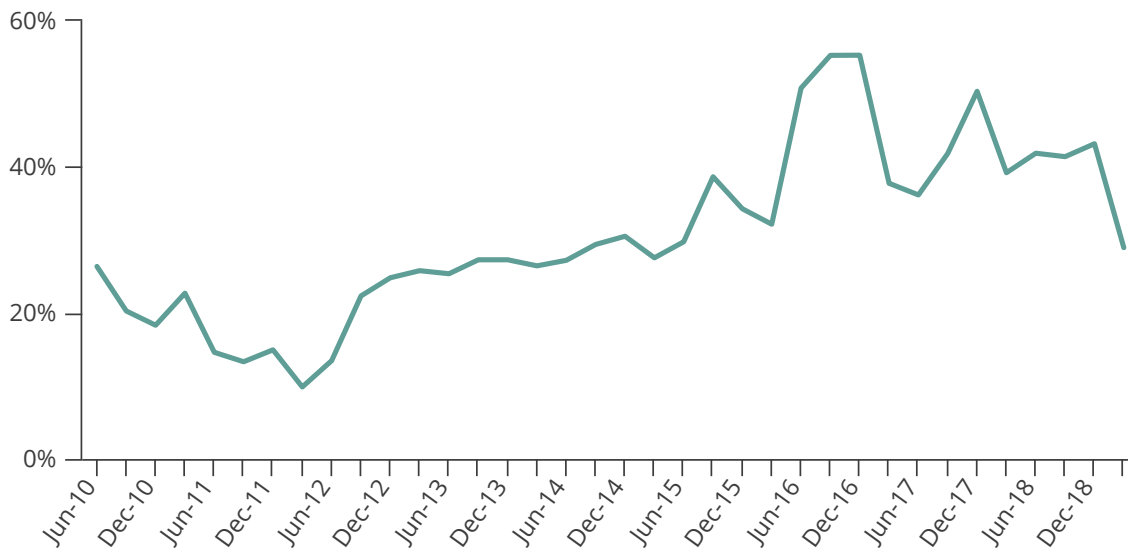
Restraint on Stimulus

As highlighted in the previous [Macro Outlook](#), Beijing only has modest capacity to stimulate the economy. For example, even though the 2019 fiscal deficit was set 520 billion yuan (\$78 billion) higher than in 2018, the central government has already spent 452 billion yuan (\$67 billion) of it in 1Q2019. In other words, most of the additional deficit is nearly used up, reflecting Beijing's front-loading of stimulus.

The outlook for off-budget fiscal spending, namely local government financial vehicles (LGFVs), remains grim. Infrastructure investment, a proxy for local spending, continues to lag GDP growth. This is because Beijing has been insistent on containing LGFV debt, as bank lending to infrastructure (excluding transportation) grew just [5.7%](#) in 1Q2019. Since Beijing did not relax regulation on LGFVs during the growth deceleration in 4Q2018, LGFV borrowing will likely remain subdued, which means a rebound of infrastructure investment in the near term isn't in the cards.

When it comes to monetary stimulus, it does not look great either. Although credit growth accelerated in 1Q2019, credit demand remains weak. Lending to property (including mortgages), a key driver of bank lending growth since 2016, has shown signs of further weakening (see Figure 1).

Figure 1. Weakening Property Lending (% of total new bank loans)



Source: Wind.

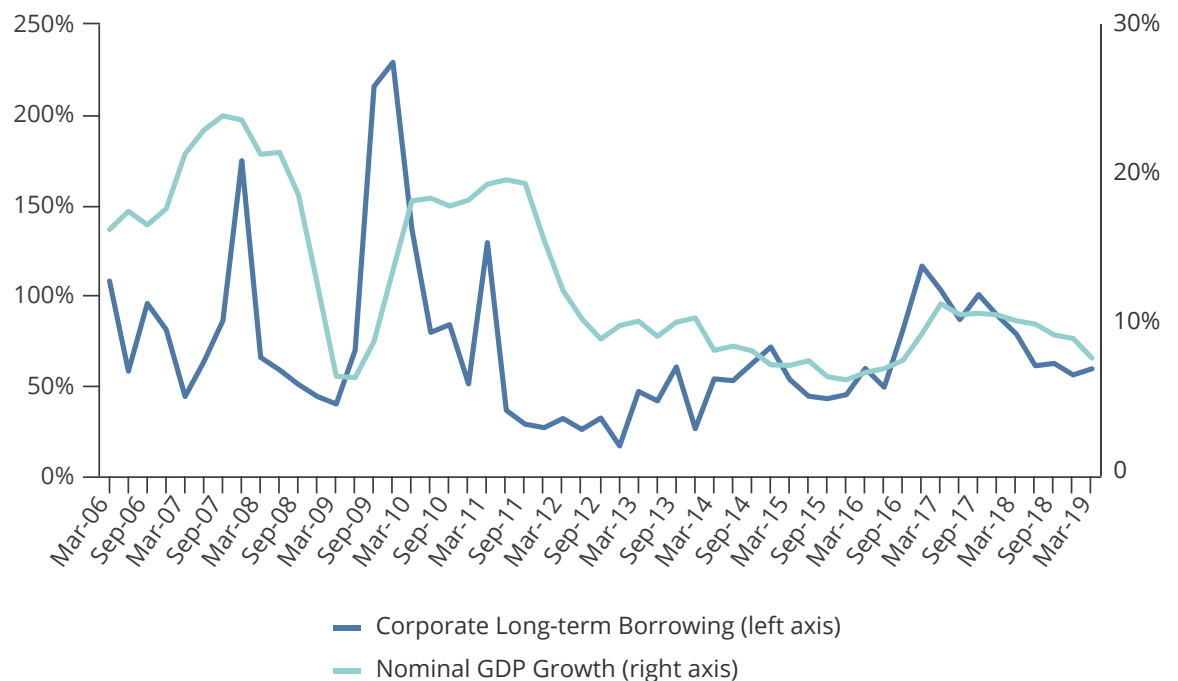
With banks having difficulty finding borrowers, credit growth during 1Q2019 was primarily driven by short-term paper financing, which accounted for around 50% of the credit growth. Since a large portion of paper financing will mature in the coming months, their expiration will put a drag on credit growth later in the year. In addition, the fiscal deficit will be increasingly used to finance tax cuts, particularly the VAT cut that just took effect in April, rather than investment. These factors do not bode well for bolstering investment-related credit demand.

On top of it all is the PBOC's credibility. Although the weak economy requires continued monetary policy support, pumping money into the economy will only reinforce the pervasive skepticism that Beijing will hold fast to its deleveraging campaign. Given that the PBOC needs to balance supporting growth and upholding its credibility on deleveraging, it is unlikely to accelerate credit growth for the rest of 2019.

Weak Fundamentals

The above-expectation headline growth in 1Q2019 masked weak underlying growth momentum. Even with considerable stimulus, annualized quarter-on-quarter growth was only 5.7%, the lowest level since 2010. In addition, corporate long-term borrowing, primarily used for investment and a reliable leading indicator of recovery, has been lackluster (see Figure 2). If companies are still reluctant to invest, despite the stimulus, it suggests business confidence in the growth outlook has not rebounded.

Figure 2. Corporate Long-term Borrowing Shows No Sign of Rebound

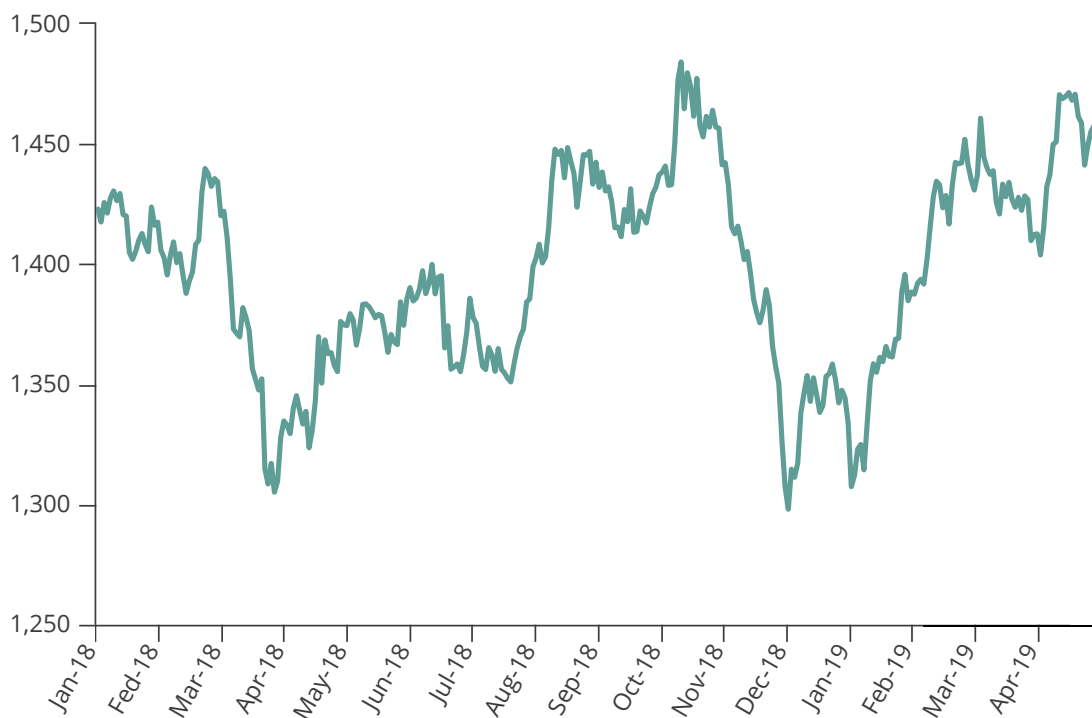


Note: Corporate long-term borrowing/total corporate borrowing can be larger than one because of the decrease in corporate short-term borrowing.

Source: Wind.

Inflation, too, has barely budged, suggesting weak demand. The Producer Price Index inflation at the end of March was still lower than at the end of 2018. The Nanhua index, composed of industrial, agricultural, and energy futures, points to the persistence of low inflation in the months ahead, further signaling continued softness in the economic recovery (see Figure 3).

Figure 3. Futures Index Points to Continued Weak Inflation



Source: Wind.

The US-China trade war has certainly weighed on growth, and its potential escalation yet again could put more downward pressure on the economy. However, since a trade deal is still a likely outcome in the near term, that will alleviate some of the pressure. Still, much of the drag on the economy stem from domestic priorities of de-risking the financial system (e.g. cracking down on shadow banking) and deleveraging (e.g. containing local government debt). Therefore, how Beijing balances near-term considerations with structural reforms will largely determine growth performance for the rest of the year.

Balancing the Short and Long Terms

That balance appeared to have shifted more in favor of structural reforms after the April 19 Politburo meeting on the economy. Or at least that's how markets interpreted the message that the main culprit of the current economic weakness "[is] [structural, rather than cyclical.](#)" The expectation of renewed tightening when the economy still showed signs of weakness spooked markets.

But that interpretation is off the mark. This message on structural reform is essentially unchanged from what came out of the December 2018 Central Economic Work Conference (CEWC), when Beijing pointed out that "[the main contradiction in the Chinese economy is structural.](#)" Yet what followed from the CEWC was not austerity but the start of significant stimulus to arrest the rapid slide in growth.

To be sure, Beijing has made no secret about its commitment to tackle long-term structural issues. But its intent is different from what it is actually capable of, because of the constraints the central government faces at any given time. Although the Chinese economy appears to have stabilized since December, Beijing recognizes the current weakness of the recovery, which means it isn't likely to pursue structural reforms aggressively at the expense of crashing the economy.

Indeed, Beijing's actions have confirmed that it is still preoccupied with ensuring a more durable economic recovery. Two days after the Politburo meeting, the readout of the Fourth Central Economic and Finance Committee (CEFC) meeting emphasized "[strengthening counter cyclical fiscal and monetary measures, and monetary policy should adjust according to growth and inflation.](#)"

Since all previous CEFC meetings dealt with long-term issues and never waded into fiscal and monetary policies, the insertion of such a message suggests that Beijing is going out of its way to clarify its intentions and calm market jitters. This essentially means that as long as the economy remains weak, an accommodative monetary policy should be expected. During [a State Council news conference](#) on April 25, a senior PBOC official further confirmed that the April 19 Politburo meeting had in fact decided on maintaining an accommodative policy stance.

This episode reveals how Beijing is struggling to balance near- and long-term considerations. On the one hand, policymakers want to prioritize structural reforms as soon as the counter

cyclical stimulus does its job to stabilize economy, in order to demonstrate that “this time is different.” On the other, tightening too much amid a weak recovery risks tipping the economy back into recession. This puts Beijing in a constant orchestra of slamming on the brakes but also tapping the accelerator whenever needed. That’s because a stable economy is a necessary condition for tackling long-term concerns like zombie firms.

Since stabilizing the economy is paramount at the moment, Beijing isn’t likely to pursue the sort of disruptive reforms seen in 2017 and 2018, such as tightening supervision over China’s banking sector. This effort almost immediately sent a booming economy to the verge of recession. So too did environmental inspections and efforts to contain shadow banking have a sizeable impact on the economy.

Even in frothy sectors that need intervention, such as property and local government investment, Beijing will likely hold off for the time being. The central government’s guiding principle for the property sector in 2019 is “[stabilizing property and land price](#),” which is aimed at preventing an abrupt slowdown. Local government deleveraging, too, is to proceed in an “[orderly and gradual](#)” fashion.

POLICY OUTLOOK IN 2Q2019 AND BEYOND

Since late March, the PBOC has abruptly tightened liquidity, sending the one-year central government bond yield up by more than 20 basis points. With no signs of a rebound in inflation, this sudden rate hike cannot be justified on the grounds of improving fundamentals.

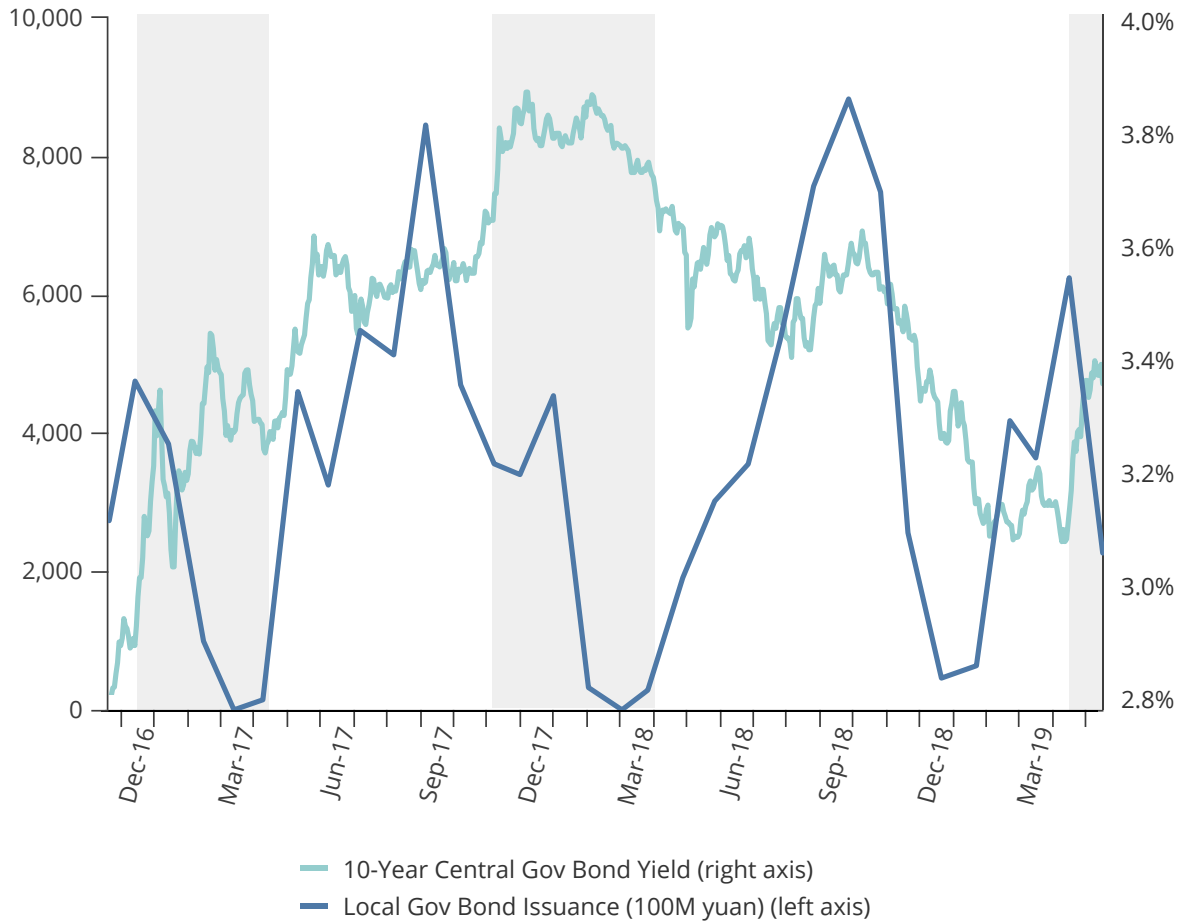
Instead, this round of tightening is likely the outcome of a compromise between defending the deleveraging agenda and supporting growth but won't last long. After the 1Q2019 loosening, the PBOC needed to burnish its hawkish credentials and defend the credibility of its deleveraging pledge.

The timing of the tightening suggests the PBOC understands that it needs to tread gingerly. April is relatively a better time to impose tightening than in other months. Since bank borrowing and lending rates are still largely administratively determined, a liquidity crunch has the largest effect on the bond market. To limit the impact on the bond market, it is best to tighten during months when bond issuance is low. April is such a month because local government, the largest borrower in China's bond market, doesn't need to borrow much in this month.

Local government spending tends to be the highest in June and September and plateaus in other months.¹ In addition, local governments will only borrow when it needs to, which means when they have plenty of cash on hand, they will refrain from borrowing much. Fiscal deposit increased by more than 165 billion (\$25 billion) during 1Q2019, driven by aggressive local issuance of bonds. As a result, for April and part of May, local governments can borrow less by running down deposits to finance their deficits.

Although the PBOC has never explicitly revealed that its tightening cycles follow local government bond issuance patterns, there are reasons to believe this is the case, at least for the last few years. Since late 2016, tightening has always started when local government bond issuance was low and ended when local government bond issuance rebounded (see Figure 4). This deliberate timing may also be a way for the central government to accommodate local government on-budget borrowing needs, to compensate for severely curtailing local off-budget borrowing.

Figure 4. Recent Tightening Has Followed Local Bond Issuance Patterns



Note: Gray areas represent tightening periods, which correspond with low volumes of local bond issuance.

Source: Wind.

Since local governments have been ordered to issue all their debt by the end of September, and the VAT cut will have a large drag on local government revenue, bond issuance will likely rebound around late May. At the end of April, local governments have already issued 1.63 trillion yuan (\$243 billion) of bonds and are allowed to issue 2.76 trillion yuan (\$412 billion) more.² This implies that high volumes of bond issuance will be sustained through early September.

As local bond issuance accelerates, there is a high probability that the PBOC will begin loosening to accommodate local government borrowing. Moreover, as the central bank has already committed to adjusting monetary policy based on the inflation outlook, the current tightening is bound to be short-lived. As such, liquidity conditions should be expected to improve in the coming months.

An acceleration of local bond issuance will lead to more government spending, which in effect means both fiscal and monetary loosening will take place, likely by late May. This will have a positive effect on supporting growth, which could well peak around the time of the 70th Anniversary of modern China's founding in October.

However, the front-loading of stimulus will turn into a fiscal drag by the fourth quarter. It is unclear how the PBOC might react to weakened fiscal spending. Will it tighten again this fall or maintain loosening to offset the anticipated fiscal drag? Suffice it to say that a number of uncertainties surround growth in the second half of 2019, which we will unpack in future outlooks.

Endnotes

[1] December may appear to have the highest fiscal expenditure, but this is mostly due to accounting rather than actual spending.

[2] These figures include both new issuance and refinancing.