MACRO POLO

Decoding China's Economic Arrival

保尔森基金会

PAULSON INSTITUTE

JUL
2019

Houze Song

MACRO OUTLOOK

Stabilizing Growth Without Stimulus

KEY TAKEAWAYS FOR 3Q2019

- Despite the latest data showing weak growth, we expect China's growth to stabilize in 3Q2019.
- The People's Bank of China (PBOC) is poised to cut interest rates by as much as 30 basis points in the second half, while fiscal spending will also be ramped up.
- Beijing will also focus efforts on rescuing small and medium enterprises (SMEs) from financial hardship, which will divert resources from stimulating headline growth overall.
- To effectively balance stabilizing growth and deleveraging while leaving policy room for contingency measures means that Beijing is unlikely to announce any major stimulus.

After briefly stabilizing in March, China's growth slowed to 6.2% in the second quarter. Although a modest boost came from the trade surplus, the Purchasing Managers' Index (PMI) has dwelled in contractionary territory since May. The main question for the third quarter, then, is how Beijing will respond to continued weakness in growth.

The short answer is that the stimulus measures currently in the pipeline are likely sufficient to stabilize growth in 3Q2019. In particular, increasing fiscal expenditure alone will likely offset most of the downward pressure on the economy. The fiscal firepower will also be complemented by more accommodative monetary policy in the form of cutting interest rates, which remain more elevated than necessary given the large decline in inflation. This has been made possible in part by PBOC's progress in containing financial risk.

Therefore, our base case expects interest rate cuts and does not anticipate major new stimulus in 3Q2019, which means credit growth won't accelerate much. There is a chance for a larger stimulus than expected but that probability is small. The remainder of this outlook examines in detail the base case and Beijing's policy actions accordingly.

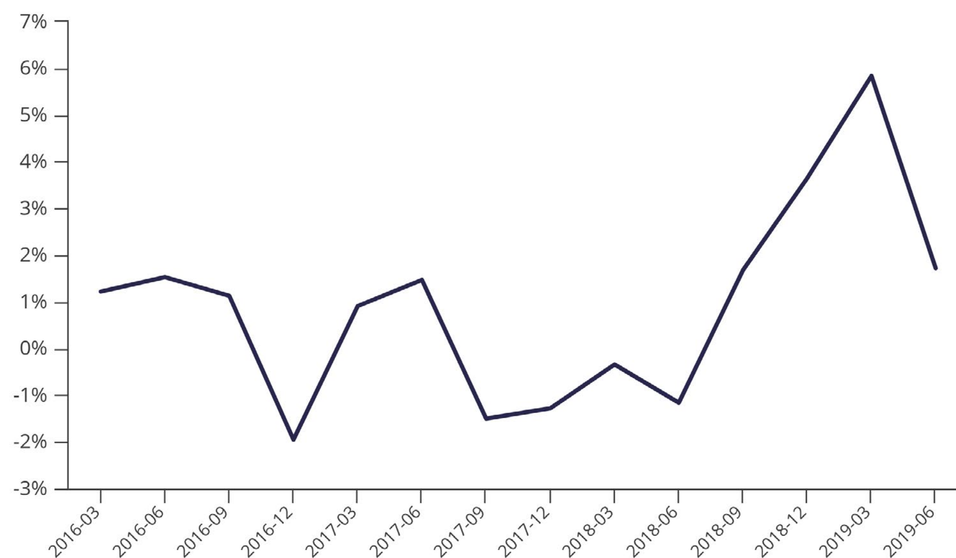
MORE FISCAL FIREPOWER

As highlighted in the previous outlook, to balance the dual mandates of growth and deleveraging, Beijing tapered fiscal stimulus at the first sign of growth stabilization in late March. That stimulus primarily took the form of deficit spending, so the fact that the fiscal deficit shrunk significantly in 2Q2019 indicates that the central government had tightened its purse strings.

This had an effect on second-quarter growth. On the spending side, the fiscal expenditure/GDP ratio in 1Q2019 rose by 4.4 percentage points compared to 1Q2018. But that same ratio in 2Q2019 was only 0.1 percentage points higher than in 2Q2018, which means year-on-year fiscal expenditure growth was essentially flat in the second quarter.

On the income side, despite an additional tax cut in April, the year-on-year drop in the fiscal revenue/GDP ratio is almost unchanged in 2Q2019 (down 1.6 percentage points from 2Q2018) compared to 1Q2019 (down 1.4 percentage points from 1Q2018). This essentially translates into an extra tax cut of 0.2 percentage points, which is too small to have much of an impact. So although the fiscal deficit still technically grew year-on-year in 2Q2019, that growth was much smaller when compared to 1Q2019 (see Figure 1).

Figure 1. Fiscal Support Weakened in Second Quarter



Note: This shows year-on-year change in quarterly fiscal deficit/GDP ratio. A decline from the previous period represents weakening fiscal support. Fiscal deficit includes both budget deficit and government fund balance.

Source: Wind; author calculations.

The upside of the fiscal austerity in 2Q2019 is that the government can now more comfortably expand the fiscal deficit in 3Q2019, giving it more ability to stimulate. Based on our estimate, the fiscal deficit/GDP ratio in 3Q2019 will increase by at least 3 percentage points compared to 3Q2018. This makes the fiscal stimulus in 3Q2019 slightly smaller than in 1Q2019, but much larger than in the second quarter and should be sufficient to stabilize growth.

INTEREST RATE CUT COMING...FINALLY

On the monetary policy front, the PBOC is expected to be more accommodative in the form of interest rate cuts. Because the PBOC still has one foot on the brakes, it prefers to control credit growth and rely more on interest rates. This is something of a change in the PBOC policy mix, since up until now, monetary easing has typically meant credit expansion, while interest rate cuts have taken a backseat.

Cutting interest rates makes sense amid falling inflation. For instance, even as industrial inflation has fallen by more than 200 basis points and credit growth has risen from 9.8% to 10.8% since last November, the average interest rate on loans has remained stubbornly high. But more than just economic necessity is dictating the PBOC's shift toward more reliance on interest rates. This shift required an alignment of PBOC's priorities with the broader macroeconomic environment that is important to understand.

One of the main factors behind PBOC's reluctance in cutting rates was its preoccupation with containing financial risk. Generally speaking, a low interest rate environment has been found to be more conducive to risk-taking. But that doesn't entirely explain PBOC's resistance to lowering rates, since in theory, financial risk can and should be addressed through regulation and not inhibit standard central bank actions like interest rate cuts.

But that assumes a standard financial regulatory system is already in place, which is *not* the case in China. It fact, that system has been largely ineffective and weak. In this context, the PBOC often defaulted to a hawkish stance on interest rates because of the considerable moral hazard that was building in the system—even risky banks can continue to borrow easily at very low rates and would benefit from monetary easing.

That meant the PBOC had little choice but to use the tools at its disposal: repeatedly raise interest rates to deter risk-taking, even when economic fundamentals didn't justify such actions. The most notable recent case was the liquidity squeeze in mid-2013, when PBOC tightened policy to battle shadow banking even though the industrial sector was facing deflation.

What Has Changed?

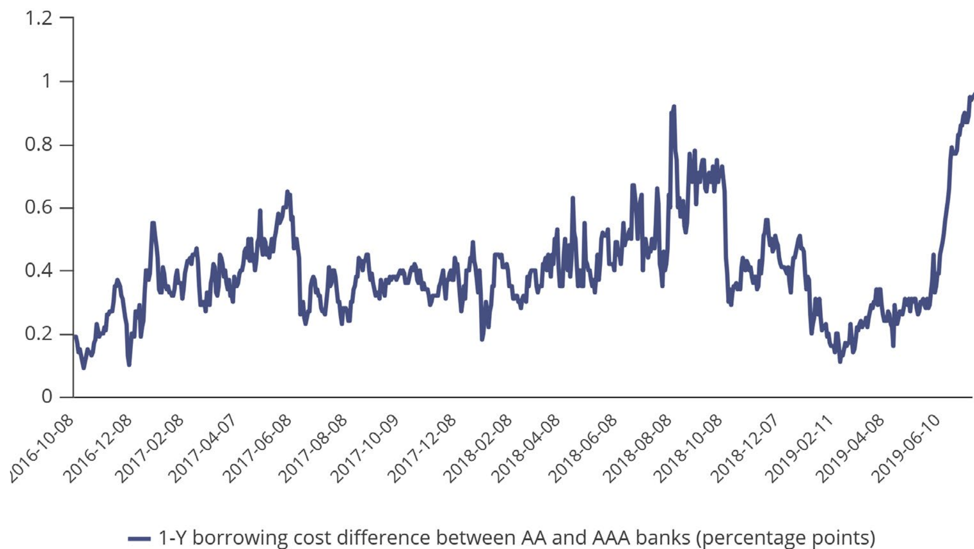
The PBOC's job has been made easier since Beijing in mid-2017 began to meaningfully strengthen financial regulation. And a recent event may have done more to address the problem of moral hazard than expected. Indeed, the recent takeover of Baoshang Bank by PBOC, which shocked many as an indicator of the frailty of the financial system, was actually a blessing in disguise.

A local bank in Inner Mongolia, Baoshang was previously owned by the now imprisoned billionaire Xiao Jianhua. The root of Baoshang's recent financial struggles was its reckless expansion during the past decade, having increased its total assets by more than ten-fold since 2007. So in late May, the PBOC took the uncharacteristic move of taking the local bank into receivership. As part of the takeover, the central bank forced Baoshang's large creditors to accept a haircut on their lending, resulting in at least a 10% loss on their investment.

This was an unprecedented move by the PBOC, one that took investors by surprise because it undermined the longstanding assumption that banks are fully backed by the government. By imposing a haircut on Baoshang creditors, the PBOC was sending an unambiguous signal that the government will not bail you out if you lend to risky institutions. In one fell swoop, the Baoshang takeover had weakened the prevailing moral hazard in the system.

The changed sentiment is showing up in the borrowing premium for riskier banks (those with an AA rating), which has widened by more than 70 basis points (see Figure 2). Put differently, the PBOC has now raised the cost of borrowing for riskier institutions, and so even if it lowers interest rates, the cost of borrowing to risky institutions will still remain higher than it has ever been before the Baoshang takeover. In short, the Baoshang takeover effectively created room for the PBOC to ease policy.

Figure 2. Riskier Banks Have to Pay a Much Higher Premium

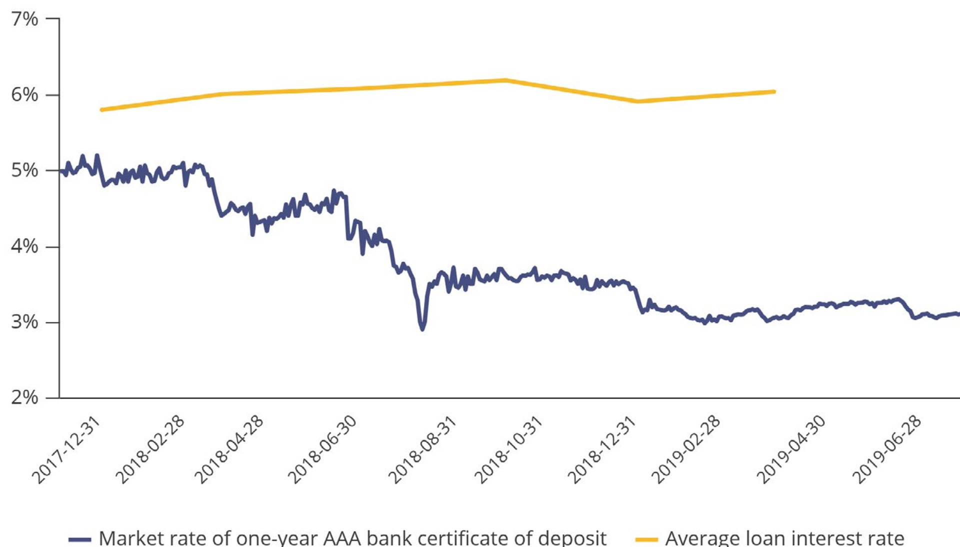


Source: Wind.

Interest Rate Cut Requires Proper Sequencing

Now that the PBOC has greater latitude to cut rates, we believe it will do so in the third quarter. in addition to macroeconomic fundamentals such as declining inflation, the PBOC's ongoing effort to reform the bank loan rate also requires lowering the interest rate. The substantial gap between the loan rate and the market interest rate, which has fallen significantly since last year, needs to be narrowed, according to senior PBOC officials (see Figure 3).

Figure 3. Divergence between Market and Loan Interest Rates



Source: Wind.

What will likely end up happening is that the loan rate will decline over the coming months, while the PBOC will also simultaneously lower the bank borrowing rate as a way to compensate banks for lowering the loan rate. The benchmark deposit rate, which is currently just above 1%, has only a bit of room left for a further cut. But interest rates on other bank liabilities, such as borrowing from the central bank or other banks, are currently above 3% and have greater room to fall. As a result, we expect the PBOC to lower the one-year policy lending rate (e.g. the targeted medium-term lending facility) by at least 30 basis points in the second half.

More specifically, we think the borrowing rate will be cut *only after* banks have lowered their loan interest rate. The sequencing here matters because there is a tendency to interpret a cut in the bank borrowing rate as the start of another stimulus. However, most of the stimulus effect will come from lowering the loan interest rate, *before* cutting the borrowing rate. In other words, even if the PBOC leaves the borrowing rate as is in 3Q2019, stimulus will still come in the form of a loan rate cut, which will also reduce the need for credit expansion in the third quarter.

A STRONG STIMULUS STILL UNLIKELY

A stronger-than-expected stimulus in 3Q2019 is possible, but we believe the base case of no major stimulus will continue to hold for three reasons.

First, Beijing simply cares less about short-term growth. This is particularly evident in the central government's crackdown on the property sector, at a time when the froth in the sector is quite mild compared to previous boom cycles.

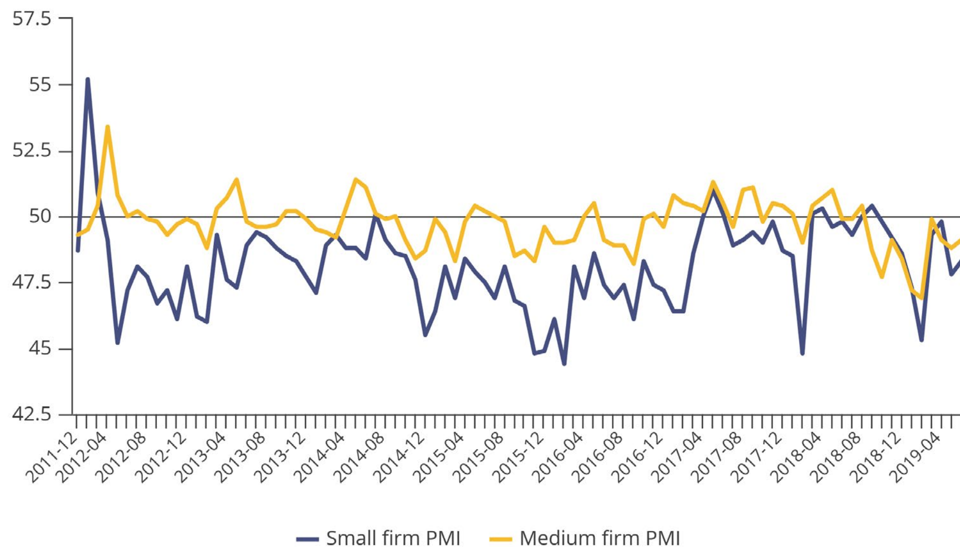
For example, land sales revenue growth is still in negative territory and property sales growth remains in the single digits—an enormous contrast to previous periods when both land and property sales grew at 40% or higher. Still, Beijing has chosen to keep a lid on the property sector at the expense of bolstering growth, suggesting that it is prioritizing longer term sustainable development, a theme highlighted in the previous outlook.

Second, the trade war requires Beijing to conserve stimulus ammunition for future contingencies. Given the unpredictability surrounding ongoing trade negotiations, the trade war could escalate yet again. The calculus, then, is whether to stimulate now or later

if the trade war evolves into one of attrition. As of now, Beijing is hoping for the best but planning for the worst when it comes to stimulus.

Third, more pressing than the weak headline growth is the financial distress many SMEs face. These private firms have struggled for some time, and the latest slowdown may well be the straw that breaks the camel's back (see Figure 4). Since 2018, Beijing has relied on a combination of targeted support, tax cuts, and reducing entitlement contributions to extend life lines to SMEs.

Figure 4. SMEs Have Been Struggling Well before the Current Slowdown



Note: PMI <50 means contraction.

Source: Wind.

In fact, the level of support for SMEs is unprecedented, particularly in terms of granting private firms a privilege that historically was reserved only for state-owned enterprises: subsidized lending. Not only has lending to SMEs been growing at above 20% since 2018, state banks are lending to SMEs at an average interest rate of 4.79%, much lower than the average corporate loan rate of above 6%. This is especially striking since SMEs are riskier borrowers: the average lifespan of an SME is only three years, while the non-performing loan ratio for SMEs is 4.5 percentage points higher than larger firms.

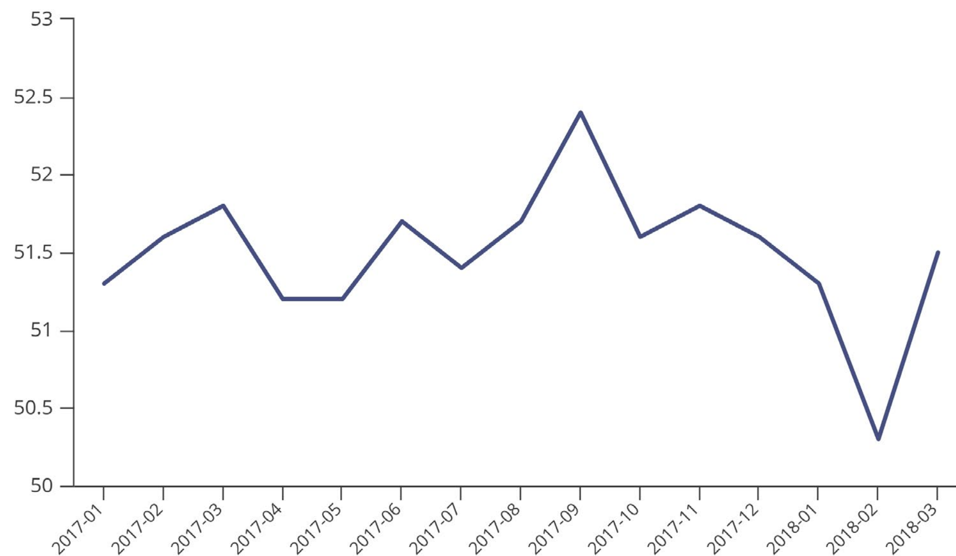
But the government's insistence on rescuing SMEs is not without reason. They account for more than 80% of jobs, and a cascade of SME failures would disrupt the labor market and potentially trigger social instability. So rather than stimulating headline growth, Beijing will be more focused on diverting resources to address the numerous SMEs in dire straits.

Pro-Growth Measures Will Be Short Lived

Although no major stimulus is anticipated, the Politburo meeting in late July could well deliver a pro-growth message. Just like in 2017 ahead of the 19th Party Congress, top leaders may choose to announce certain pro-growth measures before a major political event this year: the 70th Anniversary of the People's Republic of China in October.

But such pro-growth measures will be short-lived. Looking back at 2017, Beijing at the time called for expanding aggregate demand during the mid-year Politburo meeting, which led to a temporary acceleration in growth in 3Q2017. But the stimulus was withdrawn almost as soon as it was implemented, and economic activities weakened abruptly (see Figure 5). If an economic rebound does materialize after the Politburo meeting this year, it will evaporate quickly as growth will continue to decelerate toward the end of the year.

Figure 5. PMI Peaked Before 19th Party Congress in 2017



Source: Wind.

CONCLUSION

Overall, we remain somewhat more optimistic than the general consensus on China's near-term prospects, expecting growth to stabilize in 3Q2019. But as we have emphasized previously, unless a trade deal is made in the third quarter, downward pressure on the economy will be challenging and could lead to growth sliding toward 6% by year's end.

Even so, we expect Beijing to double down on its existing policy tools rather than pivot to another major stimulus in the case of no trade deal. For example, financing to SMEs will both ramp up and become even cheaper. In addition, Beijing may allow local governments to issue more bonds by using leftover quotas, while the PBOC will likely increase its lending to banks and at lower interest rates.

Fundamentally, the growth outlook for 4Q2019 will be determined by how the trade war plays out, the outcome of which is difficult to predict at the moment. We hope there will be more clarity by the next outlook, which will provide a better sense of the economy's direction at the end of 2019.

ENDNOTES

1 Prior to the Baoshang takeover, the risk premium between AA- and AAA-rated banks had narrowed to around 20 basis points as a result of easing. This was far from sufficient to cover the risk of investing in AA-rated banks (Baoshang maintained AA+ rating shortly before its takeover). This effectively handcuffed PBOC on rate cuts, because that would've likely encouraged more risk-taking and further narrowing the risk premium.

2 Although the Baoshang takeover frees the PBOC to cut interest rates, this event also has costs. Creditors have reduced their exposure to similar banks to avoid suffering losses, which will disrupt the operation of these smaller banks. It is assumed that this disruption will have knock-on effects on SMEs' credit access as these smaller banks are supposed to be the primary lenders to SMEs. But the cost may be more limited than assumed. Based on PBOC data, banks similar to Baoshang collectively account for less than 15% of lending to SMEs, meaning the vast majority of SME lending actually comes from larger banks that have not been affected by the Baoshang takeover.