Clarifying China's Policy Signals

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Key takeaways

- There is a seeming contradiction between the authorities' avowed intention to support growth through stable monetary policy, and recent People's Bank of China (PBoC) rate hikes
- To understand we need to heed the PBoC's dual policy objectives of supporting GDP growth and managing systematic risk by enforcing deleveraging
- Recent interest rate increases have been surgical, which means they affect only the lending facilities and the interbank market, or less than 5% of aggregate financing in China's monetary system
- Absent any renewed growth weakness, minor selective monetary tightening in the context of a broadly neutral monetary stance is likely to remain as a tool to slow the pace of credit growth

Full commentary

The Chinese authorities have vowed to protect the country's nascent economic recovery in this year of major political transition by maintaining a stable monetary policy. However, the People's Bank of China (PBoC) has raised interest rates twice since February this year. How should we interpret these conflicting signals?

To understand this, we need to heed the PBoC's dual policy objectives of supporting GDP growth and managing systemic risk by enforcing deleveraging. The central bank has kept its overall monetary policy stance neutral while selectively raising interest rates to force deleveraging in the wholesale funding market. This policy balancing act becomes clearer when we realize that while there has been no change in the benchmark lending rates or bank reserve requirement ratios since 2016, the recent interest-rate increases have been "surgical". By "surgical", we mean that they affect only the lending facilities and the interbank market, which together account for less than 5% of aggregate financing in China's monetary system.

The targeted rate hikes are designed to force small, regional banks and shadow banks to reduce their debt levels. These institutions have increased their reliance on short-term wholesale funding, which comes from the interbank market and investment products that are issued by both banks and non-bank financial institutions (NBFI). They then use these monies to fund real economy activities, higher-yielding wealth management products and corporate bonds, and capital outflows (see Figure 1).

The latter two types of activities have raised policy concerns about the risks of balance-sheet mismatch, credit defaults and uncontrollable capital outflows. The wholesale funding market is thus the financial stress point that needs to be addressed as a priority.

With growth concerns easing, debt reduction has moved up the policy priority list. This can be seen from the PBoC's continued efforts to use economic stabilization as a cushion to force deleveraging through targeted tightening. Furthermore, the PBoC started to implement its Macro Prudential Assessment (MPA) framework in Q1 2017, which has resulted in some initial debt reduction in the system.

The MPA is a framework, introduced in early 2016, that sets parameters such as capital adequacy ratios and lending standards for assessing banks' total credit growth, including their off-balance-sheet activities such as Wealth Management Products (WMPs) and lending to NBFIs and shadow banks. Banks that fail the quarterly MPA test will be disqualified from using the PBoC's lending facilities or will be hit with significantly higher interest rates from such facilities.

Many banks have thus scaled back their lending to the NBFIs in order to comply, leading to a liquidity squeeze in the wholesale funding market and a reduction in overall credit growth. Nevertheless, the PBoC is unlikely to continue squeezing interbank liquidity and risk creating credit events that could destabilize the system. It will likely take a stop-go approach to balance its dual policy objectives.

This week's market developments

Monday, May 1
- US personal income growth decreased to 0.2% m.o.m. for March
- US personal spending growth decreased to 0.0% m.o.m. for March
- US ISM manufacturing growth decreased to 54.8 for April
- US construction spending growth decreased to -0.2% m.o.m. for March

Tuesday, May 2
- Markit UK PMI manufacturing increased to 57.3 for April

Wednesday, May 3
- Eurozone 1st Quarter GDP growth (advance estimate) increased to 0.5% q.o.q.
- US ADP employment change decreased to 177,000 for April
- US ISM Non-Manufacturing Composite increased to 57.5 for April

Thursday, May 4
- Markit/CIPS UK Services PMI increased to 55.8 for April
- Markit/CIPS UK Composite PMI increased to 56.2 for April
- US factory orders growth decreased to 0.2% m.o.m. for March

Friday, May 5
- US change in nonfarm payrolls increased to 211,000 for April
- US unemployment rate decreased to 4.4% for April

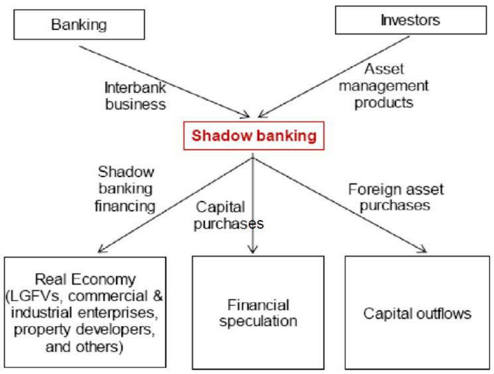
Source: Bloomberg, as of May 8, 2017

It is also unrealistic to expect a swift decline in China's debt-to-GDP ratio because it would be an impractical policy option. China's aggregate financing growth has outpaced nominal GDP growth by an average of six percentage points since 2012 (see Figure 2). To cut the debt-to-GDP ratio abruptly would mean slowing credit growth by more than six percentage points below the nominal GDP growth rate, which could crush the economy before the benefits of debt reduction emerge.

Barring any renewed growth weakness, minor selective monetary tightening in the context of a broadly neutral monetary stance is likely to remain as a tool to slow the pace of credit growth and set the stage for eventual debt reduction. The pre-condition for outright deleveraging is unfolding as the gap between credit and nominal GDP growth is already narrowing (note how green line is falling in Figure 2). If growth stabilization is sustained, selective monetary tightening may even intensify (we see one to two small rate increases targeting the wholesale funding market possible over the rest of 2017), and fiscal expansion may be scaled back.

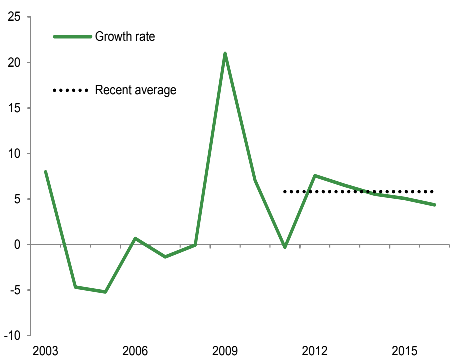
Charts of the Week

Figure 1: Risk of wholesale funding lies in the small and shadow banks



Sources: BNP Paribas Investment Partners

Figure 2: Total social financing minus nominal GDP growth rate



Sources: CEIC, BNP Paribas Investment Partners, as of April 26, 2017

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on June 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	March 15, 2017	0.75% - 1.00%	1.01%	June 14, 2017
ECB	-5 basis points	March 10, 2016	0.00 %	-0.18%	June 8, 2017
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.06%	June 16, 2017
BoE	-25 basis points	August 4, 2016	0.25%	0.33%	May 11, 2017

Sources: Bloomberg, as of May 8, 2017

Next week's market developments

Monday, May 8
- Germany factory orders growth is expected to decrease to 0.7% m.o.m. (s.a.) for March

Tuesday, May 9
- Germany industrial production growth is expected to decrease to -0.7% m.o.m. (s.a.) for March
- US wholesale inventories growth is expected to remain at -0.1% m.o.m. (s.a.) for March

Wednesday, May 10
- France industrial production growth is expected to increase to 1.0% m.o.m. (s.a.) for March

Thursday, May 11
- UK industrial production growth is expected to increase to -0.4% m.o.m. (s.a.) for March
- UK manufacturing production growth is expected to decrease to -0.2% m.o.m. (s.a.) for March
- US PPI final demand growth is expected to increase to 0.2% m.o.m. (s.a.) for April

Friday, May 12
- Germany 1st Quarter GDP growth (prelim estimate) is expected to increase to 0.6% q.o.q.
- US CPI growth is expected to increase to 0.2% m.o.m. for April
- US retail sales advance growth is expected to increase to 0.6% m.o.m. (s.a.) for April

Source: Bloomberg, as of May 8, 2017