Chi Time

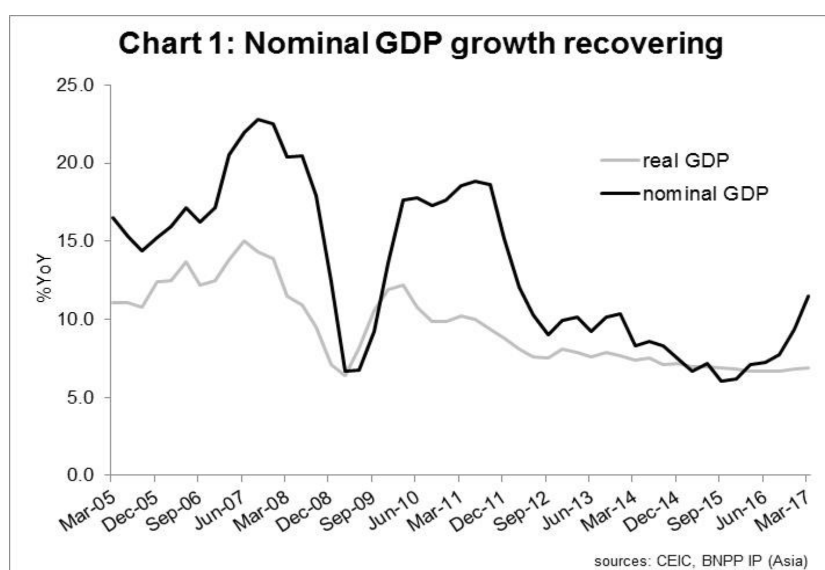
CHINA: WHAT'S NEXT AFTER GROWTH RECOVERY?

What doesn't kill you only makes you stronger.

Greg Rusedski

The hard-landing risk is diffused, once again. China's economy has shown solid signs of recovery with growth firing in all cylinders. Real GDP rose 6.9% YoY in 1Q 17 while nominal GDP soared by 11.8% YoY (Chart 1), thanks to the ending of PPI deflation since late 2016 which boosted the GDP deflator. Even net exports, which have been a drag on GDP growth since 2009, contributed to growth again. Private investment growth also returned (Chart 2), at least for now. The nominal growth recovery is positive for corporate profit growth and should lead to stronger wage and consumption growth. The burning questions are: What is driving China's growth and what is the next policy move?

Chart 1: Nominal GDP growth recovering



sources: CEIC, BNPP IP (Asia)

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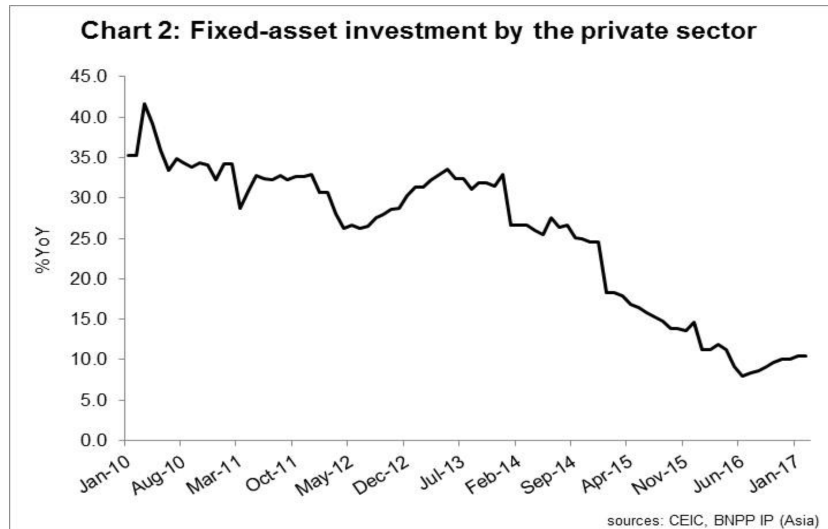
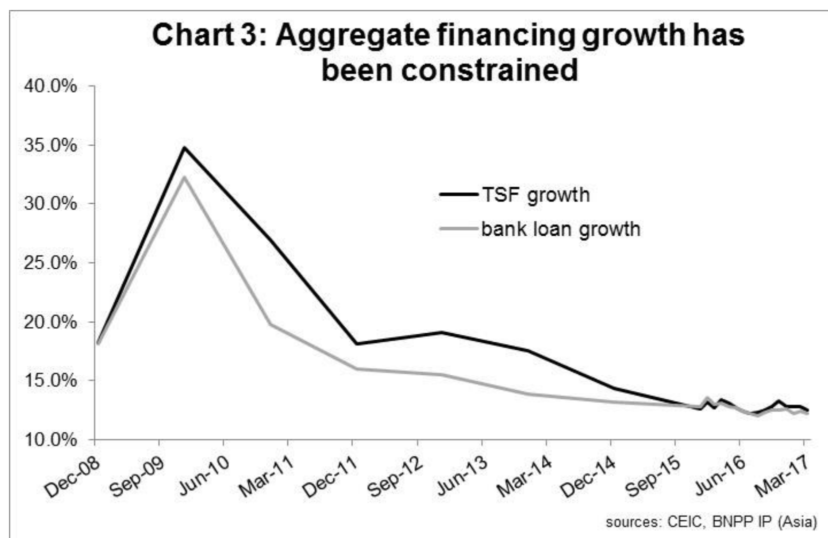


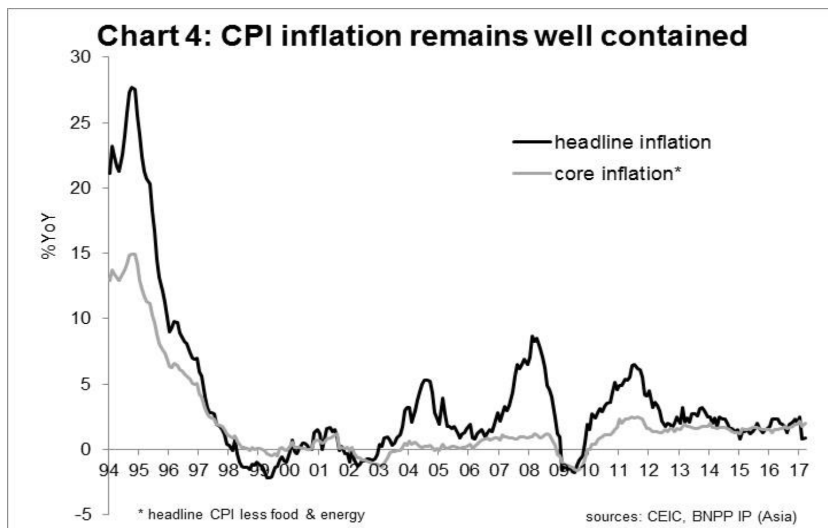
The policy complication behind growth

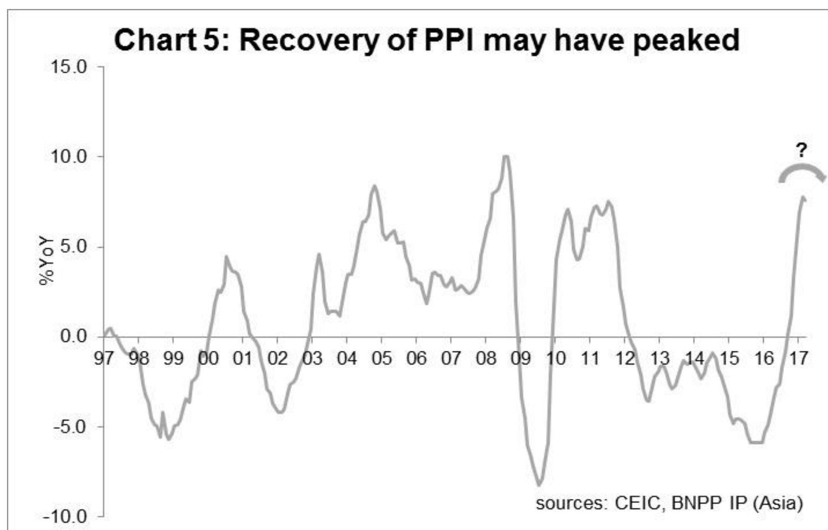
Monetary policy does not appear to be the growth driver. The benchmark lending rate and bank reserve requirement ratios, which are the two most direct monetary policy signals, have not been moved for a year, while aggregate financing (including bank loan) growth has been constrained in a narrow flat range (Chart 3). Meanwhile, the PBoC has raised its reverse repo rates and lending facility rates[1] twice (by 10bps each time) since February this year, leading to jumps in money market rates by more than the official rate hikes. Some players see this as the start of China's monetary tightening cycle.



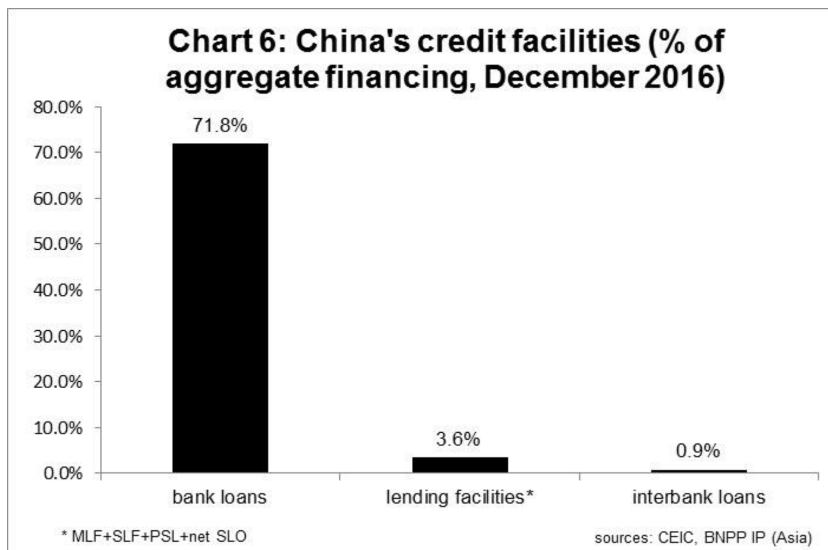
Not so soon, in my view, since the growth momentum is not strong enough to warrant a shift towards monetary tightening. PPI inflation has failed to trickle down to CPI inflation despite seven months of strong recovery, while core CPI inflation has remained at around 2% a year (Charts 4 and 5). The PPI's recovery may have peaked as sharp rise in global commodity prices seems unlikely and the bottleneck supply conditions in the commodity sector in China are easing.

[1] These include the lending rates for the Medium-term Lending Facility (MLF), Standing Lending Facility (SLF), Short-term Lending Operations (SLO) and the Pledged Supplementary Lending facility (PSL).



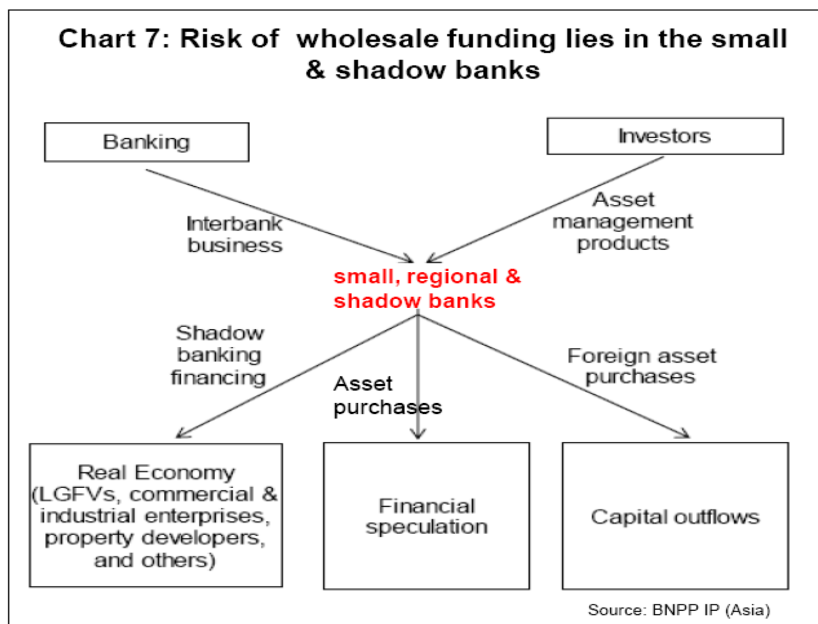


To understand why the PBoC raises rates, we need to heed its dual policy objectives of supporting GDP growth and enforcing financial deleveraging. Overall monetary policy stance has been kept neutral while selective interest rates have been hiked to force deleveraging in the wholesale funding market. This policy balance can be seen in the fact that there has been no change in the benchmark lending rates and bank reserve requirement ratios since 2016 while the recent "surgical" rate hikes only affect the lending facilities and the interbank market which account for less than 5% of aggregate financing in the system (Chart 6).



The targeted rate hikes aim at forcing the small and regional banks and the shadow banks to deleverage. 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 the funds to fund real economic activities, asset punting (including buying higher-yielding wealth management products (WMPs) and high-yield corporate bonds with relatively longer maturity) and capital outflows (Chart 7).

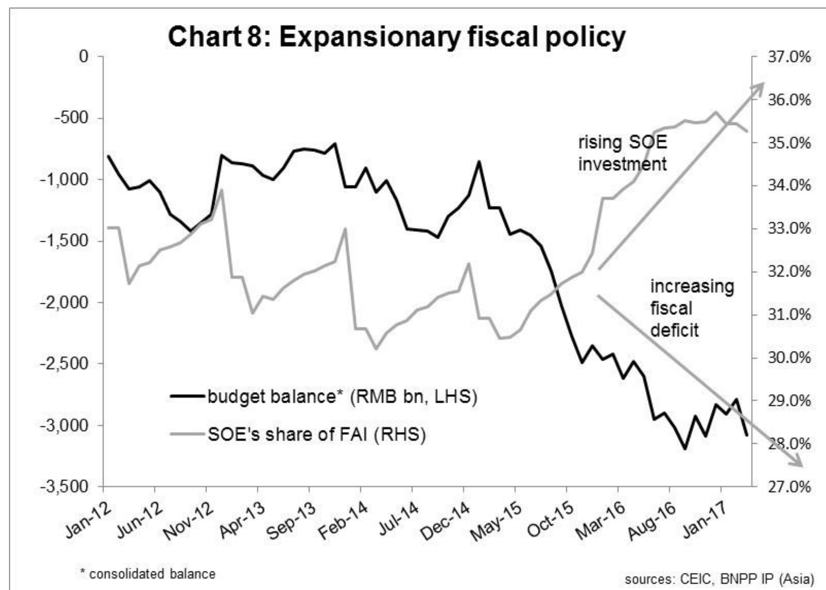
The latter two types of activities have raised policy concerns about the risks of balance-sheet mismatch, credit defaults and uncontrollable capital outflows. So the wholesale funding market is the financial stress point that needs to be addressed early[2].

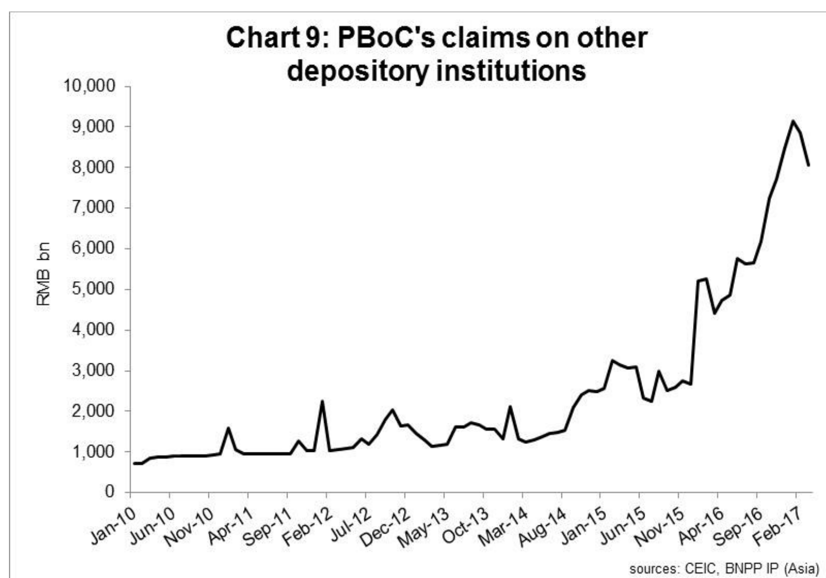


[2] See "*Chi on China: Where Does China's Financial Risk Lie?*" 23 November 2016.

Stealth fiscal expansion

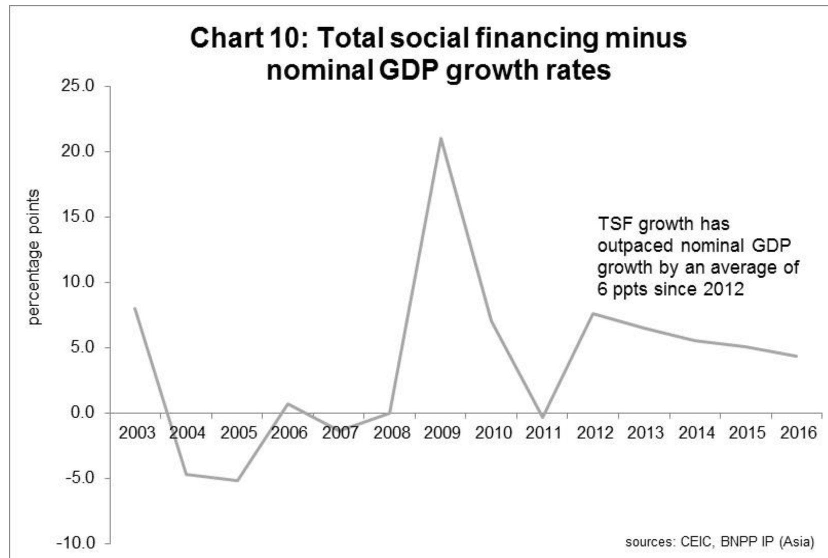
It is obvious that China’s growth has relied on public fuel (Chart 8). What is not obvious is that some stealth measures have provided an extra boost to Beijing’s fiscal prowess. The trick lies in the PBoC’s claims on other deposit-taking institutions, which include NBFIs and policy banks. These claims have soared since 2016 (Chart 9). Open market operations have accounted for about half of this surge (a monetary operation to offset the passive liquidity squeeze due to capital outflows on the back of a stable FX policy), while the rest has reflected the PBoC’s lending to the policy banks that finance public infrastructure spending (a stealth fiscal operation).





What’s next?

With growth concerns easing, deleveraging has moved up the policy priority. This is seen in the PBoC’s continued effort on using the economic stabilisation as a cushion to force deleveraging through small “surgical” tightening. However, it is unrealistic to expect a swift decline in the debt-to-GDP ratio because it would be an impractical policy option.



China aggregate financing growth has outpaced nominal GDP growth by an average of six percentage points since 2012 (Chart 10). To cut the debt-to-GDP ratio abruptly would mean that credit growth would have to drop by more than six percentage points below the nominal GDP growth rate. This would likely crush the economy before the benefits of deleveraging could emerge.

Hence, China's deleveraging can only go gradually. Barring any renewed growth weakness, small selective monetary tightening, amid a broad neutral monetary stance, will remain as a tool to slow the pace of leveraging and set the stage of eventual deleveraging. The pre-condition for outright deleveraging is unfolding as the gap between credit and nominal GDP growth is already narrowing. If growth stabilisation is sustained, the selective monetary tightening may even intensify (with one to two small rate hikes targeting the wholesale funding market possible for the rest of 2017) and fiscal expansion may be scaled back.

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