Markets in High Resolution

China Stimulus Update

- "Fiscal stimulus" requires credit growth
- No sign of "stimulus" yet
- Effective stimulus will require official capitulation on "deleveraging"
- Capitulation will exacerbate the Impossible Trinity problem

China doesn't really use "fiscal stimulus."

What's commonly referred to as fiscal stimulus in China is actually more of a monetary operation, with fiscal authorities merely acting as a conduit for monetary policy.

The formula is straightforward: The central bank increases liquidity to state-owned banks who on-lend to local governments who then build a bunch of stuff they really don't need. Goose that process with official inducements to property market speculation and voila: stimulus!

There can be no effective stimulus without accelerated credit growth. And credit growth in China is still decelerating:

There is a debate in the market as to whether the lack of stimulus is for lack of trying or whether the stimulus button is no longer functioning. It's a little of both. The stimulus button is a little sticky, but if they bang on it hard enough it really can't fail to "work."

The Chinese government has a credibility problem, which exacerbates its impossible trinity problem.

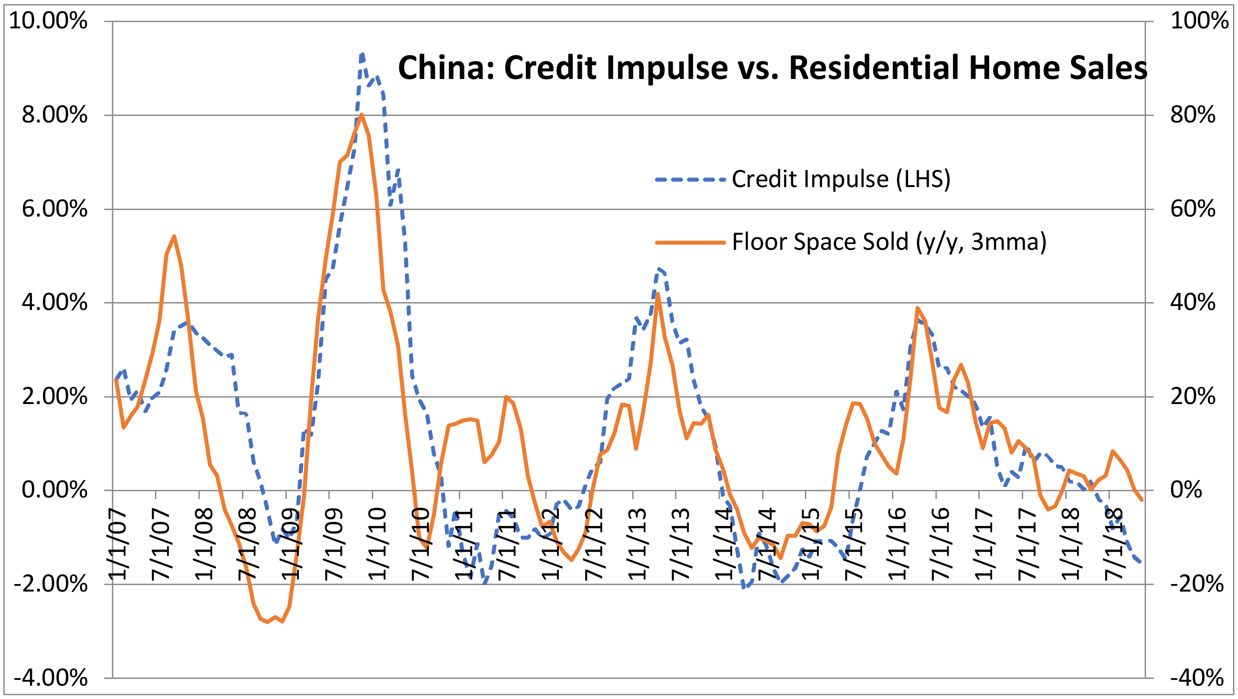
With top leadership having declared just a year ago that the policy priority was "deleveraging," ending real estate speculation, and controlling risk in shadow banking, economic actors are receiving mixed signals in the recent call to renewed stimulus.

Any effective call to stimulus will have to be loud and clear. Economic actors, including local government officials, will require some assurances that if they again lever up the government won't pull the credit rug out from under them as soon as asset markets re-heat.

The clearest way for the government to credibly signal its capitulation on deleveraging would be to relax home purchase restrictions.

China's housing market acts as a key conduit for credit stimulus and is a symbiotically linked with infrastructure spending through local governments' heavy reliance on land sales.

The chart below shows the year-over-year growth in residential floor space sold vs. China's credit impulse. Credit impulse is the difference between this year's increase in credit and last year's increase in credit as a proportion of GDP. So here we are looking at the second derivative of outstanding credit vs the second derivative of outstanding household-owned real estate volume:



Regardless of credit availability, local government officials are unlikely to "borrow and build" aggressively against a backdrop of lackluster residential real estate markets. Residential development is often a key component of infrastructure development plans (the "new district" justifies the new subway line) and local governments are reliant on land sale revenue to meet debt servicing commitments.

Chinese investors require an implicit guarantee but that guarantee is becoming less credible.

China's credit and real estate markets are moral-hazard dependent. The government will need to spike the easy credit punchbowl with a relaxation of home purchase restrictions to signal a free at-the-money put on home prices. There clearly remains a subset of Chinese investors who possess an unbounded belief in the Chinese government's ability to control outcomes and will happily play that game.

However, that subset will no doubt have shrunken appreciably since the last stimulus effort in 2016-17. With Xi Jinping himself having declared deleveraging to be the new mantra and so famously dictated that "houses are for living in, not speculation," reversal of those policies will incur more than loss of face. It will reveal Chinese policymakers as bereft of any idea as to how to get the Chinese economy off of a path that they themselves have declared as unsustainable, a sentiment reinforced by acknowledgement that Xi's "Made in China 2025" plans have hit a serious speed bump.

Effective stimulus will require a more forceful approach and entail more "capital leakage."

Getting the requisite number of the shovels in the ground will require a more forceful approach than in prior stimulus cycles, and is highly likely to entail a higher degree of "capital leakage" on the part of a growing contingent of disillusioned investors who decide not to play what seems likely to be the last iteration of the stimulus game.

Despite the existence of capital controls there is no evidence that China can sustainably disconnect domestic credit policy from the RMB. Post-crisis stimulus cycles have either come against a QE backdrop (2009, 2012-13) or have dislodged the RMB (2015).

Half-hearted stimulus attempts won't work. "Effective" stimulus will require overt capitulation on deleveraging and, barring a significant broad-Dollar selloff, will undoubtedly unhinge the RMB.

Any trade deal that requires RMB-stability will relegate China to a continued slide towards debt-deflation.