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# China Stimulus Update II

- Tax cut euphoria is misplaced – it's all about credit growth
- Credit growth did tick up in December
- But PBoC is signaling a "stable leverage ratio" stance that is doomed to failure
- Is Xi in a bubble regarding the bubble?

## Forget about "Fiscal Stimulus"

While Tuesday's equity market bounce-back is being widely attributed to talk of tax cuts in China I'd attribute it simply to the favorable macro set up for bombed-out indices that I detailed last week in "Powell's Shanghai Moment."

As for the supposed tax cuts, the Chinese have made the same pronouncement at least three or four times in recent weeks. Rest assured, the tax cut is not getting bigger with each pronouncement.

In fact, with the central government budget deficit being tipped to expand only from 2.6% to around 3% in 2019 it's hard to see what all the excitement is about. There won't be much "fiscal stimulus" coming from the central government.

Selective enforcement on the local level renders Chinese business taxes uncertain and opaque. There are reports that plans to centralize collection of SME social insurance charges (so as to improve compliance) are being put on hold, but this kind of thing just adds to the muddle. Is postponing a plan to collect a tax more broadly and efficiently equivalent to a tax cut?

If the real estate market remains moribund, cash-strapped local governments (who often rely on land sales for 30-50% of revenues) are unlikely to extend tax-collection forbearance for long.

*Credit growth remains the key*. Without increasing the flow of credit to local governments there is no way to fund "fiscal stimulus" and no hope of turning around the real estate market that's so critical to GDP growth and local government finances.

## Credit Growth Bounced

The latest news on credit is mixed. The good news is we saw the first visible uptick in the growth rate of outstanding credit in many months. The bad news is the PBoC seems wedded to a "stable debt ratio" strategy that will keep the economy in the grips of a downward spiral until the strategy is abandoned.

The credit flow picture has been muddled by a series of methodology changes to the Total Social Finance data that seem designed to back-fit the series to a "stable debt ratio" edict. PBoC has altered the headline TSF series to exclude ABS, exclude loan write-offs, and include one subset of municipal

bonds – “Special Purpose Bonds” - used to finance specific infrastructure projects (not the general local government budget). In order to get a proper picture of overall credit growth we take the new PBoC series and add the local government bond issuance the PBoC leaves out as well as issuance of Chinese Treasury bonds.

It doesn’t look like much, but on this metric year-on-year credit growth did tick up from 11.0% to 11.5% in November:

<u>PBoC Remains Wedded to “Deleveraging”</u>

China’s credit addiction is such that it would not be unreasonable to conclude from one data point that policymakers have turned on the spigots again. But PBoC rhetoric gives me pause. Here was Governor Yi Gang last week (bolding mine):

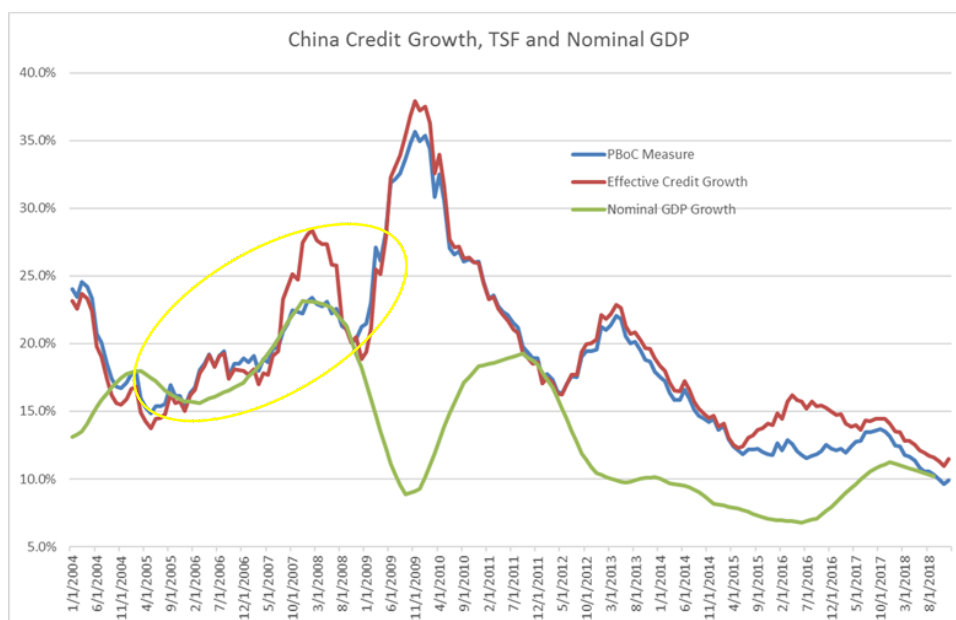
> *With regard to monetary policy, Yi Gang said that “total quantities must be rational, structures must be optimised, and [we] must create a monetary and financial environment which is appropriate for supply-side structural reforms and high-quality growth.*
>
> *“On the one hand, we must accurately grasp the total volume of liquidity, in order to prevent excessively rapid credit contraction causing shocks to the real economy, as well as avoid ‘flood-style irrigation’ impacting structural deleveraging.*
>
> ***“M2 and total social finance growth will also be kept largely in line with nominal GDP growth, and it is necessary to maintain basically stable macro-leverage****.*
>
> *“On the other hand, we must accurately grasp the direction of liquidity, and employ the role of structured monetary policy and targeted irrigation.*

The comment about keeping TSF growth in line with nominal GDP was reiterated by PBoC Deputy Governor Zhu Hexin again on January 15.

Here's the problem with stabilizing the credit to GDP ratio by growing the numerator and denominator at the same rate: *there is not a chance in hell that it's going to work.*

If we plot the PBoC's new preferred measure of TSF growth (blue line), lo and behold it sits right on top of nominal GDP growth in recent quarters. (The red line is the proper credit growth measure):

Perhaps Chinese policymakers are harkening back to a simpler, happier, pre-crisis era in which it was in fact possible to run credit growth at levels similar to nominal GDP growth. Here's the same set of lines going back a bit further:



The "Stable-Leverage Ratio" Policy is Doomed

Unfortunately for PBoC, a stable debt ratio in today's China is not compatible with a stable economy. The debt accumulated in China since 2009 totals $26.3T at current exchange rates. That's a heady decade. We know much of that credit was forced through the system for glorified make-work programs and much of it has funded rampant speculation in real estate that isn't generating cash flow.

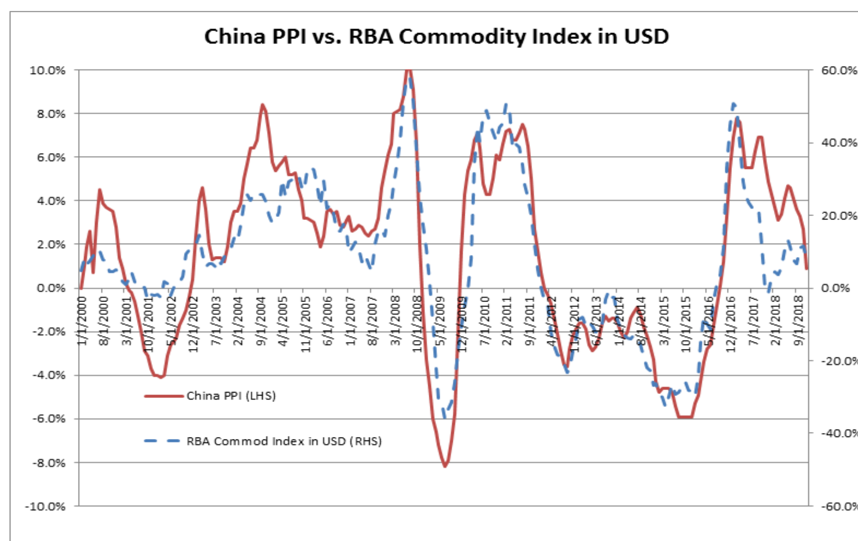
- Let's start from the assumption that China intends to maintain heavy control over default rates.
- That requires debts to be serviced out of either cash flows or new credit.
- If nominal growth is slowing, cash flows are growing at a decreasing rate.
- That implies a greater proportion of new credit going towards debt-servicing requirements. Less is going towards funding new projects.
- That puts further pressure on growth.

***China will remain in the grips of a debt-deflation spiral until credit growth accelerates.***

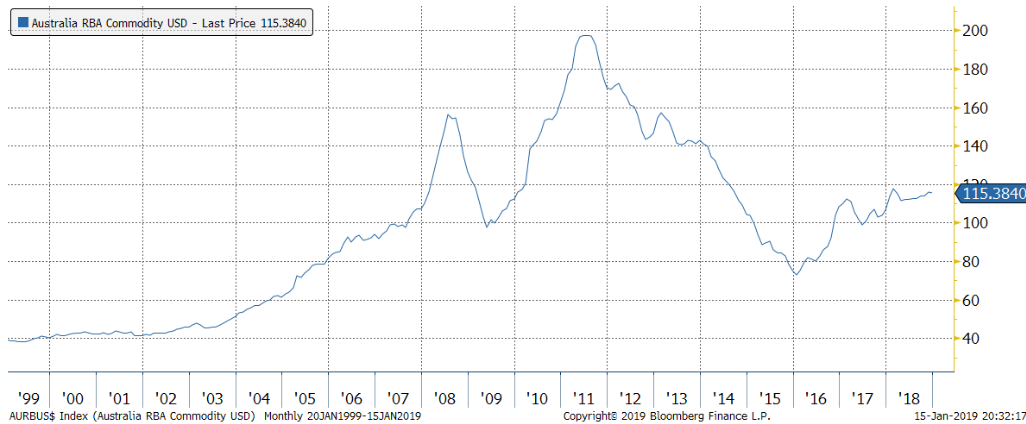
Can China get bailed out by a pop in nominal GDP like they did in 2016?

I doubt it. A rough rule of thumb for the Chinese GDP deflator is to average PPI and CPI inflation. The big swing variable is PPI, which in 2016 swung from -6% to +8%! That more than accounts for the acceleration in nominal GDP growth from 7% to 11% in 2016-17.

While many attribute the 2016 to PPI pop to "supply side reform," Chinese PPI is actually driven by commodity prices, which are set globally, with swings in Dollar liquidity conditions (largely determined by Fed policies) predominating. That's not to say that China, as the world's most voracious commodity consumer, has no effect on the prices or iron ore and other hard commodities. But the fact remains that all manner of commodity prices sold off in 2014-15 as the Dollar rallied and stabilized in 2016 as the Fed abandoned the dot plot. The correlation between Chinese PPI and the RBA commodity index (denominated in USD) is 88% going back to 2000:



Here is the RBA Commodity Index itself. Unless something pushes the Fed into easing mode it's unlikely we'll get the kind of year-on-year gains that would be required to push China's nominal growth rate out of debt-deflation territory.




In fact, a sideways assumption for commodity prices would imply Chinese PPI settling near zero. Assuming CPI inflation around 2%, we can forecast a deflator of no more than 2%. Tack a 2% deflator on to a real growth rate of 6% and *2019 portends a further deceleration of nominal GDP growth towards the 7-8% levels that proved wholly untenable in 2015*.

Is Xi in a bubble about the bubble?

Surely, Chinese policymakers understand this dynamic and will once again blink when faced with the economic pain required to affect an actual deleveraging. This remains my assumption, but I would be remiss in not detailing the risk. The risk is that Xi Jinping is in a bubble when it comes to the credit bubble.

Policymaking in China operates through the setting of targets. Targets are how objectives are communicated and compliance enforced.

The boss wants that capital account problem to go away? Fine, tell all the banks that they can only supply FX to clients to the extent that they can source FX from other clients. Voila: capital account balance.

The boss wants to show the world that China can grow without the endless accumulation of leverage? Fine, tell the central bank to make it so – not by changing the underlying structure of the economy from which the problem ultimately stems – but by simply dictating that reported leverage will no longer rise.

If we presume from PBoC signaling that these are in fact their marching orders, it begs the question of how and when it will get communicated back up the chain of command that they're on an economic suicide mission. How long will economic policymakers, like good soldiers, keep marching towards the debt-deflation abyss?

If there is not a burst of credit extended in Q1 that pushes year-on-year credit growth up by 1 or 2 percentage points, we might conclude that Xi is ensconced in a sycophantic information bubble a la Chairman Mao.  If that proves to be the case all manner of potential policy error will be on the table.

Conclusions

- Credit growth is the key to any "stimulus"
- "Fiscal stimulus" will fail unless PBoC abandons its target of credit-to-GDP stability
- China's economic leadership will be severely tested in coming months