Q&A Bullets on Chinese "Perp QE"

What happened?

- Dec. 25: China's Financial Stability and Development Committee (FSDC) encourages expedited issuance of perpetual bonds by commercial banks to replenish Tier 1 capital
- Jan. 17: the Chinese Banking and Insurance Regulatory Commission (CBIRC) approves a CNY 40bn issuance of perpetuals by Bank of China
- Jan 21: Reuters reports that "China Readies First Perpetual Bond Issue by Bank, but Demand Could Be Weak"
- Jan 24: PBoC announces a new "Central Bank Bills Swap" facility through which primary dealers can swap bank perpetual bonds for high-quality collateral. In addition, perpetual bonds rated AA or better were deemed eligible collateral for PBoC lending facilities.
- Jan 24: CBIRC lifts restrictions on Insurance companies' purchase of perpetual bonds
- Jan 25: Bank of China Ltd issues CNY 40bn of perpetual bonds at a coupon of 4.5%

Does this amount to "PBoC QE?!?"

- PBoC didn't accumulate $3T in foreign assets by being squeamish about QE.
- PBoC can easily add liquidity via RRR or expand its balance sheet through its array of lending facilities.
- They have no need to engage in such esoterica as swapping CB bills for perpetual bonds if the purpose is to improve liquidity conditions by effecting QE
- The objective here is to increase the otherwise limited market appetite for perpetual bonds, which could see issuance of as much as CNY 500bn this year by some estimates.

They cut the RRR and now they're adding bank capital. Stimulus is coming, right?

- Probably, but not necessarily.
- A recent blog post from Mike Pettis described how GDP in China is a system input – ie the policymaking process *starts with determining the level of GDP growth* – as opposed

to an output resulting from the setting of various policy parameters. Ditto for bank lending.

- In a market-based financial system, policymakers would set parameters (system inputs) such as interest rates, reserve balances, and capital requirements and bankers, working within those parameters and assessing the risks and rewards of various opportunities, would engage in some level of lending activity (system output).

- In China, lending volumes *are the system input*. That's where the policymaking process *starts.*

- That renders variables such as the size of PBoC balance sheet, the RRR and bank capital levels as system outputs. That is, *they are not determinative of the policy stance*. They result from it.

- We don't yet know China's target for 2019 credit growth. But PBoC has stated an intention to keep credit growth in line with nominal GDP growth, a policy objective I've described previously as doomed to failure.

But surely bank recaps are consistent with an impending credit stimulus?

- Yes, but they could also be consistent with "not stimulus."

- If policymakers are intending to cap credit growth, continue the on-balance-sheeting of "shadow system" assets, and accelerate the pace of NPL recognition, raising capital now is an absolute prerequisite.

- Capital raising is a less urgent matter in a "blow out stimulus" scenario. While accelerating credit growth does entail an expansion of banks' risk-weighted assets, *abundant liquidity conditions also allow for continued suppression of NPL levels*.

- Further, in a "blow-out credit stimulus," policymakers could simply relax regulatory constraints on off-balance sheet credit creation to allow for "capital-free" credit creation

- *The capital raise is most clearly suggestive of a continued restrictive environment for "shadow banking"*

How might trade negotiations effect the domestic policy stance?

- Counterintuitively, stimulus is more likely in the “deal” scenario. Presuming any deal will require Xi to burn some political capital in submitting to U.S. demands on “structural issues,” he can’t have the economy fall apart as well

- A trade deal provides considerably more fertile ground for stimulus as it will underpin systemic confidence and create “room” via a rally in the RMB.

- Conversely, stimulus in a “no deal” scenario could be extraordinarily risky. Xi has no apparent Plan B in the case of international resistance to “moving up the value chain” and “made in China 2025.” The RMB will sell off against a backdrop of badly shaken systemic confidence. If Xi’s only response is to revert to naked credit stimulus – which he himself has declared unsustainable - there is a risk of inducing not giddy speculation in credit and real estate markets, but instead panic at the prospects of a systemic dead end.

- The 100th anniversary of the Communist Party in 2021 and the end of Xi’s second term in 2022 are key political dates on the distant horizon. In the wake of a breakdown in China’s most important strategic relationship, could Xi expect credit stimulus to carry him all the way through to 2022? Or might he to finally try “rip the band aid” on the zombie asset problem, and blame the resulting fallout on pernicious Westerners looking to “prevent China’s rise?”

<u>Conclusions</u>

- This isn’t “QE.” It’s just a tool to facilitate the purchase by banks of the perpetual bonds of other banks (which improves capital ratios without actually adding any capital to the system).

- Because RRR and capital levels are “system output” in China we need to be careful drawing conclusions about the policy stance using these variables.

- Capital raising is suggestive of a continued crack-down on “shadow banking.”

- The outcome of trade talks may influence China’s decisions on stimulus.

So what about the trade talks then?

- Chinese policymaking is a black box. We can never really know the real-world political pressures being brought to bear behind the scenes.

- Swallowing a bit of national pride to appease Trump in the hopes of riding him out through 2020 is the smart move for China in the medium-term. However, contrary to popular belief, the Chinese government often engages in strategically suboptimal short-termism.

- *All we need to see out of the Liu He visit to DC is that China is prepared to acknowledge the validity of some of the U.S. complaints* on structural issues. This should be a low hurdle for success. But admitting you have a problem is the first and most difficult step.