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Markets in High Resolution

As a follow up to yesterday's Part I: The Mechanics of Chinese Monetary Policy, let's look at how the tools and objectives of Chinese monetary policy have evolved in the post-crisis period. Armed with this perspective we'll then map out a policy roadmap for 2019 in tomorrow's note.

PART II: The Evolution of Chinese Monetary Policy

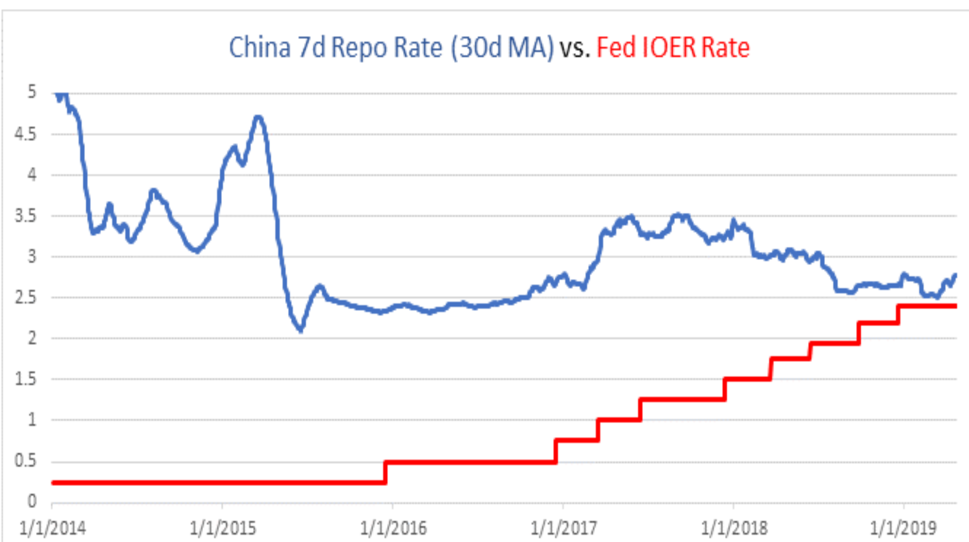
To see where Chinese monetary policy is headed we need to understand where it's been. Several developments in recent years warrant discussion:

- The post-2010 stability in bank lending growth
- The rise and decline of Shadow banking
- The monetization of muni bonds

But first let's touch on one thing that *hasn't happened*: a move from controlling the volume of credit to controlling its price (i.e. the interest rate). An eternal "reform objective", abandoning control of the quantity of credit is an impossibility in a State-owned banking system, by nature rife with moral hazard. As became apparent amidst the explosion of off-balance sheet (or shadow) credit, it is foolhardy in the extreme for the government to allow unfettered credit expansion when its writing free default insurance on all of it.

With the State controlling both the lenders and most of the borrowers, there need not be any connection between interest rates and credit volumes. Policymakers won't press their luck with sub-US interest rates to incentivize credit expansion when they can simply command it.

7-day repo rates are likely to remain range-bound around 2.75% this year. (Receiving the 5y CNY swap ~3.25% probably makes sense).



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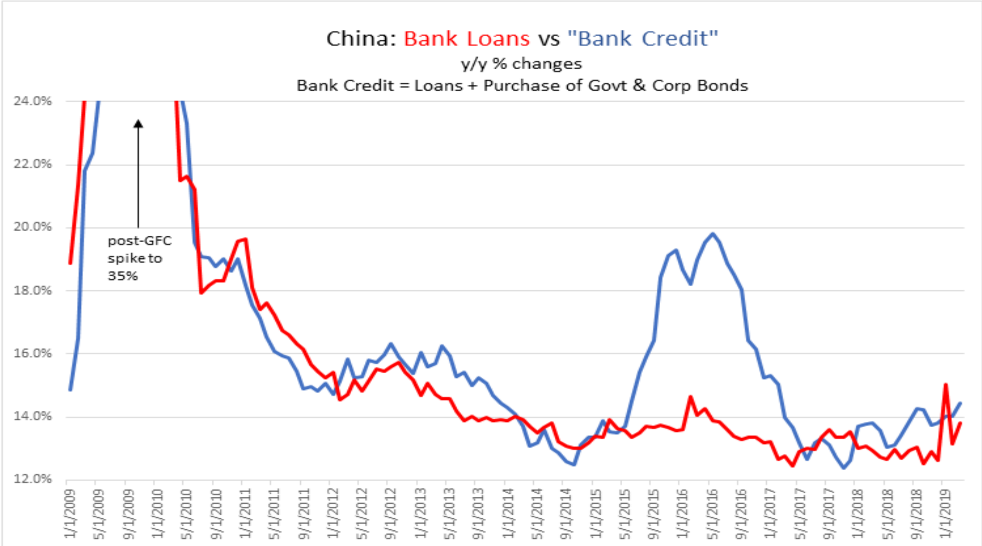
There have been three distinct episodes of "credit stimulus" since the GFC, driven by three distinct methods of credit extension.

The first stimulus effort in 2008-09, taking annual credit expansion from RMB 5T to 15T, was fueled by a blowout in bank lending, with loans outstanding expanding by over one-third on calendar 2009.



The red line above is growth in outstanding bank loans, while the blue line is a proxy for "bank credit" (all credit extended by banks to the private and government sectors via both loans and bond purchase). We'll return to that 2016 "hump" in bank credit in a moment.

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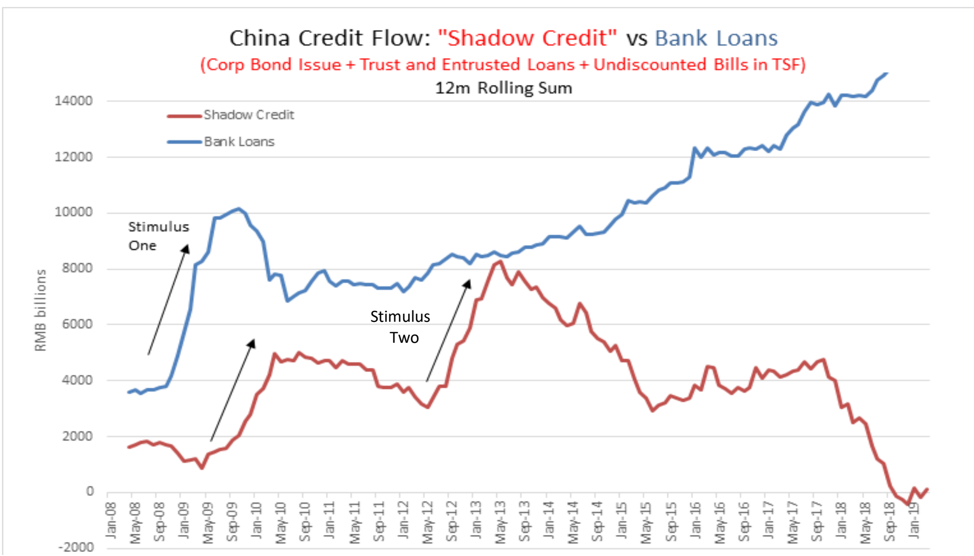
But first note that the 'stimulus action' in Chinese credit markets in recent years has *not come via bank lending* - growth in bank loans has been quite steady at around 13%-14% per annum since 2013. (Not that compounding the loan book by 13% year in, year out is sane or anything, but that's a rant for another day).

The 2012-13 stimulus effort came in response to a sag in home sales and deceleration in growth amidst the global liquidity tightening around the Eurozone crisis. "Stimulus two" took the flow rate of new credit from RMB12.5T to 20.5T in the 12 months to May 2013. This stimulus effort did not rely on already over-burdened bank balance sheets but was couched as a modernization of the financial system. The credit conduit was "shadow banking:"



By 2015 Chinese policymakers were beginning to see the folly of allowing off-balance sheet Wealth Management Products to proliferate with the combination of near-zero regulation and near-blanket implicit guarantee. But with the Federal Reserve embarking on an unwitting liquidity tightening coincident with its exit from QE3 ("Fed Memo: You Had One Job", 12/18/18), China again found itself subject to an unwanted tightening of liquidity conditions and unacceptably slow growth.

So they turned to the one balance sheet under state control that remained "clean" (as long as you ignore the $35T+ in implicit guarantees and contingent liabilities): the government itself. Once again touted as a "reform," the plan was to roll off-balance sheet Local Government Financing Vehicle debt into lower-cost, longer maturity municipal bonds. As it turns out, under great pressure to once prop up laboring real estate markets and hit unrealistic growth targets, rather than rolling implicit debt into muni bonds, local governments just layered on the muni issuance without retiring much in the way of LGFV debt. "Stimulus three" – this time entailing a RMB10T+ increase in new credit flow – was underway.

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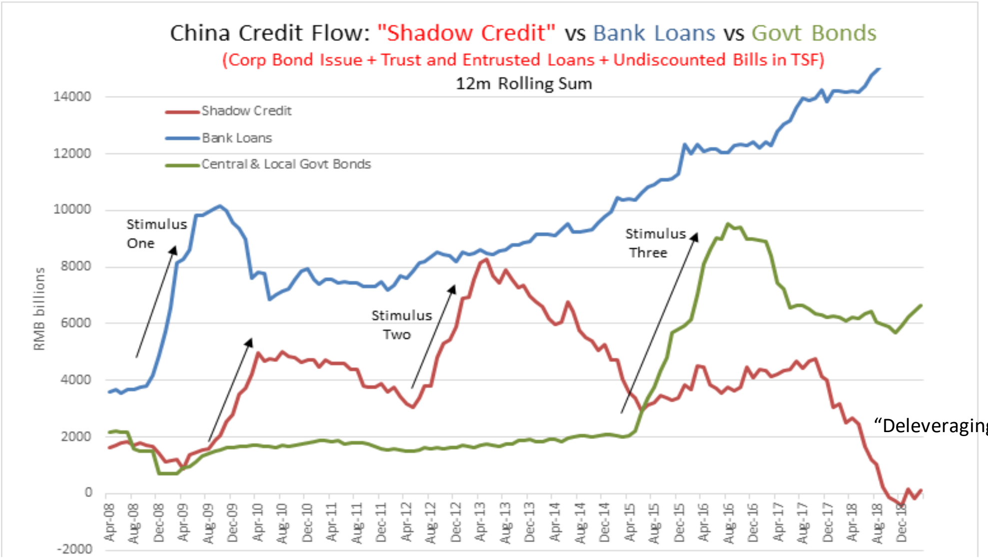

While a blowout of government bond issuance looks like "fiscal policy," the effort was more akin to a "helicopter drop." Recall the "hump" in our chart of bank credit, above – the issuance was predominantly purchased by banks, financed by monetary expansion. This was a "QE" program.

We've seen three post-crisis stimulus programs financed via three different balance sheets. The 2009 and 2015 efforts were money-financed, while the 2012 "shadow stimulus" was not accompanied by an extension of bank credit but was fostered by what amounted to the issuance of free options (government's risk, my reward). Chinese policymakers appear to be out of easy options for "stimulus four."

We'll look at what comes next in Part III tomorrow.