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Markets in High Resolution

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

In Part I: The Mechanics of Chinese Monetary Policy we discussed the centrality of top-down quantity targets to Chinese monetary management and laid out a means of assessing the policy actions required for any given target for the growth of bank credit.

In Part II: The Evolution of Chinese Monetary Policy we reviewed the three post-GFC stimulus programs which relied on three distinct forms of credit extension

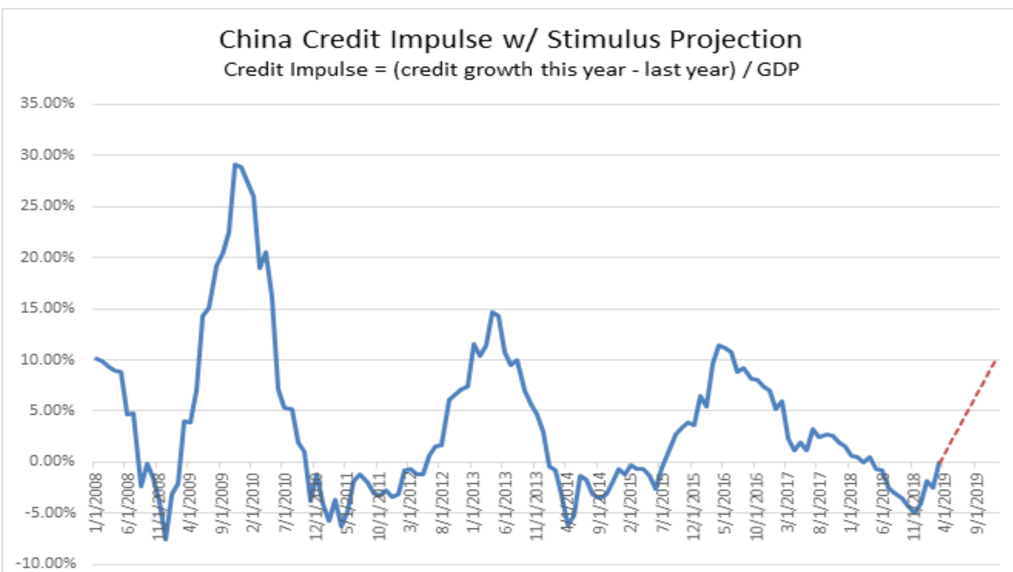
PART III: The Outlook for Chinese Monetary Policy

In this note we'll estimate what's "in the market" in terms of policy stimulus, look at how a stimulus might be executed, and lay out markers to assess whether China is in fact on a "stimulus" course. (Spoiler: they're not).

What do people mean by stimulus?

As China's financial system expands, real estate prices rise, and zombie credits accumulate. each iteration of "stimulus" requires a heavier lift. With late-cycle psychology proliferating, an overhang of structural trade risk, and a lack of reflationary impulse from global conditions, a successful stimulus will have to be at least as powerful as the last couple of efforts.

That implies a credit impulse on the order of 10% of GDP by year-end 2019. (Credit impulse is the change in credit *growth* relative to GDP). As a marker for whether or not they're on such a path, **flows in Total Social Financing would have to exceed 2018 levels by an average of 570bn per month for the rest of the year** (even after the already blown-out numbers for Q1).



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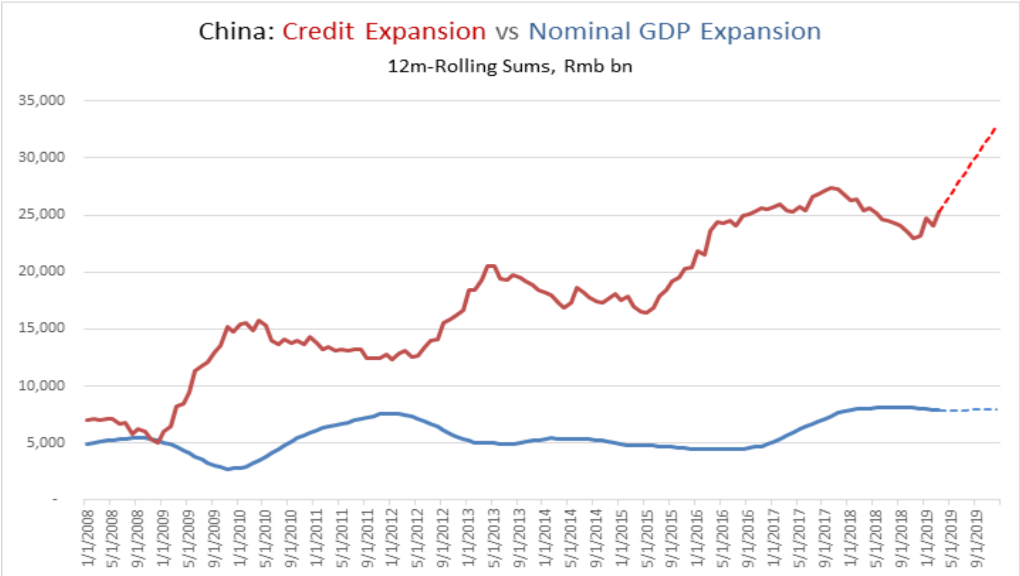
A pop in the credit impulse to 10% would require RMB 33t in credit – nearly $5t - to be extended in calendar 2019.



That's your garden-variety China stimulus program.

<u>How might stimulus be funded?</u>

As described in Part II yesterday, the three post-crisis stimulus plans have been funded by three different means: a massive increase in bank lending, a "shadow credit" free-for all and a municipal bond blowout. There are problems with going back to any of those wells again.

First, let's rule out the idea of reverting to the shadow credit orgy that was in play for much of the 2011-2017 period. New regulations on Wealth Management Products being rolled out for full implementation by end-2020 indicate an official understanding of the dangers of combining rapid growth in unregulated off-balance sheet lending with the strong public expectation of an implicit backstop.

WMP assets are in the process of being rolled out of amorphous, opaque pools (from which assets could be inserted or extracted at will) into segregated, marked-to-market structures akin to mutual funds. The process will pressure the banks, who are being forced to bring the bad assets buried in these non-transparent vehicles back on balance sheet or risk exposing them to the light of day in a new, more transparent vehicle,

The shadow credit channel is effectively closed as an avenue for aggressive stimulus. What about "fiscal stimulus?"

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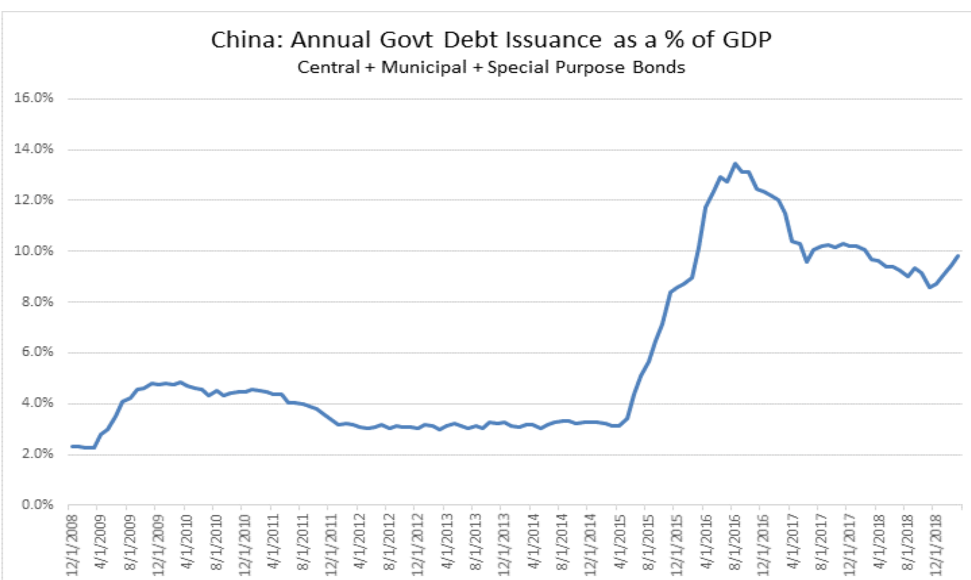
As noted in Part II yesterday, the 2015-16 stimulus program was financed by a sharp increase in municipal bond issuance. That budget blowout left **Chinese government finances in much worse shape than is generally understood**. Here are the IMF estimates for China's "Augmented Budget Deficit" from the 2018 Article IV report (2018-2023 are forecasts):

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
On-budget Revenue:	27.7	28.1	28.5	28.2	28.4	28.8	28.9	28.6	28.3	28.2	28
On-budget Expenditure:	31.2	31.6	33.2	33.9	34.9	35.2	35	34.4	33.8	33.5	33.1
On-Budget Balance:	-3.5	-3.5	-4.7	-5.7	-6.5	-6.4	-6.1	-5.8	-5.5	-5.3	-5.1
Infrastructure Financed by LGFV & Special Bonds:	6.8	6.3	5.6	6.7	6.8	6.6	6.8	6.7	6.6	6.3	6.2
Augmented Budget Deficit:	-10.3	-9.8	-10.3	-12.4	-13.3	-13.0	-12.9	-12.5	-12.1	-11.6	-11.3
Expenditure Financed by Land Sales:	2.7	2.7	1.9	2.0	2.6	2.3	2.0	1.7	1.4	1.2	1.0
Estiamted Borrowing Need (Central, Local + LGFV):	-7.6	-7.1	-8.4	-10.4	-10.7	-10.7	-10.9	-10.8	-10.7	-10.4	-10.3

What the table shows is that in 2017:

- China had an on-budget balance of -6.5% and spent an additional 6.8% of GDP on infrastructure investment for an "augmented budget deficit" of 13.3%.
- 2.6 percentage points of that was financed by land sales by local government
- That left a borrowing requirement of 10.4% of GDP.
- 7.7% of that was financed by official government debt issuance, with the rest financed by LGFV borrowing (local-government sponsored corporate entities).



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Fiscal policy is in no position to be providing effective stimulus this year – and it won't be. Land sales are under severe pressure and LGFV borrowing is officially frowned upon (and therefor viewed as increasingly risky by investors). That leaves explicit debt issuance as the fiscal lever.

The government has set a municipal bond issuance target that implies an increase in total government debt issuance (central + local) from 8.7% of GDP in 2018 to 9.4% in 2019. While government debt issuance of 9.4% of GDP is nothing to sneeze at, the fact that it won't be much bigger than last year means it won't be much help to GDP growth. The budgeted increase is a pittance in the scope of the expected stimulus effort.

Again, an expectations-meeting stimulus requires RMB 10T more credit in 2019 than in 2018. Shadow channels are unlikely to provide much of that at all, while budgeted government bond issuance should grow by some RMB 1.5T. **That leaves the heavy lifting to the banks**, who are already suffering from a ruptured hernia and a slipped disk.

The banking system is balance-sheet constrained by the need to bring shadow assets on-balance sheet (as noted above) as well as the constant pressure to address the NPL problem. (Here's a good overview of ongoing gradual NPL-reduction efforts). Leaning on the banking system to generate the bulk of the required RMB 10T in additional stimulus would push the growth in bank lending to above 17% for 2019. Is that possible?

Sure, it's China. They can do whatever they want. Neither liquidity nor capital are proven barriers. Banks are already shoring up capital levels (on an institutional but not systemic basis) by selling perpetual bonds to each other. As for liquidity, assuming the level of reserves remains broadly steady (as it has for the past few years), **a further 150-200 bps of RRR cuts would be required to accommodate the requisite expansion of bank balance sheets**.

The constraint is credibility. The sustenance of some RMB 40T in financial assets is reliant on a strong public belief in the Chinese government's ability to make sure it's all money-good. No one knows where the breaking point for that credibility is, but beyond it lies financial crisis.

President Xi's initiation of the "deleveraging campaign" in 2017 suggests deep concern that they have been pushing the limits of the public's belief system. A quick U-turn on that very policy by the maximum leader himself would only further stress, perhaps irreparably, the public's confidence that China's leadership knows what it's doing.

There is no "stealth stimulus" option. There is either stimulus, entailing a visible expansion of bank balance sheets accommodated by aggressive RRR cuts, or there isn't really stimulus.

I continue to bet on the latter. Continued strong beats in TSF and a 100bp RRR cut in Q2 would suggest I'm wrong.