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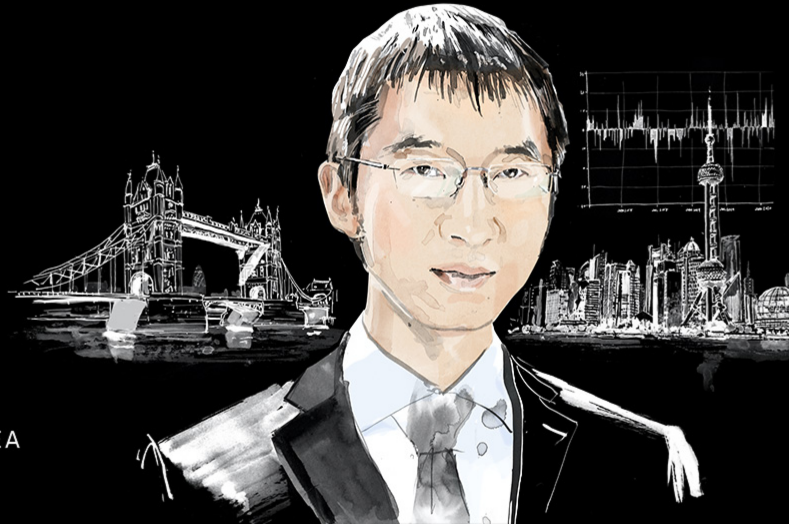


October 11, 2023

China Update: Crossing Stimulus Lines

Reports on Tuesday had China planning new stimulus to the tune of CNY 1trn to ensure meeting the year's growth targets. In contrast to previous rounds which looked piecemeal and industry-specific, this one appears to be direct fiscal injection and will reportedly be accompanied by an increase in the budget deficit. This was clearly on the agenda for Q4 as the Ministry of Finance in the past maintained a hard line on fiscal discipline.

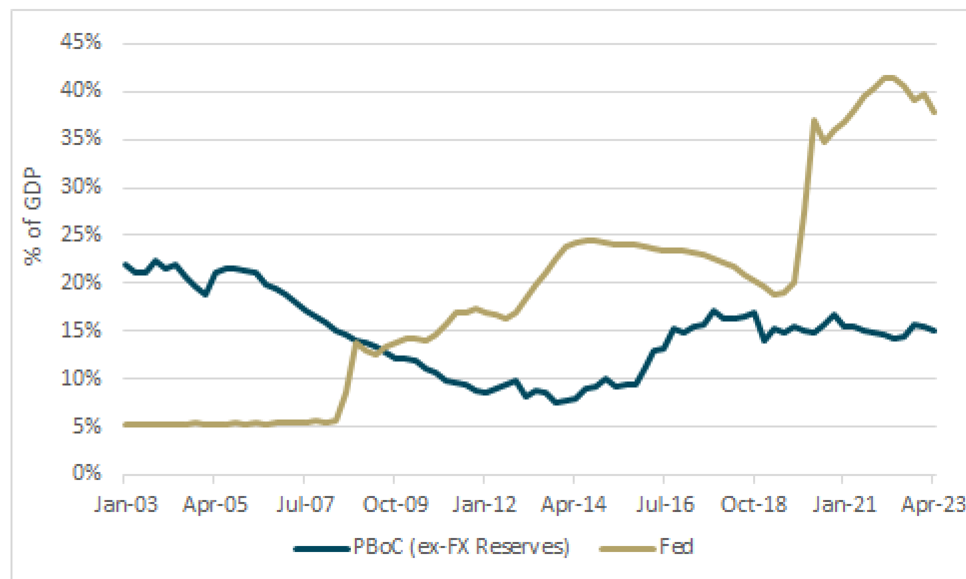
In our view, this step should have been taken at the March National People’s Congress, when reopening expectations were the strongest. Furthermore, targeting ‘route-one’ investment growth rather than consumer demand also runs against the long-term needs of the economy and its rebalancing towards domestic consumption. Nevertheless, in the near term, we fully acknowledge that the step should represent a clear tailwind to data; it could even prove another push-factor for global energy and industrial commodity prices. iFlow had indicated that various expressions on weaker Chinese growth have been steadily reduced or not added to, and the news will likely accelerate the process.

Considering the scale of the challenges China’s economy is facing, we believe the size of the stimulus matters far less than the quality and the transmission. It is plausible that growth tailwinds will support the economy through to Q1 next year, ahead of a new budget at the 2024 National People’s Congress, at which point markets will be asking what the long-term strategy is. A ‘rinse and repeat’ approach would yield diminishing returns to growth.

If a more radical approach to financial conditions is required, then policies akin to quantitative easing must be on the table, in our view. Presently, the People’s Bank of China has more than enough capacity for a comprehensive programme. Excluding FX reserves, we can see below that the current balance sheet-to-GDP ratio is around 15%, comparing far more

favourably to just under 40% at present in the US – though admittedly globally these figures are on the decline as policy tightening continues. Even if we use the Fed's pre-pandemic balance sheet as the benchmark, which stood at 20% of US GDP in Q4 2019, that would give the PBoC around 5% to manage. That is equivalent to CNY 6trn and we think enough to comprehensively move global growth expectations.

Balance Sheet-To-GDP Ratios

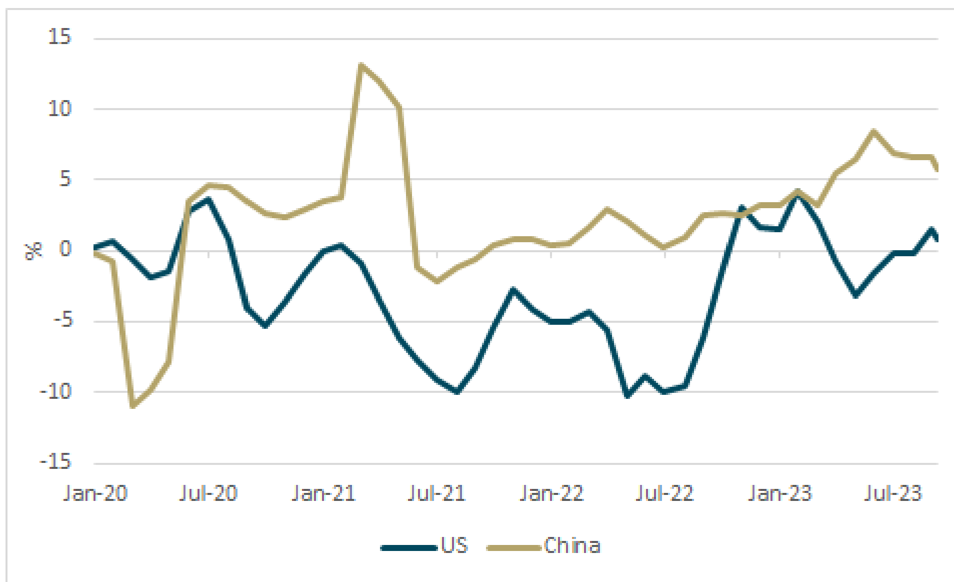


Source: Macrobond, BNY Mellon

There are legal limitations on direct subscriptions of newly issued government debt but the PBoC can act in the secondary market. There are other ways to deploy its balance sheet on an outright basis through reserve creation: in December last year, the PBoC carried out open market operations (OMOs) with relevant banks to provide liquidity support with the objective of absorbing the supply of a special bond issue to the tune of CNY750bn. If there is an operation along these lines every month over the course of a year, that would not be dissimilar to a fully fledged QE programme worth up 5% of GDP.

The 'quality' of any easing will be measured through any general easing in financial conditions. The primary focus will be on real rates, to which Chinese corporates are exceptionally sensitive. As shown below (5y yields deflated by sequential inflation), real yields in China are well above US equivalents. That real rates have been rising since the economy reopened shows that financial conditions have been counter-cyclical, when realistically they should have been pro-cyclical as the initial months of China's reopening clearly indicated growth was not picking up strongly. In contrast, US real rates are now fully counter-cyclical while inflation remains above-target, but arguably they were too pro-cyclical during 2021-22 when the economy was clearly gaining momentum through re-opening.

Real Yields, China vs. US

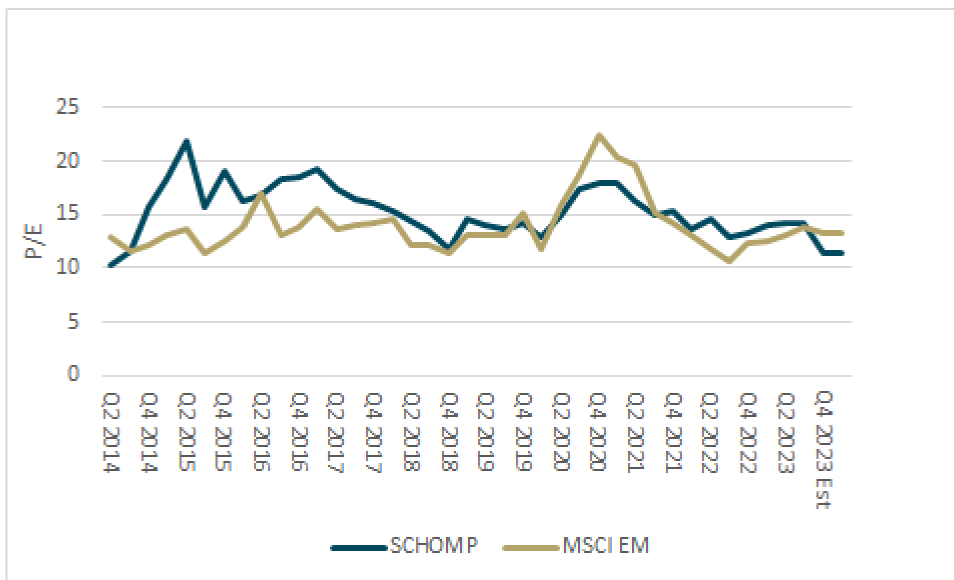


Source: Bloomberg, BNY Mellon; deflator is annualised sequential inflation over three months.

The current state of Chinese real yields also runs counter to the narrative that higher real yields are needed for currencies to perform. This may have worked in Latin America, but the likes of BRL and MXN had high nominal yields in support, reflecting strong growth. When real yields are high because of disinflation or deflation and coupled with low nominal yields, asset allocators are fully aware that currency strength would be a hindrance. This is particularly true for economies such as China's where the export sector is still a large employer, if not a major contributor to GDP value-added. Higher financing costs through the real rate coupled with weaker FX transition risks material earnings erosion. Consequently, we believe that the PBoC is not averse to currency weakness; periods of enforced stability are merely designed to control the pace of change.

One other major channel for financial conditions in China which is often ignored are equity markets. Due to very low levels of international participation, this is understandable. However, this is where we see very strong potential for upside risk in domestic sentiment, especially for household consumption. As stated above, PBoC balance sheet expansion will focus on pushing down real yields. However, central bank remits are wide and we note that purchases of Japanese equity ETFs have been a material component of Bank of Japan quantitative easing for over a decade. China has its own so-called 'National Team' which have essentially conducted ad-hoc support operations. Current valuations in the Shanghai Composite are at the lowest levels in close to a decade, though in relative terms this appears to be a general theme amongst emerging markets.

P/E Ratios, China vs. MSCI EM



Source: Bloomberg, BNY Mellon

The preponderance of retail investors in China's A-share market and previous instances of unintended consequences of National Team purchases means that the PBoC will be extremely wary of taking direct risk. However, we think similar OMOs which could support institutional purchases are not out of the question. As opposed to the real-rate channel where corporate transmission is more pronounced, the impact on domestic household sentiment is stronger through the equity market and more immediate. If more savings are also 'stopped into' equities and improve valuations, there will also be a commensurate easing of financial conditions for corporates through the equity channel to complement existing efforts through the real rate channel.

The PBoC and MoF are both very cautious by nature. In addition, considering the disquiet generated amongst emerging market central banks by the 'currency debasement' of G7 central banks over the past 15 years, there are subjective barriers to overcome as well. Even so, the evolution of Beijing's efforts to stimulate the economy this year is a clear progression in the crossing of some very firm lines, especially regarding property. If hitting the growth target is the ultimate red line, then all others lines are traversable for the central bank and other key entities, including – however reluctantly – outright quantitative easing.

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