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China Debt Dynamics

Where's the stimulus? – Parsing Beijing's lackluster response to growth

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It's been a tough year for China's economy. Despite early optimism that the end of zero-COVID would unleash a wave of pent-up consumption as people rushed to make up for lost time, the spending boom never materialized. Instead, consumer confidence remains in the doldrums, depressing private sector investment and deterring firms from hiring more people and expanding their factories.

During previous periods of economic weakness, Beijing has typically responded with either fiscal or monetary stimulus - or both. This time, there's been neither. In recent months, authorities have rolled out a flurry of measures that have loosened restrictions on property investment and aimed to boost purchases by households of big-ticket items like cars and household appliances. But such efforts have so far fallen flat.

The lack of more robust policy support for the economy is partly due to hard constraints limiting what Beijing can do. The People's Bank of China (PBoC) has so far only cut interest rates by token amounts for fear of putting downward pressure on the yuan and undermining financial sector stability by eroding bank profits. Meanwhile, local governments' over-indebtedness means they're ill-positioned to ramp up borrowing to expand infrastructure investment.

Given such constraints, analysts have wondered why Beijing hasn't tried stimulating the economy by providing direct financial support to households. After all, authorities have repeatedly said consumption is at the heart of China's economic recovery this year. However, Xi Jinping has a well-documented aversion to what he calls "welfarism," suggesting he is not willing to make the sort of large-scale direct transfers to the public common in developed economics. Moreover, any large-scale stimulus would require the central government to expand its budget deficit, something it seems reluctant to do.

Instead, Beijing has so far taken a unique approach that eschews a short-term economic boost in favor of measures designed to permanently bolster consumption over the long-term. That approach has two prongs. The first is to unleash pent-up latent demand among consumers; the second is to use market-based measures to boost household incomes. Whether the approach will work as intended remains uncertain.

A two-prong approach

We outlined the rationale behind the first prong in our Q2 Newsletter. In short, Beijing has rolled out a wave of measures designed to unleash latent demand by removing impediments that were previously holding back consumption. For example, authorities believe that a lack of parking deters some city-dwellers from purchasing a car, and a lack of charging piles in rural areas is a disincentive to would-be buyers outside of the cities. They're promoting the construction of more parking and charging piles in the hope of creating new demand for vehicles. Meanwhile, they're trying to ensure that consumers have access to the goods they want, particularly in rural areas where e-commerce logistics aren't yet up to scratch.

Beijing is also trying to boost household incomes so that people have more money to spend. Most notably, the PBoC has instructed banks to cut interest rates on the existing stock of home mortgages. In China, most homeowners have adjustable-rate mortgages (ARMs), with interest rates that typically adjust annually on January 1. However, banks often don't pass on central bank interest rate cuts fully to mortgage holders. Consequently, many households currently pay interest rates well above the minimum set by the PBoC.

Starting late September, banks started adjusting homeowners' mortgage rates down to the regulatory minimum, a move that will reduce households' monthly mortgage payments and free them up to spend more on other things. Whether households spend their windfall remains to be seen. With consumers in a cautious frame of mind, they may opt to save more rather than spend.

Beijing is also trying to encourage household spending by engineering a recovery in the onshore stock markets. In late August, regulators launched a wave of measures designed to reduce the cost of stock trading - such as by cutting stamp duty - and boost share purchases - such as by encouraging share buybacks. Beijing's motivations are widely debated, but we believe authorities are driven by a desire to expand household wealth. On August 3, a few weeks prior to the support measures being rolled out, the Economic Daily - the Party's official broadsheet on economic issues - published a commentary flagging the need for higher A-share valuations, saying:

"The wealth effect brought about by a rise in the stock market can directly increase investors' income and boost income growth expectations, thereby translating into actual consumption…In short, the capital market can stimulate consumption, expand domestic demand, and drive economic growth."

With housing prices having fallen throughout the year, a revival in stock prices would provide a much-needed boost to household wealth. However, the measures haven't as yet translated into the "slow bull" market the commentary said Beijing aspires to.

Monetary policy

In theory, Beijing could bring much needed relief to the economy by slashing interest rates. In fact, some government advisors have advocated doing exactly that. However, the PBoC has taken a firm stand against aggressive monetary policy partly because deliberately widening the spread between US and Chinese interest rates would further weaken the RMB, and partly because lower rates would undermine financial sector stability. Of the two issues, the PBoC seems to be more concerned by the latter.

By relentlessly pushing down lending rates over the last couple of years, the PBoC has squeezed banks' net interest margins (NIMs), banks' main source of profit. At the end of June, banks' average NIM was 1.74%, down from 1.94% a year earlier, and about half the level enjoyed by banks in the US. The PBoC is worried that weaker profits will undermine banks' ability to deal with mounting financial sector risks.
The problem is that Chinese banks aren't allowed to issue new shares at a price lower than their net asset value (NAV) per share, otherwise known as price-book. For years now, most listed Chinese banks have traded at prices well below price-book. Equity in non-listed banks has also consistently sold below that level.

That's left banks with two ways to replenish core tier-one capital, which is used to make provisions and write-down bad loans. They can either retain earnings, or they can sell new shares to state institutions that are willing to pay inflated prices.

However, with local governments' finances under mounting pressure, many have found it increasingly difficult to find the resources necessary to recapitalize their banks. Consequently, retained earnings have become increasingly important to ensuring banks are adequately capitalized.

Nonetheless, the PBoC is willing to make minor cuts. Benchmark interest rates have declined twice in recent months. In June, the PBoC announced that both the one-year loan prime rate (LPR) - the benchmark for pricing most corporate loans - and the five-year LPR - which is used to price mortgages - had fallen by 10 bps. In August, the one-year fell by a further 10 bps. That brings the one-year LPR to 3.45%, and the five-year to 4.2%. (The LPRs are calculated based on the average interest rate charged by China's biggest commercial banks to their lowest-risk customers.)

Such small cuts have done little to revive the economy. At best, they offer marginal relief to firms struggling with persistent producer price deflation, which has pushed up the real cost of borrowing.

Conclusion

During past cycles, China's authorities have invariably responded to economic weakness by stimulating the economy. This time is unquestionably different. Beijing is reluctant to ramp of infrastructure investment, wary that increased borrowing by local governments would exacerbate their already precarious financial situation. Moreover, cutting interest rates complicates efforts to ensure financial sector stability.

Additionally, China's authorities are no longer committed to delivering fast-paced growth at all costs. Xi Jinping has repeatedly stressed that growth needs to be high-quality, rather than the low-calorie growth that the borrow-and-build model previously delivered. It appears that Xi and his colleagues are willing to ensure sluggish growth for time, and perhaps even see it as necessary in order to set the economy on a path that is less dependent on property investment.

If that's the case, then the current policy mix - which is dedicated to unlocking consumers' latent demand, and using markets to boost household income - will likely persist for some time yet.

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