China Economic Comment

National Australia Bank

China's policy puzzle

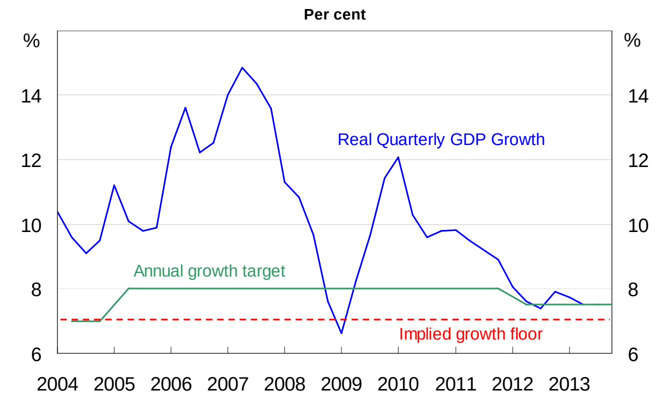
There has been a large divergence in views over the future path of China's monetary policy/stimulus over the medium term. While the majority view expects target interest rates and reserve requirements to remain unchanged until early 2015, there are still analysts calling for cuts to rates and reserve requirements in the short term to ensure adequate liquidity and reasonable growth in the economy this year and next. The divergence in views is understandable given the confusion over the true stance on policy in China at the moment as government officials give mixed messages on the policy outlook, the state of the economy, and the government's near term policy objectives. For much of this year 'Likonomics' – characterised by limited stimulus, structural reform and de-leveraging – appeared to be gaining traction amongst the leadership as they began to publicly recognise the need to address China's economic imbalances. Achieving this was expected to require 'short term pain for long term gain' as policy makers seek restraint on credit and investment growth, while simultaneously trying to facilitate household consumption. However, some recent policy measures have cast some doubt over the leadership's commitment to this mantra.

Instead of 'short term pain', recent partial indicators are signalling that the Chinese economy has started to stabilise, or may even be improving as we progress through the second half of the year. While this may be taken as a positive development for the economy, there is the risk that we are simply seeing a return to the old tricks of supporting growth through investment stimulus – with the goal of achieving the target GDP growth rate of 7.5% at the forefront of the minds of China's leadership. We have seen several policy stimulus measures in recent months, some of which are directly targeted at bolstering investment. There does appear to be room for additional government spending this year under the current fiscal budget. Government spending in July to date has been similar to the same time last year despite a significantly larger projected budget deficit (RMB1.2tn v RMB850bn).

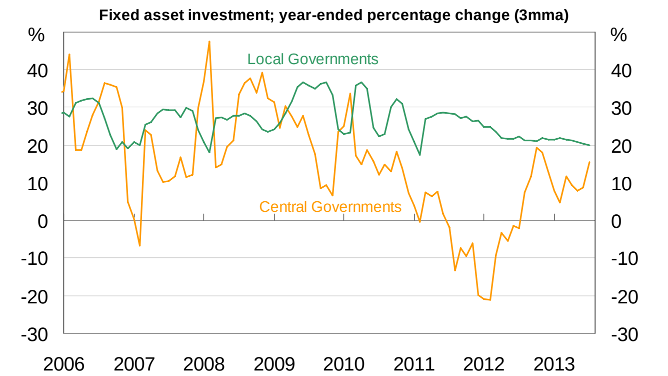
It is a tough balancing act. While it is important for China to restructure and reform, the more the economy slows the greater the difficulty of achieving these goals with minimal disruption. Premier Li himself has suggested that they can only focus on restructuring and reform so long as growth does not slip below 7%. The authorities so appear to have taken a slightly different approach to investment stimulus this time around, with the amounts involved significantly lower than the massive 2009 stimulus package. Also, government representatives have emphasised that most of the infrastructure investment taking place had already been set out as part of the 12th five year plan, rather than being new stimulus measures per se.

Intentions are a little clearer when it comes to monetary conditions. Since the onset of the 'liquidity squeeze' in Chinese money markets in late June, which saw short-term interest rates temporarily soar to record levels, there has been a marked tightening in long-term maturity bond yields. For example, 3 year interest rates have risen steadily from around 3% in early June to almost 4% recently. Over the same period, the passing of temporary strains on liquidity, and market intervention by

Real GDP growth – will they allow further declines?

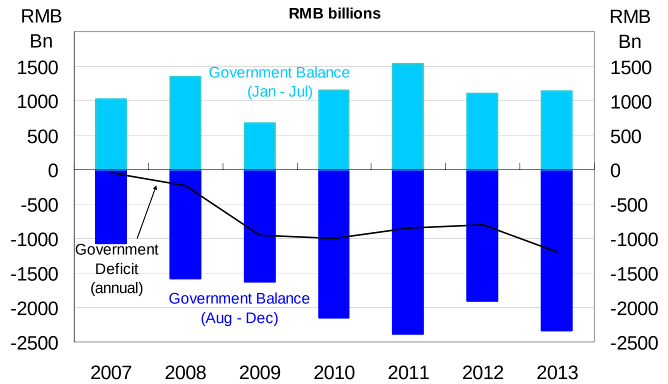


Public investment is picking up again



Sources: Thomson Reuters

Scope for government spending support in H2



Source: CEIC; NAB
* FY2013 is budget deficit

the central bank have seen short-term rates fall sharply. Consequently, the maturity spread on interest rates (a proxy for the slope of China's yield curve) was only temporarily inverted in late June/early July as a result of the credit squeeze, before returning to levels consistent with average levels since 2011.

Normally, such a widening in the interest rate spread (or a return to normality in this case), might suggest growing optimism over the economy that is driving expectations for higher inflation. While this may be true to some extent, there continue to be a number of concerns over the outlook and consumer expectations remain relatively subdued. Instead, it appears as though the idiosyncrasies in short-term money markets combined with intervention by the PBoC are probably driving much of the volatility in interest rate spreads we have observed. But what role has the central bank played and why?

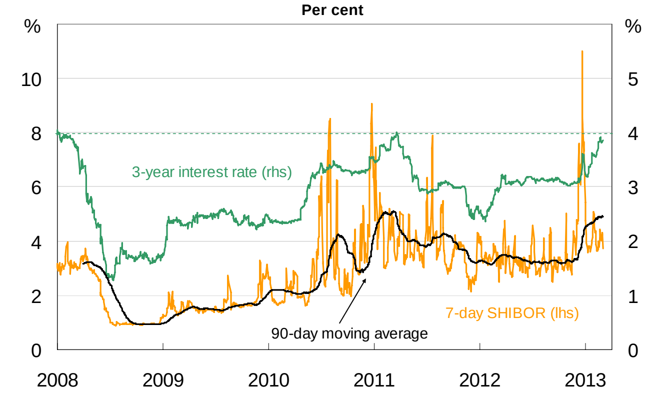
In order to settle the liquidity concerns facing Chinese banks, the central bank has undertaken its own reverse form of 'operation twist', a policy tool used by the US Fed in 2011 and 2012 to adjust the term structure of interest rates, albeit with the complete opposite objective in mind. The ultimate purpose of this intervention was to ease the liquidity squeeze for banks needing access to cheap finance in money markets while simultaneously deterring another credit binge and keeping inflation subdued. This was done by intervening to push down short-term rates on money market funds, while locking up long-term liquidity to push long rates higher. In this instance the PBoC has been offering short term instrument (reverse repurchase agreements) to inject money into the system, while reopening three year central bank bills to offset maturing debt.

Overall, monetary conditions have tightened since the start of the year, even for short-term interest rates. The 7-day SHIBOR, while well below its peak during the liquidity squeeze, have risen up to 150bps in trend terms. This is likely to have some flow on impacts to the economy if interest rates continue to rise, despite the fact that China's financial system is still developing. Up until recently, China's reliance on quantitative targets and direct administrative controls to conduct policy has limited the impact that interest rates can have on the real economy. Nevertheless, a 2011 study by the IMF found evidence of pass through to macroeconomic aggregates "suggesting a nascent price-based transmission mechanism for monetary policy, in spite of the prevalence of non-price controls." These linkages are likely to strengthen further as financial reforms, such as the recent liberalisation of retail lending rates, continue to progress.

However, economic modelling by the Bank of International Settlements (2010) found that while monetary policy has an impact on asset prices, which can flow through to consumer behaviour via wealth effects, the overall impact on consumption in China is limited. This largely stems from the fact that Chinese households have limited access to external finance. This could actually help with Chinese rebalancing as it allows for a policy setting that will impede credit, investment and downstream (industrial) prices growth, but with minimal negative consequences for consumption. In addition to this, an eventual liberalisation of (i.e. increase in) deposit interest rates would have a positive wealth effect on households, providing additional support to consumption. However, the potential influence of lending rates on households has probably risen since the ECB study in 2010 as they gain greater access to finance. Household credit as a share of all debt issued by financial institutions in China has risen from below 20% in 2009 to more than 25% at the start of 2013.

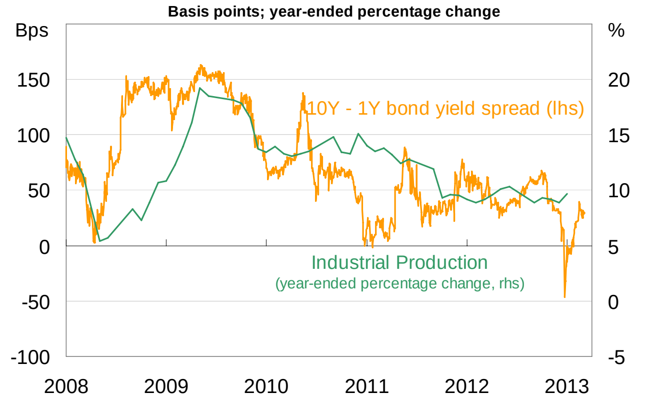
While it is difficult to gauge the likely impact of monetary tightening on the economy as a whole, our own modelling suggests that a temporary 150 bps shock to interest rates

Liquidity squeeze has past, but monetary conditions are tighter



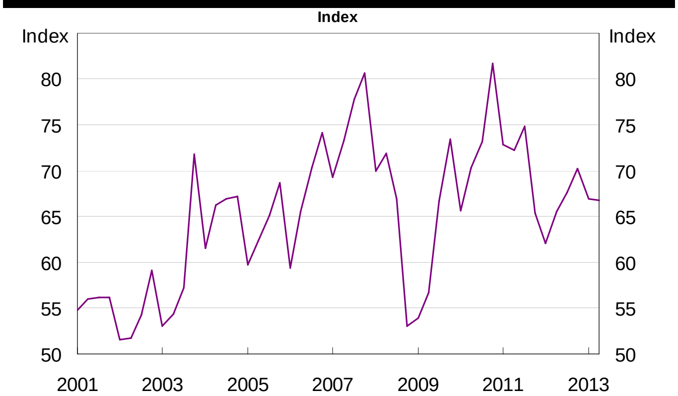
Sources: CEIC; NAB

China's yield curve is flatter



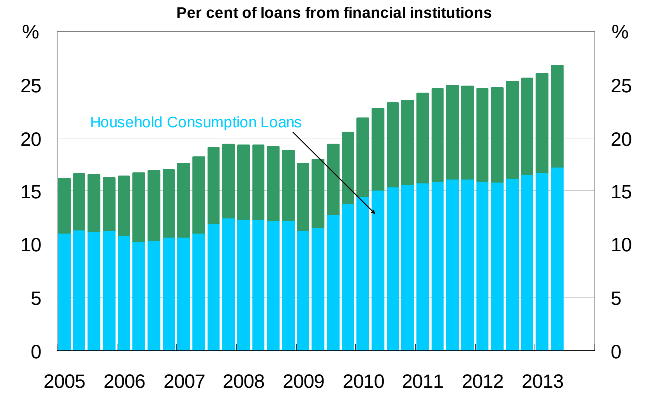
Sources: CIEC; NAB

Household future inflation expectations remain muted



Source: PBoC Urban Depositor Survey

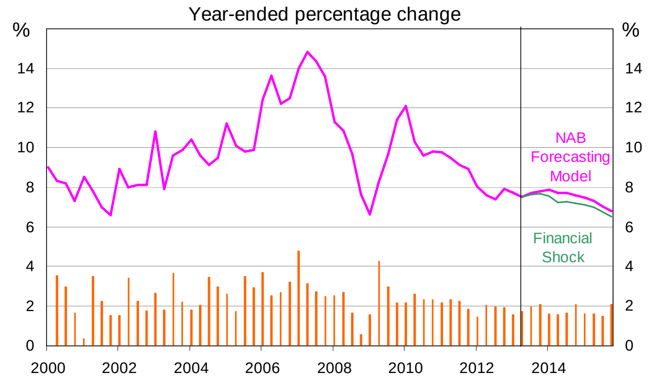
Household Credit



Sources: CEIC; NAB

(broadly consistent with the rise we have already seen across the yield curve), would detract around 0.3ppts from annualised GDP growth over the forecast horizon. Naturally, the negative impact on the economy depends on how long monetary conditions remain tight – our modelling for this exercise assumes it is only maintained for one quarter. This certainly highlights the difficulty of rebalancing, maintaining growth and limiting inflation all at once and probably explains the leadership's current policy mix.

Rapid monetary tightening likely to flow through to GDP growth



Source: CEIC, NAB

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Important Notices