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Modest Chinese stimulus highlights competing policy objectives

NAB Group Economics

Since March, Chinese authorities have eased COVID-19 countermeasures and attempted to return to normal economic activity. So far, progress has been slow, with high frequency measures suggesting a plateauing in the industrial recovery from early April and ongoing softness in services. While the majority of the country's firms are back in business, only a small proportion are fully operational, given weakness in domestic demand and a constrained export environment. As a result, China will implement stimulus to support the rebound, however it is likely to look different to earlier episodes.

WHAT DID EARLIER STIMULUS LOOK LIKE?

China faced substantial challenges from the Global Financial Crisis. While its domestic financial system was largely unaffected by the global turmoil, its economy was overly reliant on export markets, which stalled as uncertainty and unemployment rose in advanced economies. In contrast, China's domestic consumption was constrained to provide a pool of savings to fund investment (a policy of financial repression). To counter the downturn, Chinese authorities introduced a RMB 4 trillion stimulus package, of which just RMB 1.2 trillion was to be provided by the central government. Much of the remainder was funded by bank and non-bank credit.

Bank lending was seen as the fastest way to distribute funding – compared with central government bond sales and then dispersing these funds to local governments (who are responsible for the bulk of infrastructure spending). However, there was also rapid growth in non-bank lending – primarily via the shadow banking sector – with aggregate financing increasing from around 120% of GDP in Q4 2008 to around 160% of GDP in mid-2010.

This influx of funds for investment helped economic growth to accelerate, but also led to excess capacity building in a wide range of industrial sectors – including steel & other metals, cement and chemicals.

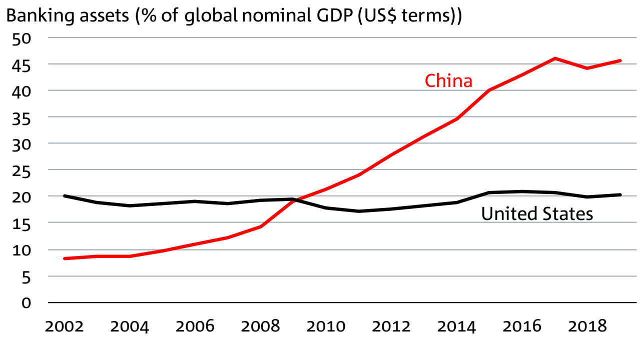
Subsequent smaller scale stimulus packages in 2012 and 2014 focused on infrastructure and other construction, leading to a slower but ultimately much larger accumulation of debt – with the official aggregate financing measure rising from 160% of GDP at the start of 2012 to over 250% of GDP in early 2020. This measure excludes parts of shadow banking and other informal lending that would increase the total debt to GDP to well in excess of 300% of GDP – comparable to higher debt advanced economies.

CHINA'S NEW STIMULUS HAS TO BE DIFFERENT

Facing the sudden sharp downturn triggered by its COVID-19 countermeasures, Chinese authorities are unlikely to be able to follow the playbook from early stimulus efforts. The rapid accumulation of assets in the banking sector since the GFC have increased the industry's risk levels, meaning that a large scale increase in bank lending is unlikely to be possible. Earlier stimulus pushed China's bank assets far beyond the levels of the United States.

CHINA AND US BANKING ASSETS

Stimulus saw China's assets soar



Source: World Bank, St Louis Fed, CEIC, NAB Economics

China requires more targeted stimulus in response to the current downturn. The country's industrial sector is still attempting to address excess capacity and does not require large scale investment. In addition, earlier stimulus pumped funds into the property sector, where authorities are keen to avoid excess investment (given existing concerns around a property price bubble). Anecdotal evidence suggests that so far this may not have been successful – given recent strong apartment sales in major cities such as Shenzhen.

Infrastructure developments are also likely to be different. China's post-GFC infrastructure developments focused on relatively simple transport construction – building bridges, roads and rail lines – including the development of a vast high speed rail network. There is little need for further large scale investment in this type, as China has sufficient infrastructure stock. Instead, it is likely that investment will be in higher technology infrastructure – including the expansion of its 5G communications network, data centres to support its tech industry and charging facilities for electric vehicles. From an Australian perspective, this is less positive for our exporters, as investment in these areas consumes comparatively less steel (and therefore iron ore and metallurgical coal) than in earlier hard infrastructure projects.

WHAT HAVE CHINESE AUTHORITIES DONE THIS TIME?

The earliest steps that Chinese authorities made in response to COVID-19 was monetary easing. Having reformed its policy mechanism in the second half of 2019, with the introduction of Loan Prime Rate (LPR) as the primary policy rate, the People's Bank of China has cut interest rates twice since the COVID-19 outbreak, bringing rates down by 30 basis points. Compared with the scale of cuts in advanced economies, these cuts have been very modest and more are possible in coming months.

The PBoC has also cut the Required Reserve Ratio – the amount of deposits commercial banks must keep at the central bank – this year, freeing up additional funds for lending.

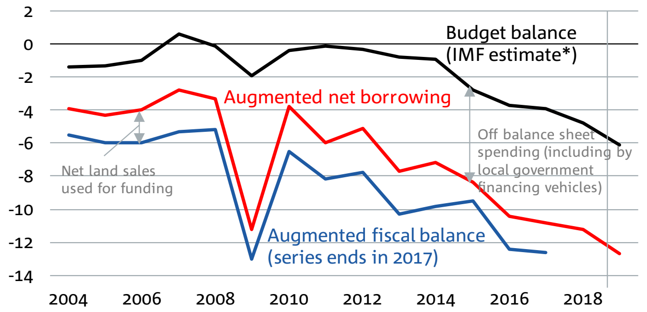
At the recent National People's Congress – which was postponed from March until May due to the COVID-19 outbreak – the central government announced further fiscal support, with the budget deficit to increase to over 3.6% of GDP (compared with 2.8% in 2019). Such a deficit would be relatively modest when compared with fiscal stimulus elsewhere – such as the anticipated double digit deficits anticipated in the US for the 2020 and 2021 financial years.

However, the central government budget does not fully reflect total government spending – given the importance of local governments in funding infrastructure and social welfare programs – or alternative funding sources (such as off balance sheet sources). IMF estimates suggest that augmented net borrowing (which adds such off balance sheet items to the headline deficit) increased to 12.7% of GDP in 2019.

CHINA'S BUDGET DEFICIT

Modest increase in deficit excludes large scale off balance sheet borrowing

Government budget balance (% of GDP)



Source: IMF, NAB Economics *includes social security and SOE funds excluded from offical data

Not all of this higher deficit is due to government spending, with cuts to taxes and government fees for businesses also announced. The government has also promised to lower utilities costs and wave businesses contributions to social welfare funds. Although authorities have emphasised the importance of firms maintaining employment levels, the policy support has been indirect (particularly compared with wage subsidy schemes used in other economies).

In addition, a larger quota for local government bonds has been announced – at RMB 3.75 trillion (compared with RMB 2.15 trillion in 2019) along with RMB 1 trillion of "off budget" special bonds to directly address the economic impact of COVID-19 and its countermeasures. It is worth noting that these measures are smaller than many observers had hoped.

The opaque nature of China's government spending makes it difficult to ascertain the potential for authorities to provide fiscal support. While it appears that there is scope for expansion at the central level, this could be tempered by the existing high debts of local governments.

CONCLUSIONS

When compared with other economies, it appears that the combined fiscal and monetary response in China has been more muted. This may reflect competing priorities – such as efforts to deleverage the country's high debt corporate sector while managing sufficient stimulus to minimise the damage in the labour market (and with it support domestic consumption).

However, the focus appears to be towards the supply side of the economy, whereas the lingering issue constraining growth is likely to be the demand side. Although government measures to support businesses are focused on keeping workers employed, there is no guarantee that this indirect support will be successful – reflected in anecdotal reports of large scale layoffs across the country (counter to official unemployment data).

That said, the poor tracking of unemployed workers may limit the capacity of governments to provide direct support – particularly for migrant workers who are ineligible to register for social security in cities without a household registration (hukou). There have been further calls for reform to the hukou system, which is a significant constraint to labour mobility, however it is unclear if this has popular support among Chinese authorities.

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