BARCLAYS

Economics Research
5 September 2019

China

This easing cycle is different

- Despite Premier Li's 4 September call for 'timely' use of reserve-ratio cuts, do not expect China to open up its liquidity taps in response to the current downturn. There are strong macro reasons why authorities are likely unwilling, even when faced with an escalating trade war and declining domestic activity, to undertake the large-scale easing seen in other periods of economic weakness over the last decade.
- We systematically reviewed the four most-recent economic down cycles (2008-09, 2012-13, 2015-16, 2018-19), focusing on macro policy and the ensuing economic impact. We show that the current easing cycle is visibly different, in terms of the magnitude of the stimulus, format of easing, and the implications for the economy.
- The policy consensus has, in our view, shifted to relying more on fiscal easing than monetary, and more on tax cuts than public spending. Monetary easing has largely been *reactive and targeted*, even as global central banks started cutting rates.
- The absence of aggressive easing reflects, in our view, more constrained policy space, reduced policy efficacy, as well as an intention to keep some ammunition for 2020 amid likely protracted Sino-US tension. These choices also reflect the Chinese government's focus on structural challenges, including reducing leverage, containing the housing bubble, and limiting systemic financial risks.
- The result is a further moderating of GDP growth, a rebalancing of the economy towards less investment and more consumption, and subdued credit-intensive old-economy, FAI and infrastructure investment, and commodity imports, in contrast to the sharp rebound in earlier cycles. These are trends we expect to continue in 2020. We expect the growth target to be further *lowered to ~6%* from 6-6.5% this year.

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FIGURE 1
Macro policy in the four easing cycles

	2008-09	2012-13	2015-16	2018 - 19
Monetary/credit				
*BACA (pp increase)	+18pp (Dec 08 - Nov 09)	+6.1pp (May 12 - May 13)	+4.2pp (Apr 15 - Apr 16)	+0.8pp (Nov 18 - Jul 19)
1y Benchmark lending rate cuts	216bp (Sep -Dec 08)	56bp (Jun - Jul 12)	125bp (Mar-Oct 15)	0
RRR cuts (for major banks)	200bp (Oct - Dec 08)	150bp (Dec 11 - May 12)	300bp (Feb 15 - Mar 16)	350bp (~180bp netting out MLF replacement)
Fiscal				
Budget deficit as % of GDP (pp increase)	+2.1pp	+0.4pp	+0.7pp	+0.2pp
Augmented deficit as % of GDP (pp increase)	-	+1.3pp	+3.5pp	+1pp
Tax cuts as % of GDP (pp increase)	+0.5pp	-	0	+0.8pp

Note: *BACA is short for *Barclays Alternative Credit Aggregate*, Source: Wind, Barclays Research

A different easing cycle: Less aggressive in magnitudes

Comparing the easing measures since last year to stimulus employed during the past three cycles (Figure 1; see Box 1 for details), we find the magnitude was indeed smaller. China has shifted from broad-based monetary and credit-intensive stimulus to more targeted credit easing, less blanket RRR cut (we estimate a total of ~180bp for now vs ~300bp in 2015-16), not (yet) employing benchmark interest rate cuts (Figure 2). Moreover, we show that 2019 saw a smaller increase in budget deficit as well as augmented fiscal deficit than in the past, plus a focusing on much greater taxes and fees cuts (Figure 4 to Figure 6).

Box 1. Comparison of the monetary/credit, fiscal and housing policies in the past four cycles

Monetary/credit easing: less aggressive, more targeted

- **More 'targeted' RRR cuts:** Although headline RRR cuts totalled 350bp in the current cycle, most of them were targeted and designed to serve specific purposes[1]. We estimate that, based on net liquidity injection, the 350bp was equivalent to roughly 180bp of broad-based cuts, which were somewhat greater than 2012-13 but less aggressive than both 2008-09 and 2015-16.

- **No cut in benchmark interest rates:** Compared to aggressive cuts of ~50-200bp in the past three cycles (Figure 2), the PBoC has not changed the benchmark rate since 2015.

- **Milder uplift in credit growth:** With more targeted credit easing being used to support privately owned enterprises (POEs) and SOEs, we note the acceleration of credit growth during this cycle has so far been more restrained than than previous episodes (Figure 3). Our estimated BACA growth has just climbed by 0.8pp since November 2018, a sharp contrast to jumps of 18pp in 2008-09, 6.1pp in 2012-13 and 4.2pp in 2015-16.

Fiscal stimulus: mildly expansionary; greater tax cuts, less spending

- **Smaller increase in budget deficit:** Despite the perception, the magnitude of fiscal stimulus is also more measured than in past cycles. The budget deficit as a % of GDP increased by only 0.2pp in 2019, which was much smaller than the 2.1pp in 2008-09, 0.7pp in 2015-16: and 0.4pp in 2012-13.

- **Milder rise in augmented fiscal deficit:** Alternatively, using the concept of augmented fiscal deficit to include quasi-fiscal measures, such as LGFVs, LG special bonds, policy bank bonds, Pledged Supplementary Lending (PSL), public-private partnership etc (see Box in *China: Fiscal policy: High expectations, constrained reality*, 4 January 2019), we find that while fiscal policy is again more expansionary in 2019 than in 2018, the increase of 1pp is milder than the previous cycles (3.5pp in 2015-16; 1.3pp in 2012-13).

- **Larger scale of taxes/fees cuts, but no substantial infrastructure stimulus**: Despite a smaller increase in the fiscal deficit, a noteworthy difference this time is the government's commitment to significantly lowering taxes/fees for households and corporates instead of substantially stimulating infrastructure as in the past. The government has implemented a total package of ~CNY2trn of tax and fee cuts this year, leading to a rise of 0.8pp in terms of the size of tax cut as % of GDP, greater than any of the past cycles (between 2015-16: 0pp; 2008-09: +0.5pp).

Housing policy: overall tightening, city-specific fine-tuning

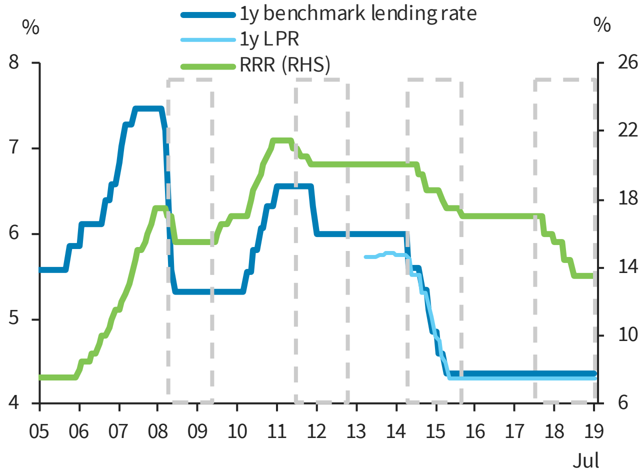
- **Some city-specific fine-tuning since late 2018:** Unlike in past easing cycles, when the government typically conducted broad-based relaxation in housing policy, including down-payment ratios and purchase restrictions, in the current cycle there has been mostly city-specific fine-tuning since late 2018, largely related to presale and mortgage rates.

- **Policy re-tightened after May:** After both land prices and home prices rose visibly since the beginning of the year.

[1] RRR cuts were either for selective banks (eg, conditional on eligibility related to SME lending) or designated for "targeted" fund use such as replacing MLF funds and supporting SME lending or debt-for-equity swap.

FIGURE 2

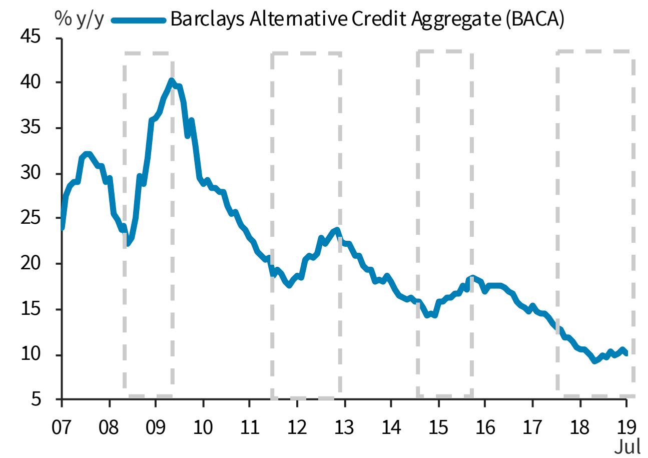
Monetary easing: RRR and benchmark interest rate



Source: Wind, Barclays Research

FIGURE 3

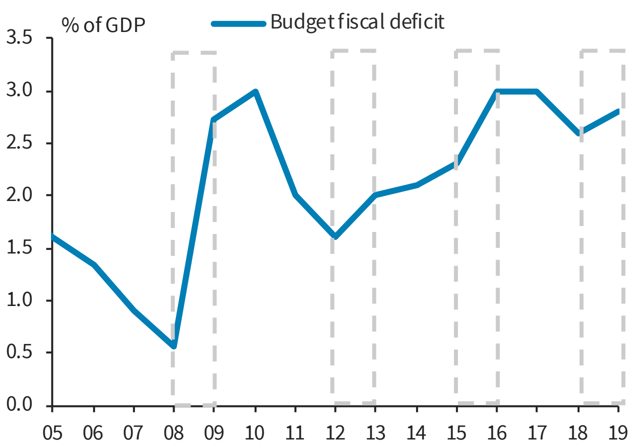
Credit easing: Barclays alternative credit aggregate



Source: Wind, Barclays Research

FIGURE 4

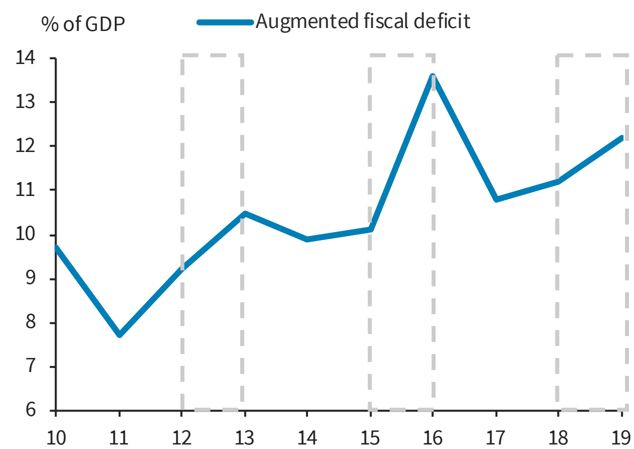
Budget fiscal deficit



Source: Wind, Barclays Research

FIGURE 5

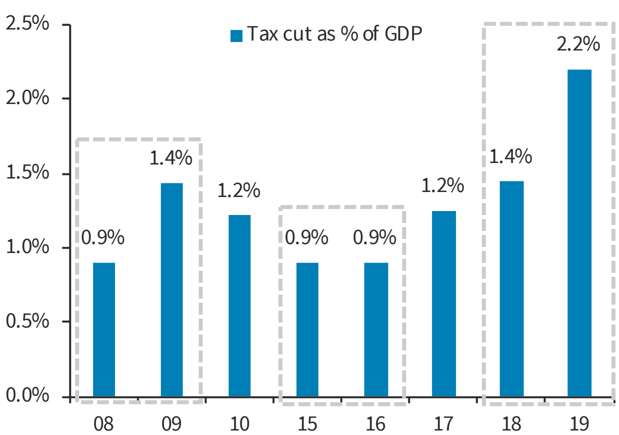
Augmented fiscal deficit



Source: Wind, IMF, Barclays Research

FIGURE 6

Tax cuts

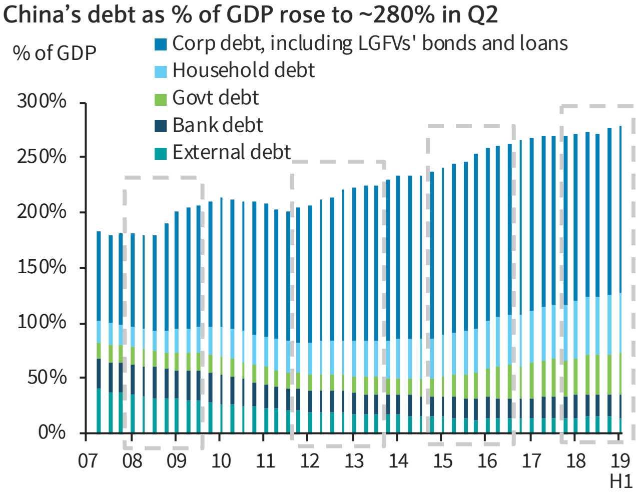


Note: No official data for 2011-2014

Source: Wind, MoF, Barclays Research

FIGURE 7

China's debt as % of GDP rose to ~280% in Q2



Source: Wind, Barclays Research

From monetary to fiscal, from spending to tax cuts

From the previous comparison, several notable differences are worth highlighting:

- A consensus of sorts has formed within policy circles to rely more on fiscal measures. And within fiscal policy, the emphasis is more shifting to tax cuts, to households and corporates; the so-called Reagan style of supply side reform.
- Within monetary policy, in stark contrast to the significant interest rate and RRR cuts of past cycles, the PBoC has avoided easing aggressively.
- Policy makers no longer view stimulating the housing market as a handy option to boost growth. This was illustrated by the July Politburo, where it was explicitly stated that the government "will not resort to housing as short-term stimulus."

Constrained policy room

We think these differences reflect more constrained policy room due to higher leverages, housing bubbles and financial risks (see *PBoC Watching: Constraints, substitutes, triggers to rate cuts*, 29 August 2019). We note China's total debt rose markedly by ~100pp in the past decade, to ~280% of GDP in Q2 19 (Figure 7). The rapid rise was particularly seen in local government (Figure 8) and household sectors, limiting the capacity to resort to big infrastructure or real estate investment. In particular, although the pace of debt accumulation has slowed in recent years amid the deleveraging campaign, Q1 19 saw a rapid pickup with debt/GDP rising by 5pp. Meanwhile, the growing housing bubble has become another major risk concern for the policy makers (see *Why did China tighten policies in Q2?*, 6 August 2019).

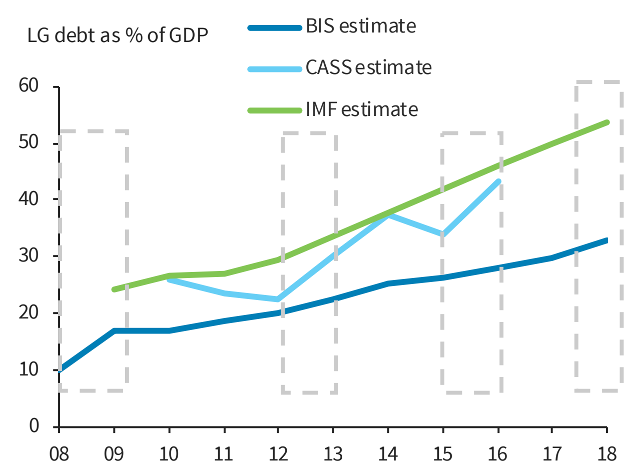
Reduced policy efficacy (hence more targeted measures are introduced)

Moreover, we think increased use of targeted measures (see Box 2) in the current cycle reflects the reduced efficacy of broad-base easing in part due to the changing behaviour of economic agents and local governments. Given local officials are subject to lifelong accountability for debt (implemented since 2017), local government incentives to embark on new projects is low at this time, in our view. Funding from LG special bonds has not been fully invested in infrastructure projects in many provinces (see *Infrastructure: watch for LG financing and behaviours*, 28 March 2019).

On monetary policy, several factors are hindering policy transmission, including: 1) lack of transmission from market rates to loan rates (Figure 9), 2) still inadequate capital for some

FIGURE 8

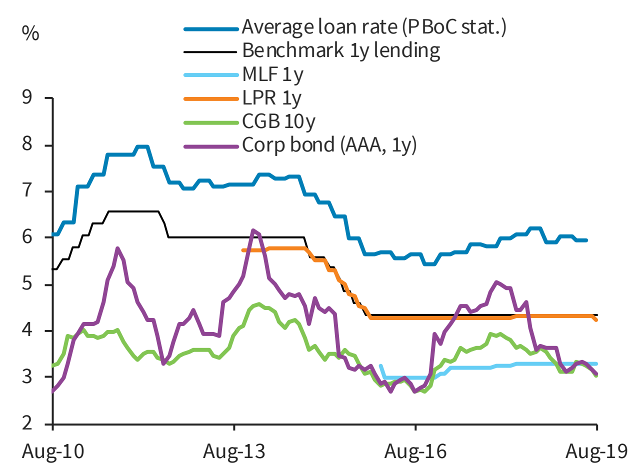
LG debt more than doubled in the past decade



Source: BIS, CASS, IMF, Barclays Research

FIGURE 9

We expect the PBoC to guide LPR lower



Source: Wind, Barclays Research

(small) banks that affect credit supply, 3) inadequate lending from large banks to small banks amid bank failure concerns, 4) unwillingness to lend to low credit borrowers. As shown in Box 2, most of the targeted credit easing rolled out by the PBoC so far has been intended to address these issues.

Given these factors, the shift from aggressive monetary easing to tax cut-type fiscal stimulus has reflected policy makers' increasing concern about the side effects of aggressive broad-based monetary easing, which has proven to be a big driver for mounting leverage, housing bubbles and financial risks in the past. Rather, the government is changing gear to rely more on tax cuts as a way to offer more direct incentives to households and corporates to boost spending, without adding to the debt pile.

Saving bullets for worse days

In addition, the smaller magnitude of easing may also reflect the thinking that shocks to the economy may last longer, and the government feels it needs to save ammunition for worse outcomes. We think China is saving more aggressive action (eg, raising LG special bonds quota in Q4, and cutting policy rates aggressively) should further downward pressure – eg from escalation of trade tension or a slowing global economy – on growth materialize.

Economic implications: lower growth, continued rebalancing

Old economy is losing momentum on less credit-intensive stimulus

Our earlier work showed that credit cycles track a series of credit-intensive "old-economy" indicators reasonably well (see *China: Another turn in the credit cycle,* 13 July 2017). In view of the much milder rebound in credit growth, it is not surprising that the Li Keqiang index (a weighted average of bank loans, electricity usage and freight turnover) – one measure for old-economy activity – has softened by 5.1pp in the current cycle (Figure 10), versus sizable surges in two of three previous cycles (2008-09: 15.9pp, 2012-13: 0.1pp, 2015-16: 5.8pp).

Investment weakened on slowing credit

One aspect of the slowing "old economy" can be reflected in the visible decline in China's fixed-asset investment as a % of GDP (Figure 11), to 65% in 2019 from 80% in 2016, when Chinese government embarked on its deleveraging campaign (see *China: The unfolding effects of deleveraging*, 9 August 2018). Policy stimulus over the past year has modestly slowed the pace of the decline but not reversed the trend.

Lack of meaningful rebound in infrastructure investment

Meanwhile, the less aggressive fiscal stimulus this time can probably be best reflected in the absence of strong rebound in infrastructure investment after a year of government efforts. The modest recovery of ~2pp to ~3pp y/y ytd in July is in a sharp contrast to the 47pp jump in 2008-09 and 28pp increase in 2012-13 (Figure 12).

Significant fall in commodity imports…

Declining commodity imports

With the so-called old economy more closely linked to commodity demand, China's commodity imports (eg, mineral and base metals, Figure 13) have also posted visible declines. This is again in contrast to previous cycles, when commodity imports generally recovered on credit-intensive stimulus, including a 160bp upswing in 2008-09.

Consumption/services is taking a greater share

Consumption and services are gaining increasing importance in the economy

With the credit-intensive "old economy" losing its momentum, we note the rebalancing of the Chinese economy towards consumption and services. Consumption is taking a greater share in GDP, reaching 54% in 2018 versus 49% in 2008 (Figure 14). It has become an increasingly important as a driver for China's GDP growth over the years, with its contribution share rising to 76% in 2018, compared with 60% in 2015, and 44% in 2008.

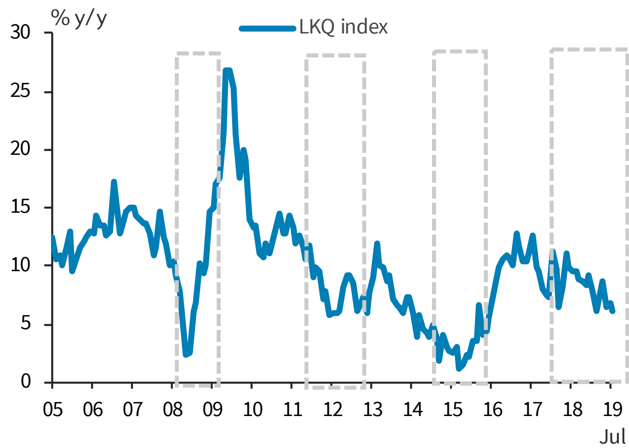
Latest data continue to support the other side of China's rebalancing story, the rising importance of the services sector. The share of services sector in GDP has risen by 9pp to 52% in 2018 from 43% in 2008 (Figure 15), which was largely driven by the real estate sector (+2pp during 2008-18), finance (+1.9pp), retail and wholesale trade (+1.2pp), and IT sectors (+1.1pp). Meanwhile, the share of services sector contribution to GDP growth also rose visibly to ~60% in 2018 from ~46% in 2008.

Tolerating lower growth

We think the government lowering its growth target to 6-6.5% this year (from about 6.5% for 2018) is indicative of its tolerance for a slower expansion, and therefore less urgency to deploy stimulus; we expect the target to be further lowered to ~6% in 2020 (see *China: Cutting GDP outlook on trade war escalation*, 6 June 2019).

FIGURE 10

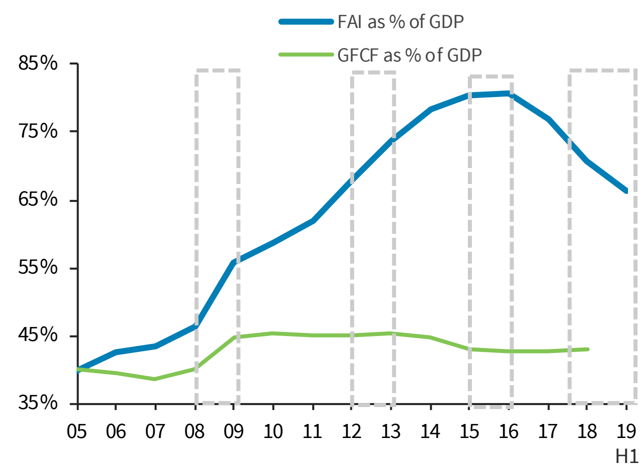
Old economy weakened further on milder stimulus…



Source: Wind, Barclays Research

FIGURE 11

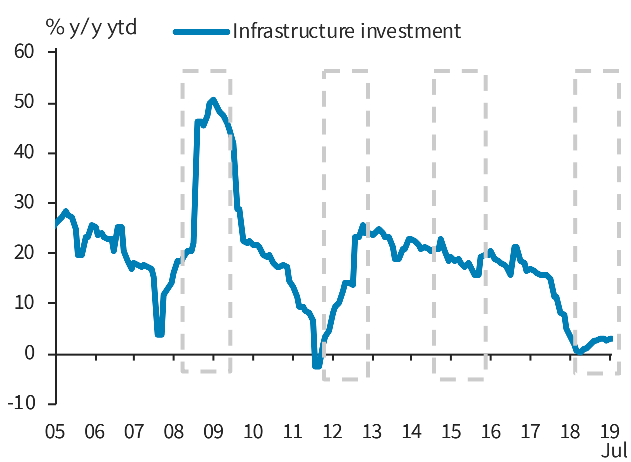
…with FAI declining visibly in recent years



Source: Wind, Barclays Research

FIGURE 12

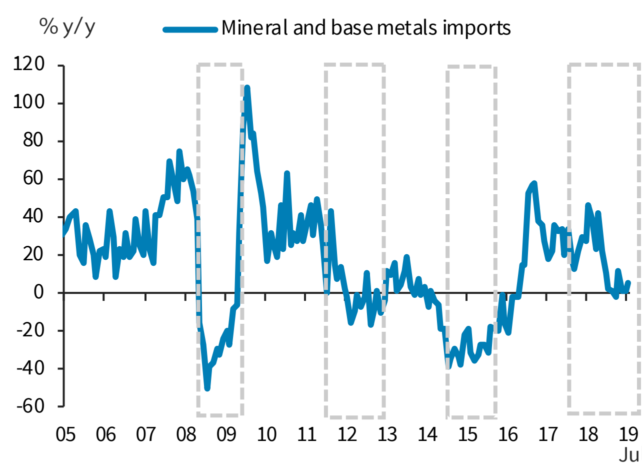
Infrastructure investment remained low single-digit growth



Source: Wind, Barclays Research

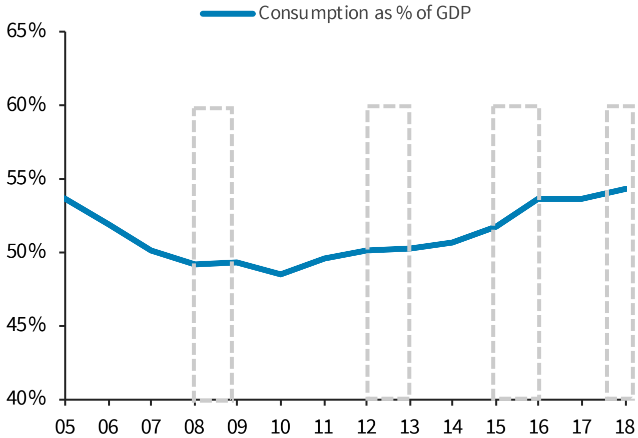
FIGURE 13

Commodity imports declined



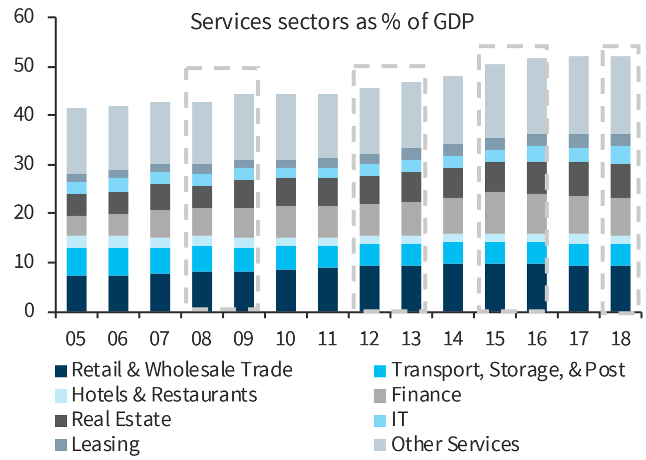
Source: Wind, Barclays Research

FIGURE 14
Consumption share (as % of GDP) is rising



Source: Wind, Barclays Research

FIGURE 15
The importance of the services sector is rising



Source: Wind, Barclays Research

Box 2. Targeted measure to improve policy efficacy this time around (Figure 16)

The PBoC rolled out a series of targeted easing measures to address inadequate policy transmission:

- First, to improve the transmission from market rates to lending rates, the PBoC announced a new market-based loan prime rate pricing mechanism on 17 August (see *China PBoC Watching: New loan prime rate (LPR) regime begins,* 19 Aug 2019). The new LPR pricing mechanism can be described as LPR = MLF rate (1y MLF is 3.3%) + adjustment factors [banks' funding costs + market supply and demand + risk premium and other parameters]. The first new 1y LPR was set slightly lower to 4.25% in August from 4.31% during Apr 2018 – Jul 2019 (Figure 9). We expect the PBoC to guide LPR lower in coming months to help lower new loan rates (see *PBoC Watching: Constraints, substitutes, triggers to rate cuts*, 29 August 2019).

- Second, to improve transmission across interbank markets amid bank failure concerns, we note the PBoC increased liquidity support to small and medium-sized banks through raising SLF and rediscount quotas in June. Meanwhile, the PBoC introduced risk-hedging tools (CRMW) to facilitate small and medium-sized bank's NCD issuances.

- Third, to address some of the constraints to credit creation, we see regulators stepping up their targeted fine-tuning measures, including easing capital restrictions (eg. introducing Central Bank Bills Swap (CBS) to facilitate perpetual bond issuance), and offering incentives to boost lending to SMEs (eg. TMLF, targeted RRR cuts).

- Fourth, to enhance banks' willingness to extending credit to low credit borrowers and the private sector, the PBoC added AA+ and AA corporate bonds to MLF eligible collateral, and has promoted the use of market-based tools, such as CRMW or debt guarantees to support bond issuance by private enterprise.

On fiscal policy, we've noted that LG's debt servicing pressures (Figure 8), a deteriorating fiscal position amid the slowing economy and falling land sales were constraining LG fiscal capacity and the delivery of expansionary fiscal policy (see *China: Fiscal policy: High expectations, constrained reality*, 4 January 2019, and *Infrastructure: watch for LG financing and behaviours*, 28 March 2019).

To ease the constraints on infrastructure investment, the government on 10 June announced measures to 1) allow LGs to use proceeds from special bonds as capital for some infrastructure projects (mainly transportation projects), and 2) encouraged banks to offer loans to projects funded by special bonds.

FIGURE 16

Targeted easing measures to improve policy efficacy

Improve monetary policy efficacy	
-Improve the transmission from money market rates to lending rates	
17-Aug-19	PBoC announced a new market-based loan prime rate (LPR) pricing mechanism. The move is designed to improve monetary policy transmission and lower funding costs for the real economy.
-Improve the transmission across interbank markets	
31-Jul-19	PBoC announced a CNY50bn increase in its re-lending quota, which supplies small and medium banks with more money for supporting SME lending and lowering funding costs.
10-Jun-19	PBoC will guarantee CNY2bn of interbank CDs issued by another troubled small bank, Bank of Jinzhou, through a financing support tool, the Credit Risk Mitigation Warrant (CRMW).
-Address the constraints to credit creation	
6-May-19	PBoC announced it would lower the reserve requirement ratio for rural banks to support SME lending, injecting c. CNY280bn of liquidity,
17-Apr-19	State Council meeting reiterated financial support for micro and small enterprises (MSEs), with the goal of increasing outstanding loans offered by the five big state-owned commercial banks to MSEs by more than 30% this year, while cutting overall financing costs for MSEs by another 100bp.
25-Jan-19	PBoC launched a dynamic evaluation of the RRR for inclusive financing, with more banks to enjoy targeted RRR cut policies. About CNY250bn net long-term capital to be injected during the assessment.
24-Jan-19	PBoC launched Central Bank Bills Swap (CBS), allowing primary dealers to swap perpetual bonds they hold for central bank bills. The move would increase the liquidity of perpetual bonds, and therefore support banks to replenish their capital. PBoC also announced that perpetual bonds issued by banks with a rating of AA or above could be taken as eligible collateral for MLF, TMLF, SLF and re-lending.
19-Dec-18	PBoC announced the creation of a “targeted” version of its Medium Term Lending Facility (TMLF), which will be used to supply liquidity to qualified large commercial banks, joint-stock banks, and large city commercial banks that meet macro-prudential requirements and have potential to increase credit supply to private and SMEs. The TMLF funds can be used for up to three years, with a rate set at 3.15% now (MLF: 3.3%)
-Enhance the banks’ willingness of extending credit to low private sector	
22-Oct-18	PBoC introduced credit risk mitigation (CRM) tools to allow investors to hedge default risks associated with private corporate bonds. PBoC provided China Bond Insurance Co. with CNY10bn to support bond sales by private firms.
1-Jun-18	PBoC expands MLF-eligible collateral to include AA+ and AA corporate bonds
Improve fiscal policy efficacy	
10-Jun-19	The MoF, PBoC, CBIRC and other regulators jointly issued measures to ease some restrictions on how local governments can fund infrastructure projects through special bonds, including 1) allowing LGs to use proceeds from special bonds as capital for some projects (mainly transportation projects), and 2) encouraging banks to offer loans to projects funded by special bonds.

Source: PBoC, MoF, Xinhua, Barclays Research

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