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Orient Capital Research
Andrew Collier
631-521-1921; 852-9530-4348
andrew@collierchina.com

China Stimulus? Even the People's Bank of China Can't Decide

Investors trying to figure out if China plans to restimulate its economy should be aware that a debate is occurring among China's top economic policy makers. The pro- and anti- stimulus camps disagree over fundamental issues of taxation, capital allocation, and whether there is a property bubble. This disagreement came to light in a series of articles published recently by two officials at the People's Bank of China (PBOC).

Xu Nuo Jin, Deputy Director of People's Bank of China's Statistics Bureau, wrote that he is clearly worried a slowdown in economic activity in the second half could be structural and would need to be counteracted. Although the CPI rose 2.3% in the first six months, the PPI tells a different story, in his view. Since March 2012, there has been 28 months of negative PPI. "Some important industry production prices have fallen by more than two-thirds," he noted. What does he recommend? "We should pay attention to economic growth, with tax cuts, interest rate cuts, other adjustments to deal with the downward economic downward, and the release of economic growth potential."

The Boss Says No

But his boss doesn't agree. Cheng Shengsong, Director of the PBOC Statistics Department, is far less bullish. He is against fueling the fires with a large scale stimulus. He may be more consensus within the PBOC, which historically has acted as a check on the spending camp in the State Council. In a post online that was flagged to me by a friend at the PBOC, Shengsong makes the following points:

• Loans are Abundant. The scale of social financing is relatively high, more than RMB 10 trillion , and RMB bank loans were 5.7 trillion yuan. This reflects "relatively abundant liquidity" in the market. However, Shengsong says 2H 2014 may see a slowdown. He refers to a pattern of lending Q/Q of 30 - 30 - 20 - 20. So if 1H loans were 5.7T, 2H will loans will be lower.

• Reasonable Liquidity. YoY growth of loans was 14.0%, compared with last year, and the (2007-2013) average for the previous seven years in the first half of the year, 0.2 and 4.6 percentage points lower. Of course, because of the need to cope with the international financial crisis, GDP will not be as high as in previous years, 9%, 10% growth. "But after taking into account these factors, we can see that in the first half of this year, liquidity is adequate, and overall still in a reasonable range."

• Real Estate Loans Growing Too Quickly. In the first half real estate loans increased to 1.54 trillion yuan, an increase of 240.2 billion yuan. At the end of June, real estate loans accounted for 20.8% of all loans. "We cannot say such a high rate of growth is small," he said. They were higher than the average loans by 5.2 percentage points. From an incremental perspective,loans to the property sector are too fast compared with 2H 2013's 26.8% growth. Thus, overall, the first half growth of real estate loans was steady and rapid.

• Need for More Stability in Property. Market expectations and the real estate market are two different things. Some people say that when prices are rising the bubble is here, but once they fall people say they could go down by as much as one-third. However, China's real estate prices cannot fall by one-third. Therefore, it's important to have expectations of stability.

Free Spenders at the Top

However, despite this conflict at the PBOC, among the senior leaders,there is a bias toward further stimulus. Liu He, Minister, Office of the Central Leading Group on Financial and Economic Affairs, which advises the Politburo on economics wrote a sharply worded analysis of the U.S Depression of 1929 and the Great Recession. He noted:

In both crises, policy makers were faced with three challenges: populism, nationalism and economic problems that were turned into political and ideological ones. Market forces continued to challenge unconvincing government policies, making the situations even worse. In response to the severe crises, the major countries involved would invariably commit the same mistakes and miss out on the best opportunities when they should take actions. In particular, a tightening policy was pursued while an expansionary policy was necessary; protectionism prevailed while the policy of opening-up and international cooperation was in need; and efforts to slash social welfare programs and boost structural reforms were impeded or even rolled back.

Controlled Stimulus? Unlikely.

In my view, the PBOC has a two track agenda: Increase official lending but restrict shadow banking to avoid fueling the property and local debt bubbles. The net result seems to be a general increase in funding. Aggregate financing was a June record of 1.97 trillion RMB, with new loans up 24% to 1.08 trillion RMB. M2 rose 14.7% compared with a 12-month median of 13.88%. However, in order to control excessive debt in the property market and among local governments, there is an attempt to target official lending. The three RRR cuts we've seen have been focused on SMEs and agriculture.

Shadow Banking Still Drives the Train

I would be surprised if 2H 14 loans were lower than 1H given the concerns about growth. Also, despite the obvious signs of stimulus (including local governments pushing projects like roads and bridges), the problem is the banks can't effectively target weak sectors like Agriculture and SMEs. Too much liquidity spills out into the property/infrastructure/Local government areas, and is not invested in the targeted sectors. The little data we have shows most shadow loans are invested in these infrastructure and property loans, many tied to local governments. When confidence weakens (which it is starting to occur as reflected in declining property prices), Shadow Banking liquidity will end, but that will make it even tougher for the PBOC to stimulate the economy as there will be less money in the system.