Orient Capital Research

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New Stimulus in China?

China Hopes "Targeted" Stimulus Will Work

China is avoiding a massive liquidity injection in the hope that smaller, target injections will prevent the economy from going into freefall. But there still remains a pitched bureaucratic battle between the PBOC and other arms of government about how deep – and controlled – the stimulus will be.

Ma Jun, a former Hong Kong investment banker who recently joined the PBOC as Chief economist, told a group in Washington October 11 another stimulus is unlikely "in the foreseeable" future, mainly because the job market "looks pretty stable. While admitting that the country's property sector is weak, he noted that other areas are picking up. "Although we worry about some downside risk like the real-estate slowing down and so on, there are also growth engines, including the service sector in general, the Internet in particular ... and healthcare is rising very rapidly." The PBOC appears to be hoping that targeted stimulus -- lower mortgage rates and higher loans to agriculture -- will keep the economy from grinding to a halt.

According to Ma, the PBOC is avoiding a massive liquidity injection because it is worried about excessive leverage among local governments and their off-balance sheet companies, known as local government financing vehicles (LGFVs).

Debate at the Top

One PBOC official told me he agrees that there is no stimulus in sight. "I think for a considerable period of time, the government can loosen (monetary) constraints, which is a good substitute for a stimulus. " But he thinks demand will be low because "commercial banks have no willingness to lend in a low interest rate environment. " Therefore, he wouldn't "exclude the possibility of lowering the key interest rate later on." Certainly, total lending (both official and unofficial) fell sharply in August, to RMB957.4 billion, from RMB1.58 trillion a year earlier. September bank loans rose slightly to RMB857.2 billion and total lending was up to RMB1.05 trillion.

But has the PBOC backed away from further injections? Some think the PBOC hasn't decided yet. One economist for the Guangzhou Government – who used to work for the PBOC -- told me he doesn't believe the PBOC is actually anti-stimulus:

"As the senior economist of financial research bureau, I don't think Mr. Ma's comment represents the official attitude of the PBOC towards a stimulus," said the economist, who works for one of the Provincial government's investment arms. "Furthermore, "No major" doesn't mean "no". The policy stance will pretty much depend on the statistics for the third quarter. If economic growth remains on the current path, the PBOC will take so called "targeted easing" measures to differentiate the policy from the past. On the other hand, I think if we are not in an extreme situation, the possibility of overall adjustment of reserve ratio or benchmark interest rate may not be very high.

The Happy Medium – "Controlled" Stimulus

The PBOC traditionally opposes relaxed monetary policy due to worries about inflation and financial bubbles.They are in opposition to the NDRC. One of the co-heads of the group in charge of economic planning is Xu Shaoshi, who is head of the NDRC, a sign of that group's rising power.

In fact, there are rumors that the NDRC is backing a coup at the PBOC, to replace the highly respected but fiscally tight PBOC head Zhou Xiaochuan with an official with a more easy attitude toward monetary policy. The NDRC has direct authority in distributing fiscal and credit resources. It controls approval power for large-scale fixed-asset investment projects as well as major public works projects requiring state funding, which is financed by bond issuance or the state banking system, according to political scientist Victor Shih. Shih also believes Yi Gang, director of China's foreign exchange, is the likely candidate to replace Zhou Xiaochuan, due to his experience linking domestic liquidity with international flows.

A New Set of Targeted Policies

Arguably, Beijing has already instituted a stimulus through a series of controlled, and targeted, policies and fiscal injections. This may reflect the power of the National Development and Reform Commission (NDRC), which tends to be pro-spend. These include:

Mortgage Rules. First, the PBOC inaugurated lower rules for mortgages. Investment banks like the Bank of China International jumped on this news, upgrading their outlook on the property sector from "Neutral" to "Overweight" on the news. "The magnitude of policy loosening is stronger than estimated. We expect such relaxation to offer solid downside support to the property market," BOCI noted.

But the property sector is facing major headwinds that such measures are unlikely to counteract. .

First, land sales have declined by more than 30% this year because developers are skittish about building inventory, a sure sign that they see the handwriting on the wall for declining market activity for some time to come. Land sales are a long leading indicator because land banks take several years to be turned into finished inventory.

Even worse, speculative buying may turn into a pro-cyclical rout if prices continue to fall. The vacancy rate in the property sector has been rising. The vacancy rate of sold residential homes in urban areas reached 22.4% in 2013, or 49 million homes, up from 20.6% in 2011, according to the Survey and Research Center for China Household Finance at the Southwestern University of Finance and Economics in Chengdu. The researchers surveyed households in 262 counties in 29 provinces. Empty flats are a bet on rising property values, which have been falling, according to even the overly optimistic data put out by Beijing, which wildly soft pedals the extent of the downturn. Even a 2013 survey by the Beijing Police discovered a vacancy rate of 28.9 percent.

If plummeting land sales are an indication, home prices will start free falling, and there will then be a pro-cyclical dumping of apartments.

Meanwhile, the frequently cited argument (by the PBOC among others) that urbanization will provide new demand for housing may be a myth. According to official statistics, About 70 million families moved to the cities between 2000 and 2010. At the same time, the net number of urban housing units rose by 70 million between 1998 and 2013. This all sounds positive for GDP growth. However, some mainland academics believe the statistics are misleading. Li Gan, a professor at Southwestern University in Chengdu, says most of the supposed growth comes mainly from reclassification of rural land to urban. He believes annual housing supply is still 1.6 times demand.

"Targeted" Stimulus through the China Development Bank

The PBOC is also using "behind-closed-doors" stimulus through backchannels. The PBOC, with the backing of the Ministry of Finance, has given the China Development Bank 1 trillion RMB ($600 billion) to build low-income housing. The money is filtering through the state banks. The PBOC is channeling the funds via a new monetary tool called "Pledged Supplementary Lending." Beijing has pledged to redevelop 4.7 million homes this year and has already spent 1 trillion yuan this year, according to the Ministry of Housing and Urban-Rural Development. One source told the Caixin news magazine the central bank offered the funds to CBD for a three-year period with an interest rate less than 6 percent.

One PBOC official likens this to the U.K.'s "Funding for Lending Scheme" or the European Community's TLTRO long-term refinancing operations. But those are liquidity injections to banks that then decide how to lend. In this case, the Chinese government is engaging in directed lending.

How consequential will these loans be? Fixed asset investment rose 16.5 percent 9M 2014 to RMB30.6 trillion. An injection of RMB1 trillion over – say six months – would only add less than 4 percent to FAI for the year. And given the lackluster demand in the property market, it's likely to contribute to the excess housing stock and may be frittered away through "free" allocations to local officials.

One last note on the idea of a controlled stimulus. Beijing just announced a cutback on bond sales to local governments off-balance sheet companies (the famous local government financing vehicles.) This looks like a liquidity crackdown. However, the new document on this ruling says that joint ventures between government and "private' investors can borrow without restrictions. Since when is a JV not an LGFV? Apparently it isn't. That's a big loophole. This is typical of many of China's economic policies. A crackdown on lending -- filled with loopholes.