China’s Misunderstood QE

I read with dismay a post in the financial blog Zerohedge recently that states "while monetary stimulus is now firmly on the backburner, not even fiscal policy will match the massive stimulus dumps seen in previous years.” In other words, the writer argues that hopes for a massive Quantitative Easing are vain and future fiscal policy won’t be enough to stimulate the economy.

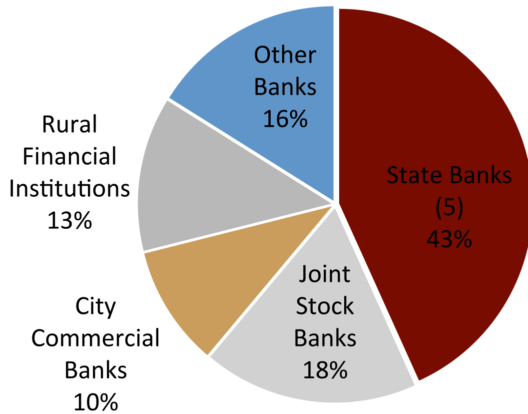
While I agree that monetary policy won't save China’s economy, I would argue with the author’s understanding of how monetary and fiscal policy work in China. Western analysts tend to use western economic categories for an economy that functions differently from the west. Much of what appears to be monetary stimulus in China is actually fiscal stimulus -- and ineffective stimulus, at that. This has significant impact on how we view China's growth.

In a so-called monetary stimulus, what happens to funds made available in the banking system when the PBOC cuts interest rates or the Reserve Rate Requirement? Does it really go to productive uses? Is it similar to a monetary stimulus in the U.S.?

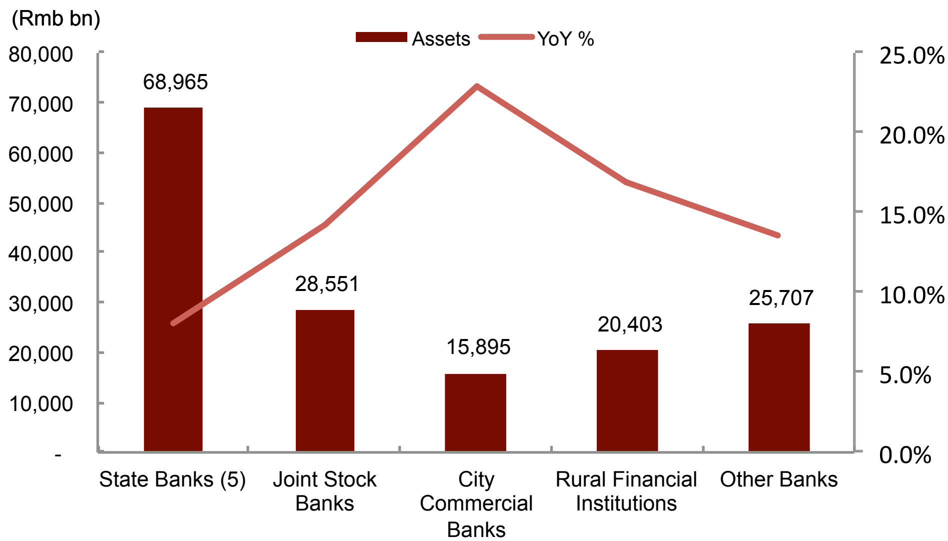
To answer this question we have to take a close look at China's banks. As Charles Calomiris and Stephen Haber say in their history of banks, Fragile by Design, “A country does not choose its banking system: rather it gets a banking system consistent with the institutions that govern its distribution of political power.” And in China, that power flows very differently to the different banks depending on their place in the power structure.

The China Banking Regulatory Commission analyzes China's banks according to five different categories: The policy banks; the four state banks; the joint-stock or commercial banks; the rural banks; and others, which would include small cooperatives. All operate according to different political calculations.

Nearly half of formal assets (not including Shadow credit) flows through the five state banks. The remaining market share is more or less divided between the other groups, with the largest held by commercial “joint-stock” banks, at 18%.



Where has the growth in assets come? The CBRC posts data for Q1 2014 which I am using here. The biggest jump in assets came from the City Commercial Banks, up 22.8%, followed by the Rural banks, at 16.4%.



Let's turn to lending; where does the money go? The Big Four state banks account for 43% of all loans. They are publicly traded and have published

accounts. Theoretically, they lend according to profitability -- but anecdotally this is not true; they tend to favor state firms. They do not provide data for the allocation of their loan book according to state or private ownership. However, the CBRC does provide overall lending data.

Approximately one-third of all bank loans -- 32% in 2012 -- go to state firms. The private sector accounted for another 36%, while the remainder went to collective firms (9%), and overseas borrowers (7%). There is some dispute about what constitutes a "state" versus a "private" firm in China, since there is a great deal of mixed ownership. But we are looking at rough calculations to prove a point so the official data should suffice. By this calculation, at least half of the money flowing through the banking system ends up in the hands of the state firms. And what do they do with those funds?

We can look at the profitability of the borrowers. According to data from the National Bureau of Statistics assembled by Nicholas Lardy of the Peterson Institute, state firms' return on assets reached a peak in 2006 of around 6%, just matching the average one-year bank lending rate. Since then it has declined fairly steadily, by 2012 dropping below 5% -- less than the average bank lending rate of over 6%. The private sector, however, has been doing much better. Return on assets in 2012 was close to 14% -- more than double the average loan rate. So while the private sector was highly profitable, the state sector hasn't been able to generate sufficient profits to pay their cost of capital.

Of course, we can speak more generally (as there is little data) about lending patterns among the other four bank categories. Policy banks obviously lend according to policy. About half of the bank's new loans of 724 billion RMB went to infrastructure. But even here we have seen a fairly frantic effort by the State Council and the Ministry of Finance to push the China Development Bank to invest in the property market -- in a clear attempt to support GDP growth.

On the Commercial Banks, Citic Bank, for example, lent 17% of its loans to finance property development, another 28% to other corporates, and a not

insignificant 24% to multinationals. It clearly didn't shrink from lending into the property bubble.

Data from the rural and cooperative banks is nearly non-existent but we can assume most of these loans were either for infrastructure or for local government projects, the infamous Local Government Financing Vehicles (LGFVs). Few of these projects are likely to be an efficient use of capital.

Of course, this analysis using official data completely ignores shadow loans outside of the formal banking system. These loans, which grew steadily up until the end of 2014, provide an alternate source of credit to the economy with differing returns. Instead of aggregate data, let's look at one institution - The Agricultural Bank of China. In 2014, the bank's "Interest in Trust Products" rose 45% to 248 billion RMB. Trust products are funds collected from individuals and corporates that are invested in specific projects. The bank takes a fee for arranging these loans but doesn't keep them on balance sheet. Apart from Trusts, the Agricultural Bank raised 672 billion RMB in Wealth Management Products, an increase of 63% from 2013. These are similar to Trusts, but solely from individuals. The bank charged 0.75 percent, making a tidy 5 billion RMB profit on these WMPs.

Can we consider an expansion of credit by the PBOC (either through interest rate cuts or lowering the reserve rate requirement) that flows through the Ag Bank into WMPs and Trusts as a form of monetary stimulus? Yes. In addition, we could argue that Shadow Banking loans are a more efficient use of capital than quasi-policy lending through the banks. Why? Because Shadow Banking has no interest rate caps, or intervention by the state, that would dictate the use of capital. However, Shadow Banking does suffer from other unusual forces caused by the dual-track nature of China's economy. These include: 1) The higher risk due to lack of regulatory or bank oversight; 2) The use of most of this capital for short-term loans for high returns; 3) The excessive investment in China's property bubble (related to point number 1).

There have been rumors that the recent interest rate cuts have resulted in more than $1 trillion flowing into the stock market. This reinforces the point that so-called monetary stimulus in China frequently results in a misuse of capital through the banking system -- not through low return loans to state companies but through loans to corporates (state or private) that are quickly transferred to other "get rich quick" sectors such as the equity markets and the property bubble.

What is the point of arguing that there is no "real" monetary stimulus in China?

1) The loose comments about a new Quantitative Easing causing the Chinese economy to regain high growth are a classic example of western analysts and investors imposing a western view on the Chinese economy, ignoring fundamental institutional differences.

2) Any stimulus through the banking system (that is called monetary stimulus or other) is going to have a de minimis impact on GDP growth due to rampant mispricing and misuse of capital.

3) Institutions matter in China. Making predictions by relying on macroeconomic data ignores the impact that institutions have on the fundamentals of the economy.