



Why China is not reflating – a special type of Balance Sheet Recession.

By John Greenwood

Overview

- Just over two years ago, I wrote an article entitled “China faces its Minsky moment” (available on request). Since then, even ignoring the effects of the Covid pandemic, China’s economic growth has tumbled, and deflation has returned. Standard monetary and fiscal policy measures have failed to revive the economy. Allowing the exchange rate to weaken has also failed.
- The reason is that China is in a **balance sheet recession** – primarily in the property market. But it has not been diagnosed or treated correctly yet. This is why standard prescriptions are failing.
- Unlike other balance sheet recessions which arose from real estate but then contaminated the financial sector – as in the case of the S&L crisis of 1988-92 in the US, or the banking crisis in Japan in the 1990s, or the GFC in the US and elsewhere in 2008-09 – this crisis is concentrated in China’s property sector. The official banking sector in China has been largely insulated.
- The issue is that property developers in China are not simply builders who sell property units after completion. The developers have a special characteristic: they are both real estate developers and quasi-banks. They build and market apartment blocks and homes (and commercial buildings), but they also accept deposits equal to the final sale price from buyers, far ahead of completion.
- The problem is that the developers have spent these “deposits” on more and more new projects, raising additional amounts of money in the form of bond issues at home and abroad, and some are now so stretched that they cannot repay either the interest or the principal due on the bonds and nor can they complete the apartments or houses that they undertook to build.

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*The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor. A pioneer of monetary research in Asia, John was also the publisher, editor and lead author of **Asian Monetary Monitor**, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. From 1999 to 2021 he was Chief Economist at Invesco, based in London.*

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Introduction

Hyman Minsky's framework for financial crises proposed that they invariably arose from excess accumulation of debt. His taxonomy classified the progression from normality to excess debt in the economy as having three phases impacting cash flow:

- **The hedge phase** in which the cash flow from a firm's operating activities would be larger than the cash needed for its scheduled debt-servicing payments.
- **The second, or speculative, phase** occurred when the cash flow from the firm's operating activities would be large enough to enable the firm to pay the interest on its debt on a timely basis; however, the firm would need to borrow the amount necessary to get the cash to pay some or all of the principal due on the maturing loans.
- **The third, or Ponzi phase**, occurred when the cash flow from the firm's operating activities would not be large enough to pay all of the interest due on debt on a timely basis. Firms experiencing this degree of stress would need to borrow or obtain fresh inflows to pay some or all of the interest or they would need a capital gain on some of their assets to get the cash to pay the interest. If they could not, this would lead ultimately to foreclosure and bankruptcy.¹

Applied to Chinese real estate developers, the current squeeze on cash flows suggests that these companies have reached somewhere between the second and third phases: some companies are hoping to survive, but some have already borrowed so much that they will default and go bankrupt.

By and large the Chinese authorities have treated the crisis in the real estate sector as a normal economic slowdown, and have therefore, though with some exceptions, implemented standard stimulatory programmes. Section 1 will document some of the orthodox policies that have been implemented over the past two years to revive the Chinese economy: on the monetary policy front, on the fiscal policy front, and by allowing some exchange rate depreciation. Section 2 will explain why, using the framework of balance sheet recessions, the standard cures cannot be expected to work, and what needs to be done instead.

Section 1. Conventional Stimulus Policies are Failing.

On the monetary policy front what really matters is the rate of growth of broad money, but as I shall show, China has not wholly adopted this philosophy. The authorities, having gradually brought down the rate of M2 growth over the past decade or so, have, if anything, become too restrictive and the result has been periodic episodes of deflation. Also, the authorities have drifted towards the standard, western, Keynesian textbook-style approach to monetary policy. As a result, there have been a series of measures in the past three years that have not

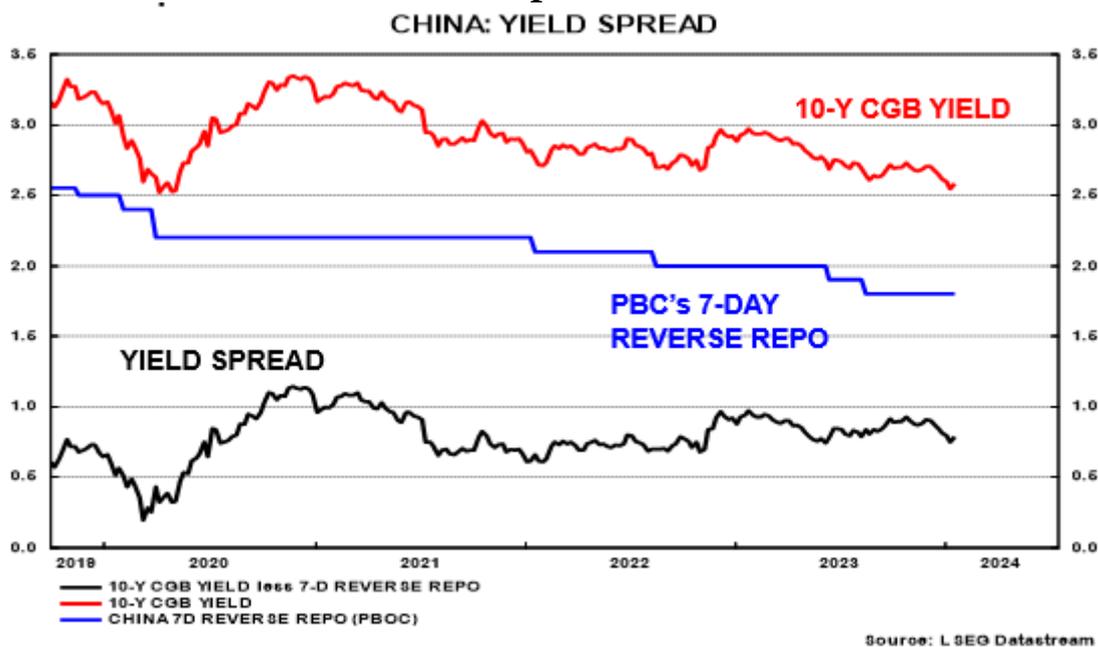
¹ From "Manias, Panics and Crashes" by Charles Kindleberger and Robert Aliber, 7th Edition, pp.41-42.

really achieved anything other than what one might expect from orthodox prescriptions.

In what follows I will outline the main recent measures before returning to discuss monetary growth and its appropriate or optimal growth rate for a 3% inflation target.

The first instrument that the Chinese authorities have used is interest rates, which they have cut on four occasions since December 2021, the most recent cut being in August 2023 from 1.9% to 1.8%. Last week, despite widespread expectations of a further cut, the People’s Bank of China (PBC) chose not to cut rates – probably out of concern about the exchange rate. Figure 1 shows the four cuts in the PBC’s 7-day reverse repo rate, its key short-term lending rate. As 10-year Chinese government bond (CGB) yields declined by approximately the same amount, the yield spread remained stable around 0.75%. Normally, cuts in interest rates would be expected to lead to faster bank lending growth and alongside that, faster broad money growth. But this has not really happened.

Figure 1. Despite rate cuts, the yield curve has not become significantly more positive.



The yield curve, which does not count as a separate “instrument” because the authorities cannot control the long end of the curve, is illustrated in Figure 1 by the yield spread between the 10-year CGB yield and the PBC’s 7-day reverse repo rate. It has not become significantly more positive despite the rate cuts of the past two years. It would therefore appear as though rate cuts and making the yield curve more positive have reached their limits.

The second instrument that the authorities have deployed – changes in the reserve requirement ratio (RRR) – is shown in Figure 2. There have been numerous cuts starting from March 2018 (pre-Covid), differing in scale among the three classes of banks, and continuing through the Covid period. Again, such persistent reductions would normally be expected to provide a positive boost to bank lending and hence to

broad money growth. But this has not turned out as expected. Bank lending growth – and bank credit growth more broadly – have both been gradually slowing from about 13% year-on-year in the early stages of Covid to about 11% today.

Figure 2. The Reserve Requirement Ratios have been declining since 2011, but more rapidly since 2018

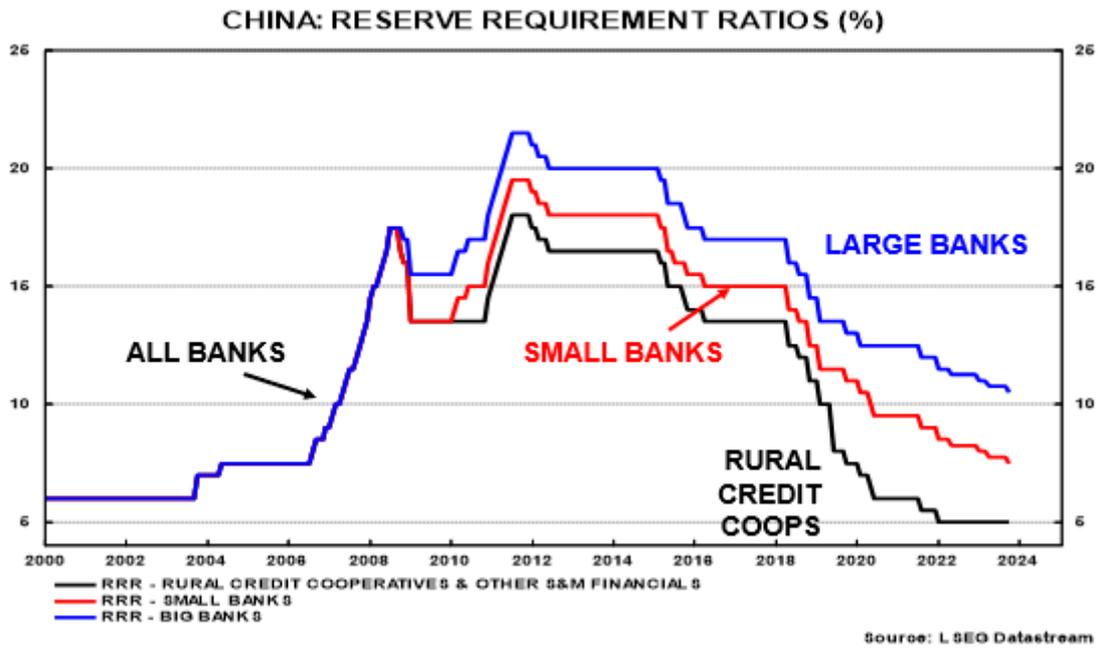
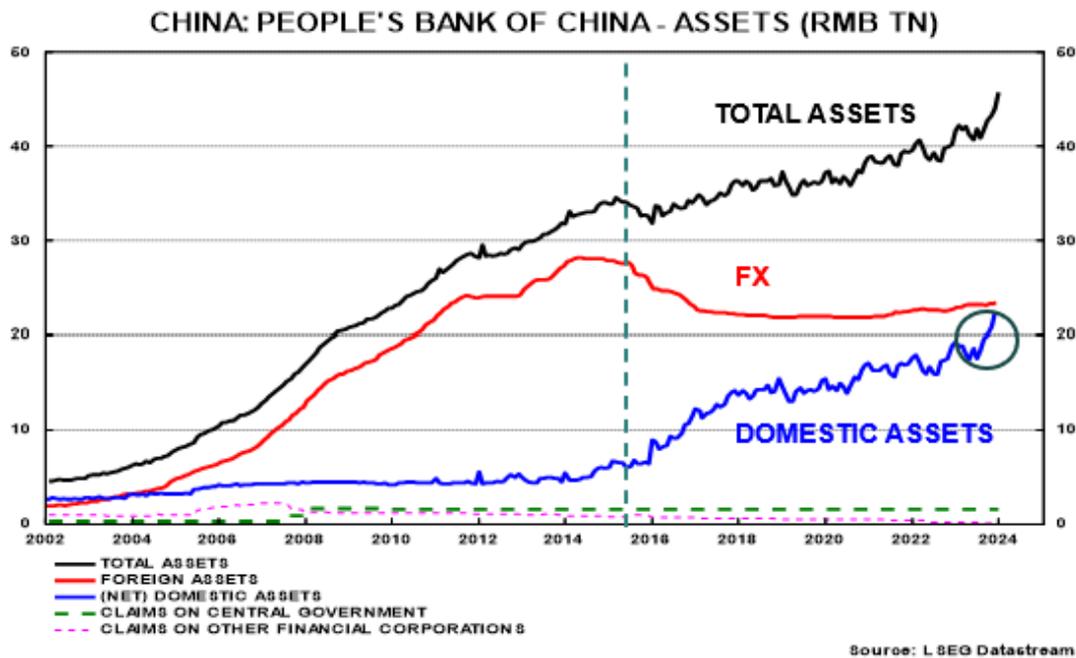


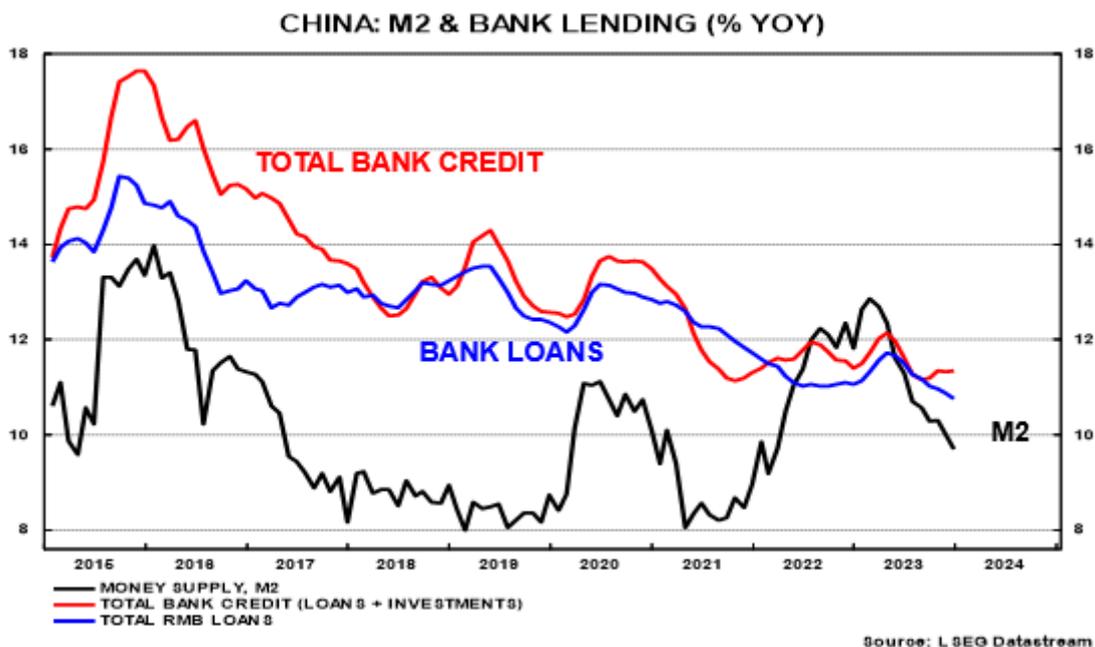
Figure 3. The People’s Bank of China is expanding its balance sheet.



A third “instrument” has been the expansion of the PBC’s balance sheet, although this has been much more recent – since August/September 2023 (circled in Figure 3). The abrupt expansion has been based on an increase in domestic assets which in turn is comprised mainly of lending to banks – “claims on other depository corporations” in the jargon of the reporting statistics. These have risen from a level of CNY 14.7 trillion in August to CNY 18.6 trillion in December, or by over 26% in four months. These loans to banks probably derive from the MLF, or Medium-term Lending Facility. The amounts of each new “facility” are periodically announced by the PBC, but as they do not announce the redemptions, it is not possible to track the outstanding volume. If this is the start of a new strategy, it could be significant, but it would need to carry through to the broad money supply (M2), or money in the hands of the public.

Turning to broad money itself, M2 initially accelerated from 8.1% (year-on-year) in April 2021 to 12.9% by February 2023 – a period of two years – but since then it has gradually decelerated with the latest figure being 9.7% in December 2023 (Figure 4). The common assumption about this pattern of money growth would be that the initial 2-year upturn in broad money growth ought, in normal circumstances, to have boosted growth and inflation 6-18 months later, but that has not happened. The widespread expectations of a surge in growth as China emerged from its draconian zero-Covid lockdowns and containment policies have been dashed.

Figure 4. The economy has not responded to two years of monetary acceleration.



But are the common assumptions valid? To obtain the answer requires calculating the appropriate, or optimal, broad money growth rate for a given, target inflation rate from the rate of change form of the equation of exchange:

$$\Delta M2 = - \Delta V + \Delta y + \Delta P$$

where ΔV is the expected annual change in income velocity, Δy is potential real GDP growth, and ΔP is the inflation target (3% for China). Using approximate current values for China we have:

$$\Delta M2 = -(-3) + 5 + 3 = 11\% \text{ p.a.}$$

This suggests that M2 growth rates since 2017 (in Figure 3) have been too low, and that even the acceleration of M2 to 12% p.a. could only just qualify as “stimulatory”. In short, despite all the rate changes, all the RRR changes, and the new PBC lending programs, money growth has barely been adequate.

On the fiscal front, China has made numerous announcements and implemented several spending programs, the most recent being the measures taken in October 2023. An extra CNY 1 trillion (USD 137 billion) bond issue was announced, lifting the budget deficit from 3.0% of GDP to 3.8%.

The targeted areas for spending were “civil infrastructure and reconstruction” which included spending for protection against natural disasters, expansion of social housing, and the renovation of decaying urban areas. In addition, there was to be some front-loading of some of 2024’s local government bond issues. Compensating for some of the downturn in private construction, these were all public sector projects. Broker estimates at the time suggested that these plans could lift real GDP in 2024 by 0.4-0.8%. It is too early to come to a judgement on the success or otherwise of these fiscal initiatives, but there are few signs so far that the programs will be transformative.

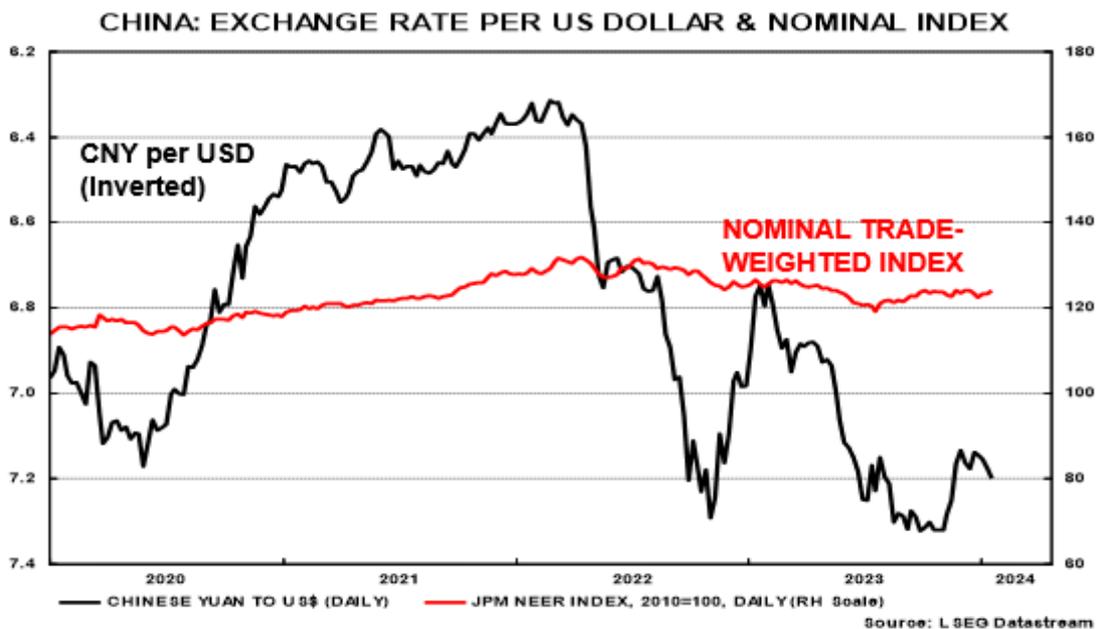
More generally, fiscal expansion – that is, increased government spending leading to a larger budget deficit or a smaller budget surplus -- does not increase overall spending in the economy (and therefore is not “stimulatory”) *unless it is accompanied by an acceleration of monetary growth*. To see this, all that is necessary is to appreciate that a deficit can only be financed in three ways: by taxation, by borrowing, or by the printing of money. Taxation merely transfers funds from the private sector to the public sector, implying no net stimulus. Similarly, borrowing absorbs funds that would otherwise have been available to lend to the private sector, implying that private sector borrowers will be crowded out by such public sector financing. Finally, if the quantity of money is increased (either through the banking system or through the central bank) to fund, directly or indirectly, a government program of spending, then this is a monetary policy measure, not a purely fiscal measure.

In short, when it comes to boosting the nominal GDP or total spending in the economy, monetary policy dominates. Fiscal policy is largely a matter of shifting the share of total spending or spending in particular sectors from the private sector to the government sector or vice-versa. It follows that fiscal spending alone should not be expected to revive China’s nominal GDP growth rate.

On the exchange rate front the CNY remained firm against the USD during the first two years of Covid (2020-21), but since March 2022 it has been allowed to depreciate from 6.40 to almost 7.35, or nearly 15% (see Figure 5). Measured on a trade-weighted basis against its main trading partners the depreciation has been negligible. Since on

a 3-month moving average basis China's exports peaked in USD terms in mid- to late 2022 and have not yet recovered that level, it would be hard to argue that the exchange rate depreciation against the USD had made a solid contribution to boosting export-led growth – at least so far.

Figure 5. CNY depreciation versus USD has not boosted exports.



In summary, neither monetary policy tools (in the shape of interest rate cuts, lowering of the RRR, CBC balance sheet expansion, or M2 growth), nor fiscal stimulus (in the shape of the CNY 1 trillion announced in October), nor exchange rate depreciation have been sufficient to boost the short-term performance of the Chinese economy.

Section 2. The Source of the Problem.

So what is it that is going wrong? Why has China seemingly hit a roadblock which is preventing a full-scale recovery?

The reason is that the crisis – which is primarily in the property market – has not been diagnosed or treated correctly yet. This is why standard prescriptions – monetary, fiscal, or exchange rate solutions – are failing.

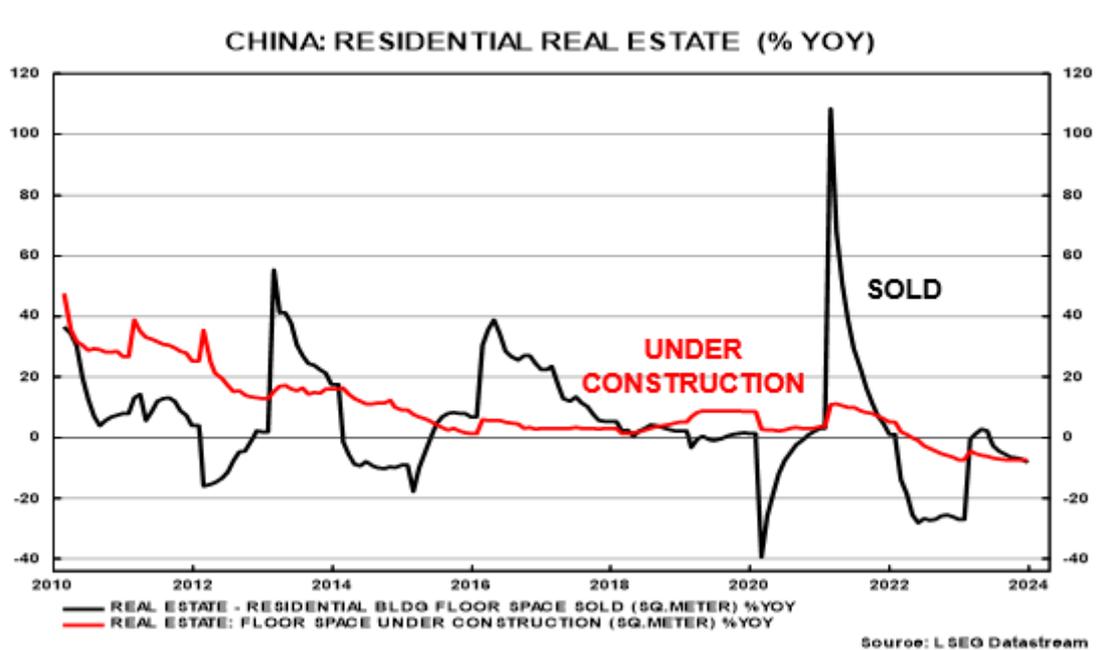
First and foremost, this is essentially a balance sheet recession which means that stimulative measures should not be expected to become effective until balance sheets in the property sector have been repaired. However, unlike other balance sheet recessions that were concentrated in the financial sector – as in the case of the American S&L crisis of the late 1980s until the early 1990s, or the banking crisis in Japan in the 1990s, or the GFC in the US and elsewhere in 2008-09 – China's crisis is concentrated in the property sector. The official banking sector has been largely insulated.

The issue is that property developers in China are not simply builders who sell property units after completion. **They have a special characteristic: they are both real estate developers and quasi-banks.** They build and market apartment blocks and homes (and commercial buildings), but they also accept deposits equal to the final sale price from buyers, far ahead of full completion.

The problem is that the developers have spent these “deposits” on more and more new projects, raising additional amounts of money in the form of bond issues at home and abroad, and they are now so stretched that they cannot either repay the interest or principal due on the bonds and nor can they complete the apartments or houses that they undertook to build.

Meantime the consumers or would-be householders who previously were willing to place deposits (pre-payments) at the developers in anticipation of completion in a year or two – like a 2-year time deposit – have lost confidence and have disappeared. With no more funds flowing in, the developers do not have the funds to complete the promised apartments.

Figure 6. Residential property construction and sales have both slumped.



Section 3. Conclusion.

The result is that pre-sales have collapsed, and large parts of the property market are now frozen: buyers have evaporated, builders cannot build, and the developers cannot fulfil their obligations to deliver completed apartments or to repay bondholders.

The solution is to embark on a wholesale restructuring with the government authorities temporarily creating some entity similar to the Resolution Trust



Corporation (RTC) to take on or guarantee a substantial part of the troubled liabilities of the developers, just as governments have done in the case of banks in other (western) financial crises. The aim must be to clear – or at least restore confidence in – the bulk of existing liabilities of developers over several years and then to reform the property development market so that the financing of property development is largely separated from the construction and sale of buildings.

Because the property sector in China is so large (20-30% of the economy by some estimates), until some radical solutions along these lines are proposed and implemented, it is hard to see China recovering its full growth potential.

Summary and Investment Conclusions

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- The solution is to embark on a wholesale restructuring with the government authorities temporarily taking on or guaranteeing a substantial part of the troubled liabilities of the developers, just as governments have done in other (western) financial crises. The aim must be to clear the bulk of existing liabilities over several years and then to reform the property development market so that the financing of property is largely separated from the building of it.
- Because the property sector in China is so large (20-30% of the economy by some estimates), until some radical solutions along these lines are proposed and implemented, it is hard to see China recovering its full growth potential.
- The investment conclusions are clear but limited. Economic growth will be held back by the continuing troubles of the real estate sector, affecting sales and profits in the sector for several years ahead. As potential homebuyers hold back from purchases and from all the associated expenditures on household goods, other sectors will inevitably be affected. The problem for the financial markets as a whole is that confidence has been undermined and will likely not recover until a broad-based solution is implemented and well under way.

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