

China's Stimulus Package

By John Greenwood

Overview

- After much seeming procrastination the Chinese authorities – principally the People's Bank of China (PBOC) and the China Securities Regulatory Commission (CSRC) under the State Council, China's cabinet – have at last rolled out a series of stimulative measures to boost financial markets and economic growth.
- They did not tackle the property market crisis head-on, but several of the measures they announced will address problems in that sector indirectly.
- The main measures comprise a set of small rate cuts (0.2 to 0.3 percentage points), a reduction in the reserve requirement ratio (RRR) for the banks, guidance to banks to cut mortgage lending rates, reduced downpayments for second home buyers, guidance from the CSRC to encourage medium and long-term funds to enter the stock market, and measures to promote mergers, acquisitions and reorganizations.
- In addition, the People's Bank of China introduced two new lending schemes to boost the capital market.
- The question is, will these measures work to lift the gloom that has pervaded Chinese financial markets, and in turn spark a period of higher activity in the economy? If they do not do so, China risks undershooting its real GDP growth target of about 5% in 2024.
- To assess the planned stimulus, it is interesting and helpful to compare the September 2024 measures with those taken in November 2008 in the teeth of the Global Financial Crisis (GFC).
- The earlier programme was highly successful in engineering a doubling of the stock market, an upturn in property prices, and an economic recovery. But it also brought inflation.
- How does the September 2024 stimulus plan stack up against the 2008-09 template?
- This Newsletter explains the key points of the new stimulus plan and makes a detailed comparison with the 2008-09 plan to assess whether the current programme will succeed.

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Introduction:

After procrastinating since last October and a miniscule rate cut in July, the Chinese monetary, fiscal and securities authorities finally acted in concert last Tuesday, September 24th with a broad package to stimulate financial markets and the economy. They unveiled a stimulus package that comprised rate cuts, a RRR cut, guidance to banks to cut mortgage lending rates, reduced downpayments for second home buyers, guidance for medium and long-term funds to enter the stock market, and measures to promote mergers, acquisitions and reorganizations. In addition, the People's Bank of China introduced two new programmes to boost the capital market.

This is the first comprehensive programme of its kind since the RMB 4 trillion fiscal stimulus (equivalent to 6% of GDP at the time) launched in November 2008 in the teeth of the Global Financial Crisis (GFC) to boost activity and recovery in China. The success of that package has given investors the optimism to hope for a similar outcome from the current plans.

But is the package comparable to the 2008-09 plan, and is it enough?

This report starts with a full outline of the latest package (Section 1), followed by a comparison between the 2008-09 programme and the newly announced package (Section 2). We will conclude with an assessment of the implications for the plan (Section 3), and its likely impact on the various stages of the transmission mechanism: on asset prices, on economic activity, and on inflation.

Section 1. Components of the September 24 Stimulus Package

The Chinese stimulus package consisted of seven main elements:

1. REDUCTION IN CENTRAL BANK LENDING RATES

On Tuesday, September 24 the PBOC, China's central bank, announced that it would cut the seven-day reverse repo rate by 0.2 percentage points from 1.7% to 1.5%. Governor Pan Gongsheng expected the measure would effectively lower the medium-term lending facility (MLF) rate by about 0.3 percentage points, and the loan prime rate (LPR) and deposit rates lower by 0.2-0.25 percentage point. He did not specify when the moves would come into effect. The next day, on Wednesday, September 25, the People's Bank of China (PBOC) notified the market of a cut in its one-year medium-term lending facility (MLF) for loans to some financial institutions from 2.30% to 2.00%.

2. REDUCTION OF THE BANKS' RESERVE REQUIREMENT RATIO (RRR)

A cut of one half of one percentage point to the RRR is expected to provide liquidity of about 1 trillion yuan (about US\$142 billion) to the market, according to Pan.

3. REDUCTION IN EXISTING MORTGAGE RATES

China's central bank announced that it would guide commercial banks to reduce the interest rates on existing mortgages by 0.5 percentage point on average, in order to provide some relief to households. In terms of scale, 0.5% cuts in the existing mortgage rates will reduce household repayment obligations by an estimated 150 billion yuan annually. However, this amounts to the equivalent to only 0.12% of annual economic output, and some of it may be saved for early mortgage repayments.

4. LOWER DOWN-PAYMENT REQUIREMENT ON SECOND HOMES

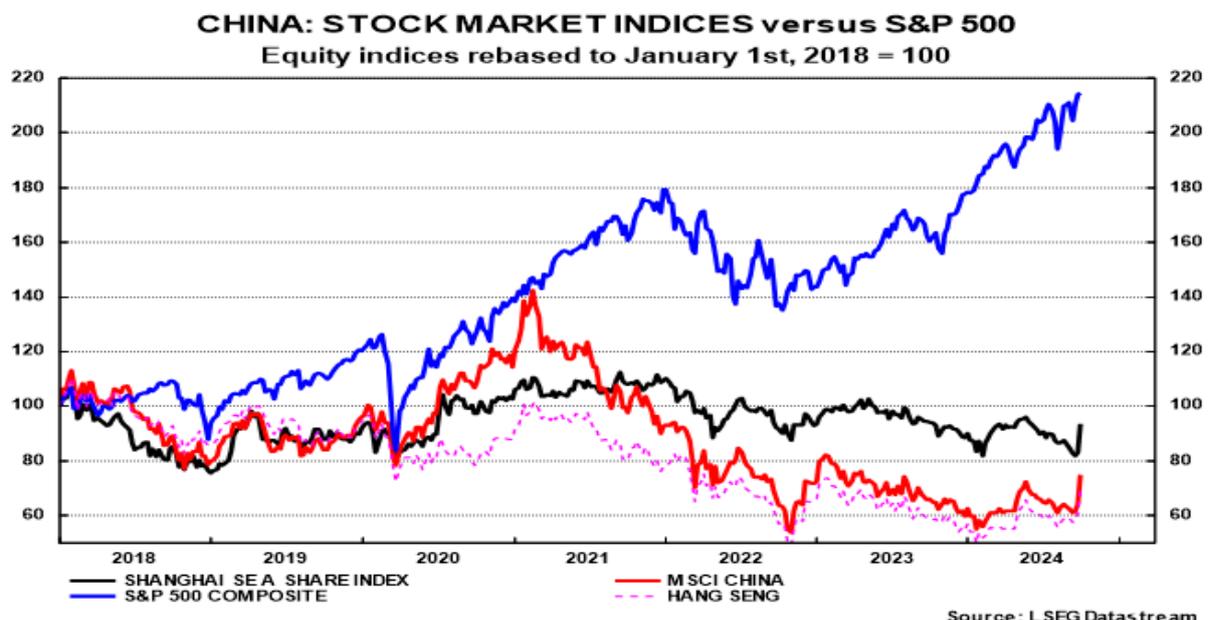
The authorities will lower the minimum down-payment ratio to 15% for second-home buyers national-wide, from the current 25%. This follows a similar move for first-home purchases in May. Both rates are now set at 15%.

5. REVIVING THE STOCK MARKET

China's securities regulator (the CSRC) announced that he would issue guidance for medium and long-term funds to enter the equity market, along with additional measures to promote mergers, acquisitions and reorganizations. The CSRC planned to support China's state fund Central Huijin Investment with stock purchases and expanding the scope of its investments.

The PBOC also introduced two new funding devices to boost the capital market. The first – a swap programme with an initial size of 500 billion yuan (US\$70.9 bn) – allowing mutual funds, insurers and brokers easier access to funding to buy equity stocks. Inevitably, being a swap programme, this can only provide short-term assistance at best. The second provides up to 300 billion yuan (US\$42.5 bn) in cheap PBOC loans to commercial banks to help them purchase listed companies' shares and fund buybacks. Whether banks will wish to finance equity acquisitions with leverage provided by the central bank must be open to doubt.

Figure 1. Chinese Equities Trailing US Equities since 2018



6. FISCAL POLICY

There will be an issue of CNY 1 trillion (\$142 bn) of special bonds to fund (a) child benefits – CNY 800 per child for families with two or more children but not including the first child, and (b) subsidies for household consumer goods and equipment replacement and upgrading by firms. This constitutes an expansion of a CNY 300 bn scheme announced in March. There will also be another CNY 1 trillion bonds to help municipal and local governments with their debt problems, effectively exchanging local government or LGFV bonds for more popular central government bonds.

7. BANK RECAPITALISATION

The National Financial Regulatory Administration (NFRA) said that CNY 1 trillion will be used for capital injections into the six largest banks, the so-called “mega-banks”. This would imply an increase in their common equity tier 1 capital of about 8%. But the banks are already capitalised at 11.8% (core Tier 1), well above the current 8.5% requirement. Either the banks are not lending because loan demand is weak, or they consider the credit risk too great at current levels of interest rates.

The puzzling thing about this aspect of the plan is that it is the smaller banks that require capital injections. Many are more exposed to property price declines and have more concentrated portfolios of loans to real estate developers or construction firms. They may also have depended excessively on bond trading revenues. The recapitalisation plan therefore seems to imply that any difficulties in the banking sector will be met with further consolidation into the “Big 6”.

Nevertheless, the immediate reception of the September stimulus package was very positive. The CSI 300 index of Shanghai- and Shenzhen-listed companies surged by 15.7% for the week – its best performance since November 2008 when a similar stimulus package was announced. The Hang Seng Index jumped 13% during the week. The CNY/USD rate also bounced from 7.06 to 6.98 while industrial metals such as copper, zinc, and aluminium moved upwards, building on a rally that started earlier in the month.

The immediate surge in prices recalled the stock market rally of 2014-15 when the Shanghai A Share Index more than doubled between November 2014 and June 2015, although that upswing was followed by an almost equally abrupt sell-off.

Section 2. Comparison with the 2008-09 Stimulus Package

There can be no doubt that the RMB 4 trillion stimulus announced by China’s State Council in November 2008, equivalent to \$586 billion or 6% of China’s GDP, was the major reason why China alone recovered rapidly from the GFC. For example, the economy recovered from 6% real GDP growth at the end of 2008 to over 10% by mid-2009. However, it was not the spending totals that were important – it was the way they were financed that mattered. As Figure 2 shows, broad money, M2, saw a

doubling in its growth rate from 15% year-on-year in November 2008 to almost 30% by November 2009 with the 3-month annualised rate reaching 40% in March 2009.

Figure 2. The Key to the 2008 Package was the Doubling of M2 Growth

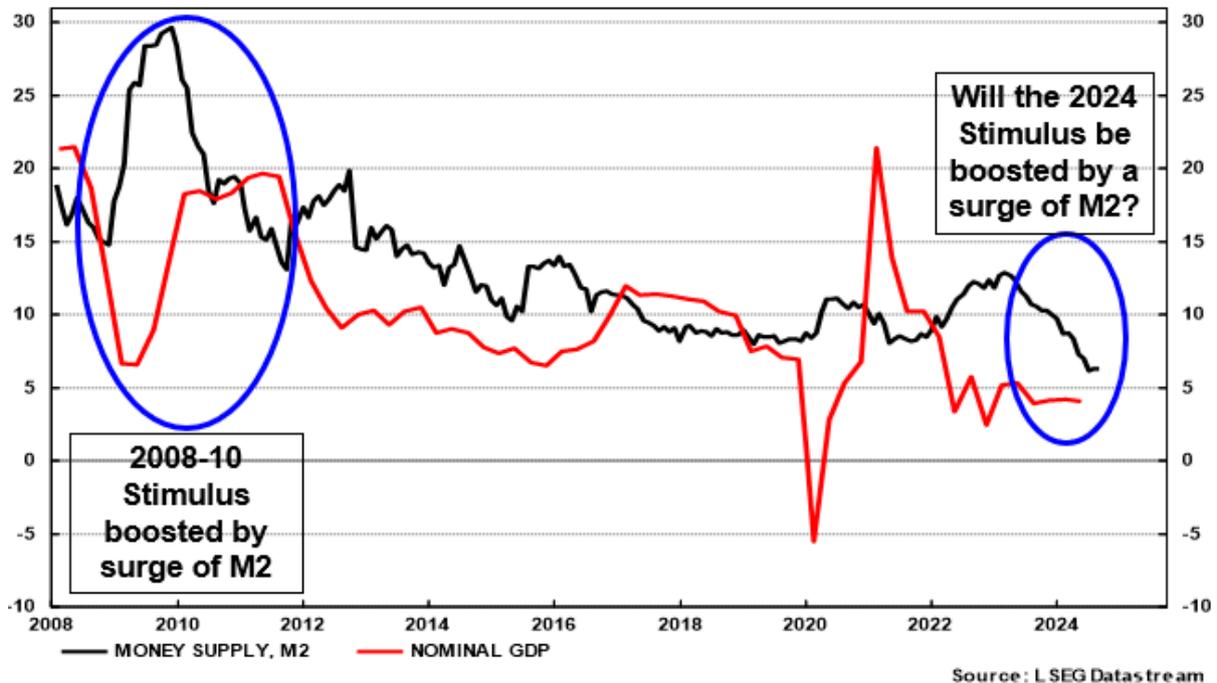


The details of the November 9, 2008 package differed markedly from the latest September 2024 announcement. The focus of the 2008 plan was public sector investment in key areas such as housing, rural infrastructure, transportation including railways and roads, irrigation, and airport construction, plus spending on health and education, environment, industry, and disaster recovery following the Sichuan earthquake of May 2008. The central government provided just RMB 1.2 trillion of the funds (30%), while the remainder was to be invested by provincial and municipal governments. Crucially, the bulk of the funds were to be provided through the commercial banking system, meaning that bank credit (mainly lending) by the banks was increased, with parallel increases in deposits and hence in M2.

By contrast, on this occasion, not only are the funds in the September 2024 stimulus plan to be directed to very different objectives as compared with the 2008 plan, but the monetary growth backdrop is entirely different.

First, this time the stimulus plans are far more dependent on a positive response from the private sector. The PBOC's measures – comprising rate cuts, a RRR cut, some easing of mortgage lending conditions, plus additional funds for lending into the stock market – and the CSRC's proposals to increase stock market activity all seem to depend much more on a positive private sector reaction. None of this rules out a positive long-term result from the stimulus, but the starting point, the content and the targeted sectors are significantly different.

Figure 3. Critical Difference in Stimulus Packages will be M2 Growth
CHINA: M2 & NOMINAL GDP (% YOY)



Second, as Figure 3 shows in the blue circles, there is a dramatic difference in the monetary environment. In the aftermath of the 2008 announcement and as already mentioned, M2 money growth roughly doubled. (Note that at that time the underlying growth rate of the Chinese economy was about twice what it is today. This would have required a substantially faster M2 growth rate to achieve any given rate of inflation.) It should be said that the intention to double the money supply growth rate in 2008-09 did not form part of the original announcement in November 2008. It was, therefore, by no means a certainty that the stimulus package was to be financed through the banking system by the creation of new money. However, it quickly became clear in 2009 that, in contrast to other major economies, China's M2 was accelerating rapidly, greatly enhancing the prospects for success of the stimulus programme. Ultimately, China paid a price for the scale of its 2008-10 stimulus both in terms of inflation (as the annual change in the CPI went from -1.8% in July 2009 to 6.5% by July 2011 – exactly what one should expect from such a large monetary stimulus) and in terms of the rapid development of the shadow banking sector and the over-leveraging which accompanied it.¹

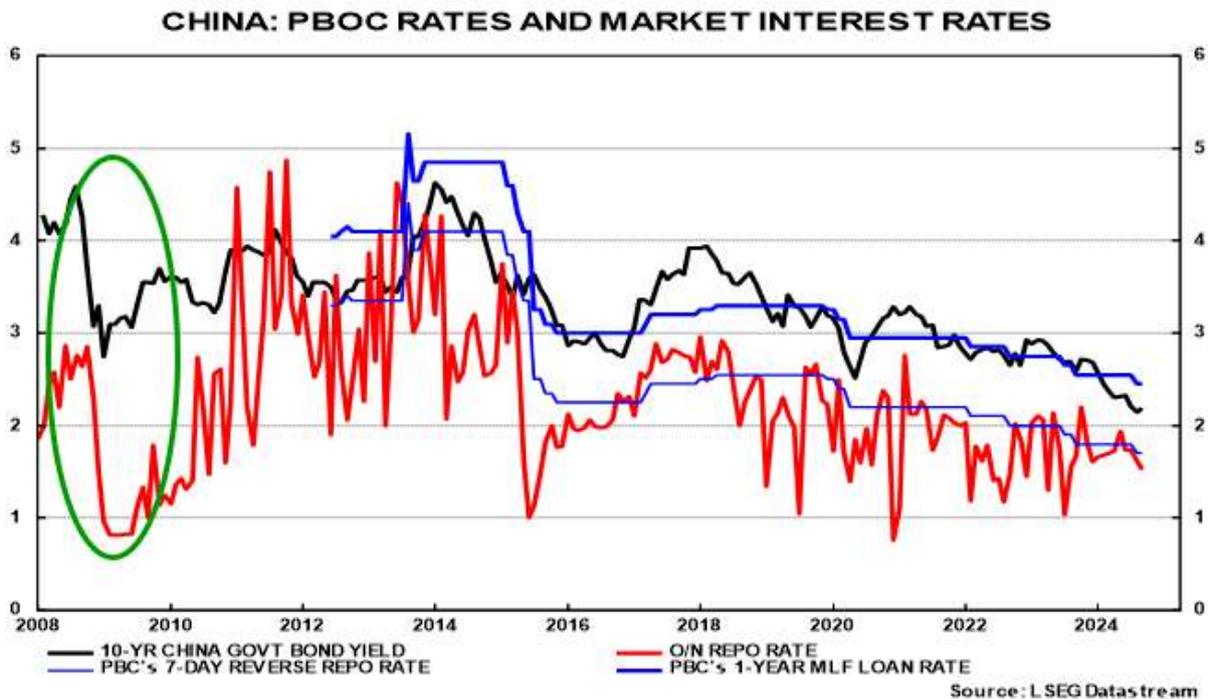
Section 3. Prospects for the September 2024 Package

In light of our comparison with the 2008-10 stimulus plan, how do we assess the prospects for the September 2024 package?

¹ The combination of inflation and the official failure to raise bank deposit interest rates meant that the return on regulated bank deposits became unattractive, prompting new types of unregulated lending outside the banking system in the form “shadow bank” loans. Such shadow banking activity grew rapidly from 2010 onwards, leading to soaring levels of leverage in the corporate and household sectors.

The first thing to be said is that the interest rate cuts are almost certainly too small to move the dial on economic growth. What will matter is their quantitative impact – in other words, the effect they will have on boosting lending and deposit growth on the books of the banks, and hence on M2 money growth. The green oval in Figure 4

Figure 4. Incremental Declines in Interest Rates Unlikely to Boost M2 Sufficiently to Stimulate the Economy



shows that the rate cuts in 2008-09 were substantially greater, though admittedly from a higher starting point. In a state-dominated banking system like China's, it is certainly easier to insist or ensure that bank credit growth increases at a faster pace even if the decline in rates is very small than in a privately owned and operated banking system. However, the key point is that without a substantial boost to M2 money growth, it is highly unlikely that, in current circumstances, the growth rate of the economy will be boosted by very much.

This is especially true given the currently abnormally low rates of M2 growth. As Figures 2 and 3 above showed, China's M2 growth has slumped over the past 18 months, falling from its recent peak growth rate of 12.9% in February 2023 to 6.3% in August 2024. In IMM#44 (**"The PBOC in a Monetary Tangle"**, August 1, 2024) I explained that: "To escape from this downward spiral the PBOC needs to boost M2 growth in a steady and sustained manner – but the rate is critical. It will not be a good idea to push too hard on the accelerator to generate, say, 15% M2 growth. Using China's M2, the best rate or "golden growth rate" to aim for is derived from the equation of exchange,

$$MV = Py.$$

Converting this to a growth rate format and rearranging the variables gives:

Inflation Target + Potential Real GDP Growth + Growth of M2 Demand = M2 growth

This works out as follows: 3% + 5% + 2.9% = 10.9% p.a.

Rounding and allowing for short-term errors, the M2 target should be set at 9-13% in current circumstances, perhaps later being narrowed to 10-12%.”

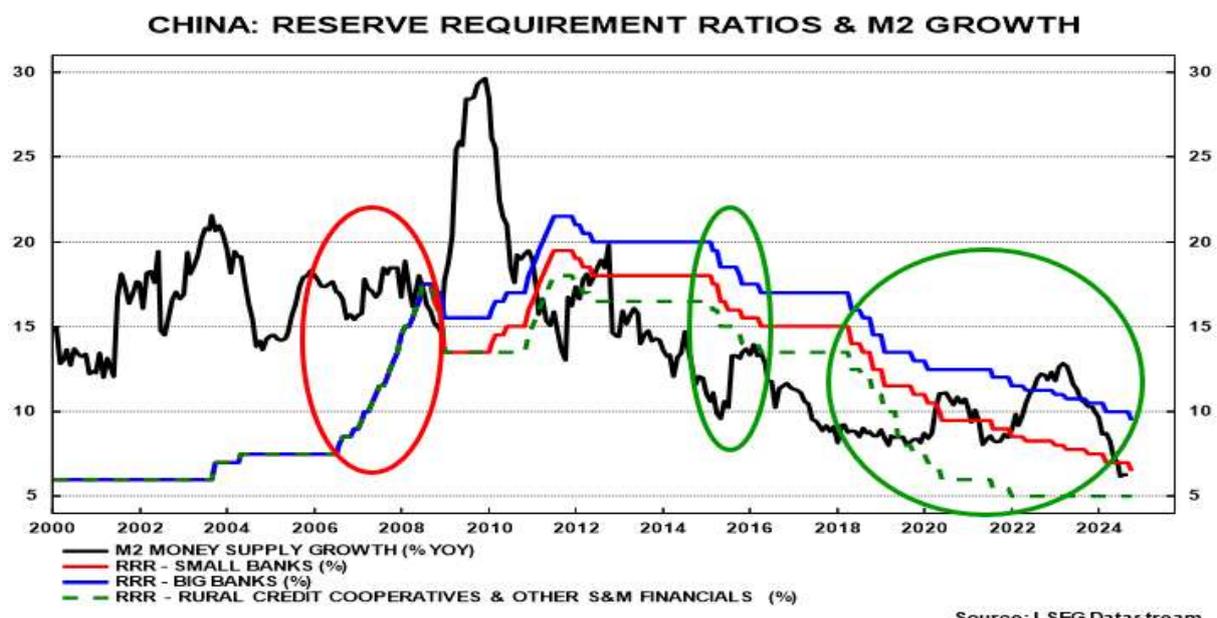
The second observation to share is that cuts in the Reserve Requirement Ratio (RRR) are by no means always conducive to faster money growth. Figure 5 shows the changes in the RRR (three different ratios for different classes of bank since 2009-10) from the year 2000 onwards and the associated changes in the rate of growth of M2 (in black).

The red oval in Figure 5 designates the period May 2006 to August 2008 when the RRR was rising steeply, but the M2 growth rate did not slow, remaining continuously in the 15-20% range. In other words, a rising RRR did not constrain money growth.

Entering the GFC between September and December 2008 there were just two small cuts in the RRR for large banks and three cuts for smaller banks. At the same time M2 grew strongly, doubling its growth rate as discussed above.

The first green oval captures the RRR cuts between January 2015 and March 2016 when a cut of three percentage points produced only a brief upturn in M2 growth from 10% to 13% year-on-year in early 2015, but did not prevent M2 growth falling to single digit growth rates in 2017-18.

Figure 5. RRR Changes Not Always Associated with Changes in M2 Growth Rates



Moreover, a series of RRR cuts between March 2018 and the present (from 17% to 9.5%), included in the area shown by the second green circle/oval, have also produced only two brief upticks in monetary growth. In the past 18 months alone, as mentioned above, a series of RRR cuts amounting to 1.5 percentage points has not prevented the money growth rate from halving.

All in all, these observations amount to a warning not to assume that the RRR cut included in the September package will have any decisive impact on M2 growth – upwards or downwards.

Extending this analysis to the transmission mechanism, it is critical to asset prices – equities and house prices - that M2 money growth recovers to a growth rate of around 10%. As we have witnessed in Japan over the past three decades, broad money growth rates that are too low not only hold down asset prices and discourage real growth in the first instance (although this effect is only temporary), but also put downward pressure on nominal GDP which eventually shows up in very low inflation or deflation. Based on 18 months of sub-par M2 growth, China is already seeing inflation close to zero. If the current stimulus programme fails to lift money growth to near double-digit growth on a sustained basis, the prospects for a full-scale recovery will be hampered and near-deflationary conditions will persist.

In my opinion, the current measures are barely sufficient, and I would be very surprised if they prove adequate to re-invigorate the domestic economy. More steps will be needed over the months ahead.

Summary and Investment Conclusions

- After much seeming procrastination the Chinese authorities – principally the People’s Bank of China (PBOC) and the China Securities Regulatory Commission (CSRC) under the State Council, China’s cabinet – have at last rolled out a series of stimulative measures to boost financial markets and economic growth.
- They did not tackle the property market crisis head-on, but several of the measures they announced will address problems in that sector indirectly.
- The main measures comprise a set of small rate cuts (0.2 to 0.3 percentage points), a reduction in the reserve requirement ratio (RRR) for the banks, guidance to banks to cut mortgage lending rates, reduced downpayments for second home buyers, guidance from the CSRC to encourage medium and long-term funds to enter the stock market, and measures to promote mergers, acquisitions and reorganizations.
- In addition, the People’s Bank of China introduced two new lending schemes to boost the capital market.
- This Newsletter assessed the planned stimulus by comparing the September 2024 measures with those taken by China in November 2008 in the teeth of the Global Financial Crisis.
- My judgment, based on a comparison of the two programmes, is that the September 2024 plan starts from a much weaker monetary position and the measures taken appear to be considerably weaker than in 2008-09.



- Unless M2 money growth accelerates from its current 6% level to something more like 10-12% then the prospects for the stimulus plan are not good.
- Without such an acceleration in money growth, equity prices will lose their recent shine, house prices will continue to fall, and domestic economic activity (personal consumption, retail sales, private fixed asset investment etc.) will remain subdued, and inflation will continue to be well below the PBOC's 3% target.
- Although equity prices have surged in the short term based on expectations (or hopes) for a successful stimulus, a hard-eyed view suggests more caution.
- Chinese government bonds (CGBs) are likely to continue to perform well with yields following inflation downwards.
- However, the outlook for domestic equities is much more problematic. Top line sales, bottom line earnings growth and earnings multiples all depend ultimately on the state of the domestic economy and/or expectations about it. The latest stimulus package, although a welcome step in the right direction, is barely large enough in terms of scale and impact to shift the financial markets and the economy to a sustainable upward trajectory. More steps will be needed.

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