

The View

NO CHINA BOND BUBBLE

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- The PBoC is using quantity measures and could move further up the curve
- Fearing RMB weakness and trying to prop up bond yields can work for a bit but ultimately will fail
- The domestic economy cannot take the strain, heralding some form of QE, but that won't stimulate activity growth or help equities; bonds are the place to be

Summary

In March last year, we wrote a View entitled [China govies: 2020s widowmaker](#). Since then, the 10-year yield has fallen to 2.2% from 2.9%, while the US counterpart has risen to 4.3% from 3.4%. Chinese policymakers are now worrying about a bubble in bonds. Attempts to support yields may work, temporarily, but they will prove self-defeating, as declining yields are the outcome of the government's chosen deleveraging route - demand deflation – and this trumps any liquidity shenanigans.

China is becoming less capable of generating money growth without government support. In turn, money created as a result of private demand weakness tends to be absorbed more into saving, rather than spending. And the PBoC is not even sure that it wants to support money growth, continually flip flopping between supporting domestic activity through more accommodative quantity policies and supporting the value of the RMB by pulling out funds and attempting to prop up interest rates. But as soon as the authorities choose interest rates and the RMB over growth, the latter promptly deteriorates, proving the effort self-defeating.

To be clear, we are not saying that RMB depreciation is the best policy to generate growth. Instead, given that China has chosen to try to deleverage by running surpluses, then trying to support the RMB by removing liquidity will prove unfruitful. The next thing they will try is QE/MMT, something we see hints of in the China policy debate – more on this in future publications. But QE and blunt MMT also will be unfruitful.

The better policy from a growth perspective, and one which would truly re-elevate bond yields, would be to stimulate domestic consumption demand, which in turn would eventually support the currency (higher consumption → lower savings → higher interest rates). In short, trying to support interest rates to support the RMB will do little to help consumer demand. China produces so much at home meaning the purchasing power effects are dwarfed by the contractionary effect of higher interest rates. Instead, the RMB would be sustainably strengthened by stimulating domestic demand through fiscal policy, rather than finding new ways to use up excess savings in investment and subsidising businesses to build global market share in an increasingly precarious global trade system. And that is before even considering the risk of retaliation.

QE/bank bond buying won't work and MMT would need to be cleverly crafted

The problem is that China, like Japan before it, is becoming incapable of generating liquidity without government support. Whatever liquidity is then generated then drops into a sinkhole, absorbed into the effort to save. ([Trump vs deflation](#), [Big QT mistake](#), [Various Nixon shocks](#), [China QE/MMT](#))

MMT'ers often hold up Japan as an example of prolonged government debt increase without inflationary consequences. But while Japan may have gotten away without inflation, government deficits combined with bank or central bank generated liquidity creation may not have been the best policy for Japan. Indeed, debt increase was probably the result of deflation rather than a generator of inflation.

The framework on which MMT is built is the flow of funds architecture, which was the magnum opus of Wynne Godley. A predecessor of mine, Brian Reading, helped develop this architecture for the Bank of England in the early 1960s, following the Radcliffe Report in 1959. The framework, therefore, is integral to our approach. But more effort needs to be applied to understanding the direction of causality.

Understanding the importance of the direction of causality was what allowed Brian in the mid-90s to predict a decade of Japanese stagnation. Surpluses were in the driving seat. In this case, surpluses were the result of demand deficiency and hence were disinflationary. The need to rebuild balance sheets was the root of all else. The resultant surpluses created the government deficit and the deflationary situation. Commercial banks then bought the government bonds, offering, as they did, a pick-up on central bank reserves, while demand for lending in the real economy was severely limited. And subsequently the BoJ got involved in buying the bonds. When a bank – commercial or central – buys government bonds for its own balance sheet it creates money. If a non-bank buys bonds, money is taken from one area of the economy and reintroduced somewhere else when the government spends. But when a bank buys, whether that bank is commercial or the central bank, new money is introduced. However, money in was created in Japan in its deleveraging phase and in China today as a result of the initial desire to save – the government deficit results from the private surplus – meaning that demand for money likely has risen. People and firms hold onto money in this environment so velocity falls rather than inflation or real activity picking up.

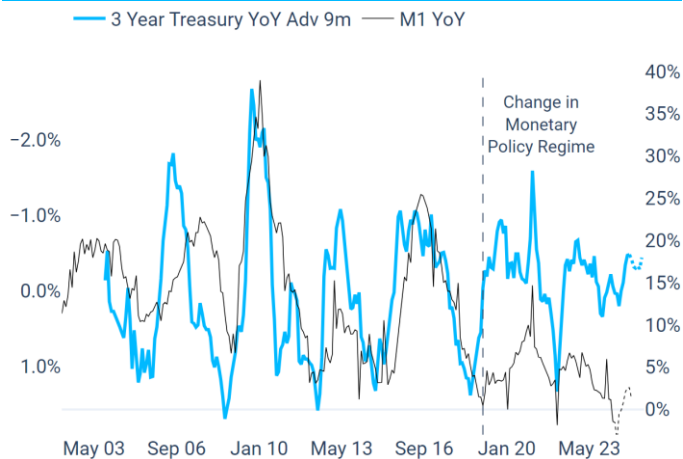
One way or another, the same thing appears now to be happening in China. **The point is that stimulus through interest rate channels has become increasingly ineffective in generating liquidity – hence the rumblings about Chinese QE and MMT – but also that this liquidity is likely to become increasingly ineffective at generating GDP growth or sustained asset price gain.** Indeed the recent [property stimulus package appears to be a clear example of a policy that will create money but not growth, leading to a decline in velocity, and weakening the RMB.](#)

The transmission mechanism is broken...more so than it was

Interest rate channel – pushing on a string

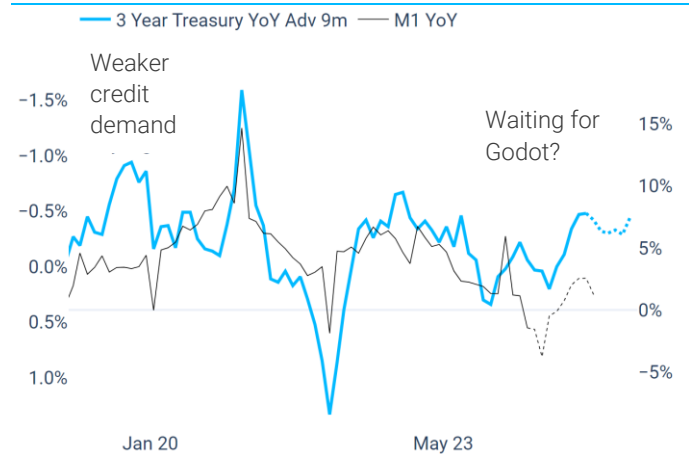
In 2019, we sat patiently waiting for M1 growth to pick up in line with previous relationships with interest rates. It never did. The PBoC had chosen to shift closer to a DM way of operating, aiming to avert a further build up in debt, just as that debt became unsustainable, leading firms and households to reduce their demand for it. The PBoC had its first lesson in pushing on a string. We have subsequently reset our axes, viz the right-hand chart below, but we again have that feeling of waiting for Godot, even based on the post-2019 relationship between interest rates and money growth.

Is China going through another transmission reset?



Source: GlobalData TS Lombard, CEIC, Datastream

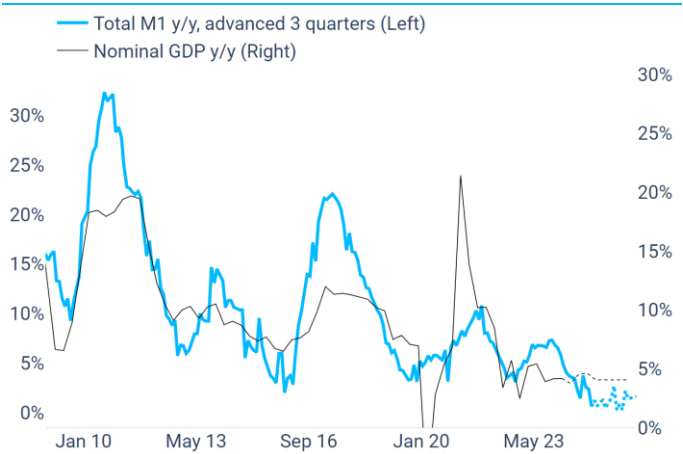
Waiting for M1 growth to pick up...again



Source: GlobalData TS Lombard, CEIC, Datastream

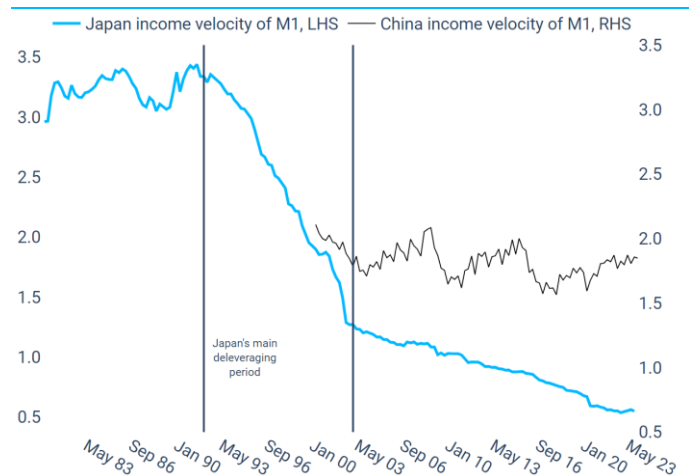
Without progress on M1 growth, the hopes for nominal GDP growth must be very restricted, beyond one-off boosts from fiscal stimulus. Weak money growth is all the more worrying, given the likelihood of slower turnover of money, meaning that each new RMB is associated with less growth. Admittedly, the relationship between M1 growth and nominal GDP growth appears to have held in recent years, though it is hard to tell, given the distortions of the pandemic. But going forward, China's velocity is likely to slow rapidly, just as it did in Japan during its period of deleveraging.

Low M1 growth means low GDP growth



Source: GlobalData TS Lombard, CEIC, Datastream

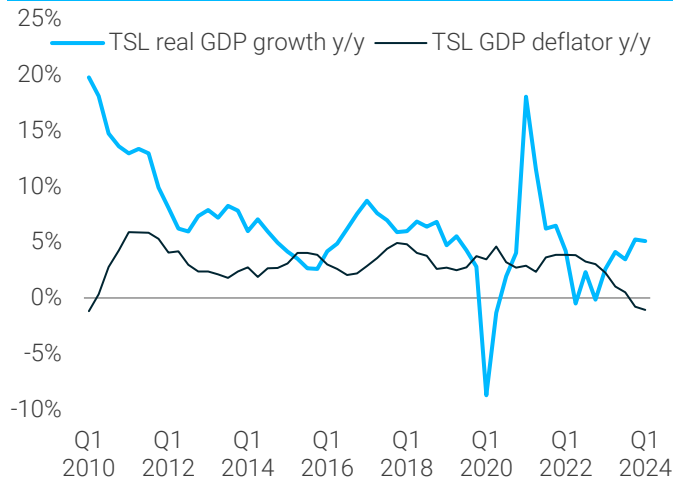
Especially with velocity likely to drop



Source: GlobalData TS Lombard, CEIC, Datastream

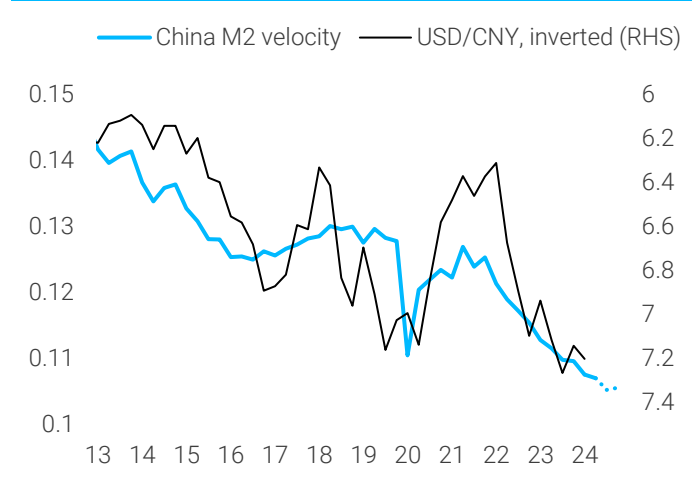
Indeed, at this stage in the game, with the authorities seemingly unwilling to do what it takes to stimulate domestic demand, the best hope of Chinese real GDP growth is deflation. Households and firms will need to continue to be incentivised to spend through the lure of lower prices.

The best hope for real GDP growth is deflation



Source: GlobalData TS Lombard, CEIC, Datastream

Falling velocity means RMB weakness

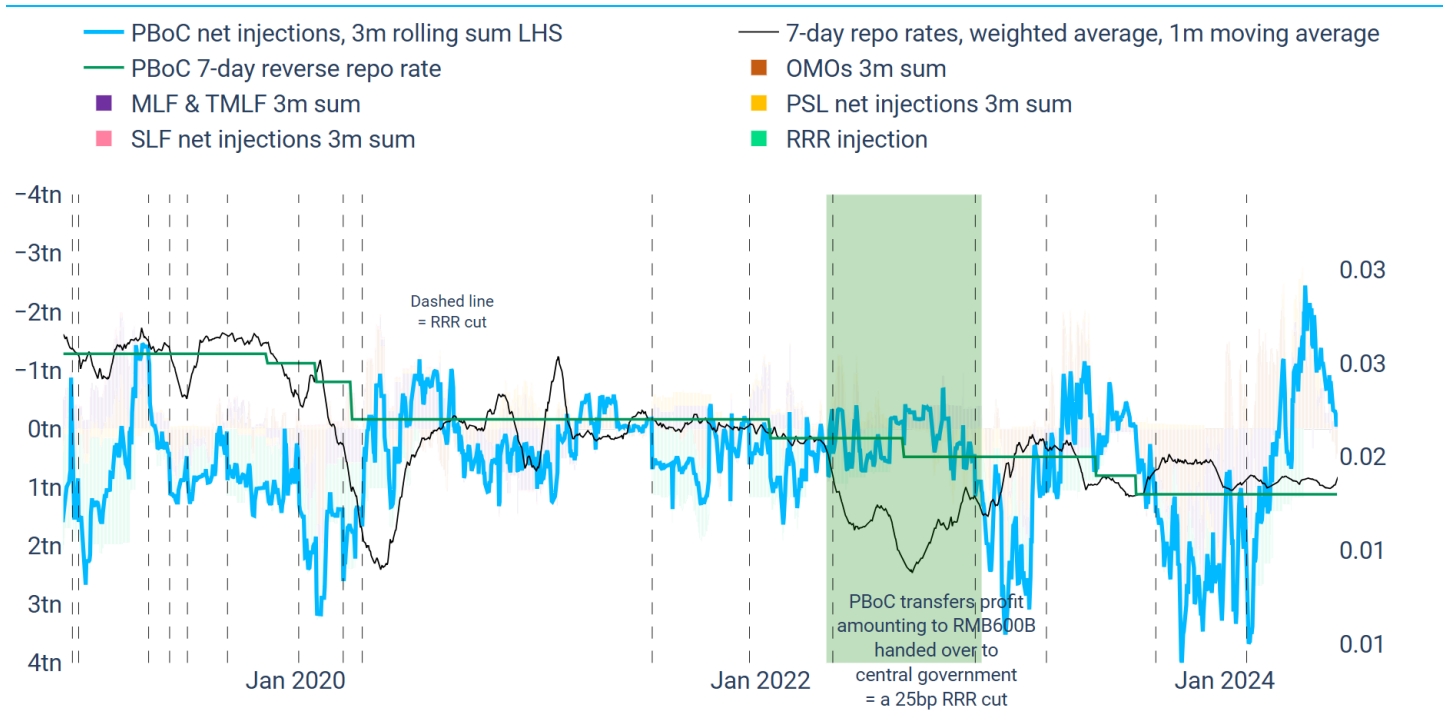


Source: GlobalData TS Lombard, Datastream

Existing quantity channels are failing to generate M1 growth

The PBoC's dashboard of levers rivals that of the Starship Enterprise, but unfortunately, none of the buttons seem to be generating the characteristic blaze across the sky. The chart below is comprehensive in tracking everything that is trackable in the PBoC toolkit and the total injections sustained through Q1 were significant.

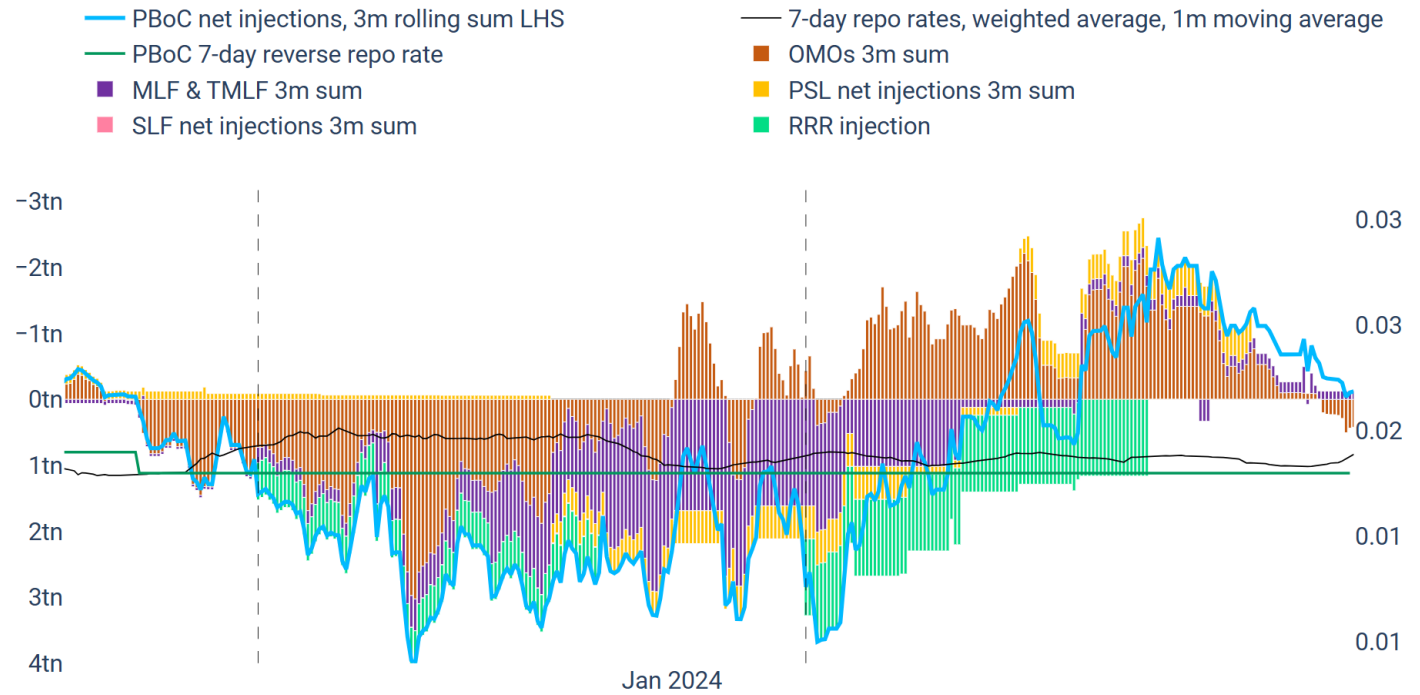
The PBoC has been pumping to no avail and has now alarmingly shifted deep into contraction



Source: GlobalData TS Lombard, CEIC

Indeed, when it is in injection mode, the PBoC increasingly has been relying on longer-term injections, including the Medium-term Lending Facility, and even wheeling out Pledged Supplementary Lending, in addition to RRR cuts.

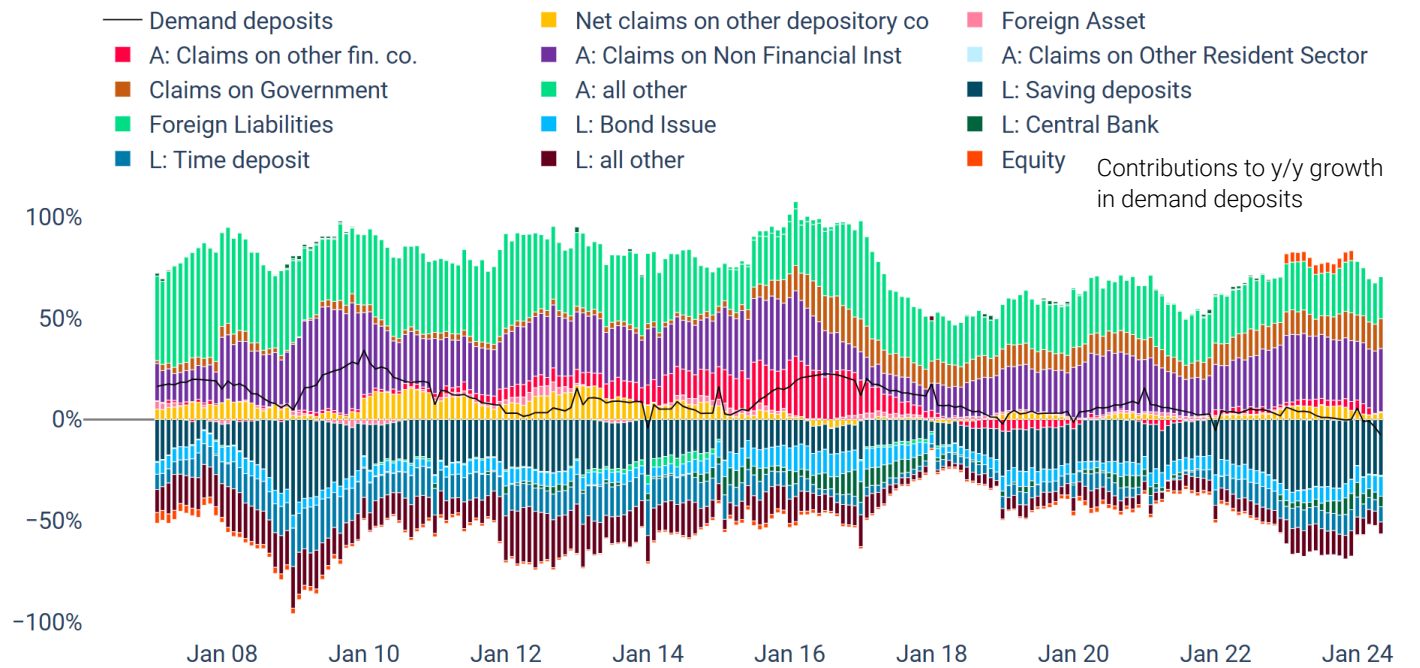
Having pulled on the old levers, the PBoC is now allowing roll-off



Source: GlobalData TS Lombard, CEIC

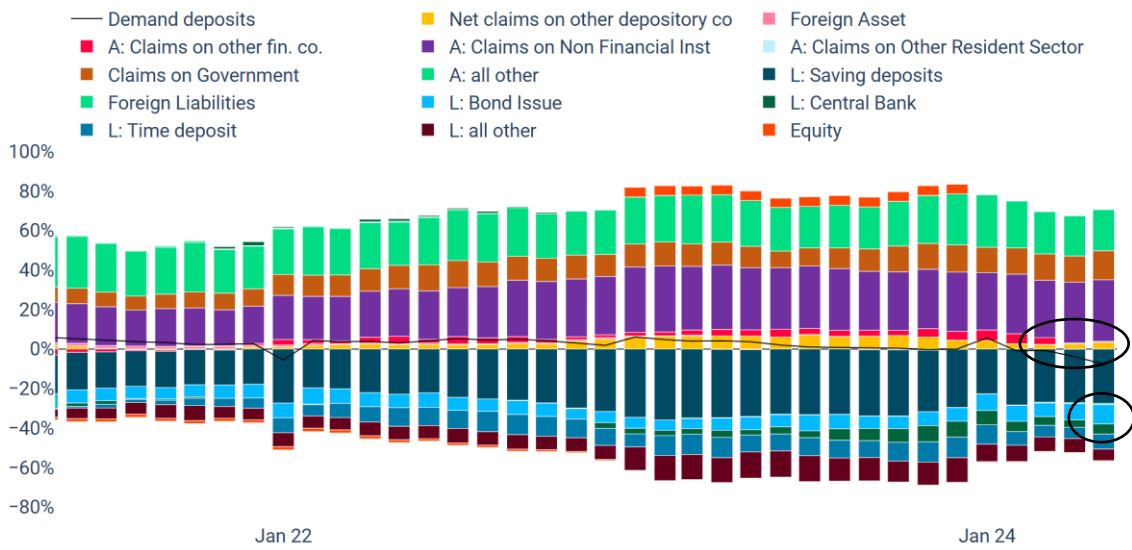
Even when the PBoC is pumping, however, M1 seems oblivious to the PBoC's efforts. It could be that we are not being patient enough and we should linger in the absurdism of waiting for Godot a little longer. But the PBoC has now shifted from trying to bolster interbank funds to sucking them up on a large scale, fretting about a bubble in bonds and worrying about RMB depreciation, while US interest rates remain resilient.

Money is being sucked up the curve or failing to come into existence in the first place



Source: GlobalData TS Lombard, CEIC

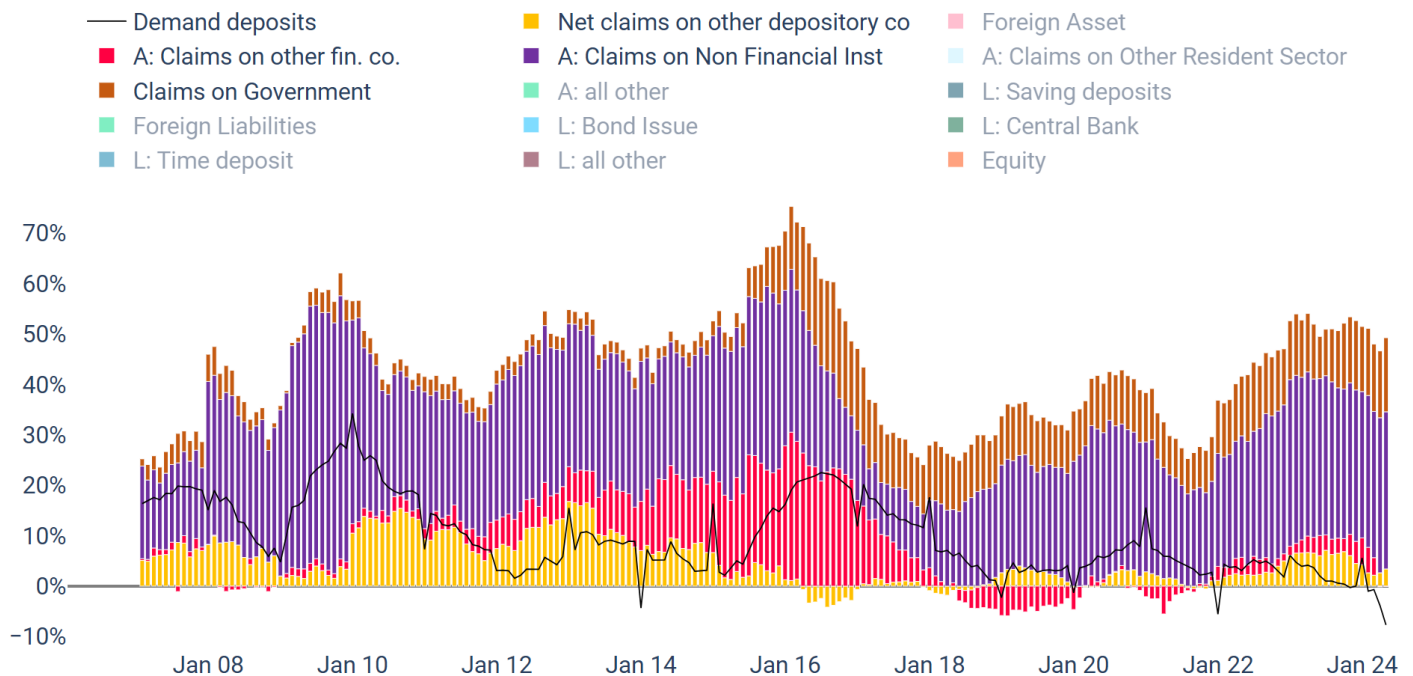
Bank bond issuance and weak credit demand has cratered M1 growth



Source: GlobalData TS Lombard, CEIC, Datastream

The eyewateringly low rates of M1 growth are partly the result of both slowing credit creation and agents moving their money up the curve and away from the real economy. In May demand deposits *dropped* 7.7% y/y, an unprecedentedly weak performance, even among Lunar New Year distortions.

Credit creation has weakened sharply, with lending to government taking over ...



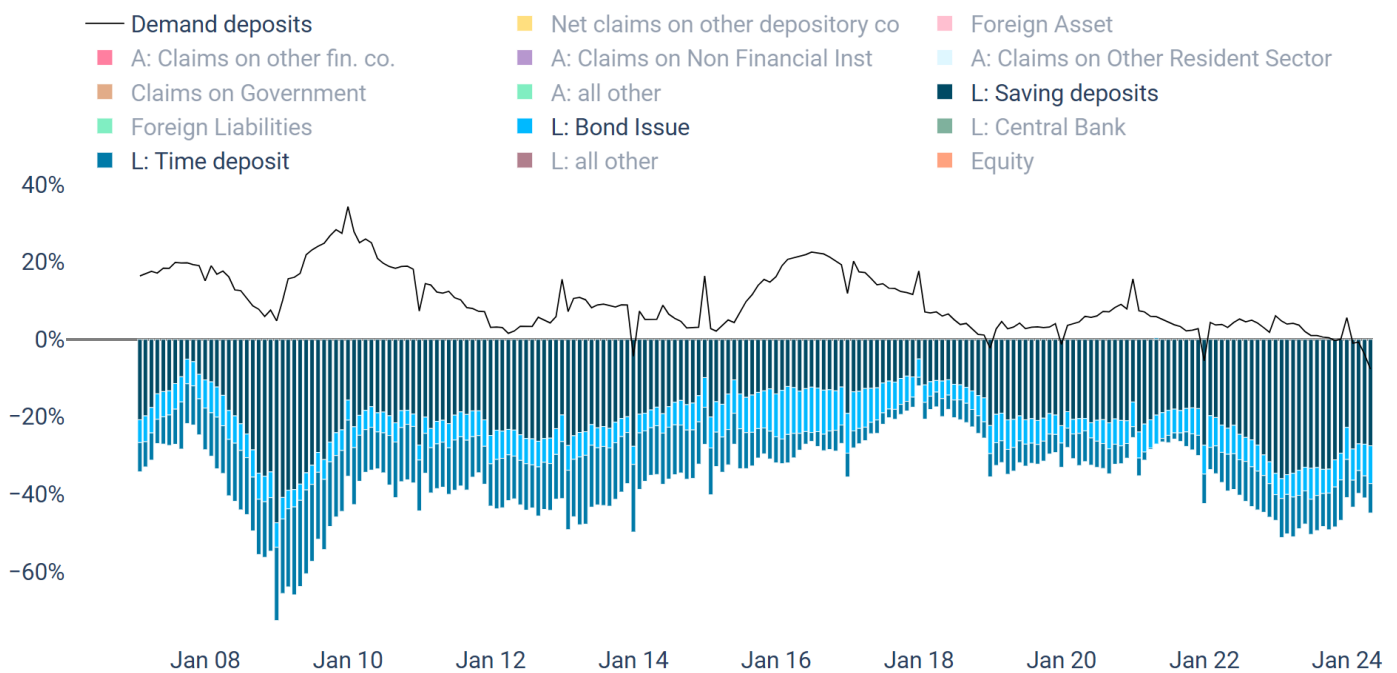
Source: GlobalData TS Lombard, CEIC

The chart above shows how weaker credit growth has dragged down money growth. When banks lend to non-banks, they credit the account of the borrower with a deposit. Lower lending, all else equal, therefore, means lower money growth. In the most recent data, the drop seems to be attributed to a decline in claims on other financial corporations. This could easily reverse in the next print. But the broader trend is clear. Credit growth had staged a comeback since late 2021, but it has weakened again from mid-2023.

We include net lending to other depository corporations – banks – here because it shouldn't exist. Bank lending to banks should cancel out, but it doesn't because it is used as a way for non-financial firms to use their financial wings to gain funds, which are credited to their deposit accounts. Growth in this type of lending has slowed rapidly in 2024.

Lending to government is making up for some of the weakness in credit, and this still creates money when the government spends. But this type of government borrowing reflects weakness in the real economy, suggesting that people are more likely to hold onto money than previously. In short, this money is less stimulatory.

... while money is moving up the curve and banks are busy issuing their own bonds



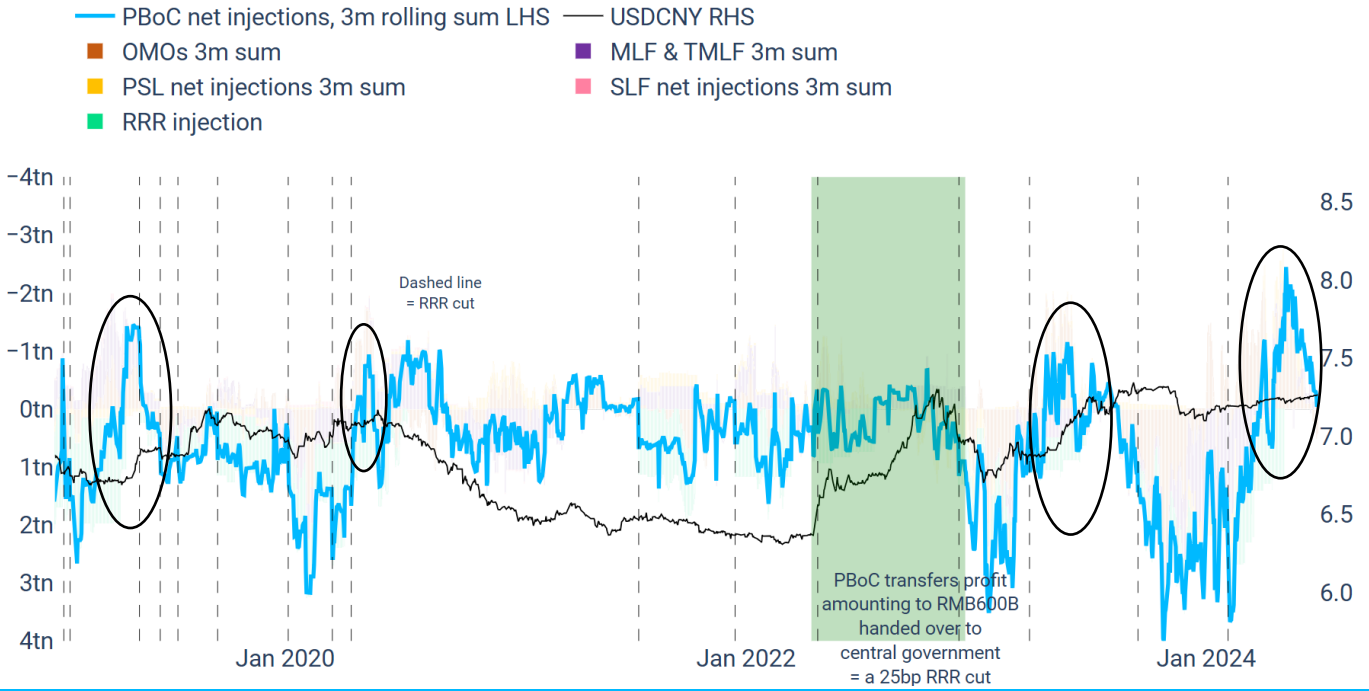
Source: GlobalData TS Lombard, CEIC

At the same time, a greater share of whatever money has made it into existence has simply moved immediately up the curve into longer-dated deposits and away from the real economy. Similarly, banks' own bond issuance has been a drag on money growth as well, contributing to the decline in recent months.

QE – properly named – would entail buying bonds further up the curve, and so would be more likely to generate liquidity growth. But even here, this seems unlikely to be effective in generating activity growth, as the money created is a poor savings instrument, yielding less than the bonds it replaced and therefore making it harder for the private sector to save its way out of deleveraging.

Finally, what the PBoC is giving with one hand in its attempt to stimulate growth, it is taking away with another as state-owned banks join the effort to support the currency in its crawling peg to the dollar, with the US economy both structurally and cyclically in a completely different playing field from the Chinese economy, and the PBoC now tightening through quantitative measures.

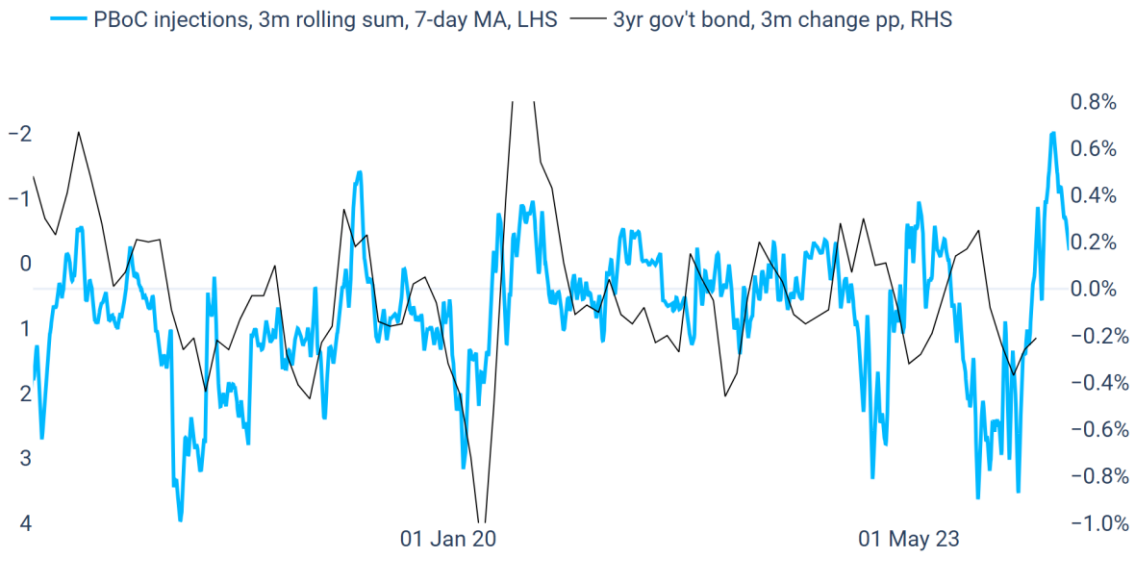
The PBoC is running scared of RMB depreciation



Source: GlobalData TS Lombard, CEIC, Datastream

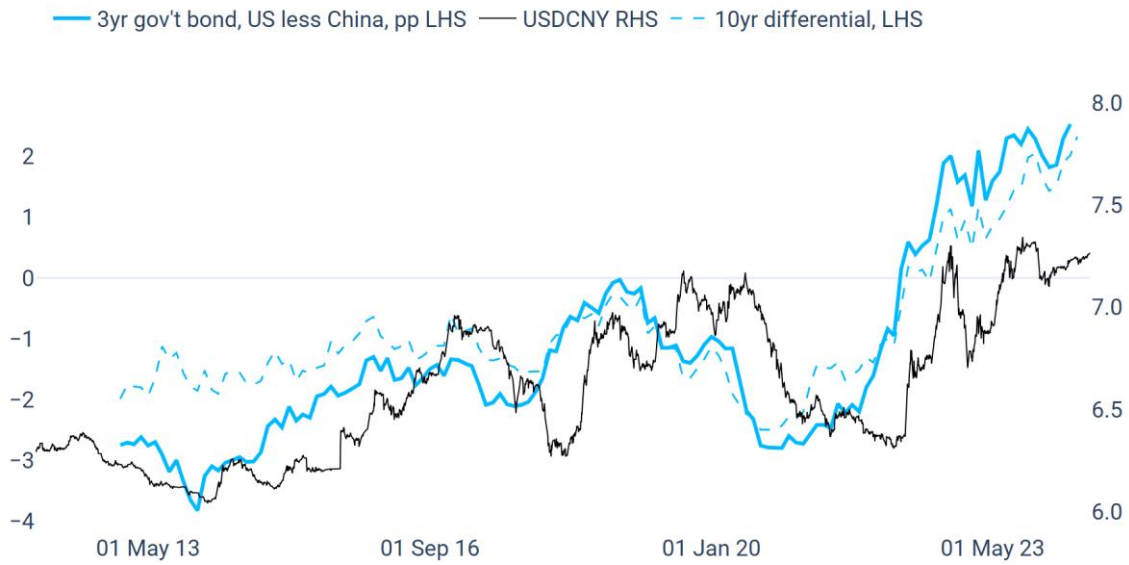
Growth weakness undermines the RMB, with the PBoC then reacting to support interest rates and further undermining growth. Our measure of PBoC injections and withdrawals is clearly related to yields at the short-end of the curve. As the PBoC worries about interest rates being too low in the global context, it withdraws funds helping push interest rates up.

Chinese attempts to support yields will be self-defeating



Source: GlobalData TS Lombard, CEIC, Datastream

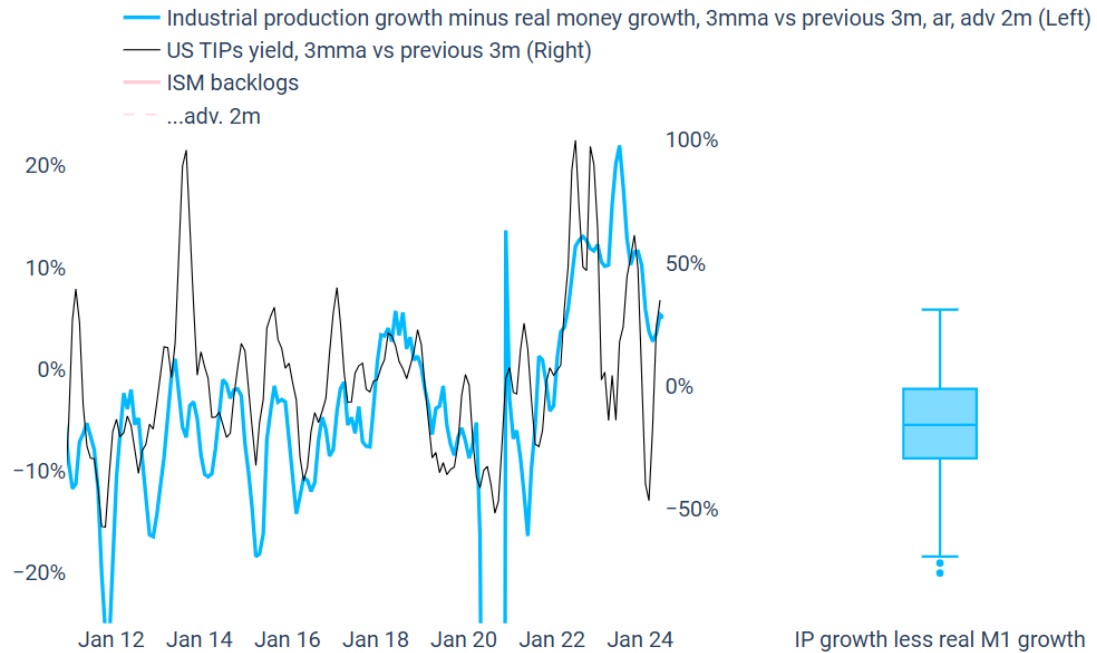
The interest differential is leading the RMB weaker



Source: GlobalData TS Lombard, CEIC, Datastream

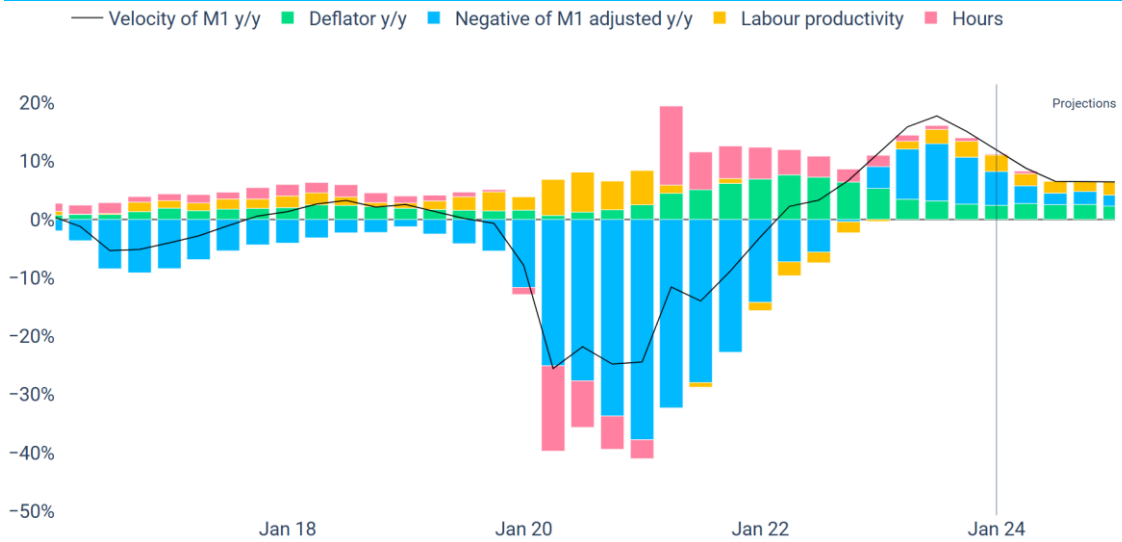
While we believe the Fed will be able to cut interest rates this year, weak growth will force Chinese policymakers to abandon any attempt to squeeze a perceived bond bubble. The Chinese economy simply cannot keep up with the US economy right now. US interest rates have been led higher by resilient domestic demand, with money turning over more rapidly due to underlying confidence *despite* policy tightening. In contrast, official attempts to support yields in China are *forcing* money to turn over more rapidly, a situation which cannot last, with growth looking unsupported by liquidity.

US money is still turning over more rapidly, alongside high interest rates



Source: GlobalData TS Lombard, CEIC, Datastream

Fed money destruction is only part of the US story, with productivity also strong

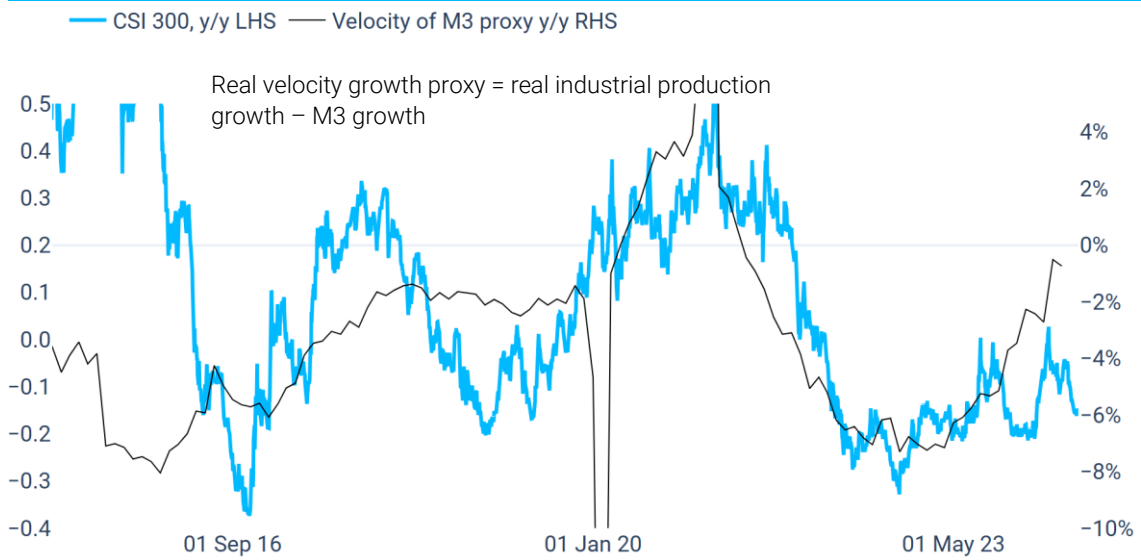


Source: GlobalData TS Lombard, CEIC, Datastream

The futility of trying to support the RMB through a policy-driven increase in interest rates is visible also in the Chinese equity market. Chinese money turnover is fast because the authorities have pulled the rug out from underneath the non-bank sector and because credit growth has crumbled.

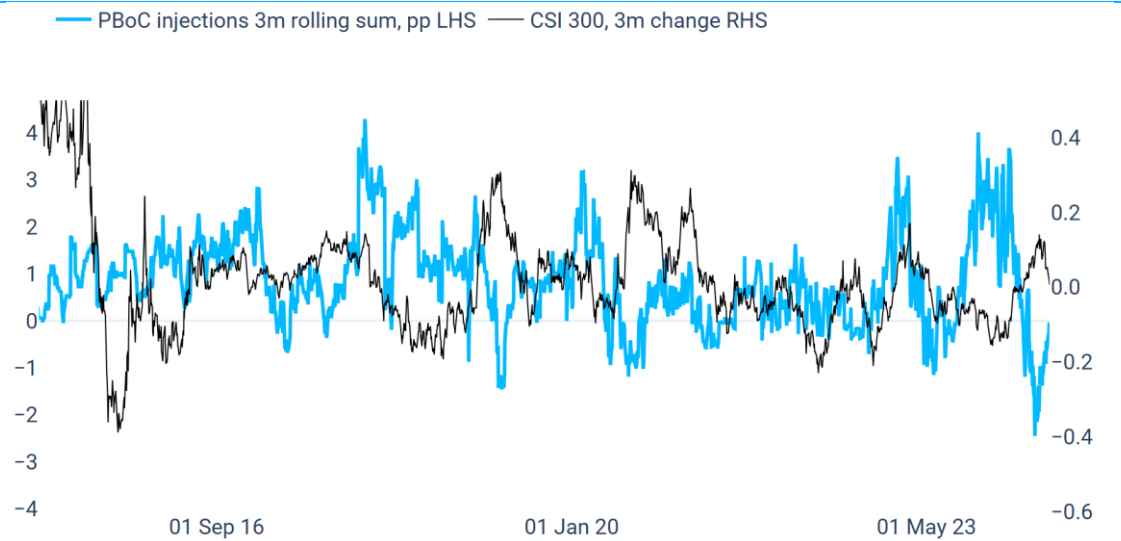
In short, velocity will revert down to the CSI in the chart below, with activity growth – industrial production in our velocity proxy – dropping back following the weakness of money growth.

Equities see through the rise in velocity as driven from weak money growth



Source: GlobalData TS Lombard, CEIC, Datastream

PBoC injections do little for equities but neither would QE, without bank recaps



Source: GlobalData TS Lombard, CEIC, Datastream

Would MMT actually work?

A successful MMT package would not just be about running a large government deficit and relying on the PBoC to provide the liquidity – or equivalently on commercial banks. Government policy currently appears to be trained upon redirecting the flow of excessive savings away from the old-guard sectors towards green sectors, with final demand – consumption – as an afterthought.

The composition of fiscal spending really matters. Spending and tax cuts in different areas of the economy have different multipliers and the timing of spending matters too. The implicit drive of government policy seems to be to fix the problem of oversupply by creating more oversupply but in new sectors. The result will be more disinflation and further compression of aggregate returns. Neither of these things help the non-government sector to deleverage, with disinflation helping keep rates low but debt ratios high and weak returns increasing the *need* to save.

To become more positive, we'd need to see a more concerted effort to stimulate final demand and redirect funds to the household sector, either by allowing capital to flow to higher-return prospects, or by improving the social safety net. Otherwise, the money created in counterpart to the government deficit will simply be absorbed into the effort to save, with flat yield curves creating little incentive to get out of money.

Bottom line

The PBoC seems more likely to be sucked into bond purchases or incentivising banks to buy bonds over a 12-month horizon, than to be able sustainably to back up its jawboning of yields. The money created, however, will not result in a prolonged improvement in GDP growth, unless the government redirects its efforts towards stimulating final demand, rather than subsidising investment and ultimately depressing aggregate returns. The equity market is right. If the government does capitulate and try the QE route, this too will do little for equity prices, though it will embed the decline in bond yields unless the government pairs a QE packaged with a re-direction of fiscal support from businesses to households, recapitalises the banking sector and allows failing firms to fail. QE and a big deficit is not enough. The make-up of the deficit affects demand for money, interacting with QE. Just pumping would result in a drop in the turnover of money. Fiscal policy needs to be adjusted so that Chinese consumers start to see the relative merits of goods, services and real assets over money.

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