

Daily Note

# CHINA GROWTH <5% THROUGH 2024

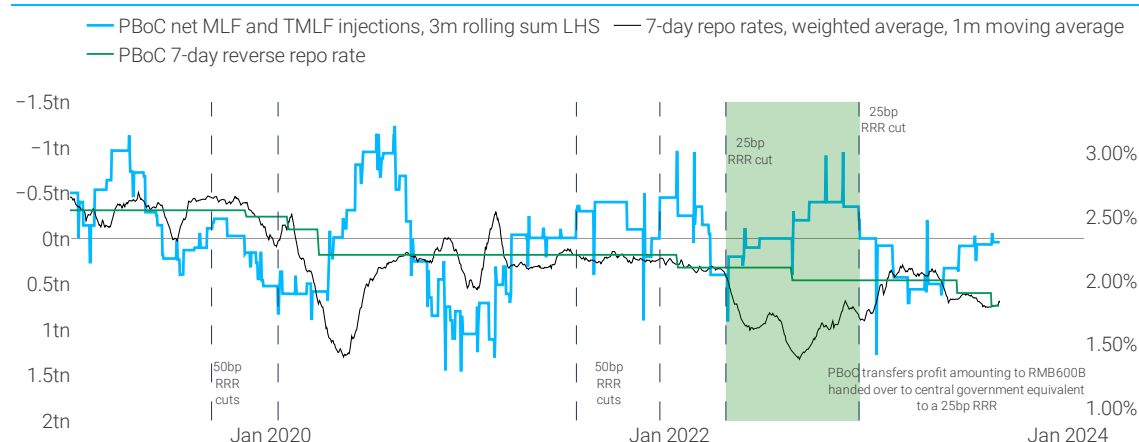
Freya Beamish / Rory Green

- The PBoC made the mistake of tightening through H2 last year
- Growth this year - and next - will suffer the consequences
- Turning the ship takes time; growth to remain <5% through 2024

The PBoC doesn't usually announce policy changes - at least - not the significant ones. Instead, it guides short-term interest rates and liquidity through open-market operations and its various lending facilities, and even by simply transferring money to central government. Analysts are left to extrapolate the policy stance from the data and by reading between the lines of PBoC speak. The current stance is clearly shifting towards greater easing. The Q2 monetary policy report, in conjunction with government rhetoric, and much stronger intervention in FX and equity markets indicates Beijing is only now preparing to enact more forceful domestic stimulus. Easing, however, will be more pistol than bazooka. With the PBoC forced to rely on structural and quantity based loosening, as it acknowledges that demand for credit is anaemic whatever the price.

Last year, amid the turmoil of seemingly global inflation and rapid monetary tightening, PBoC policymakers assumed that something similar might happen to China upon re-opening. Let's get ahead of the curve, they thought, and began the process of tightening by removing liquidity through open market operations. The blue line in the chart below is inverted on the left-hand side, and shows the accumulation of net injections through the PBoC's primary interbank liquidity policy channel. Withdrawal of liquidity pulled a weighted average of 7-day repo rates up from 1.4% at the trough in August last year to 2.1% at the peak in March this year, when it then became clear that China's re-opening was not following the playbook. One would be forgiven for having missed this tightening, as the official policy rate, and supposedly the floor of the PBoC corridor - remained unchanged through this period at 2.0%.

**Chart 1: The PBoC began tightening last year but soon reversed course**

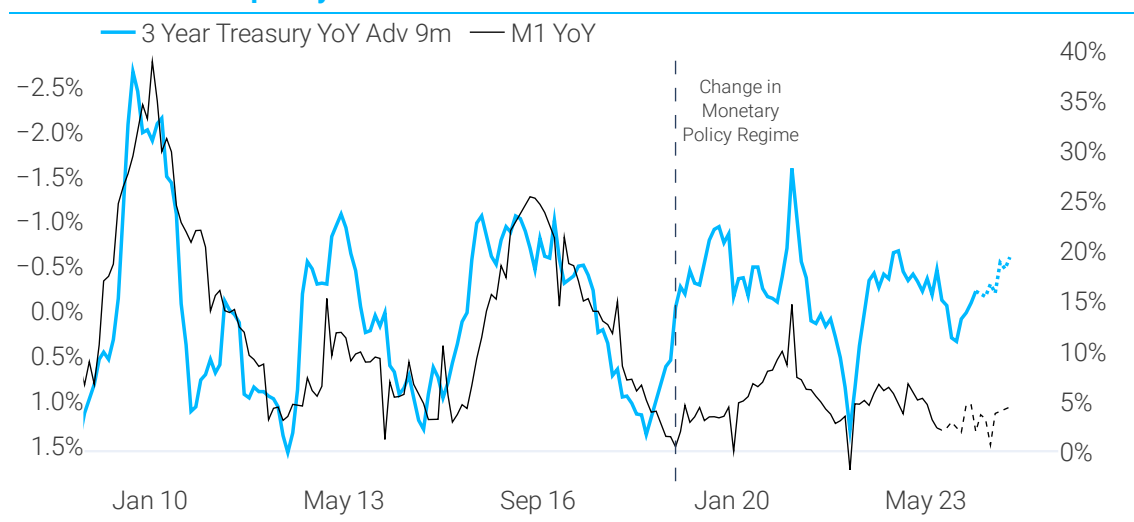


Source: CEIC, Datastream, TS Lombard

Chinese consumers lacked the rocket fuel of wealth left over from pandemic stimulus. They had saved less and the value of the wealth accumulated through this saving was more than wiped out by the loss of value in housing and equity market wealth. Chinese release of pent-up demand was a one-shot behavioural boomlet that fizzled out almost as soon as it started. As expected, there were some pockets of eye watering inflation due to the surge in demand and restricted supply in parts of the services sector. But China is now in deflation, or very low inflation excluding volatile pork effects. And growth is low enough to worry the authorities. While the PBoC quickly realized its mistake and began loosening again in Q1, the damage to liquidity conditions and to growth had already been done.

Parts of the Chinese policy machine – above all, the issuance of local government infrastructure bonds – can boost growth relatively quickly, as long as the money is, in fact, spent by the beleaguered local governments. But monetary policy operates with a lag. Even the feed-through from a shift in open-market operations appears to take a month or so, although it can be hard to tell at times owing to the wide array of tools and the behind-the-scenes action. However, once short-term interest rates start moving, it takes around three quarters for liquidity conditions to turn around. (We look at official M1 plus household demand deposits, which for some reason are not included in the official number, despite their importance to GDP growth.) And then the lag from M1 to GDP growth is another three quarters.

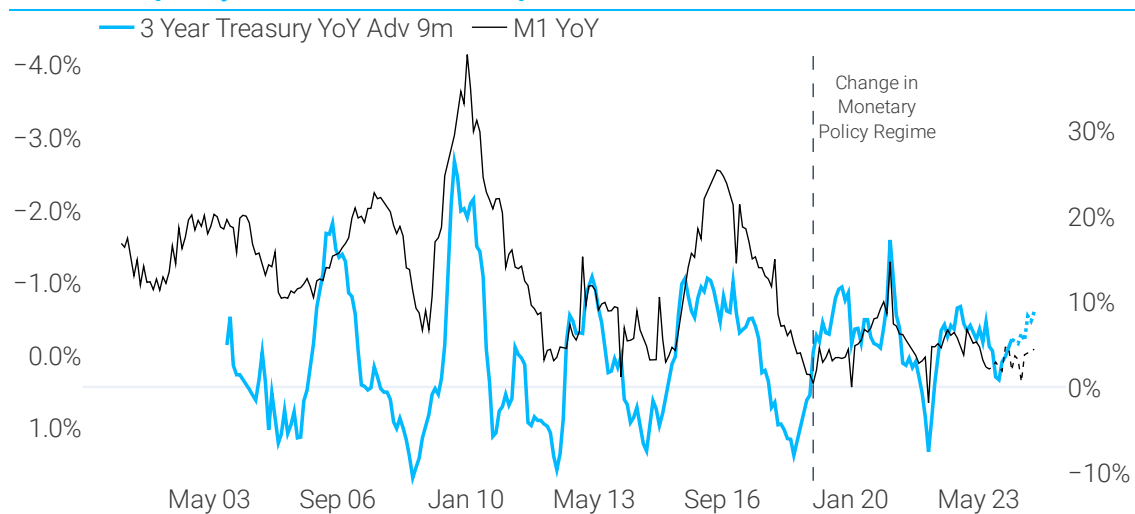
**Chart 2: China's liquidity machine is broken**



Source: CEIC, Datastream, TS Lombard

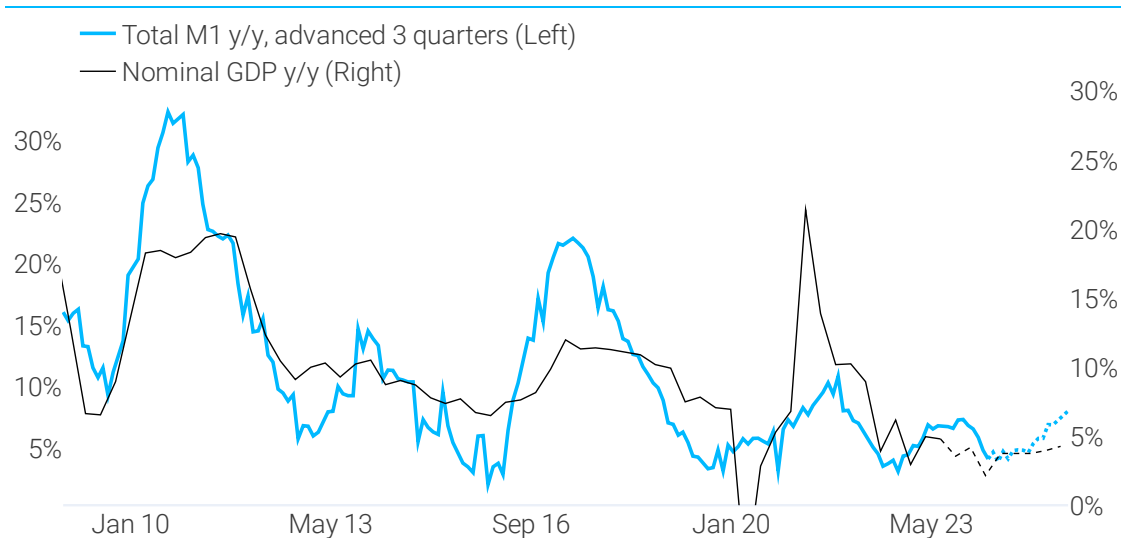
We expect the PBoC to continue loosening and the rise in M1 to match the pace in early 2020 (which, though, not particularly strong by historical standards or compared with other central banks in 2020 was significantly quicker than that over the last 12 months). And we reckon that pace will be sustained for much of next year.

**Chart 3: Liquidity is now much less responsive to interest rate cuts**



Source: CEIC, Datastream, TS Lombard

**Chart 4: Growth seems unlikely to exceed 5% this year or next**



Source: CEIC, Datastream, TS Lombard

If the lags are standard, then the liquidity conditions for the real economy should start to loosen from early next year. Activity will stay weak well into next year. Growth should start to pick up from around the middle of next year, albeit only mildly. It is hard to see the true year-on-year growth rate or quarterly annualized rates of growth rising above 5% in this period, though the official number will hit the target. Growth looks likely to trough in year-on-year terms in Q1 of next year with monthly data stabilizing in late Q4, and momentum in the economy staying moderate for most of 2024.

Indeed, our forecasts are pretty conservative. Admittedly, we don't have much on which to calibrate our models as something changed fundamentally in China around 2019 (possibly debt saturation or the shift to a more DM-style policy toolkit, followed by the "Three Red Lines" in 2020) and then Covid hit. But the experience of trying to loosen policy in 2018-19 reveals that monetary

**Chart 5: China is entering its structural hard landing**



Source: CEIC, Datastream, TS Lombard

policy doesn't work how it used to. The PBoC pushed down interest rates and the economy said "No thanks, we've had enough"; liquidity growth remained stubbornly low. So, we know that the PBoC still has control over short-term interest rates and that the relationship between M1 growth and nominal GDP growth has remained reasonably stable, but what comes in between – China's ability to create liquidity growth without resorting to large scale forced lending programs (PSL, MLF, special treasury bonds) – has hit a hurdle. In short, liquidity growth may not respond to PBoC loosening.

We've stayed on the conservative side for our M1 and GDP growth forecasts because we expect the authorities to rely on a kind of bank QE (commercial and policy bank lending to the government), as was the case in Japan before the BoJ's forays into full scale QE. Looking at the big picture, with widespread deleveraging and the attempt across swathes of the non-government sector to reduce financial deficits and increase surpluses, the government deficit (and the current account surplus) will have to accommodate the endeavour. But without the help of commercial banks or the PBoC, government borrowing does not create new liquidity. If banks buy the debt, though, money is created if and when government spends the proceeds. Banks are major buyers of local government bonds, providing a way to supplement liquidity growth, although this is no guarantee that GDP growth will respond in the same way. Indeed, it is possible that households and firms will simply hold onto the money in this environment.

All of this assumes, of course, that nothing more serious goes wrong in the meantime. Given the fragility of the corporate sector, this will be a big ask during a prolonged period of low growth and tight liquidity. Remember, the likes of Evergrande survived only as long as prices were rising, while the likes of Country Garden survived only as long as households were willing to transfer liquidity over to corporates through presales. 35% of developer funding in July was still via presales and we expect further property price declines as the impact of tight liquidity conditions feeds through together with concerns over the future actual build-out of developments whilst households become more cautious with their cash. This means things will get worse before they get better.

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