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Pushing on a string: The failure of Chinese stimulus

Low interest rates and easy access to credit have failed to boost growth because firms and households aren't willing to borrow.

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Key takeaways

- As of the end of June, three new relending quotas launched two months earlier, designed to provide cheap credit to key parts of the economy, had not been tapped at all.
- Despite a 35 basis-point reduction in the minimum mortgage rate in May, housing sales declined in June and July.
- Firms want to bolster their balance sheets by reducing debt, not borrowing more – and households are reluctant to wade back into the property market when it seems likely housing prices will fall further.
- With corporate and household demand for credit so weak, the state has stepped in as borrower of last resort. However, debt-fueled infrastructure stimulus has so far given the economy an insufficient boost.
- Beijing is doubling down on its approach, cutting interest rates further to stimulate home buying and making more funds available for infrastructure investment.
- We expect policymakers to take stock again after the 20th National Party Congress, when they might get more creative.

Beijing is in a strange position. The tools it's deployed to stimulate the economy aren't proving to be up to the task.

On one hand, the central bank (PBoC) is pushing on a string – low interest rates and easy access to credit have failed to boost growth because firms and households aren't willing to borrow. Meanwhile, efforts since May to ramp up debt-fueled infrastructure investment – the mainstay of Chinese stimulus programs since the Global Financial Crisis – have fallen flat. While past periods of infrastructure stimulus have typically been free-for-alls with little consideration for projects' financial viability, this time, there are real constraints on the type of projects that can get funded. That's limiting the scope to pump up economic activity.

Beijing hasn't given up as yet. Rather, it has doubled down on its traditional tools in the hope that lower interest rates and more funding for infrastructure will eventually breathe life into the economy. But if it doesn't, policymakers will have to get creative – but probably not until after the 20th National Party Congress in the fall.

Pushing on a string

Monetary policy has long been a major component of Chinese stimulus efforts. Traditionally, that has involved what the PBoC refers to as "flood irrigation" – repeatedly cutting banks' reserve requirement ratio, freeing vast funds to course through the financial system. The downside of the approach is that while the increased liquidity helps boost economic activity, it also fuels asset price inflation.

However, in 2019 the PBoC retired flood irrigation in favor of "drip irrigation," which involves loosening monetary conditions for those parts of the economy that need the help, avoiding unwanted side effects. In practice, that means gradually increasing interbank liquidity through open market operations; providing cheap credit to key industries through its relending facility; and gradually reducing certain interest rates.

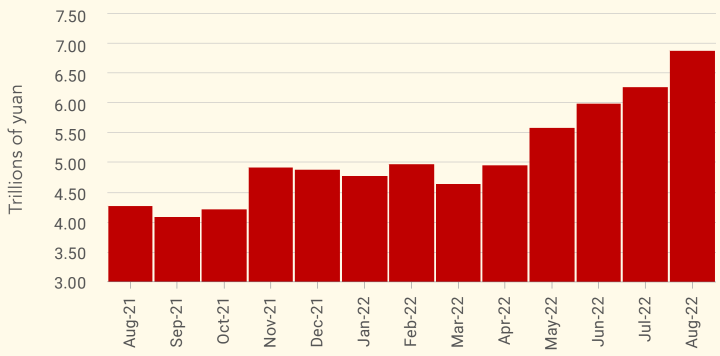
All three measures are perfectly reasonable, but credit demand is currently so weak that they've failed to stimulate growth.

1. Interbank liquidity

The banking system is awash with liquidity but has no way to deploy it. Since April, the interest rate on seven-day collateralized repos between banks (DR007) has hovered around 1.7%, well below the 2.1% level at which the PBoC sold seven-day reverse repos in open market operations for most of that time. (On August 15, the PBoC cut the rate on seven-day reverse repos to 2.0%.)

Low interbank rates reduce banks' borrowing costs, allowing them to make loans to companies and households at lower interest rates. Lower interest rates boost demand for credit among companies and households, resulting in greater economic activity. At least, that's how it's supposed to work. However, not enough firms or households currently want to borrow, even at reduced cost. Instead, lending among financial institutions has surged as they borrow cheaply to make leveraged bond purchases **[Fig. 1]**.

Fig. 1 – Average daily trading volume (collateralized repos)



Source: CEIC, Trivium

2. PBoC relending – Unspent stimulus

One of the ways the PBoC has tried to stimulate the economy is with relending. Under its relending facility, the PBoC provides commercial banks with post hoc funding for loans to certain borrowers. First, a bank makes a loan. The bank then asks the PBoC to lend the bank an amount equivalent to the loan's principal. If the loan fulfills the PBoC's criteria and the central banks' quota hasn't been used up, the PBoC transfers the funds.

The interest rate charged by the PBoC for relending is below the rate at which banks can borrow from the interbank market, thereby allowing the bank to earn a higher return than would usually be possible. Relending is supposed to be at the heart of drip irrigation, allowing the central bank to direct credit precisely to those parts of the economy it wants to stimulate. At least, in theory.

Starting in May, the PBoC increased the relending facility by RMB 340 billion. That was made up of an RMB 200 billion quota to support innovation in science and technology, RMB 100 billion to help logistics and supply chains ride out the COVID lockdowns, and RMB 40 billion to help develop elderly care facilities. The PBoC loans the funds to banks at 1.75% for a year.

It now appears that the relending facility has been a bust. According to data recently released by the PBoC, at the end of June – two months after rolling out the new quotas – all three quotas were untouched. The total amount of funds outstanding under the three programs was zero.

Of course, the banks may simply need more time before being able to take advantage of the new facilities. However, older programs are having similar problems. At the end of June, only RMB 35.7 billion of the RMB 300 billion relending quota introduced in November to support the coal industry had been used **[Fig. 2]**.

Fig. 2 – Recent PBoC relending quotas

	Quota size (billions of yuan)	Amount used at end-June 2022 (billions of yuan)
Relending to Support Clean and Efficient Use of Coal	300	35.7
Relending for technological innovation	200	0
Relending to support aged care services	40	0
Relending for transport and logistics	100	0

Source: PBoC

3. LPR and mortgage cuts

The PBoC has also been trying to stimulate home sales with interest rate cuts, without much luck.

On May 20, the five-year loan prime rate (LPR) – the benchmark lending rate against which home mortgages are priced – declined by 15 basis points (bps), from 4.6% to 4.45%. The LPR's one-year tenor remained unchanged. That same week, the PBoC delivered even more relief for the property market when it reduced the minimum interest rate banks can charge on mortgages for first-time buyers to 20 bps below the five-year LPR. Previously, the LPR had been the floor.

However, lower mortgage rates haven't delivered the hoped-for boost in housing demand. Home sales dropped 28.6% y/y in July, down from a 23.1% y/y drop in June. Meanwhile, net new medium- and long-term household loans – which includes mortgages – dropped 63% y/y in July.

The PBoC is still hoping that the lower mortgage rates will eventually stimulate demand. On August 22, it announced a further 15 bps decline in the five-year LPR, to 4.3%. The one-year LPR also declined to 3.7% from 3.65%.

Why is monetary policy proving to be less effective?

The short answer is that no one wants to borrow. Beijing's zero-COVID – or "dynamic clearing" in official bureaucratic parlance – has suppressed domestic consumption. Consequently, now is not a good time for firms to take on additional debt.

Meanwhile, people aren't willing to buy homes. Home prices have been falling across much of the country, so people are wary of buying in case they fall further. Moreover, they're wary of buying homes in advance of completion – which is central to developers' funding model – particularly from private-sector developers for fear that the home they buy won't be delivered on time.

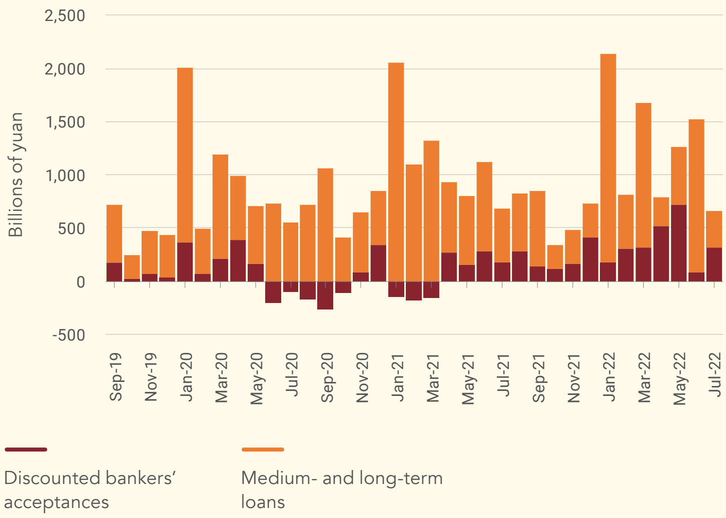
That's further suppressing domestic consumption. In its second quarter Monetary Policy Report, the PBoC warned that one reason consumption is still so weak is that household "balance sheets are damaged." We believe the PBoC is saying that declining housing prices have reduced households' net worth, making people less willing to spend.

A similar dynamic is at work among firms. Li Yang, chairman of the National Institution for Finance and Development (NIFD), a state-linked think tank, recently said that because the economic slowdown has forced asset prices down (both equities and property have taken a battering this year), firms have less collateral against which they can borrow. Instead, they're focused on riding out the storm by reducing their debts. Li said,

> ***"Companies usually aim at maximizing profits. They're beginning to minimize liabilities"***

Banks are under political pressure to lend but can't find borrowers. Instead, they've been bolstering their loan data by discounting bankers' acceptance, a type of low-risk credit that contributes very little toward economic activity (see our June 24 report "Low-calorie loans: How bankers' acceptances are undermining the impact of credit growth"). In July, the increase in discounted bankers' acceptances (RMB 313.6 billion) was only marginally less than the increase in medium- and long-term loans (RMB 341.1 billion) **[Fig. 3]**. Meanwhile, short-term loans contracted.

Fig. 3 – Monthly increase in banks' medium- and long-term loans vs. discounted bankers' acceptances (in billions of yuan)



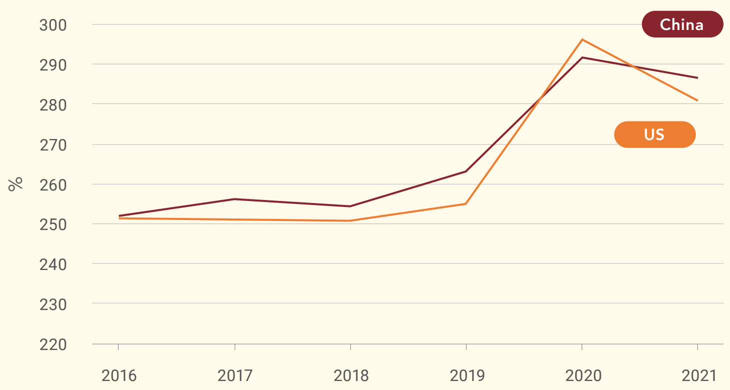
Source: PBoC

This is where infrastructure-led stimulus usually comes in

When pushing on a string, the solution is for the state to step forth as the borrower of last resort. It's a role Beijing has played time and again. Whenever growth slows, the government commits itself to using borrowed funds to build new infrastructure. That creates instant demand. It employs construction workers, truck drivers, and other logistics workers. It generates demand for cement, steel, glass, construction machinery, copper, and aluminum. The economic activity generates taxes that local authorities put to work providing public services.

True to form, China is doing the same again this time. Except this time, Beijing is insisting that the infrastructure projects can generate sufficient income to repay the debt they incur. With China's debt-to-GDP ratio at levels comparable to developed economies, Beijing doesn't want to add to it with projects that will result in bad loans **[Fig. 4]**.

Fig. 4 – Debt-to-GDP ratio: China vs. the US



Source: BIS

This time, Beijing only wants to deploy funds toward projects that can generate adequate returns to repay the debt. However, either there are not enough of these projects, or they can't be launched quickly enough, or local governments don't have sufficient capital to get them off the ground. It's likely a combination of all three. But the result is that even though Beijing wants the state to be the borrower of last resort, it's operating under self-imposed constraints, which means the state has so far proven incapable of borrowing – and investing – in sufficient quantities to offset the decline in property activity and consumption.

So, what happens next?

At the moment, Beijing is doubling down. After May's mortgage rate cuts failed to stimulate housing demand, the mortgage benchmark was lowered again when the five-year LPR declined on August 22.

Then on August 24, the State Council rolled out more stimulus. Local governments will be allocated an additional RMB 500 billion special-purpose bond quota to be issued from previously unused quotas. Additionally, the funds that policy banks can use to capitalize local government infrastructure projects was doubled from RMB 300 billion to RMB 600 billion. In addition, the State Council said that major state power producers will issue RMB 200 billion in special bonds to ensure power supply.

Will this all prove sufficient? Maybe. However, incremental expansion of existing stimulus efforts strikes us as inadequate for dealing with China's greatest economic challenge in 15 years. We expect Beijing will likely stay the course until after the 20th National Party Congress, which will be held sometime in the next three months.

After that, policymakers can take stock – and perhaps try a new approach. But the upshot, for now, is that growth will continue to bump along at very weak levels for most of the rest of the year, at a minimum.