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China caught in 'dead money' trap as central bank pleads for fiscal stimulus

Struggling to haul itself to sustainable growth? Officials at China's central bank have begun to call for a fundamental change in strategy, warning that interest rate cuts have become an increasingly blunt tool. CREDIT: REUTERS

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China is at mounting risk of a Japanese-style "liquidity trap" as monetary policy loses traction and the economy approaches credit exhaustion, forcing a shift towards Keynesian fiscal stimulus.

Officials at the Chinese People's Bank (PBOC) have begun to call for a fundamental change in strategy, warning that interest rate cuts have become an increasingly blunt tool.

They cannot easily stop companies hoarding cash or halt the slide in private investment.

Sheng Songcheng, the PBOC's head of analysis, set off a storm last month by warning that the economy had "started to show some signs of being caught in a liquidity trap".

He has since stepped up his pleas for action by the fiscal authorities to relieve the burden on the central bank, a Chinese variant of the parallel drama that is being played out in Europe and Japan.

Mr Sheng told China Business News on Monday that the country has a very low reliance on foreign borrowing and can easily afford to shore up the economy with a Keynesian boost.

Zhou Xiaochuan, governor of the People's Bank of China CREDIT: AP

“China can let its deficit-to-GDP ratio rise to over 3pc or even 5pc in the long run. It can spur growth more effectively by lowering corporate taxes than by cutting the interest rate,” he said.

The powerful State Council has now joined the chorus with calls this week for a $75bn cut in business taxes to boost confidence and channel stimulus to the productive economy.

Caixin magazine said Chinese companies are hoarding record sums of “dead money” rather than spending it. The growth rate of private investment has dropped to 2.1pc over the last seven months, the lowest since global financial crisis.

The central bank is effectively 'pushing on a string', an expression coined by John Maynard Keynes in the 1930s.

It cited a client report by China International Capital Corp (CICC) warning that the underlying picture is deteriorating, despite a surge in public spending and a property boom that is for now masking the problem.

“Funds are being held back by a dam and are not flowing into the real economy, which shows that the liquidity trap is getting worse,” it said.

While the term ‘liquidity trap’ is loosely used, it has menacing echoes of the Great Depression, and has plagued Japan on and off for fifteen years.

Louis Kuijs from Oxford Economics said credit expansion is achieving ever less “bang for the buck” as money floods into real estate speculation and financial assets - a saga all too familiar in Anglo-Saxon economies.

Mr Kuijs said it took 44 yuan to generate 100 yuan of gross fixed capital formation from 2002 to 2008. This rose to 62 last year. It is now running at 70.

Each time the authorities resort to credit to keep the boom going, the less traction they achieve and the greater the risks.

The International Monetary Fund earlier this month that corporate debt has reached 145pc of GDP. “Vulnerabilities are still rising on a dangerous trajectory. They must be addressed immediately,” it said.

The financial system is clearly out of kilter. The outstanding stock of mortgages has jumped by 30pc over the last year alone to $2.5 trillion, crowding out the credit market. Net new loans to businesses contracted in June for the first time in eleven years.

The Chinese authorities have to walk a tightrope since capital outflows crept up to $42bn in July, the highest since the panic earlier this year. Capital Economics estimates that the central bank had to sell $29bn of foreign bonds to support yuan last month.

Such bond sales automatically entail monetary tightening unless they can be fully sterilized, which is difficult in China. While reserve loss at this pace is not in itself worrying, any further acceleration would ring alarm bells.

Caixin said PBOC officials are worried about a rare divergence in the key monetary aggregates. So-called ‘narrow’ M1 –cash and checking accounts - surged 25.4pc in July year-on-year. Yet the broader M2 measure that matters more has slowed to 10.2pc.

“The slowdown in M2 suggests that the money created by the PBOC is not being put to productive use. It is just sitting idle in corporate bank accounts,” it said.

Simon Ward, a monetary expert from Henderson Global Investors, said there is nothing to fear. The surge in M1 is a sign that companies and consumers are shifting money into their accounts in order to spend it, and this will cause economic growth to pick up yet further over coming months.

Mr Ward said the ‘velocity’ of M2 money is almost certainly accelerating. “It is the opposite of a liquidity trap,” he said.