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China in Ten Charts

A New Impossible Trinity

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China's policy trilemma: Growth, credit risk and foreign debt

Many who are conversant with the Chinese economy and renminbi should be familiar with Robert Mundell's theory of Impossible Trinity: a country cannot have an independent monetary policy, an open capital account, and a fixed exchange rate at the same time. So if China loosens cross-border flows further, the currency has to float to enable the central bank to be autonomous (to fix the interest rate).

But this trilemma is no longer a pressing concern. The PBoC can now influence onshore interest rates. Bond yields have dropped after the reserve requirement ratio (RRR) cuts from April to June. Policymakers seem to have successfully floated the currency too. CNY weakened rapidly, hitting 6.7 against USD in July without any market panic (slide 3). Cross-border flows are still closely monitored, but generally corporates and investors can buy and sell USD for genuine transactions (slide 4).

However, China faces a new policy trilemma: if President Xi Jinping truly prioritises reforms over growth, we must see more corporate defaults or foreign borrowing. But if the government does not want higher offshore USD debts, they must sacrifice some growth. They can't have all three.

Removing the implicit government guarantee is a necessary evil. Since the national fiscal audits in 2013 and 2015, the central government has tried to detach itself from ill-defined liabilities, notably the local government financing vehicles (LGFVs). This is done via taming shadow lending (slide 5). Since these activities were a key funding source for LGFVs, SMEs, and other borrowers which major banks do not serve, we must see credit spreads surge as a result of the deleveraging process (slide 6).

Many corporates opted to borrow from offshore (slide 7) in 2017. However, the rapid rise of foreign debt has triggered policymakers' concern (slide 8). In Q1 2018, China's foreign liabilities hit a record high of USD1.8trn (29% y/y), extending its uptrend since Q1 2016. 53% of it was USD debt and 64% were short-term debt. Meanwhile, Q1 also saw China's first current account deficits since 2001 (slide 9). Going forward, the outlook for China's FX reserves position deserves attention.

We believe that slowing GDP growth is not a risk; the temptation to pump prime the economy is. The RRR cuts in April and July are unlikely to be monetary policy responses to growth risks. Any impact from the US-China trade war is still insufficient to halt the deleveraging process (slide 10). Thus, we believe the cuts are a response to the normalised 'M1-M2 gap' (slide 11) which indicates shadow lending is under-controlled. Chinese regulators are tackling credit allocation on banks' balance sheets under the flag of 'structural deleveraging'. GDP growth will still slow (ANZ: 6.3% for H2, slide 12). Market sentiment will be poor. But targeting growth over reform will be worse, in our view.

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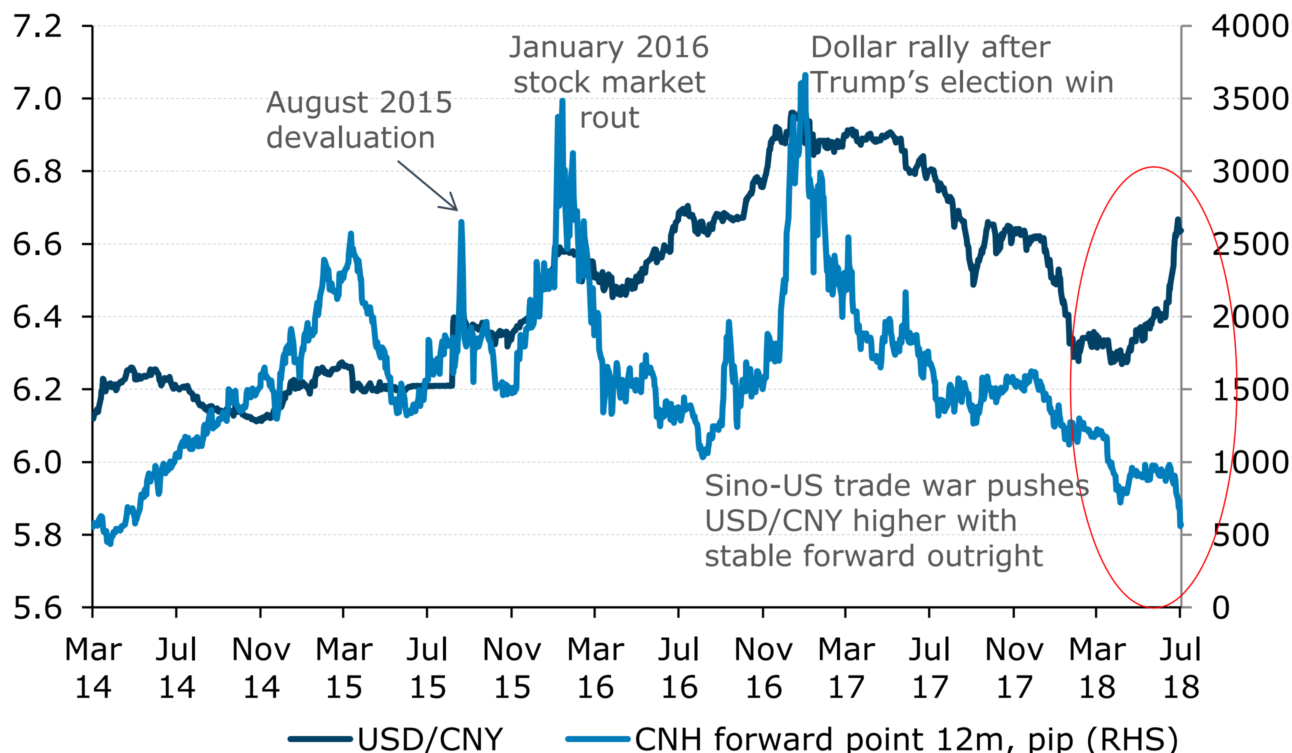
Yuan falls sharply but the market has not panicked

The yuan hit 6.72 against the USD on 3 July, compared with 6.24 on 27 March. However, the forward market suggests that currency traders don't believe this will persist. The spike in the spot rate was not accompanied with a sharp rise in CNH forward points.

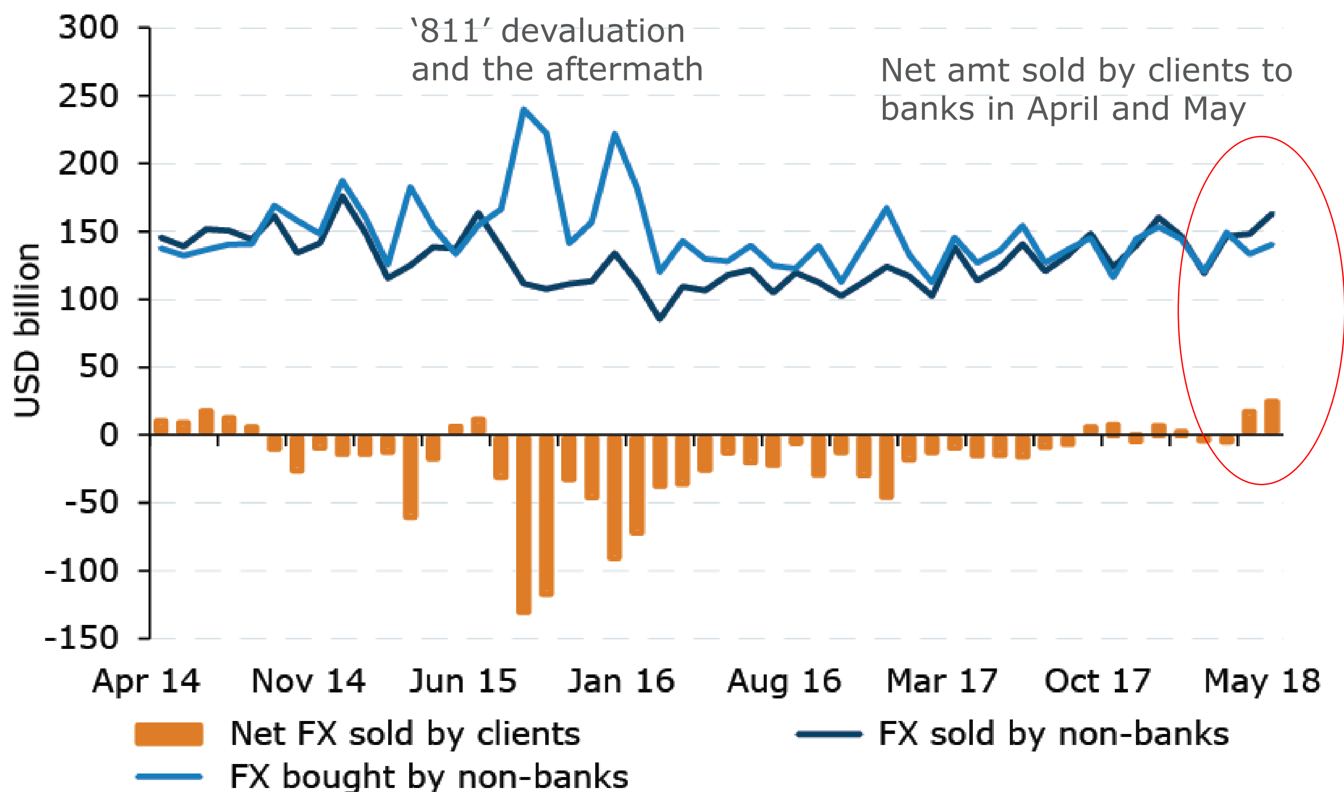


Source: Bloomberg, ANZ Research

Tight onshore liquidity could be reason for corporate FX selling

Corporates sold USD163bn of FX to banks in May, the highest since May 2015. The consecutive monthly net selling by bank clients signals the beginning of a trend reversal of corporate FX selling as clients likely want more yuan funds on the back of tighter liquidity conditions.

FX transacted between clients and their banks

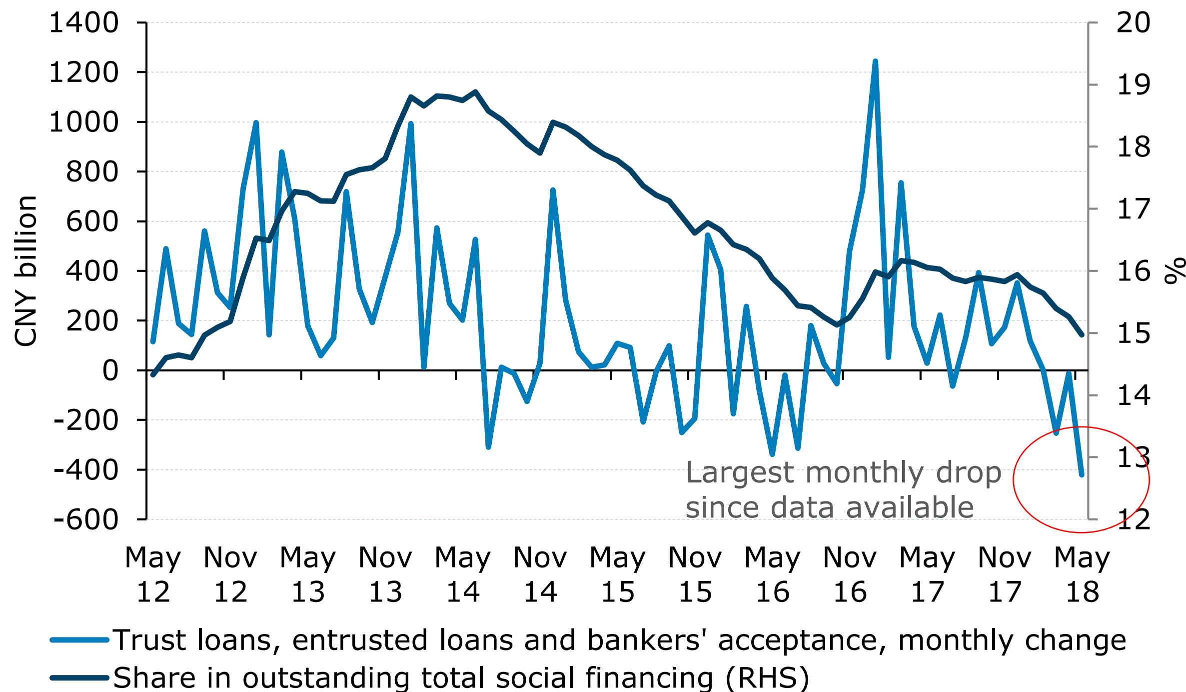


Source: CEIC, ANZ Research

Taming of shadow banking causes liquidity constraints

Chinese policymakers are determined to continue financial deleveraging. In May, we saw the largest monthly contraction in shadow lending activity since data was available. The share of these activities also reached a record low since end 2012.

Total social financing and shadow banking components



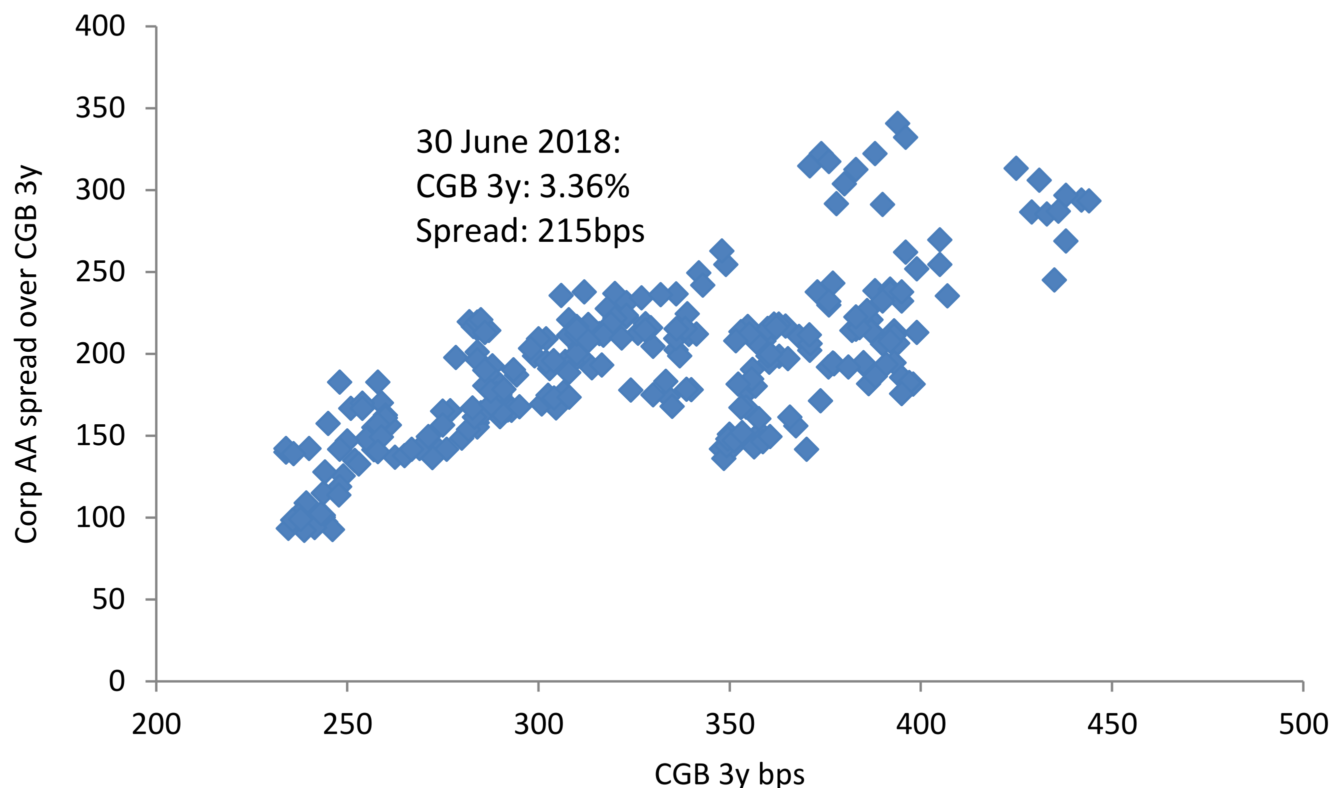
The monthly statistics of total social financing are available since December 2015. Early data are estimated by linear interpolation.

Source: Bloomberg, ANZ Research

With rising credit risks, more defaults will be reported.

Tightening liquidity conditions in the shadow lending sector drive up the credit spread. The goal of financial deleveraging is to uncover credit risks. Cracking the implicit government guarantee (刚性兑付) is the major objective of the current reform, targeting local government financing vehicles

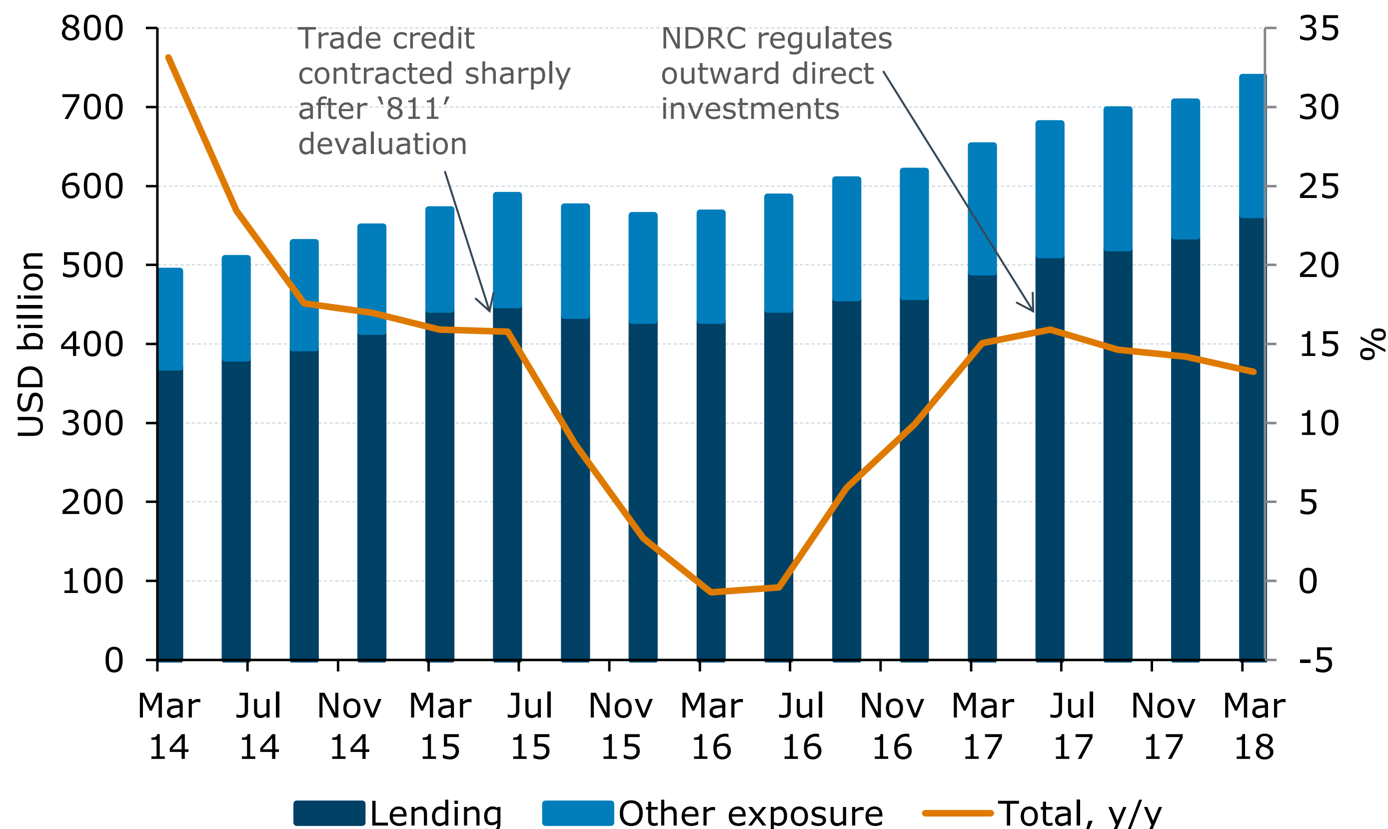
China's credit spread vs sovereign bond yields



Source: WIND, ANZ Research

Offshore borrowing by Chinese corporates will slow in H2

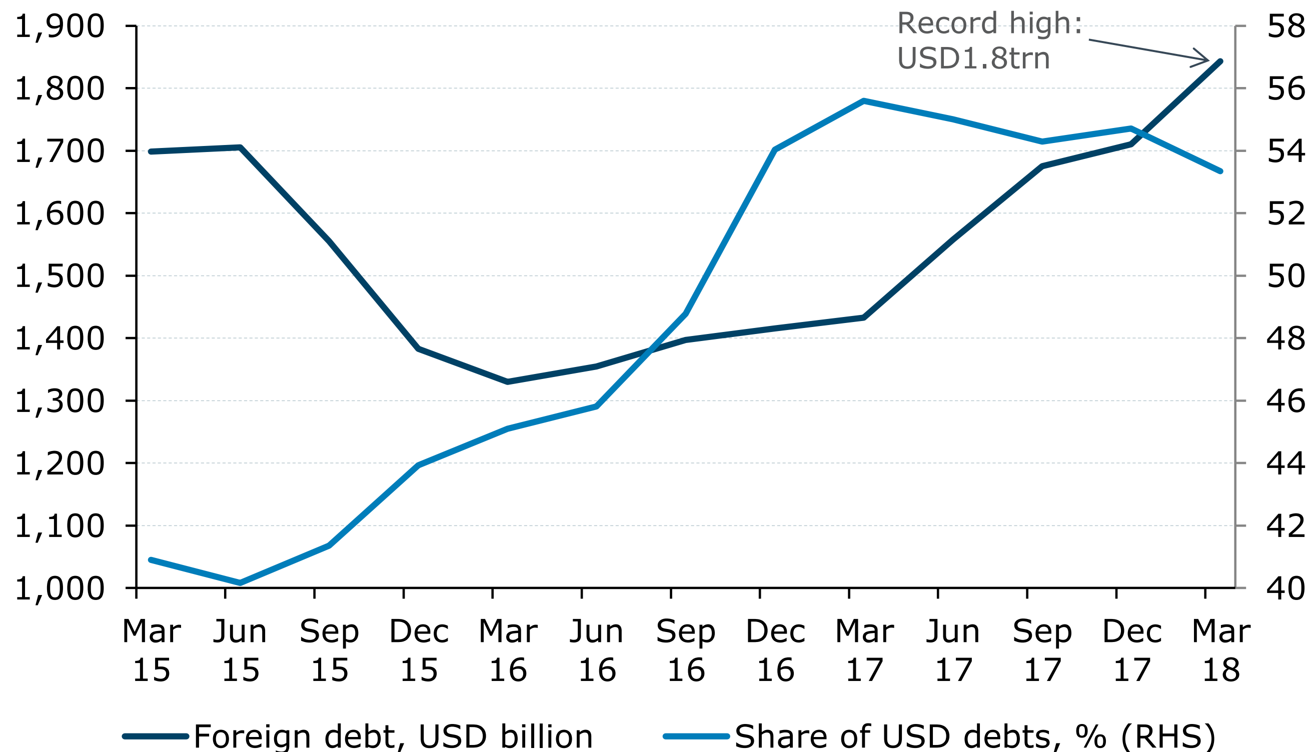
NDRC said it will control foreign borrowing by Chinese enterprises. USD bond issuance with tenors shorter than one year will also be restricted. Hong Kong, a shadow banker for large Chinese corporates, experienced a surge in loans in 2017 but they have eased to USD738bn in Q1 2018.



Source: Bloomberg, ANZ Research

Foreign debt rises rapidly, triggering policymakers' concern

Foreign debt levels reached an all-time high of USD1.8trn (29% y/y) in Q1. It is expected to increase in Q2. The authorities are concerned about the fast build-up of foreign debt. While USD debt represented 53% of the total, EUR debt rose 60% y/y (equivalent to USD109bn).

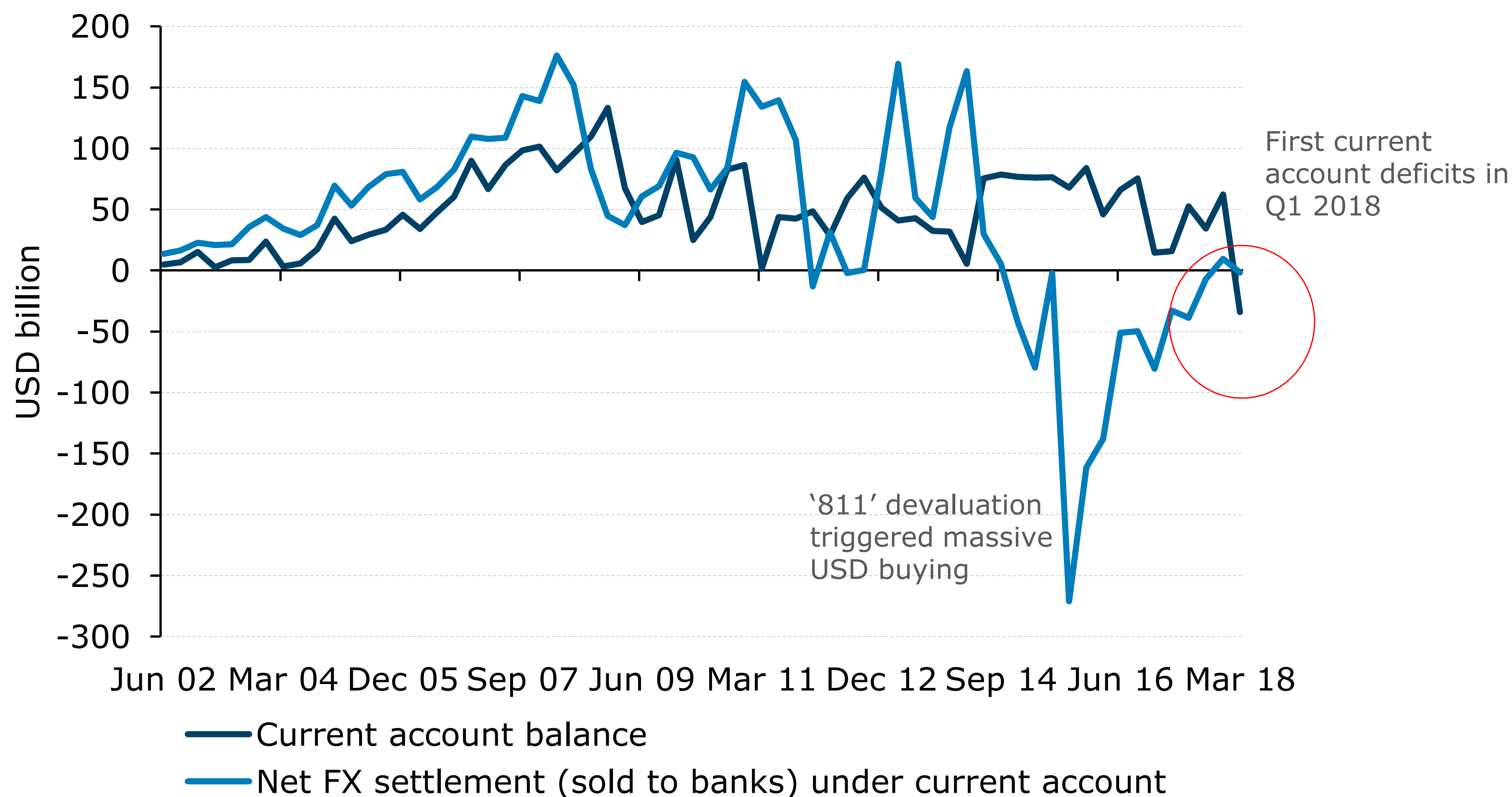


Source: CEIC, ANZ Research

China's net importer status carries FX implications

The first current account deficit of USD34bn was reported in Q1 2018. Although the deficits did not trigger massive buying of foreign exchange (ie USD). A net importing China means the end of the yuan's one way appreciation unless the financial liberalisation attracts persistent inflows.

China's current account balance and related FX settlements



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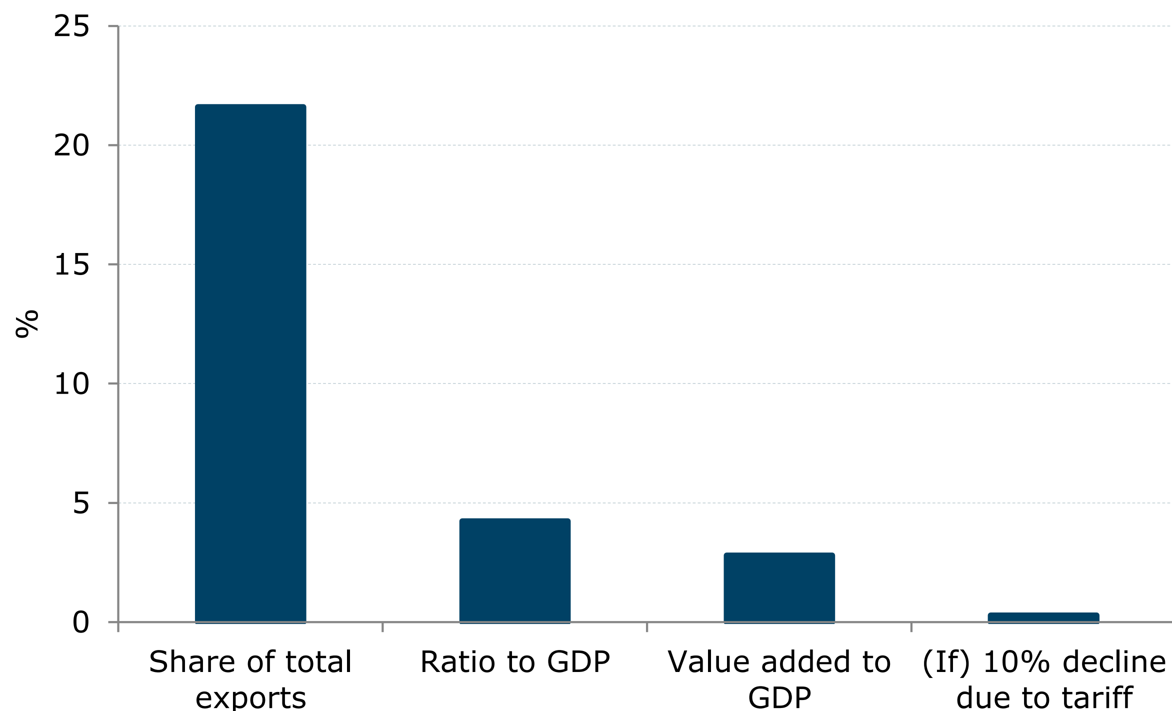
The direct impact of China-US trade war on GDP is immaterial

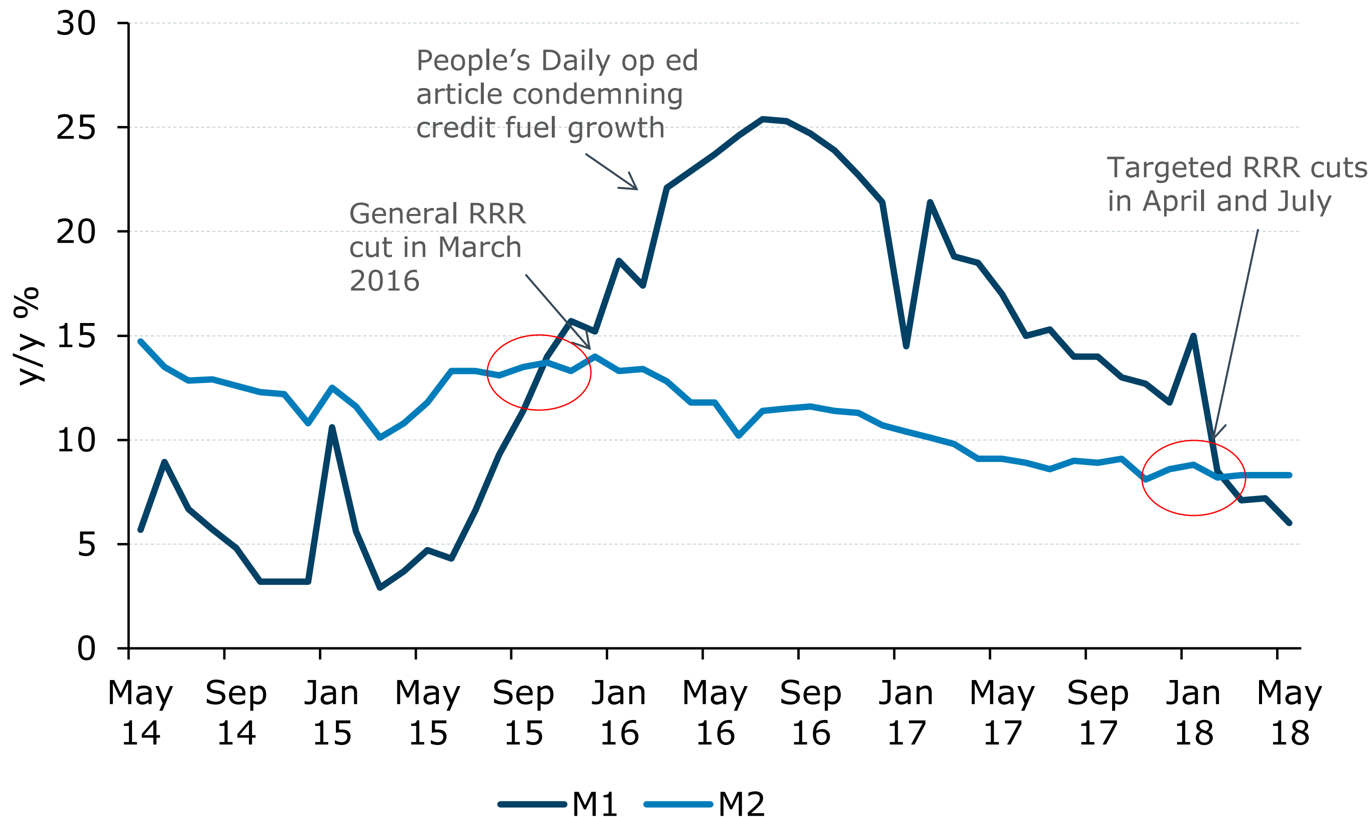
Trump's import tariffs on Chinese goods amount to USD50bn, roughly one-tenth of total Chinese imports. But USD50bn of goods represent less than 0.3% of China's GDP, and is not much higher than the combined sales made by Taobao (USD25bn) and JD.com (USD19bn) on Singles Day, their annual sale event on 11 November 2017.



Source: CEIC, ANZ Research

The PBOC resumes RRR cuts with the M1-M2 cross normalising

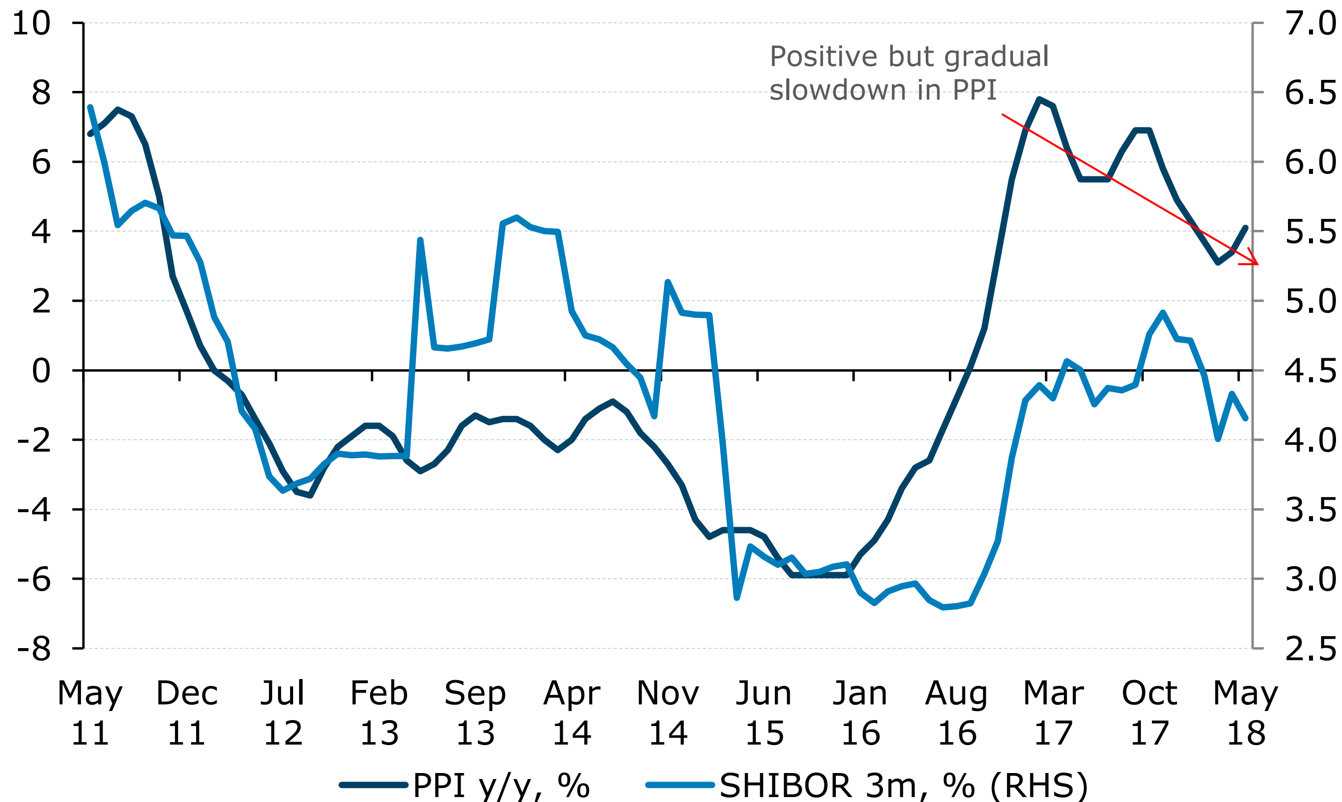
M1 money supply growth fell below that of M2 in March 2018. Way back in 2016, we wrote that the M1-M2 gap mirrors the fast rise of the wealth management sector and shadow lending. The PBoC stopped their RRR cuts afterwards. Now that the gap has normalised, the PBoC resumes its RRR cuts.



Source: Bloomberg, ANZ Research

A cyclical slowdown is inevitable amid deleveraging

The producer price index (PPI), our preferred gauge of China's business cycle, points to a likely slowdown in H2. We expect headline GDP to slow to 6.3% y/y in H2. While this will be the lowest since the GFC, China's GDP will still expand sequentially (average: 1.5% q/q sa)



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