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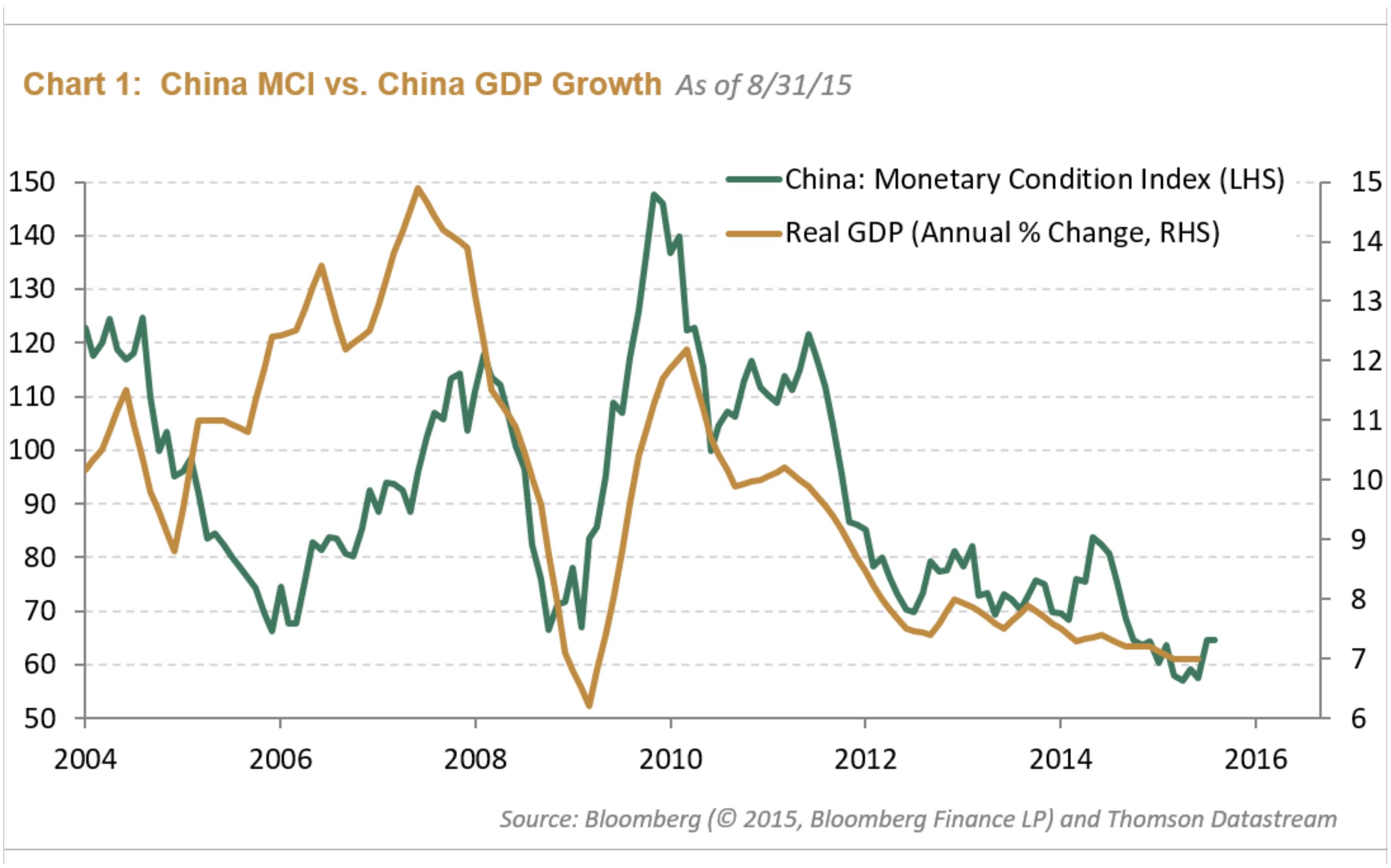
Around THE Curve

China Needs to Abandon Its Bad Economic Policy

The Chinese economy is on its worst growth trajectory since 2008, and many indicators suggest the economy has yet to turn the corner. Many forces caused the Chinese economic machine to sputter; however, Beijing's unduly tight monetary, fiscal, and foreign-exchange rate policies—together with a series of miscalculations and policy mistakes—are important factors that deserve blame.
President Xi and Premier Li inherited an economy burdened with many cyclical, as well as structural problems. High levels of debt are thought to be a key threat facing the economy. The government has bought into the idea that a deleveraging process must be engineered sooner rather than later to avoid bigger economic and financial fallout down the road.

As a result, Beijing has opted for very tight monetary and foreign-exchange rate policies, even though the economy has slowed sharply. Going into the slowdown in 2012, the People's Bank of China kept the reserve requirement ratio at punitively high levels in order to restrict credit creation. Even after three cuts this year, the reserve requirement ratio still stands at 18%, the highest in the world. Real interest rates on bank loans exceed 10% as price levels have dropped. A China monetary conditions index dropped to its lowest levels ever, indicating the tightest monetary conditions in the economy in its post-reform history.

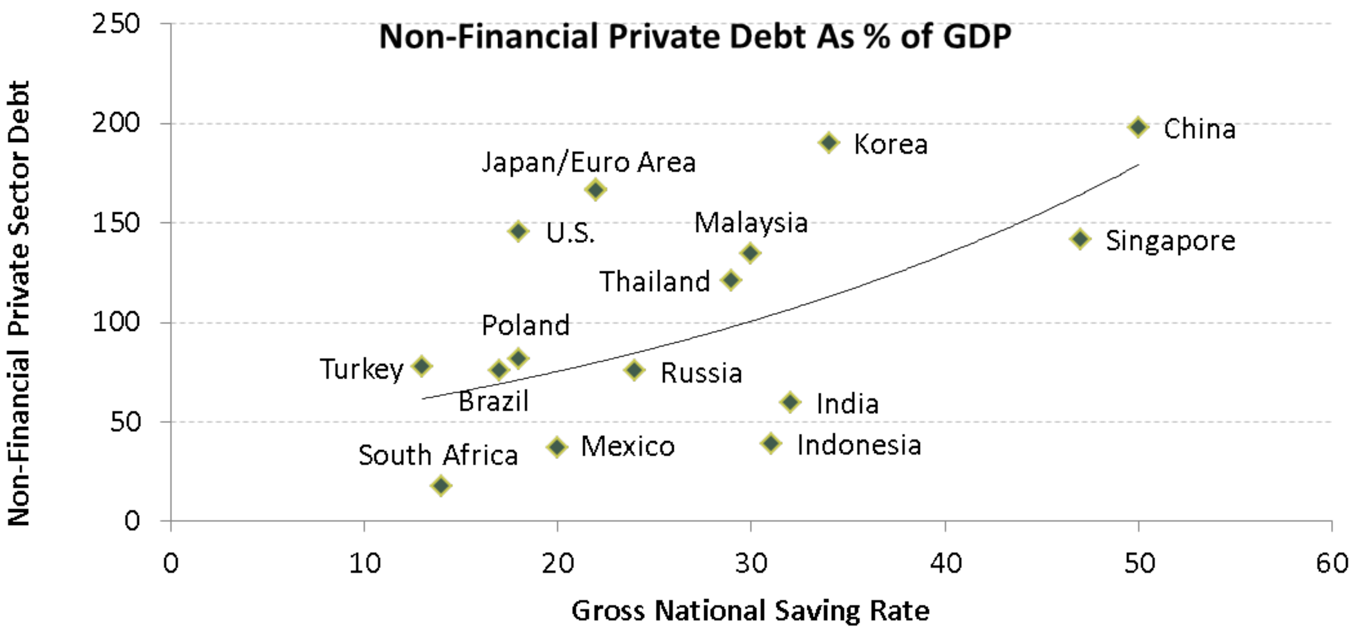


As recently as 2014, monetary authorities tacitly encouraged and potentially even orchestrated a dangerous

liquidity crunch in the interbank market as a way of curtailing borrowing activities. These events have led to severe financial dislocation today, plunging the economy into a self-feeding, de-leveraging style growth slowdown.

While President Xi and Premier Li's desire to reduce China's outstanding debt is genuine, they have ignored an important fact: de-leveraging in a high-saving economy is an extremely dangerous—if not impossible—endeavor. Debt tends to grow as savings is converted into investment. As such, countries with high savings rates inevitably end up with high levels of credit creation, or accumulated debt. This is why many Asian economies with high savings rates have significantly higher debt levels than others.

Chart 2: Savings Rate and Debt / GDP Ratio *% of GDP; As of 3/31/15*



Source: Thomson Datastream

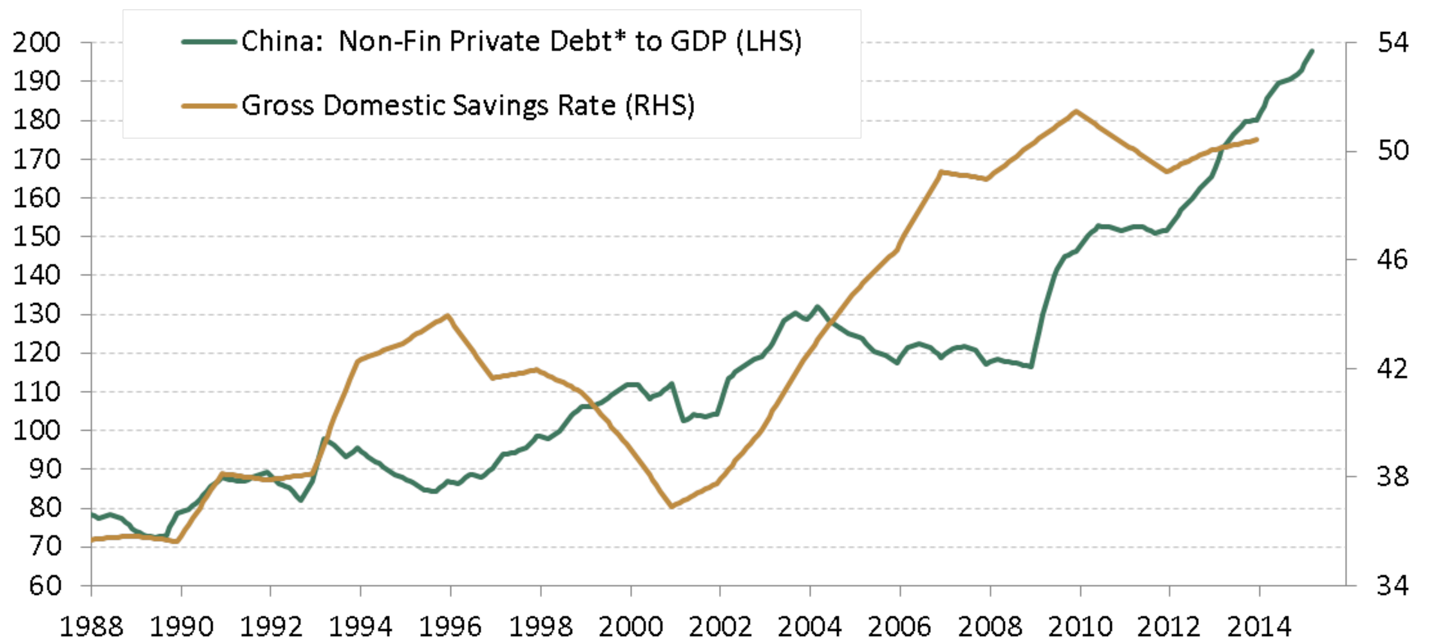
The Chinese government should view the country's "debt problem" in the context of the economy's savings behavior, financial structure, and basic macroeconomic balances. Unlike the U.S.—where over 70% of savings allocation is handled by the equity market—China's financial structure is such that banks have to be the key intermediary for converting savings into investment. The Chinese equity market is simply not deep and broad enough to fulfill the function.

This is no different from Europe or Japan, where banks also play a dominant role in financial intermediation. Within this structure, any attempt to purposely squeeze credit creation can only result in financial dislocation, leading to over-saving, price deflation, and a sharp downturn in economic growth.

Of course, this does not mean that China should expand its debt load indefinitely. Excessive accumulation of debt is not desirable for any economy, as too heavy a debt burden can sap economic vitality and trigger financial instability. Unfortunately, it is never easy to tell where the theoretical debt limit lies—beyond which point long-term growth and stability are negatively impacted without a compensating benefit to short-term growth, employment, or other desired benefits—nor do we have much success in terms of reducing indebtedness on an orderly basis. The last time the total indebtedness of the major world economies came down was in the 1930s, when deleveraging coincided with devastating economic and financial destruction.

In this regard, China's own experience actually offers some interesting insights. China's total credit-to-gross domestic product (GDP) ratio was virtually flat between 2003 and 2008, when its economy was in a massive boom. During this period, the absolute volume of total credit grew by ¥22 trillion (or $3.5 trillion), which translated into an average annual rate of 19%, while China's debt/GDP level was constant. The reason for a steady debt/GDP ratio is that China's gross nominal GDP expanded by the same amount.

Chart 3: China Total Credit / GDP Ratio *% of GDP; As of 3/31/15*



Source: Thomson Datastream

Indeed, economic growth worked wonders. Rapid Chinese economic growth reduced the debt/GDP ratio by through GDP expansion, thus increasing the denominator, and also quickened the turnover of the total inventory of credit or debt, because a strong economy allowed borrowers to quickly return their borrowed money. In other words, the same amount of credit in a strengthening economy can facilitate the creation, exchange, and consumption of more goods and services, thus increasing the efficiency of the financial system.

The picture has been drastically different since 2009. By hitting the brake hard, the Chinese government succeed in reducing total credit growth to a mere 12%—the lowest rate ever in modern China—from well over 36% in 2009. However, the debt/GDP ratio has continued to escalate, now standing at 200%, up massively from 120% six years ago. In the meantime, businesses are depressed, local governments are scrambling for cash, corporate defaults are rising, and non-performing loans are increasing.

The message to the Chinese government seems clear: promoting economic growth is the best way to resolve China's "debt problem," and using a passive and liquidationist approach to cut down debt is counterproductive and destabilizing for the economy. The good news is that deflationary pressures have forced Chinese authorities to backpedal from their untimely and misguided monetary and fiscal tightening. The bad news is that Beijing is still way behind the deflationary curve.

Although the People's Bank of China began cutting rates in 2014 and aggressively cut in 2015 by an aggregate 140 basis points, the real interest rate on Chinese bank loans remains far above GDP growth, which will continue to squeeze credit demand and create downward pressure on growth. Not to mention the yuan appreciated by 40% since 2011 in real broad trade-weighted terms, which in and of itself is de facto monetary tightening that weighs disproportionately on exporters. And lastly, although Beijing has announced a large debt-swap plan for local governments, the dramatic fall in proceeds from land sales has deprived Chinese provinces of much-needed revenues, forcing them to retrench.

All of these factors suggest that Beijing needs to wake up and slash interest rates—sharply and quickly—to stimulate credit demand, ease the credit crunch, and generate an upturn in economic growth. Fiscal policy also needs to become much more expansionary than it has been. Pro-growth fiscal policy is the only remedy or offset to devaluation pressures. Only when fiscal stimulus is ramped up will the large-scale yuan devaluation be spared. Failing to implement a comprehensive stimulus program could send the Chinese economy into a path similar to what we have seen in post-bubble Japan.

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