China blinks as economic downturn deepens

By Ambrose Evans-Pritchard, International Business Editor
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China has abandoned its policy of monetary tightening, cutting interest rates for the first time in over two years to head off a corporate crunch and mounting dangers of deflation.

The move set off an instant spike in the price of crude oil and other key commodities as traders bet on a fundamental pivot by the Chinese authorities and a return to the bad old ways of credit-driven growth.

The People’s Bank of China caught markets off guard, cutting the benchmark lending rate by 40 basis points to 5.6pc and the deposit rate by 25 basis points to 2.75pc. It also liberalised bank rates in a free market tilt.

“Every time the economy slows, they blink,” said Patrick Chovanec from Silvercrest Asset Management. “The danger is that they will keep trying to shore up a growth model that is past its sell-by date.”

The central bank denied that it is changing tack, insisting that the cuts target a specific problem of high-financing costs for firms. “It does not signal that the direction of policy has changed. There is no need for strong stimulus,” it said in a rare statement.

Tao Wang from UBS said falling inflation has caused the real cost of borrowing for average companies to rise from zero to 5.5pc since 2011, a drastic form of passive tightening. The interest burden for non-financial companies has jumped from 7.5pc to 15pc of GDP over the same period.

Yet the rate cuts are a clear shift in policy from the piecemeal liquidity injections of recent weeks, a sign that Beijing is alarmed by the depth of the economic slowdown.
HSBC’s gauge of factory output fell to a six-month low in November, touching the contraction line of 50. President Xi Jinping said last week that there are risks to growth, but they are “not so scary”.

“They are acting under duress,” said George Magnus from UBS. “There has been a hefty decline in new housing starts. I don’t think these rate cuts are going to stop the secular downswing in the economy, whatever the Pavlovian reaction of the markets. China is not safe until they put the credit genie back in the bottle but that is going to be very difficult to do.”

From IMF

Joanthan Fenby from Trusted Sources said the cuts were needed to offset $250bn of tightening caused by a clamp-down on the shadow banking system, which has been frozen over the last two months. “Parts of the private sector have been really squeezed. Mining stocks are shooting up in Australia and North America on this move but people are not looking at the rest of the story,” he said.

China is uncomfortably close to deflation, made worse by the plunge in the Japanese yen, and by China’s quasi-peg to the soaring US dollar. The country is importing a contractionary policy at a time when its housing boom is already wilting, with prices down for the last six months.
Factory gate prices have dropped for 32 months, and pressures are spreading to consumer inflation. The headline rate dropped to 1.6pc in October.

Mr Chovanec said China is so addicted to credit that it needs loan growth near 20pc to keep the game going. "Credit growth has fallen to 13pc and that is so tight for China it is strangling them. They are getting less GDP bump out of more and more credit, and that tells you loss-making assets are being rolled over. Nothing but creative accounting will stop non-performing loans from rising," he said.
Wei Yao from Societe Generale said bad loans are rising at a clip of 50pc a year. "The worst is still to come and banks know it. Chinese banks have doubled their loan loss provisions," she said.

"But the bigger concern lies with state-owned enterprises (SOE). We estimate SOE debt at close to 100pc of GDP, twice as much as private corporate borrowing. Given that banks have always preferred SOEs, a disproportionately large part of banks’ balance sheets is probably locked in to non-performing SOE loans," she said.

Analysts said the State Council may have forced the hand of the central bank, which has been trying to wean the country off credit before it is too late. The debt ratio has reached 250pc of GDP by some measures, an unprecedented level for a large developing economy.

Mark Williams from Capital Economics said growth is cooling but there is no sign yet of serious distress. "We think this is fairly gentle and manageable. We should start to worry if we hear of a
lot of firms going under or jobs being lost, but so far that is not happening. Wage growth is running at double digit rates,” he said. "We don’t think much of the links that some are drawing between the PBOC’s moves today, loosening by the Bank of Japan and the European Central Bank, and the value of the renminbi," he said. The bank could at any time drive down the Chinese currency by reverting to its old policy of purchasing foreign bonds. "If the People’s Bank did want to weaken the renminbi, it has $3.9 trillion of foreign exchange reserves to remind it what to do. There is no evidence that it wants to.”

Wao Yao agreed that there is no significant shift to a looser policy, arguing that the liquidity injections over recent months are chiefly intended to compensate for the contractionary effect of reducing purchases of foreign bonds. The PBOC has explicitly stated this in its latest quarterly report.

The government is targeting jobs and seems willing to tolerate lower growth so long as unemployment stays near 5pc. The labour force is shrinking by three million a year, a legacy effect of China’s one-child policy. Urban migration from the country is slowing fast.

This is automatically tightening the labour market, and greatly reduces the risk of a social explosion. It may yet be too early to conclude that the President Xi has capitulated and returned to stimulus as usual.