China’s fiscal cliff

By Ambrose Evans-Pritchard, The Telegraph, 6 Feb 2015

Nobody can fault China's leaders for lack of bravery. The Politburo has kept its nerve as the world's most giddy experiment in credit-driven growth faces assault on three major fronts at once.

Real interest rates have rocketed. The trade-weighted rise in the yuan over the past two years has been spectacular. Fiscal policy is about to tighten drastically as the authorities clamp down on big-spending local governments.

Put together, China is pursuing the most contractionary mix of economic policies in the G20, relative to the status quo ante. Collateral damage is already visible in the sliding global prices of iron ore, copper, nickel, lead and zinc over recent months, as well as thermal coal, oil, corn and even sugar.

Beijing attempts to rein in spending

Zhiwei Zhang, from Deutsche Bank, says China faces a "fiscal cliff" this year as Beijing attempts to rein in spending. "This year, China will likely face the worst fiscal challenge since 1981. This is not well recognised in the market," he said.

The International Monetary Fund says China's budget deficit topped 10pc of GDP in 2014 if measured properly, including borrowing by the regions through "financing vehicles" as well as land sales - a patently unsustainable form of funding that makes up 35pc of local government revenue. This is the highest deficit of any major country in the world, and far above safe levels.

The property slump drags on

A budget squeeze is already emerging as the property slump drags on. Zhiwei Zhang says land revenues fell 21pc in the fourth quarter of last year. "The decline of fiscal revenue is the top risk in China and will lead to a sharp slowdown," he said.

China's Development Research Centre (DRC) - the brain trust of premier Li Keqiang - has issued a new report on the bankruptcy of California's Orange County in 1994. "It is a warning to China that the country needs to improve its tax system," said the paper.

Interestingly, the DRC has also published a report recently on the decline in China's electrical, mechanical and car industries, a finding that might surprise some in the West.

The Chinese tax system is highly leveraged to the property cycle, like Ireland's before the boom broke in 2007. The scale is epic. A study by the US Federal Reserve found that property investment in China has risen from 4pc to 15pc of GDP since 1998. This is even higher than in Japan in the blow-off years of the late 1980s.

The denouement is well under way. Home prices fell 3.1pc in January from a year earlier. Average sales have dropped 7pc from a year ago in the large Tier 1 cities, 22pc for Tier 2 and 15pc for the Tier 3 towns.

The inventory overhang has risen to 18 months, three times US levels. New floor space has dropped 30pc on a three-month moving average.

Most of Asia housing booms exceed US 2008 bubble

China is not the only country in Asia facing a hangover. Nomura's Rob Subbaraman says housing booms in India, Hong Kong and Taiwan all match or exceed the US bubble in 2008, with Malaysia not far behind. "Asia is setting itself up for a major credit crunch," he said.

Nomura warned that markets are relying too much on a "China policy put", betting that Beijing will always come to the rescue with more stimulus if need be. "We believe there is creeping investor complacency. We assign a one-in-three chance of a hard landing – growth averaging 5pc or less over four quarters – starting within the next two years."

Premier Li appears determined to grasp the nettle, openly acknowledging that China has exhausted the low-hanging fruit of catch-up growth and reached the safe limits of credit expansion. He praised a report concluding that China will remain stuck in the "middle income trap" without a top-to-bottom overhaul of the economic system.

New regulations came into force in January that prohibit local governments from raising money off-books. If enforced fully, this will tighten fiscal policy by 5.5pc of GDP this year, roughly five times the dose in austerity in the UK each year since the Lehman crisis. That is the sort of fiscal contraction imposed on Greece.

This would risk a depression

"They will have to find some way to manouvre around this, because they can't let it happen. But there are certainly risks," said Mark Williams, from Capital Economics.

China cannot easily crank up monetary stimulus to cushion the fiscal shock because the "efficiency" of credit has collapsed. The economy is saturated. Extra growth generated by each extra yuan of loans has dropped from a ratio of 0.8 to 0.2 since 2008.

"Most new lending at present goes to roll over existing debt," said Diana Choyleva, from Lombard Street Research. "The appetite for ‘genuine’ credit is muted. Flooding the banks with liquidity may help relieve interbank stress, but it’s not going to feed straight into real activity."

Total credit $26 trillion

Total credit has already risen from 100pc to 250pc of GDP in eight years to $26 trillion, equal to the US and Japanese banking systems combined. Li Keqiang has clearly concluded that any further leverage compounds the danger for little useful effect.

The People's Bank of China (PBOC) cut the seven-day interest rate to 5.5pc on Wednesday from 7pc, the latest in a blizzard of rate cuts. This is not monetary stimulus, or a signal that China is about to flood the world with fresh liquidity, whatever the appearances.

Wang Tao, an economist at UBS, says the benchmark one-year borrowing cost for Chinese companies has jumped by 800 basis points in real terms since 2011 as inflation collapses. Business profits fell 9pc in the fourth quarter of last year. The latest cuts merely "mitigate massive tightening" already under way. "With industrial profit growth already mired in recession, risks are quickly building up in financial system," she said.

China close to a deflationary trap

China is uncomfortably close to a deflationary trap. Factory gate prices fell 4.3pc in January, a sign of excess capacity across the economy. The PBOC admitted on Wednesday for the first time that it is probing the deflation threat.

Global markets greeted the recent cuts in lending rates and the Reserve Requirement Ratio (RRR) as evidence that China is turning on the spigot once again. This is a misunderstanding. The RRR cut adds no net stimulus. It offsets monetary tightening that occurs automatically as the central bank dips into the country's €3.8 trillion foreign reserves to shore up the currency.

Capital deficit record $91bn in fourth quarter

China is no longer buying US Treasuries and global bonds. It has become a net seller, stepping in to offset accelerating outflows of capital. The capital deficit reached a record $91bn in the fourth quarter.

The PBOC is now in the mirror position of boom years when it was buying foreign assets at a vertiginous pace, causing liquidity inside China to surge. All of a sudden that liquidity is draining away.

There is another twist to this. The PBOC's reserve body, SAFE, was still buying $30bn a month of global bonds a year ago. It is now selling an estimated $10bn a month. This a $40bn a month shift in central bank intervention in the asset markets, a lot more than the extra $15bn a month that the Bank of Japan has been buying since October.

Or put another way, Asia is "tapering" at a pace of $25bn a month. You could argue that this neutralises half the quantitative easing soon to come from the European Central Bank.

China needs a devaluation

A country in China's predicament normally needs a devaluation, yet China has fixed the yuan - through a "dirty float" - to a soaring US dollar. The yuan has risen 60pc against the Japanese yen and 90pc against Brazil's real since mid-2012. It has risen 27pc against the euro over the past year alone, and 110pc against the Russian rouble.

Mrs Choyleva says China's true growth rate fell to 4.4pc last year, and to just 1.7pc in the fourth quarter. "Beijing needs to support growth and its only viable option is a weaker yuan," she said.

The obvious danger for the world is China may be forced to defend itself as monetary disorder spreads and half the big central banks resort to currency combat. Such a fateful decision would send a deflationary impulse through a global system that has already used up its monetary ammunition and no longer has shock absorbers. China's excess capacity - made worse by $5 trillion of fixed investment in 2014 - would land with a thud in Europe and America.

For now the PBOC insists that the yuan will "remain very stable". We will find out soon enough whether this means stable against the dollar, or the euro, or the yen.