Global Macro Research - Insight

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China: is a policy pivot coming out of the shadows?

Turmoil in small cap equities created another headache for the country's policy makers and is one of the reasons why household savings will probably sit on the sidelines. The elevation of 'productive forces' as policy priority should give further impetus to easing but will likely amplify the supply-side biased policy response, keeping 'low-flation' concerns on the table.

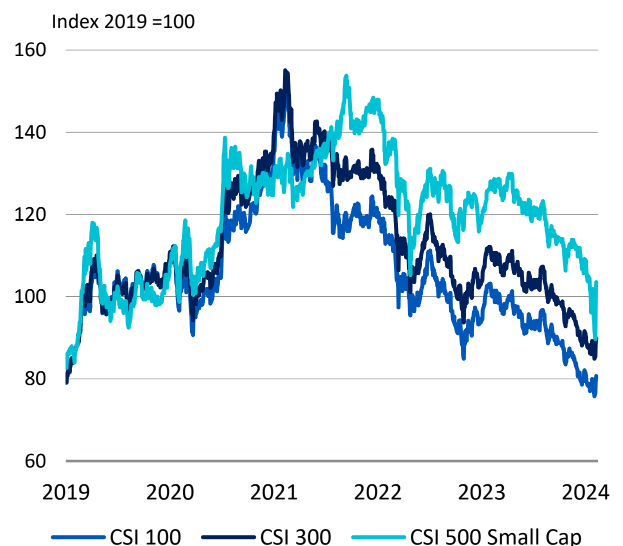
Key Takeaways

- Government interventions to shore up China's equity markets show the authorities are mindful of the risks of allowing a free fall, but there is little indication that they are meaningfully gearing up to tackle the souring of investor confidence in the economy.
- That said, rising attention given to 'productive forces' by the Politburo could imply that the authorities are concerned by the near stalling of total factor productivity since the end of 2020. This could spur further easing to target the key building blocks of potential growth. Should this policy pivot materialise, it would however risk embedding 'low-flation', as a supply-side biased policy response leans on investment and risks building excess capacity.
- Policy continues to gain traction, as illustrated by robust credit flows and a further loosening of our China Financial Conditions Index (CFCI). January's credit flow included an unusually large contribution from 'shadow' banking. But there is little indication that the authorities are about to unchain it, even if rising bank to non-bank financial sector links appear to have been condoned.
- The desire to hold the line on de-risking will still result in a targeted and incremental approach, even if potential growth moves up the priority list. Overall, we remain somewhat cautious about the Year of the Dragon and our 2024 growth forecast remains at 4.4%.

Equities act as another headwind to confidence

The CSI 500 has been on a rollercoaster ride as 'snowball' derivative contracts initially amplified the small cap slide, and then news of the authorities' interventions helped stocks to recover (see Figure 1). Central Huijin – part of China's sovereign wealth fund – said it would buy exchange traded funds, while Wu Qing took over as the head of the China Securities Regulatory Commission (CSRC), coinciding with rumours that institutions had been encouraged to hold onto their A-shares.

Figure 1: The authorities helped stop a free fall, but indices are still around 40% off their peaks



Source: Haver, abrdn (February 2024)

China's stock market has more limited ramifications for the broader economy than those in developed countries, but pressure on equities adds to the negative wealth effect from falling house prices, potentially keeping substantial household savings on the sidelines.

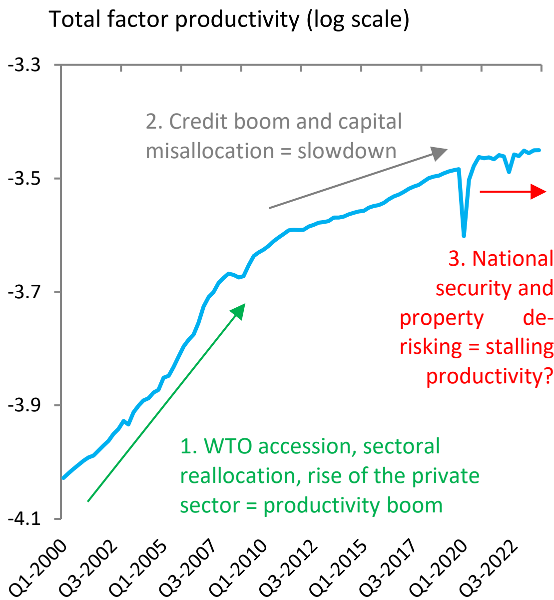
Productivity now in focus

Government interventions to prop up equities show that the authorities are mindful of the dangers of a free fall, but they are effectively treating the symptoms.

That said, the rising attention given to 'productive forces' by the Politburo could signal that efforts are set to shift towards dealing with fundamental issues.

President Xi noted the need to monitor total factor productivity (TFP), which has been a key reason for the lacklustre economic performance since the end of 2020 (see Figure 2).

Figure 2: Productivity may not be everything, but in the long run it is nearly everything



Source: Haver, abrdn (February 2024)

Our estimates of TFP imply a near stalling since Q4 2020. If it persists, it will create a major headwind to China's growth prospects, perhaps leading the economy into a 'middle-income trap'.

Of course, damage to productivity from the pandemic and attempts to de-risk the real estate sector may well fade, and the authorities may judge that this hit was worthwhile, particularly if it reduces downside risks from the systemically important property market.

But there is also a danger that productivity remains tepid. Bolstering resilience via 'dual circulation' in the face of geopolitical pressures remains a top policy priority, and that may necessitate moving down the efficiency-resilience spectrum. Attempts to create a home-grown advanced semiconductor industry risks the return of capital misallocation, which was prevalent following the post-GFC credit boom. At the same time, transitioning to a more state-dominated real estate sector could weigh on growth for a long time to come, given substantial upstream and downstream linkages.

Judging whether China is slipping into a productivity crisis will be particularly difficult. While it is a key economic variable, TFP is also referred to as a 'measure of our ignorance', reflecting its determination as a residual from GDP versus the inputs that act as the building blocks of growth (i.e. labour, education, machinery and equipment).

Given uncertainty about China's 'true' GDP, the rate of capital deepening and (especially) the state of employment, the country's productivity is harder to gauge than most. If China's employment has been weaker than we estimate, TFP may not be as dire as it appears, for example.

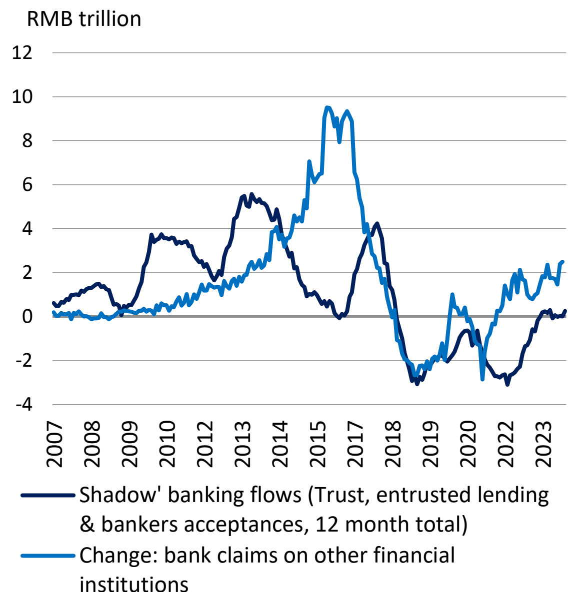
Policy continues to gain traction

Strong credit flows in January are at least indicative of policy loosening that continues to gain traction.

Total Social Financing (TSF) was RMB 6.5 trillion, 0.9 trillion above consensus, helped by robust corporate bond issuance and surging 'shadow' banking flows.

The RMB 0.6 trillion 'shadow' credit flow is particularly unusual. This component can be very volatile, suggesting it may unwind over the next few months, tempering TSF growth going forward.

Figure 3: Strong 'shadow' credit flows in January, and links from banks to the rest of the financial system rose



Source: Haver, abrdn (February 2024)

Indeed, while one interpretation is that the de-risking squeeze on this sector has abated (with flows netting out around zero over the past year), there is little indication that the authorities are about to unchain it, having forced through a painful adjustment since de-risking began in 2017.

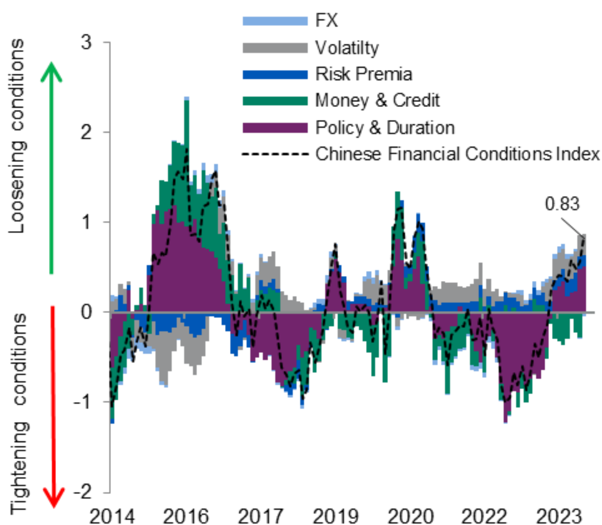
Another indicator of financial system complexity and risk has however been creeping up in a not insignificant manner. Since the end of 2021, bank claims on other financial institutions have climbed by RMB 4 trillion to RMB 28 trillion. This may reflect a degree of 'national duty' related to the stress placed on the system by zero-Covid in 2022 and the ongoing real estate adjustment. But it could also signal that some growth in the dark spots of the financial system is being condoned (see Figure 3).

Overall, we estimate that the authorities have managed to push policy further into a modestly accommodative position. Reflective of this, our China Financial Conditions Index (CFCI) rose 0.26 points to 0.83 in January (see Figure 4).

Money & Credit proved a notable driver of the monthly rise as M1 money supply growth was strong through January. The changing timing of the Lunar New Year celebrations however is likely overstating the extent to which money supply grew in the month; seasonal adjustment appears to struggle to deal with the impact of this year's Lunar New Year, and we have adjusted the series somewhat to dampen this effect.

Nevertheless, an unwind of the seasonal effects on M1 in February could cause January's CFCI loosening to partially reverse. The previously announced 50bps cut to banks' reserve requirement ratios from February 5 should boost liquidity and aid borrowing conditions, partially mitigating any tightening stemming from M1. Falling bond yields should also continue to feed into the boost from Policy & Duration.

Figure 4: Policy conditions eased again in January but lunar effects cast some doubt over the extent



Source: Bloomberg, Haver, abrdn (February 2024)

Additionally, the larger-than-expected 25bps cut to the five-year loan prime rate on 20 February signals the desire of policy makers to increase support to the flailing property sector. This decision can be viewed as part of the incremental approach of policy support for the sector, but the effectiveness of what is the largest cut to the rate since its inception may be curtailed by the squeeze on banks' net interest margins.

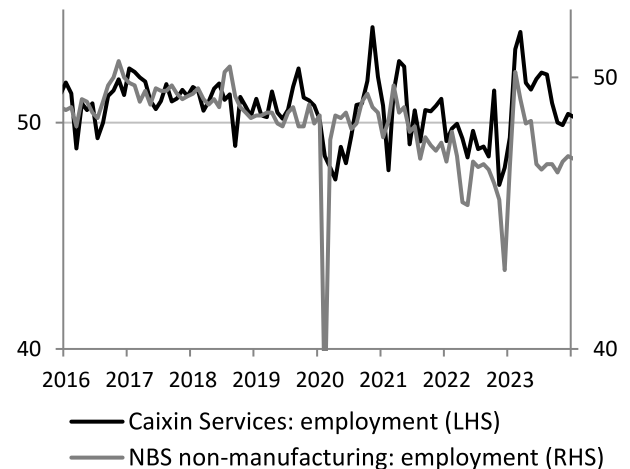
Seasonal black box

As is usual around the Lunar New Year, there is limited data available to help judge activity momentum – our China Activity Index will return next month.

What little data that is out paints a somewhat mixed picture.

The Caixin composite PMI points to an acceleration of activity since November, but the official NBS January PMI suggests a much more tentative improvement. While the large gap between the two series is somewhat unusual – primarily reflecting the strength of the Caixin services measure – both sets of PMIs continue to suggest that the labour market remains soft (see Figure 5). This, alongside falling house and equity prices, is a key reason why we expect household savings to continue to sit on the sidelines.

Figure 5: PMI sub-indices imply that the Chinese labour market remains soft, even if a gap has opened



Source: Refinitiv, Haver, abrdn (February 2024)

Inflation also remains weak, consistent with an economy that is still finding it hard to move onto firmer ground. But Lunar New Year effects are also exaggerating China's current deflationary episode.

Headline consumer prices fell from -0.3% to -0.8% year over year in January. But the seasonally adjusted index has risen marginally over the past three months, as core components have offset continued falls in food and energy (-5.5% and -0.9% respectively).

Lunar New Year effects should unwind in February, helping push headline CPI inflation out of deflationary territory more conclusively in the coming months.

We do however expect that deflation fears will instead be replaced by 'low-flation' concerns, as the focus on 'productive forces' will likely amplify the supply-side biased policy response.

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