Of Communism and Hard Money: Quantitative Tightening in China Continues (20/08/20)

‘If something cannot go on forever, it will stop’ - Stein’s Law

‘Be realistic, demand the impossible’ - Che Guevara

China now has less reserve money/commercial bank reserves than it had in February 2015. The total sum of reserve money/commercial bank reserves has contracted 10% from its peak at the end of December 2018. This monetary lethargy is in great contrast to the alacrity with which most central bankers have sprung into action to expand their balance sheets in recent times. Is the Chinese Communist Party the last disciple of hard money?

Most market practitioners are unaware that the PBOC is unwilling, or unable, to expand its balance sheet. This research piece will focus on how this enforced contraction is happening and why it matters. The conclusion is that the PBOC is unable to expand its balance sheet, which brings forward the time when it must move to a flexible exchange rate, and such a development will accelerate the move to a more aggressive phase of the cold war between China and most of the rest of the world. China too must inflate away its debts but it will not do so while pursuing a managed exchange rate policy. And now, for the reasoning behind such important conclusions.

A quick step back to explain the money creation mechanism is essential in expounding why the PBOC cannot ultimately buck the market and is unable to expand its balance sheet. In running the managed exchange rate the PBOC is forced to intervene in the foreign currency markets. Such intervention impacts the size of its assets, but also the size of its liabilities. If it intervenes to prevent the appreciation of the exchange rate, it adds to its foreign currency assets and creates matching liabilities, in the form of reserve money/commercial bank reserves, to exchange for those foreign assets. Should it intervene to support the exchange rate then the process is reversed and reserve money/commercial bank reserves are destroyed.

The expansion and contraction of a central bank balance sheet is a key tool of monetary policy and by targeting the exchange rate the authorities have effectively allowed the central bank balance sheet to adjust automatically, depending upon the conditions of the external accounts. This reserve money, created or destroyed in that adjustment, are the reserves that commercial banks hold with the central bank to meet their legally decreed liquidity ratios - a ratio between those reserves and the banks' deposits. China’s foreign reserves contracted from 2014 to 2016 and have basically flat-lined ever since. The balance sheet of the PBOC has not grown in two and a half years. Given this monetary constriction, how has the Chinese economy grown over the period?

You can’t buck the market - unless you’re the PBOC. At least, that is a statement your analyst hears regularly from investors. The very fact that the Chinese economy has continued to grow, with a fairly stable exchange rate, since 2015, despite no growth in reserve money, does suggest that the PBOC does have some unique rabbits to pull out of the hat.

There are three tools the PBOC has that add significantly to its monetary armoury. The first is that the country operates fairly successful capital controls; the second that policy makers ultimately control the so-called commercial banking system. The third, now exhausted, was the ability to redeem bonds it had previously issued to mitigate the growth in reserve money. As we shall explore, these blunt tools of monetary policy do permit the PBOC to pull some strong levers, but they do not ultimately allow them to run an independent monetary policy and continue to engineer a stable exchange rate. The lack of growth in reserve money is not compatible with domestic reflation, but that reflation is essential for economic, social and political stability in China. ‘If something can’t go on forever, it will stop’ sayeth Stein.
Through the complete redemption of the outstanding bonds it had issued, the PBOC has exhausted the ammunition from one of its exceptional monetary weapons. Using that weapon has allowed the PBOC to grow reserve money since 2014, while foreign exchange reserves have fallen. The mechanism by which this was achieved was through reversing the PBOC’s sterilization programme. In that exercise the PBOC redeemed the bonds it had issued in increasing amounts since the beginning of its sterilization process in 2004. By issuing such bonds in return for money, the PBOC had mopped up some of the reserves it had created through its foreign exchange intervention. As foreign exchange reserves dropped from 2014, contracting reserve money, the PBOC redeemed these bonds and added reserves back to the system.

By September 2016 the PBOC’s bond issuance had been reduced to negligible amounts and RMB4.7tn of reserve money had been added back to the system. The major initial decline in reserve money from 2014 had thus been largely offset by the reverse sterilization. With all the bonds redeemed by mid-2016 there would now be a more direct link between the PBOC’s foreign reserves and the amount of reserve money. Since that reverse sterilization operation was completed reserve money has grown by just 2.2%.

Reserve money has flat-lined, along with the growth in foreign reserves. Reserve money is now tied directly to growth in the PBOC foreign assets and those assets are not growing. In the absence of a sudden move to larger external surpluses forcing greater growth in PBOC external reserves how might the PBOC’s other unique monetary weapons be used to buck the market?

The use of capital controls, an administrative fetter upon market-driven movements of capital, is also helping to keep monetary policy easier than it would otherwise be and the economy growing. By operating capital controls the policy makers of China can, to some extent, manage whether there is upward or downward pressure on the exchange rate. By refusing to permit the exit of domestic capital, and increasingly foreign capital, they can mitigate the downward pressure on the exchange rate and the forced contraction of reserve money that would follow.

Of course, the capital controls only allow the authorities to manage one of the key flows of money that ultimately impact whether there is net selling or net buying of RMB on the foreign exchange markets. What is more difficult to control is the rate of capital inflow, and also the import and export growth rates that determine the scale of the current account surplus or deficit. So, by restricting capital outflow the capital controls engineer greater net buying of the RMB than would otherwise occur but that, of course, does not mean that it must engineer net buying and it hasn’t. The control of one key factor determining the capital account is important but it is still just one factor.

The stability of the PBOC’s foreign assets, China’s foreign exchange reserves, from early 2017, indicates that the country is running a capital account deficit that offsets the impact on foreign reserves of its now small, relative to GDP, current account surplus. The capital controls are still helping the PBOC manage the size of its balance sheet, because they are ensuring the capital account deficit is smaller than it would otherwise be. Without such controls the ensuing capital outflows would see China running an even bigger capital account deficit, forcing a contraction in reserve money as PBOC foreign assets shrink to defend the exchange rate. This tool of capital control has helped for three and a half years but it has not resulted in upward pressure on the exchange rate, a rise in the PBOC’s foreign assets, or a rise in reserve money. The market has been bucked somewhat but the result has still been a tight monetary policy - the tightest by far of any major nation.

If there has been no rise in reserve assets since the beginning of 2017, how has the Chinese economy continued to grow? In nominal terms the Chinese economy is 24% larger in June 2020 than it was in June 2017. Over the same period Chinese M2 has grown by an almost identical amount. So the real riddle of Chinese growth is how the commercial banking system, that has seen no growth in its reserves since the beginning of 2017, has been able to grow its balance sheet and in the process create a 24% growth in broad money over the same period.

State ownership of China’s deposit-taking institutions does mean that Chinese policy makers can create broad money growth on demand. A phone-call from the Chinese Communist Party (CCP) can see bank management respond with the requisite amount of loan growth, regardless of available reserves, to
create ever more credit and money. Many analysts believe that it is through this mechanism that the
PBOC can buck the market. If there is no link between the level of reserves in the ‘commercial’ banking
system and the size of its balance sheet, then the commercial banks’ balance sheets can expand to
whatever size necessary to produce enough money to support Chinese growth.

That analysis ignores the fact that China needs to reconcile its level of economic growth with the stability
of its exchange rate. A central bank that contracts its foreign reserves and reserve money to defend the
exchange rate, but with the other hand encourages money creation by the commercial banks, is dicing
with danger. Any managed exchange rate regime works around the ability of the domestic economy to
adjust to produce the alterations in the external accounts that create the stability of the exchange rate.
By forcing the banking system to expand its balance sheets to create credit and money, the PBOC
prevents the adjustment of the domestic economy that alters the condition of its external accounts and
underpins the stability of the exchange rate.

China has been doing just that for the past few years and the result has been that its external accounts,
the current account plus the capital account, are only just in balance. That balance we can measure
monthly in the failure of the foreign exchange reserves to increase. The creation of ever more money
by the commercial banks has prevented the domestic economic slowdown that would have seen the
current account surplus rise to much higher levels. If capital flows had been maintained, the result would
have been to trigger a new monetary cycle with growing reserve money. The PBOC’s action has
sustained a cyclical expansion beyond its natural course, but sustaining it does not prevent the
necessary downswing needed to re-generate competitiveness and boost the current account surplus. If
the managed exchange rate is to be maintained, the downside of the economic cycle is delayed but not
abolished.

So, if the PBOC contracted its balance sheet into the COVID-19 crisis, was it able to engineer a growth
in broad money through instructing the commercial banks to accelerate their loan books? Yes, a bit. As
at end December 2019 total loan growth in China was running at 12.7% year on year. By the end of
May 2020 the growth rate had accelerated to 13.2%. From that peak it has since decelerated to 13.0%.
The impact on broad money growth is that it has nudged higher from 8.7% in December 2019 to 10.7%
in July 2020. This might sound like a high level, but it remains below any level reported for China before
2017 - when the flatlining of reserve money began. If the PBOC can really buck the market by
demanding more money creation from its commercial banking system, it is making modest demands in
that regard at the moment. Chinese broad money growth remains right at the bottom end of its historical
range.

This is not the first time that this analyst has pointed out that the PBOC cannot buck the market. Often
in markets it is obvious that something cannot go on but the problem is that one is paid not to say that
something cannot be sustained but when it cannot be sustained. It is often the wrong incentives, not the
data, that drive us to the wrong conclusions. The conclusion in relation to China is that unless something,
other than a further major economic contraction, drives it to a large external surplus, then it will have to
consider a more flexible exchange rate to meet the economic growth targets and prevent the spiraling
of its non-financial debt-to-GDP ratio that began in 2009. That it has sustained growth for this long
should not lead one to the conclusion that it can continue to sustain growth, but rather that its ability to
sustain the unsustainable is diminishing.

The last thing the world needs today is a flexible Chinese exchange rate. The RMB would fall because
the reason for abandoning the exchange rate management regime is to cut interest rates, boost the size
of the PBOC balance sheet, and generate the growth and inflation that can reduce China’s escalating
debt-to-GDP ratio. Everybody else is doing it but then everybody else, well most everybody else, has
the flexible exchange rate that permits them to inflate away their debts. Just because China has not yet
chosen such a policy does not mean that it won’t have to. Today it is the exchange rate policy that
prevents it, but that cannot remain as such a constraint might, if the external accounts do not improve
soon, force China towards a debt deflation.
When the global business cycle peaked in December 2007, China's total non-financial debt-to-GDP ratio was 143%. As at the end of December 2019, it had reached 259% and, as with other countries, it will have spiraled higher during the COVID-19 crisis. In 2007 China had a non-financial debt-to-GDP ratio of 143% compared to a US level of 229%. Based on the most recent data China’s non-financial debt-to-GDP ratio is marginally higher than the US! Across the world central bankers, supported by government fiscal policy and bank credit guarantees, are doing everything they can to inflate away their debts. China stands almost alone in responding to the crisis by contracting the central bank balance sheet. This is not a sign of strength or prudence, it is a contraction forced upon them by their commitment to manage the level of the exchange rate. This commitment is not sustainable, however, and China will have to join the global imperative to inflate away debts. That imperative is out of its reach, unless it moves to a flexible exchange rate. To contemplate anything else is to believe that this is a communist party, admittedly more by name than nature, that is committed to hard money! If so, it will be the first.

So we sat down for coffee and his Cuban Cohiba cigars, just Fidel and me, for an hour-long meeting. Cohibas were his preferred cigar, so it was an indulgence to smoke one with him. He told me that he had made a mistake putting in Che Guevara as governor of Cuba’s Central Bank. The old joke going around Latin American circles at the time, which some insisted was true, was that when Fidel assembled his men in the aftermath of the takeover of Havana and said, “Who here is an economista?” Guevara misunderstood the question and thought Castro had asked, “Who here is a comunista?” Che raised his hand.

William R. Rhodes, Banker to the World: Leadership Lessons from the Front Lines of Global Finance

Hard money is something one can only find advocated these days by the estimable Jim Grant in the pages of Grant’s Interest Rate Observer. It has no acolytes amongst the PhDs who tend the monetary springs across the developed world. That Jim might have disciples in Beijing is something that this analyst is prepared to bet against. In betting against it, he sees a float and decline of the Renminbi exchange rate.
Important Legal and Regulatory Disclosures & Disclaimers

This research is for the use of named recipients only. If you are not the intended recipient, please notify us immediately; please do not copy or disclose its contents to any person or body as this will be unlawful.

Information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but Orlock Advisors Limited does not accept liability for any loss arising from the use hereof or make any representation as to its accuracy or completeness. Any information to which no source has been attributed should be taken as an estimate by Orlock Advisors Limited. This document is not to be relied upon as such or used in substitution for the exercise of independent judgement.

At Orlock Advisors Limited we are committed to protecting your privacy. Our Privacy Policy explains when and why we collect personal information about people who receive Russell Napier’s written research or contact us; how we use it, the conditions under which we may disclose it to others and how we keep it secure. It also contains information how to make a Subject Access Request.

If you wish to receive a copy of this policy or have any questions regarding it, please send an email to dataprotection@orlockadvisors.co.uk

© 2020 Orlock Advisors Limited

Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH
Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220