Record Insights:

Is China's Policy Playbook Outdated?

Impacts of China's Stimulus

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Background

China's economy is in the doldrums as the country contends with an array of economic issues both cyclical and structural. A floundering property sector, stagnant equity markets, arduous debt burdens and weak domestic consumption are a sample of the challenges facing China as its 5% annual growth target falls further out of view.

In response to sluggish activity and below-target growth, China's central bank elected to ease monetary policy in September while the Ministry of Finance (MoF) moved to support the property sector, banks and local governments. The slate of policy announcements from Chinese authorities and the prospect of a high-profile stimulus package has captured the attention of investors.

The re-election of Donald Trump to the White House presents additional risks to China's economy and compelled us to analyze possible scenarios for China's fiscal policy path and the FX response.

PBoC Leads the Initial Policy Response to Stabilize Equity and Property Markets

The initial wave of stimulus came from the People's Bank of China (PBoC) which announced several policy adjustments at its September meeting, detailed below:

PBoC stimulus measures announced

Policy Measure	Purpose
Policy rate (7-day reverse repo rate) cut by 20bps to 1.5% (historical low).	Support overall economic activity and return growth to 5% goal pace.
Reserve Requirement Ratio cut by 50bps to 6%.	Stabilize liquidity by freeing up 1 trillion yuan ($143 billion) for banks to lend.
1-year medium-term lending facility (MLF) rate cut by 30bps to 2.0% and reduction of collateral requirements.	Support overall economic activity and increase the supply of tradable bonds that no longer need to be held for collateral.
A swap facility of 500bn yuan ($71 billion, open ended in size) allowing securities firms, funds and insurers to borrow for stock purchases.	Bolster equity market sentiment and "significantly enhance these institutions' ability to raise funds and increase stock holdings."
A re-lending facility of 300bn yuan ($42 billion) to fund buybacks at 2.25% annual interest rate for listed companies and their major shareholders.	Bolster equity market sentiment, enhance shareholder returns and drive valuation re-rating. Aims to help pull local equity markets out of 3-year downtrend.

This marks the first time ever that the PBoC has established facilities to directly support local equity markets. Chinese equities have suffered a long downward grind since the end of 2021, and stabilizing these markets seems to be a primary concern for policymakers. The Politburo went so far as to encourage pension funds, insurance and wealth management funds to increase their exposure to equity markets, which helped spur one of the strongest rallies in the Shanghai Composite Index in a decade.

The PBoC also elected to extend supportive housing measures, set to expire at the end of 2024, into end-2026. The struggling residential real estate sector is a major quandary for policymakers as a supply overhang, a consequence of post-GFC infrastructure spending, threatens to devalue the existing housing stock. To relieve current homeowners and boost demand, the PBoC ordered rate reductions for existing mortgages, which are estimated to save homeowners 150bn yuan ($21 billion) in interest payments per year. The minimum downpayment for a second home mortgage was also lowered from 25% to 15% to match the minimum required for a first home. Tier-one cities including Beijing and Shenzhen have also relaxed home purchase restrictions to juice demand in China's most economically active regions.

The initial round of stimulus was well received by investors as an effort to stabilize key sectors, and as a sign of more stimulus to come. EM currencies and China's proxies strengthened upon the initial announcement; however, FX strength soon tapered as investors awaited concrete details on China's overall stimulus plan, a topic we now turn to.

NPC Fiscal Announcement a Disappointment for Investors

The key known unknown for China is the MoF's fiscal stimulus plan. The MoF has committed to increasing debt issuance to stimulate China's economy and stabilize the problem sectors, but the overall extent of support remains a point of speculation. Financial media initially expected a package of around 2 trillion yuan ($284 billion), but larger sums were floated, with a "bazooka" stimulus of around 10 trillion yuan thought to be necessary by some economists. Stimulus of this magnitude would be more comparable in size and breadth to the 2008 stimulus (e.g. as a percentage of GDP).

The much-anticipated November National People's Congress (NPC) policy meeting provided markets some clarity. Indeed, the NPC unveiled a 10 trillion yuan ($1.4 trillion) package, though the majority was dedicated to a debt swap program to help local governments refinance debt. The program aims to reduce debt accumulated by Local Government Financing Vehicles (LGFVs), often referred to as "hidden debt", as local governments use LGFVs to circumvent official debt limits. While sizable and in-line with the "bazooka" scenario, the stimulus is stretched out over the course of five years, and the NPC's announcement ultimately fell short of expectations for direct consumer and demand-side support.

Table 2: NPC Stimulus measures announced

Policy Measure	Purpose
6 trillion yuan increase in local government debt ceiling for hidden debt swap program. • 2 trillion yuan per year for three years from 2024.	• Lower outstanding "hidden" debt from 14.3 trillion yuan to 2.3 trillion yuan by end-2028. • Reduce interest burden by ~500 billion yuan over next five years. • Ease local government debt burden and derisk public balance sheets.
Allocation of **4 trillion yuan** from the special local government bond quota **for local government debt swap program.** • 800bn yuan per year for five years from 2024.	

Future Fiscal Stimulus at Odds with Growing Debt Burden

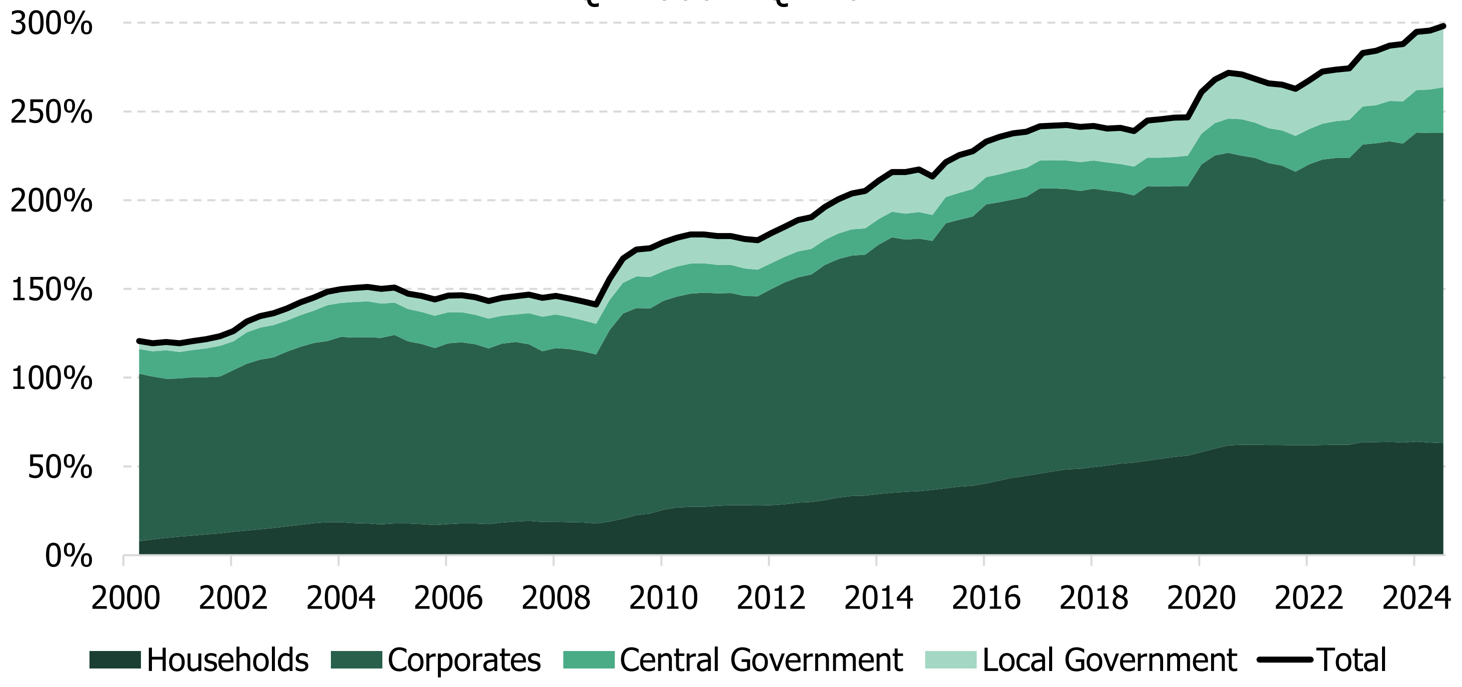
Traditionally, Chinese policymakers prioritize support for banks, real estate, and manufacturing over welfare-based fiscal measures. Authorities so far appear averse to pivoting towards supporting consumers directly, especially when considering overleveraged public balance sheets and the perceived risk of moral hazard. Counting the off balance-sheet debt, which is concentrated in LGFVs, China's total debt-to-GDP ratio stands at over 300%. System-wide leverage has more than doubled compared to pre-GFC, and the specter of the growing debt burden is hard to ignore.

Indeed, the playbook of old seems less viable now for China as it attempts to balance near-term policy easing and deficit spending with long-term fiscal consolidation. However, Trump's hawkish trade policy may prove to be the catalyst for Chinese authorities to redirect fiscal support towards consumers and aggregate demand as China and the US economies further decouple from one another. Trump's proposed 60% tariff on Chinese goods could significantly impact exports—one of the few resilient sectors—and further weigh on growth relative to the 5% target. Greater clarity on tariff impacts could encourage authorities to finetune stimulus measures in 2025.

For the renminbi, policymakers face a delicate balancing act: stabilizing the trade-weighted exchange rate, maintaining capital account liberalization, and conducting independent monetary policy. To prop up the exchange rate, China's nominal interest rates have had to compete with high US rates, in turn generating tighter real policy rates under muted inflation. With tariffs potentially dragging activity lower, the injection of new fiscal policy into the mix is essential to maintain that delicate balance. President Xi and fellow Politburo members have been resistant to consumer-focused support policies, but that exact kind of stimulus may be needed to revive consumer confidence and fend off deflationary pressures in the near term.

China debt to GDP %, distribution by sector

Q1 2000 – Q2 2024



Please note that this chart doesn't include bank loans to local government financing vehicles (LGFVs). GS estimates total debt to GDP by LGFVs would account for another 50% in 2023.

Source: Record, Macrobond and Goldman Sachs. Data as of June 30, 2024

Renminbi Path Hinges on Fiscal Response and US Post-Election Trade Policy

Our outlook is one which contrasts the structural challenges in the Chinese economy and event risks abroad, against potential upside from evolving crisis management and more favorable developments external to China.

To the downside, we are concerned primarily with further stimulus disappointing or doing little to address structural issues. The announced policy changes and fiscal stimulus can help mitigate weakness in specific sectors of the economy but may not provide longer-lasting momentum to domestic demand. If real estate prices remain unstable, we can expect adverse knock-on effects for investment and consumption. Industrial overcapacity also presents deflation risks, and industrial profits have taken a hit as deflation has taken its toll on the manufacturing sector. These firms may find it harder to service debt payments, an issue akin to the crisis currently facing the real estate sector.

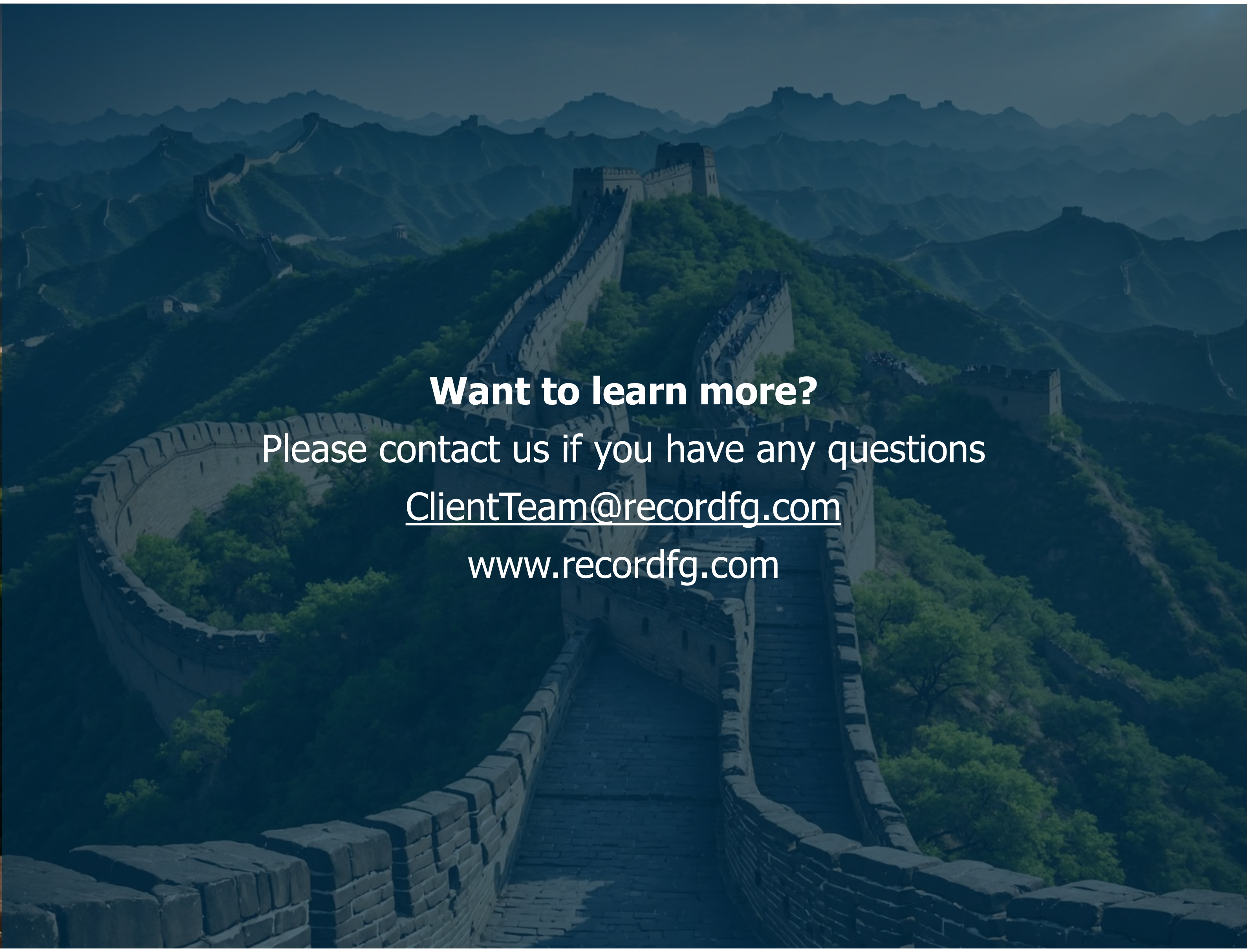
Outside of China, Trump's election victory will likely result in further tariffs being implemented on Chinese goods. There is evidence that China is circumventing standing tariffs by exporting through Vietnam and Mexico, but a universal tariff would severely limit China's ability to do so and compounds growth risks. If tariffs weigh further on the growth outlook, real interest rates may need to become more supportive and the PBoC may need to abide by a weaker currency to maintain competitiveness.

In a worst-case scenario, we can draw historical parallels to 2018, when the US imposed 25% tariffs on approximately 50% of Chinese exports, resulting in an effective tariff rate of around 12.5%. This led to a roughly 10% depreciation of the renminbi. Applying similar sensitivity to a more conservative blanket 30% tariff rate (as opposed to 60%), we could expect a 14% depreciation in the renminbi, or a move in USDCNH to beyond 8.0.

Since the election, the renminbi has depreciated only about 2% against the US dollar. This could indicate market complacency regarding tariff risks or an expectation that the PBoC will take strong measures to counter currency weakness. Additionally, there may be assumptions that the MoF will respond with further stimulus yet. However, if these factors do not materialize, the renminbi could face further depreciation pressure.

Upside scenarios for the renminbi include smaller US tariff implementations, targeted fiscal stimulus to boost consumption, and PBoC interventions. That said, further stimulus is likely contingent on more aggressive tariff policies. Meanwhile, the PBoC is unlikely to pursue outright currency strength, making a significant appreciation beyond current levels appear less probable without some major policy adjustment in the US. For example, steady interest rate cuts by the Federal Reserve and narrowing rate differentials could reduce capital account pressures and provide support for the currency.

The next NPC meeting will be held in March 2025, two months after Trump takes office. Notably, the November NPC meeting was originally scheduled for late October but was pushed later likely to coincide with the US presidential election. Chinese authorities are somewhat tipping their hand here and future fiscal considerations will hinge on policy enacted by the incoming Trump administration. On the immediate horizon is the December Central Economic Work Conference which will set economic goals for 2025 and provide guidance on 2025 macro policy. We expect the MoF will reserve some additional fiscal firepower to react to external policy developments in the coming year.



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