QE China Style
The intentions and impacts of Chinese monetary policy easing
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Introduction

We believe the Chinese government is undertaking its own version of Quantitative Easing (QE). We examine how this is happening and the potential impacts as well as drawing conclusions on the outcomes for the Chinese Equity markets. We believe QE 'China Style' could be one of the most significant financial market policies that is not fully understood. In our view the key message is: China’s goal is to stabilize growth in the world’s second largest economy through monetary policy and it will do this in size and force.
Much has been written about the Chinese stock market in recent months. However, we suggest investors put the stock market aside for the moment and focus on the bigger picture: the Chinese economy. The key turning point to keep in mind was the third Quarter of 2014. It was at that time that the People’s Bank of China (PBoC) third Quarter Monetary Statement announced a significant easing of monetary policy while at the same time creating new policy tools. This point in time and these outcomes have in our view been greatly overlooked by the broader international market and have led many to incorrectly read future signs in the same vein. In our view the key message is: China’s goal is to stabilize growth in the world’s second largest economy through monetary policy and it will do this in size and force.

The PBoC is currently overhauling the use of traditional policy tools and preparing for significant monetary easing. What began as a policy aimed at bringing down borrowing costs for companies and boosting banking sector liquidity has transformed into a longer term strategy of bringing down government borrowing costs. We think investors should consider this a deleveraging program. A significant part of this is to facilitate the creation of a municipal bond market for the Ministry of Finance (MOF) to assist in reforming the fiscal system. This will be the world’s largest ever debt swap and the market has overlooked the meaning and significance of this program. More recently, the PBoC has recapitalised (via a debt for equity swap) its policy banks such as the Central Development Bank (CDB). Meanwhile, the National Development Reform Committee (NDRC) stepped up its effort towards stimulating government-led investment via support loans from the CDB and China Agricultural Development Bank (ADB) into targeted commercial banks, like the China Postal Savings Bank (CPSB). These are all targeted liquidity injections using various government-controlled financial institutions.

This action has important impacts for investors both locally and globally. With significant quantitative easing (QE) this should form the basis of a long-term equity bull market in China. As the economy worsens (though we argue a hard landing is not on the cards) this time around soft economic conditions will be countered with further (and then again further) monetary easing.

We believe fiscal spending this time will be selective and subservient to QE and investors should forget about another RMB4.0tn open cheque book which was observed in 2008. We don’t make predictions on commodity prices (for example) but understanding all the ramifications of this QE means understanding the effects in nearly all parts of the economy and China’s trading partners’ trades too.

QE China style began with billions of dollars, has already moved to trillions of dollars this year. In this paper we look at what has happened, why it has happened and suggest the impacts this may have for investors asking, how much of the change in Chinese Monetary and Fiscal policy has been understood and appreciated by markets?

**Quantitative Easing (QE)** is a monetary policy tool where a central bank purchases government securities (bonds or other securities like asset backed securities (ABS)) in order to lower interest rates (typically long duration) and increase the money supply. QE has often been viewed as an unconventional form of money creation (‘cheap money’) with the aim to directly increase private sector spending in the economy and return inflation to a target rate.
China’s monetary system

How different is China’s monetary system?

China’s monetary policy this year has primarily been driven by three factors:

1) **growth**: slowing growth owing to rising borrowing costs,
2) **capital account**: persistent capital outflows, and
3) **leverage**: debt refinancing for both corporate and government sectors.

The PBoC has historically tended to use tools aimed at adjusting the quantity of money, rather than its price (the interest rate). The traditional quantitative tools include open market operations (OMO) and changes to banks’ reserve requirement ratio (RRR). The central bank has preferred quantitative tools because of the limited effectiveness of interest rates in influencing lending.

Two factors explain this limited effectiveness. First, banks’ net interest margins were protected by state-determined lending and deposit rates. Second, state-owned banks tended to direct loans on a political basis to state-owned enterprises. This is why China’s interest rate cuts do not influence lending rates as directly as they do in developed markets. Concerns remain over the lingering high real rates in China despite four rounds of rate cuts over the past year. We believe there is a high probability that going forward the PBoC will cut interest rates and significantly cut the RRR, the question and concern is, what will happen if they don’t?

Interest rate liberalisation

How free are China’s interest rates from controls? What does this mean for international markets?

As interest rate liberalisation and an economic slowdown have pushed up real borrowing costs, the central bank has shifted its approach to target interest rates, as well as the amount of liquidity. Over the last 18 months, it has introduced tools that both provide liquidity and guide interest rates. Investors will recall that the lending rate in China was only liberalised on 20 July 2013 and the deposit rate is not yet liberalised.

By narrowing the margin between deposit and lending rates, the PBoC is forcing banks to pay savers something that is closer to the actual market price for cash on deposit. One reason we have been negative towards Chinese banks (beyond the use of off-balance sheet structures and opaque wealth management and trust structures) has been the fact net interest margins (NIMs) are being squeezed for the reasons above.

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**Figure 1: Real vs nominal rates in China**

- Nominal 1 year policy lending
- CPI
- Real 1 year policy lending

Source: Bloomberg

**Figure 2: China’s narrowing interest rate gap**

- Lending rates
- Deposit rates

Sources: PBOC benchmark 1-year interest rates; The Economist

**RRR is the minimum amount of deposits required to be held by commercial banks to ensure liquidity and reduce leverage.**
The topic of interest rates (i.e., price of money) continues to be under the magnifying glass of the International Monetary Fund (IMF) despite Chinese officials demanding RMB inclusion in the IMF’s Special Drawing Rights (SDR). These are important special reserve assets that are made up of key global currencies, including the dollar, the yen, the euro and the British pound. But without free movement of interest rates (abolishing the controls) and full interest rate liberalisation, the IMF could quite openly delay the decision to include the RMB as a global currency. The key term “freely usable currency” depends upon being widely used to make payments for international transactions and widely traded in the principal exchange markets. All this is an exercise of judgment. What is clear is that the Chinese currency has become much less competitive over the past five years with the real effective exchange rate rising more than 25 per cent. This explains the Chinese government’s strong desire for RMB inclusion to drum up demand for its currency and avoid any sharp depreciation.

Unconventional vs conventional monetary tools

Why has the market missed something so important?
The goals of China’s monetary policy tools include controlling systemic financial sector risk, lowering funding costs for the economy and boosting lending. We have argued strongly that the risk-free rate in China will and must be lowered. Without lower funding costs, how can China deleverage and reduce its interest cost burden? As an example, China has 120 per cent corporate debt to GDP. That’s over USD12tn of debt in over-leveraged Chinese companies, most of this comes from the remains of capital spending by State Owned Enterprises (SOEs).

Examples of quantitative tools at China’s disposal include the Short-term Liquidity Operations (SLO), Standing Lending Facility (SLF), Medium-term Lending Facility (MLF) and Pledged Supplementary Lending (PSL). Understanding these tools, their purpose and the potential size is key.

In general, we believe there were three primary factors to be addressed with liquidity tools:
1) managing banking sector liquidity, specifically to avoid systemic risk and defaults of trust products and bonds,
2) adding liquidity to ensure lower funding costs and boost general lending, and
3) providing funds for targeted lending.

We see the first two (SLO, SLF) as tools that fall under the first category. PSL falls into the third category. Re-lending and re-discounting were also used to provide liquidity for lending. MLF, as well as traditional tools such as open market operations (OMOs), Treasury deposits and the reserve requirement ratio (RRR) also fall into this category.

What is PSL? It is a policy tool to provide cheaper 5–10 year funding for targeted infrastructure projects such as shantytown, water and education sectors. This lowers long-term rates and boosts liquidity.

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**Figure 3: China’s real effective exchange rate**

![China real effective exchange rate](image)

- **China real effective exchange rate**

  - **Less competitive**
  - **More competitive**

**Figure 4: Differences in monetary tools**

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<td>Debt swap (LGFVs to municipal bonds)</td>
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Source: BofA Merrill Lynch Global Research, Bloomberg
In the 12 months to March this year, the central bank clearly shifted its preference to these newly created targeted tools. The central bank added RMB1.9tn of liquidity to the financial system through PSL, MLF, SLF and SLO, compared with RMB1.5tn through traditional tools such as the RRR and open market operations.

Then in May 2015, China’s monetary policy appears to have shifted again. After driving down short-term borrowing costs in the interbank market in April, it began to target long-term interest rates. The PBoC’s policies appeared to be taking a page out of the Federal Reserve’s playbook. In particular, it looks similar to Operation Twist, which aimed to bring down long-term borrowing costs by selling short-term securities and buying long-term securities.

For example, since May 2015 the central bank has extended the duration of funding through the MLF from three months to six months and begun offering more liquidity through PSL, which can carry duration of three years or longer. MLF provided at a rate of 3.35 per cent also helped to lower 6 month interbank rates by 120bps from 3.4 per cent at end 2014 to 2.2 per cent as at end-July 2015. Put another way, this is a lot of cheap liquidity. Again the softer the economic conditions the more liquidity and the cheaper the liquidity will get.

What we observe here is the potential for unprecedented quantities of liquidity flooding the market. We see the possibility for RMB4tn in the next 12 months; this is more than the size of the US Troubled Asset Relief Program (TARP). This is not well understood by the broader market. For this reason we coin the term “QE China Style” because whilst the effect will be the same as the West (USA and Europe, etc), the way it is executed has great variances. Over the past 12 months as at end-June 2015, a total of RMB3.8tn has been injected into the financial system. The magnitude has gone almost unnoticed by the broader markets.

Figure 6: China’s monetary system overview

Source: Macquarie Securities
Local government debt reforms will create a huge municipal bond market. Potentially the largest in global financial history.

We believe that the ultimate goal of this policy is to facilitate the Ministry of Finance’s (MOF) debt swap and fiscal reform. Most local governments in China have taken on large debts in recent years, with much of this debt being in unregulated, off-balance sheet financing platforms at high interest rates of 14–20 per cent per annum. In the future, the MOF aims to make local governments’ income and expenditure transparent, with tax revenues and municipal bond sales funding investment and debt repayment. As this fiscal reform will require large debt issuances, the government wants to bring down its own borrowing costs.

We estimate that local government debt totalled RMB24tn (US$3.9tn) at the end of 2014, of which just RMB1.2tn (US$200bn) were in municipal bonds or 5 per cent of the total. As the government has guaranteed more financing platform debt this year, we estimate that as much as 80 per cent (or RMB19tn, US$3.1tn) of local government debt could be moved into the municipal bond market in the coming years.

On conservative assumptions, total local government debt would rise from RMB24tn (US$3.9tn) and 38 per cent of GDP in 2014 to RMB38tn (US$5.8tn) and fall to 36 per cent of GDP by 2020. On more aggressive assumptions, it could grow to RMB45tn (US$7.2tn) and 45 per cent of GDP. If 80 per cent of this debt is rolled into the newly created municipal bond market, it means that a RMB32–40tn (US$480–640bn) municipal bond market will be created in China over the next five years. The government has announced debt swaps of RMB2tn (US$320bn) this year and could bring this to RMB3-4tn (US$480–640bn) or more. It would not be unreasonable to see debt swaps of RMB4tn (US$640bn) or more per year for the next five years. This significantly large amount of municipal debt to be issued, stresses the importance of financial market liberalization to attract both local and foreign buyers.

Figure 7: Municipal bond market and debt: aggressive

Figure 8: Municipal bond market and debt: conservative

Source: Bloomberg, National Audit Office, CEIC, forecast (F) from NSBO China
Central bank bond repurchase is needed to create the municipal bond market

For this plan to work, the government needs willing buyers of these bonds. There are three potential (and likely) ways this plays out:

1) the government eases bank reserve requirement ratios to create liquidity
2) more foreign investors are allowed into the domestic bond market
3) the central bank engages in bond repurchases from banks.

While options 1 and 2 are likely, they cannot match the sheer scale that is needed to create a municipal bond market. The municipal bond market could rise from 2 per cent of GDP to over 30 per cent of GDP in just five years. This would be unprecedented growth: the US municipal bond market peaked in 2009 at below 25 per cent of GDP.

Clearly the People’s Bank of China has room on its balance sheet to conduct bond purchases from banks as well. Debt securities, whether Treasuries or mortgage-backed securities (MBS), account for 94 per cent of Federal Reserve assets. Government bonds are 84 per cent of the Bank of Japan’s assets. In China, they are just 5 per cent, as the majority of PBoC’s assets (78 per cent) are denominated in foreign currency (the foreign-exchange reserves accumulated as a by-product of managing the exchange rate).

Figure 9: Federal Reserve: securities vs. total assets

Source: Bloomberg

FOREIGN OWNERSHIP OF CHINESE GOVERNMENT BONDS IS ONLY 0.4 PER CENT OF GDP
In the last couple of years there has been a change in direction. Foreign currency assets have been losing share of PBoC assets as PBoC has extended liquidity to banks through newly created facilities such as MLF and PSL. Since the end of 2013, the PBoC’s lending to banks has risen by RMB1.7tn. By reference to international experience, this trend has clear room to continue. If for no other reason than the slowing of foreign capital inflows, the Chinese government has plenty of monetary tools to inject liquidity domestically.
Let’s put this into context against other developed markets that have been on this easing path before – the US and Japan. Analysing balance sheet expansion, the Federal Reserve’s balance sheet doubled in size between October 2010 (before QE2) and May 2015. It is five times larger than it was in 2008. BOJ’s balance sheet is three times larger than in 2008, while PBoC’s is double. If PBoC’s balance sheet were to double in size between 2015 and 2020, as the Fed’s balance sheet did between 2010 and 2015, it would be an increase of RMB34tn. This would be in between our two scenarios for the growth in China’s municipal bond market. Given reasonable expectations for buying activity by banks and foreign investors, it is not a stretch to imagine the Chinese government in the form of the central bank taking a large share of municipal bonds.

Figure 12: Growth in Central Bank balance sheets

Source: Bloomberg, NSBO China
Is this déjà vu?

What happened to equity markets in US and Japan when the QE program was conducted?

Quantitative easing in other countries such as the United States and Japan has had a well-documented impact on equity markets. The S&P500 has a correlation of 0.96 to the Fed’s bond purchases over the last two years, while the Nikkei’s correlation with the BOJ’s bond purchases stood at 0.92 over the period. If we shorten the period to 15 months in Japan, the correlation rises to 0.99 – almost perfectly correlated. Over the last 15 months, the value of bonds owned by BOJ rose 47 per cent, while the Nikkei rose 36 per cent.

In the simplest form, QE leads to a stock market rally.

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Figure 13: S&P 500 and Fed purchase of securities

![S&P 500 and Fed purchase of securities](image1)

Source: Bloomberg, Federal Reserve

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Figure 14: Nikkei and BOJ purchase of bonds

![Nikkei and BOJ purchase of bonds](image2)

Source: Bloomberg
Conclusion

Despite all the complex terms and unconventional tools being used, we believe that QE China style suggests that the Chinese equity markets could be entering a long-term bull market. One which is driven by PBoC policy. The Chinese government remains the largest owner of A-shares with over 50 per cent, so we highlight the vested interests which is very much needed to help stabilise the economy.

We suggest that through the reforms to SOEs and local government fiscal positions, the creation of more diversified sources of funding such as a municipal bond market, and the accompanying quantitative easing the PBoC will seek to develop, modernise and stabilise the economy. It is important to note that a repurchase program for bonds would be facilitating fiscal reform, rather than simply bailing out banks or providing liquidity. As it is ultimately an economic reform decision, the likelihood is even greater, given that the current leadership of President Xi Jinping and Premier Li Keqiang have made economic reform a key priority for the next eight years of their administration.

Over time, we expect financial liberalization to come with more market transparency and an efficient pricing of financial products. This will make for better risk differentiation and asset allocation based on risk tolerance and returns. Better market transparency and risk pricing should drive more efficient capital into higher risk assets from deposits. As pricing of risk assets improves overall systemic risk rates should lower. In the medium term, we believe we have entered into a new phase of the investment environment for China.

The question is once the market understands all this, what will happen to equities in Asia?
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