Chinese Monetary Policy

Part Two

Crisis Management

Macro Watch

Third Quarter 2018

http://www.richardduncaneconomics.com

Impossible And Inconceivable

- In the previous video, we saw that the creation of RMB 28 trillion by the PBOC between 1990 and 2014 transformed not only China, but the entire world.
- It’s important to understand that that kind of Monetary Policy only became possible after the breakdown of the Bretton Woods System in the early 1970s.
- Before then, central banks were not free to create as much money as they pleased.
- Under the Gold Standard, central banks had to hold gold to back the money they created; under the Bretton Woods System, they had to hold Dollars.
- Therefore, it would have been impossible for the PBOC to create RMB 28 trillion. The idea of creating so much money would have been inconceivable.

The Turning Point

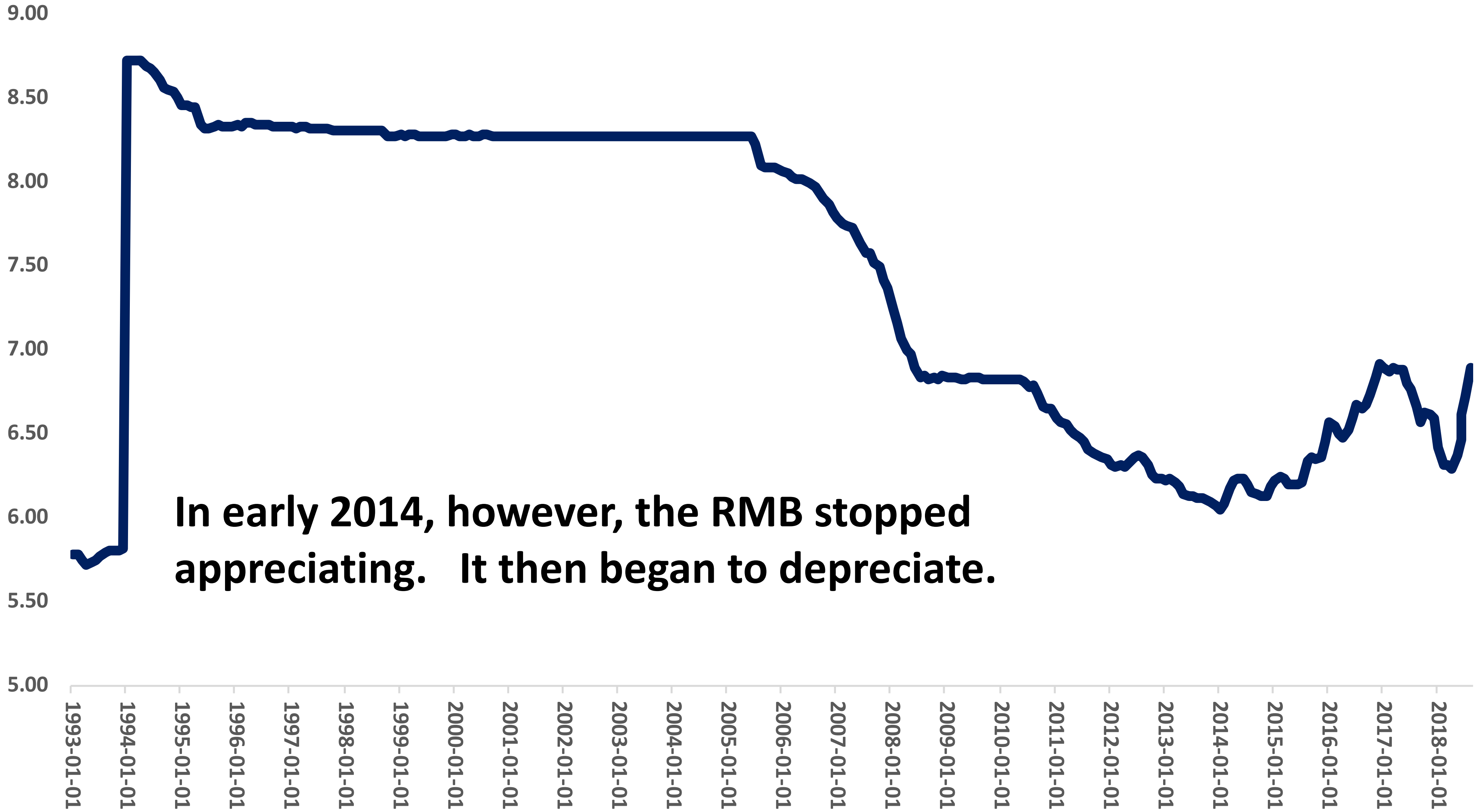
- The turning point for China came in mid-2014.
- By then, China’s economic growth model of export-led and investment-driven growth was exhausted.
- Investment on a mind-boggling scale had resulted in excess industrial capacity across every industry.
- Median disposable personal income in China is less than US$10 per person per day.
- Therefore, purchasing power within China is far too weak to absorb everything that Chinese factories can produce.
- In fact, by 2014, the aggregate demand of the entire world was insufficient to soak up all of China’s industrial output.

Gradual Appreciation

- The Chinese government had allowed the RMB to begin appreciating gradually in 2005.
- Given the growing strength of China’s economy, as well as China’s extraordinarily large trade surplus, it was widely believed that the RMB would continue appreciating indefinitely.
- Over time, Chinese corporations and banks began to borrow large amounts of US Dollars, believing they would be able to repay the US Dollar loans more cheaply as the RMB continued to appreciate.

RMB per US Dollar

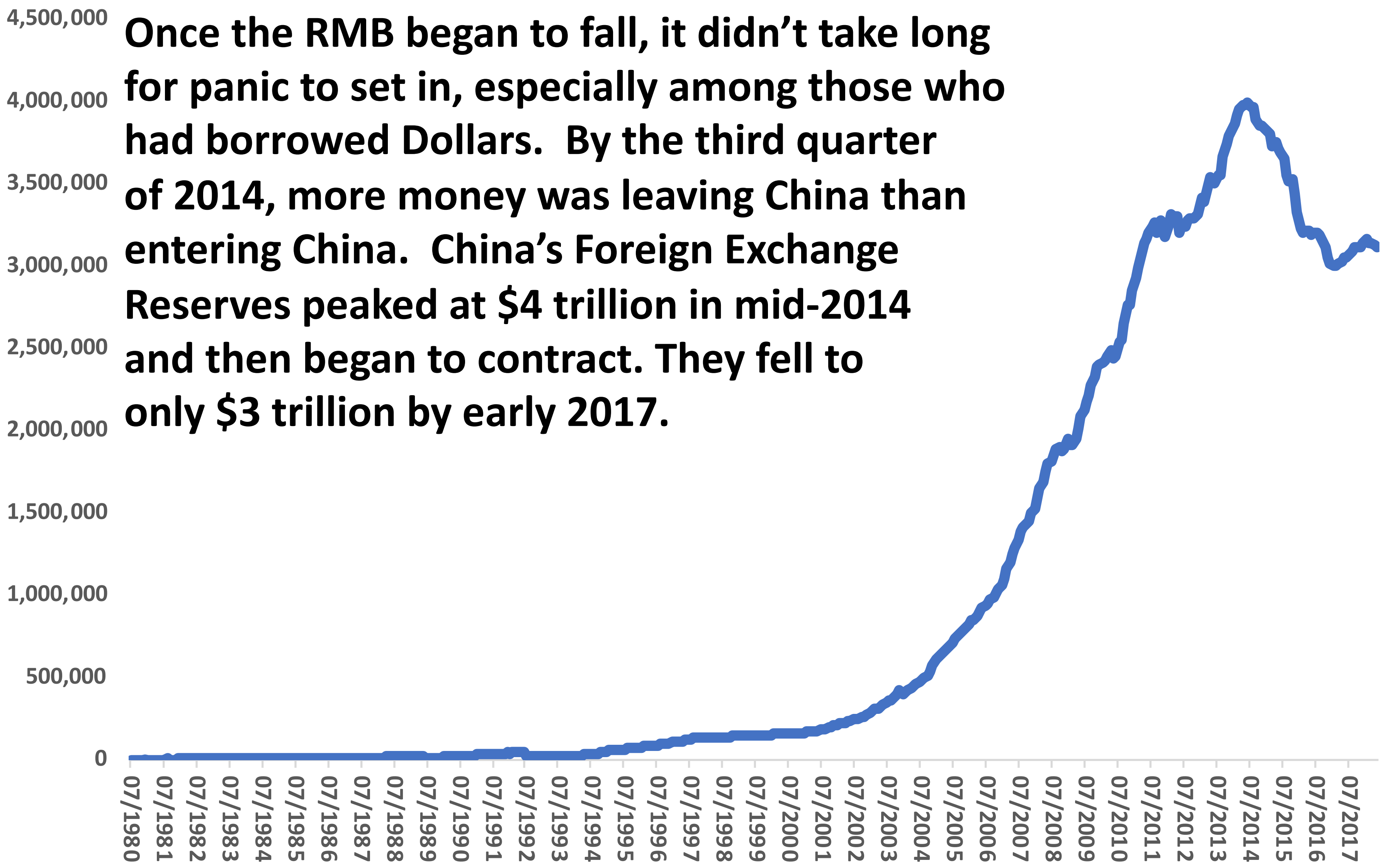
1993 to August 2018



Source: St Louis Fed

China's Foreign Exchange Reserves

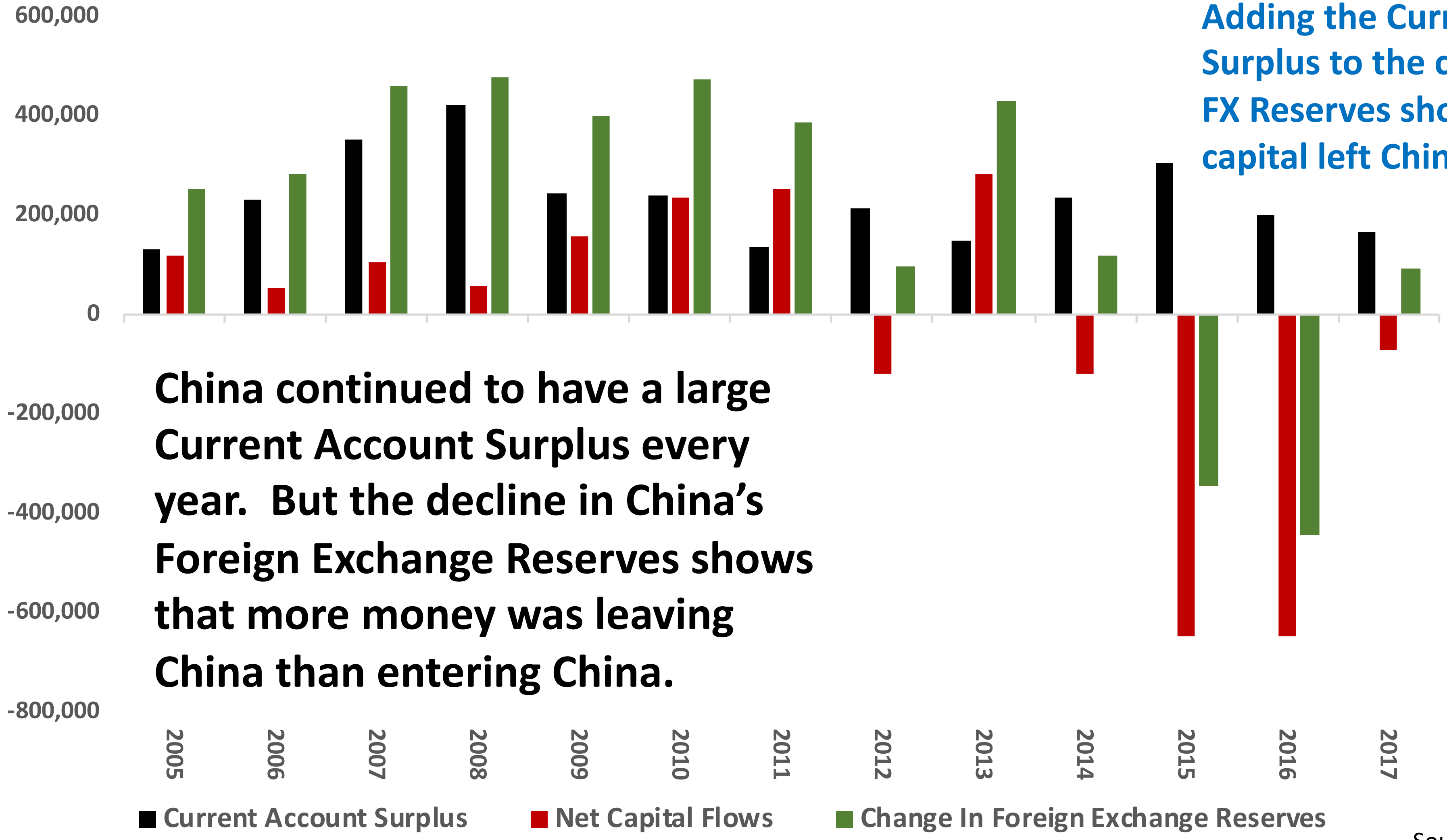
US$ Millions, 1980 to May 2018



Source: CEIC

Current Account Surplus, Net Capital Flows & Change In Foreign Exchange Reserves

(i.e. Overall Balance Of Payments), US$ Billions, 2005 to 2017



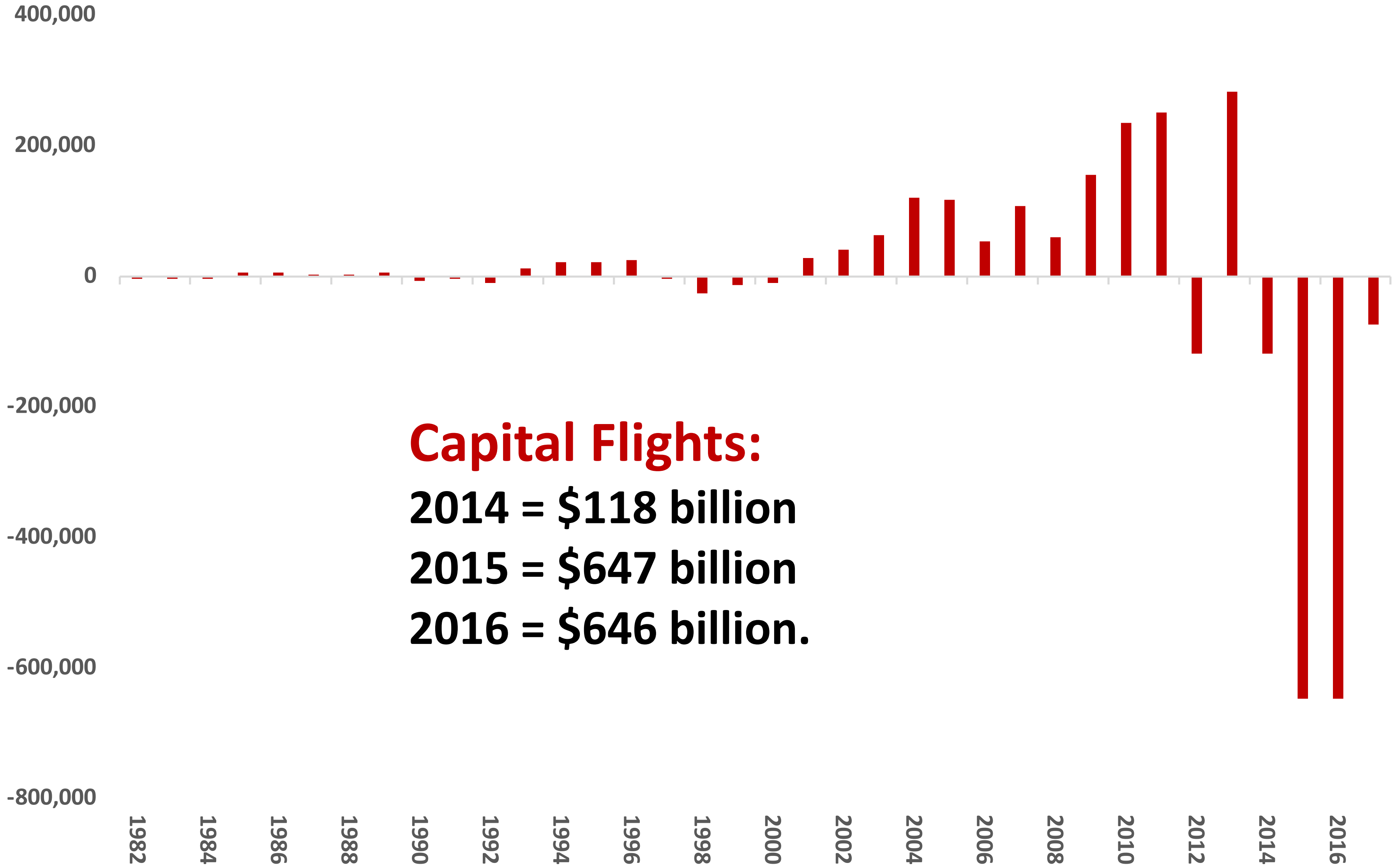
Adding the Current Account Surplus to the change in the FX Reserves show how much capital left China.

China continued to have a large Current Account Surplus every year. But the decline in China's Foreign Exchange Reserves shows that more money was leaving China than entering China.

Source: CEIC.
RD: Net Capital Flow estimates.

Net Capital Flows

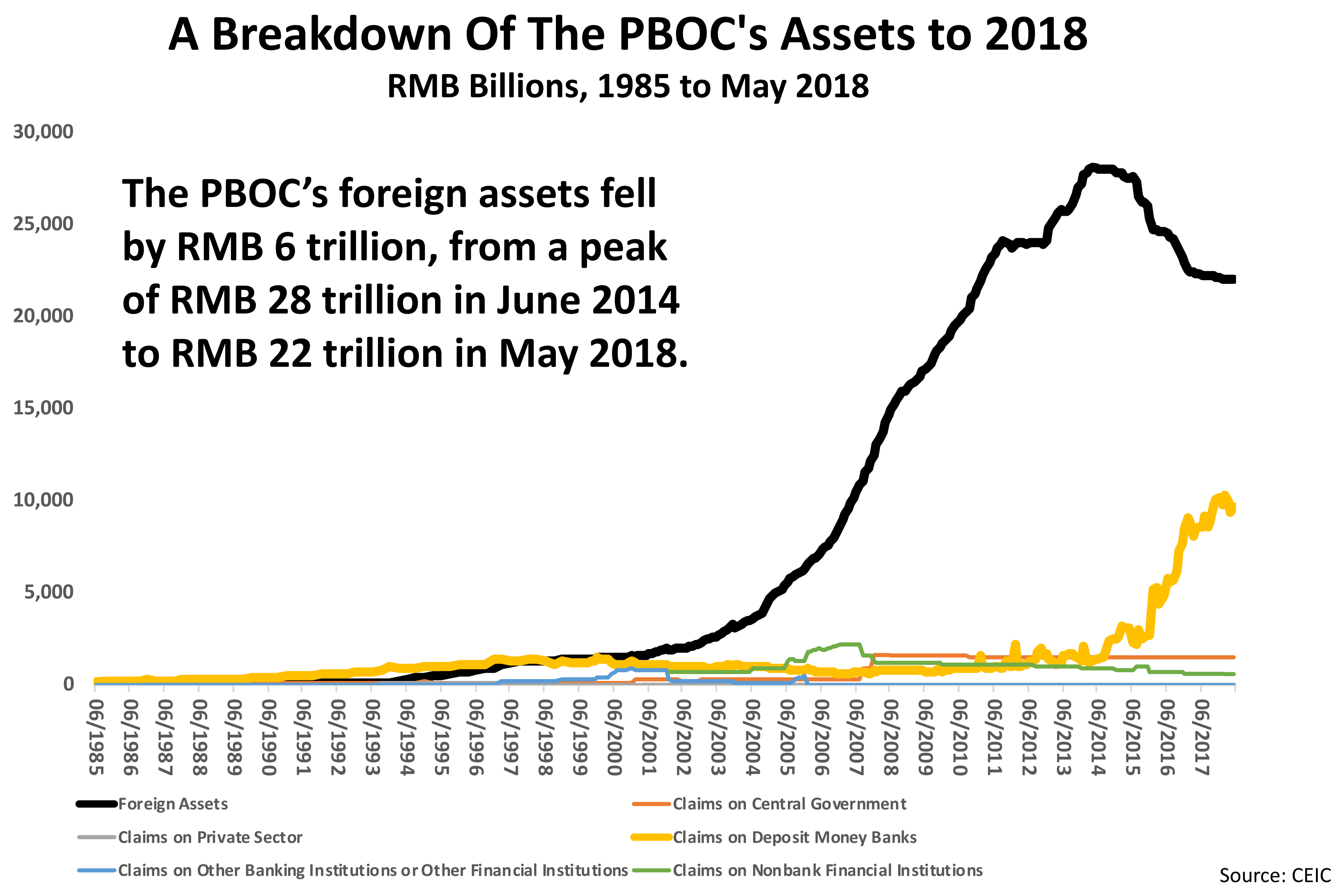
US$ Billions, 1982 to 2017



RD estimates based on Current Account and Foreign Exchange data from CEIC

Phase Two: Mid-2014 To The Present

- Capital flight on such an extraordinary scale forced a 180-degree change in PBOC policy.
- Rather than buying foreign currency to prevent the RMB from appreciating, as it had done for decades, the PBOC now began to sell foreign currency and to buy RMB in order to prevent the RMB from falling too far, too fast.



A Breakdown Of The PBOC's Assets to 2018
RMB Billions, 1985 to May 2018
30,000
25,000
20,000
15,000
10,000
5,000
0
The PBOC's foreign assets fell by RMB 6 trillion, from a peak of RMB 28 trillion in June 2014 to RMB 22 trillion in May 2018.
06/1985
06/1986
06/1987
06/1988
06/1989
06/1990
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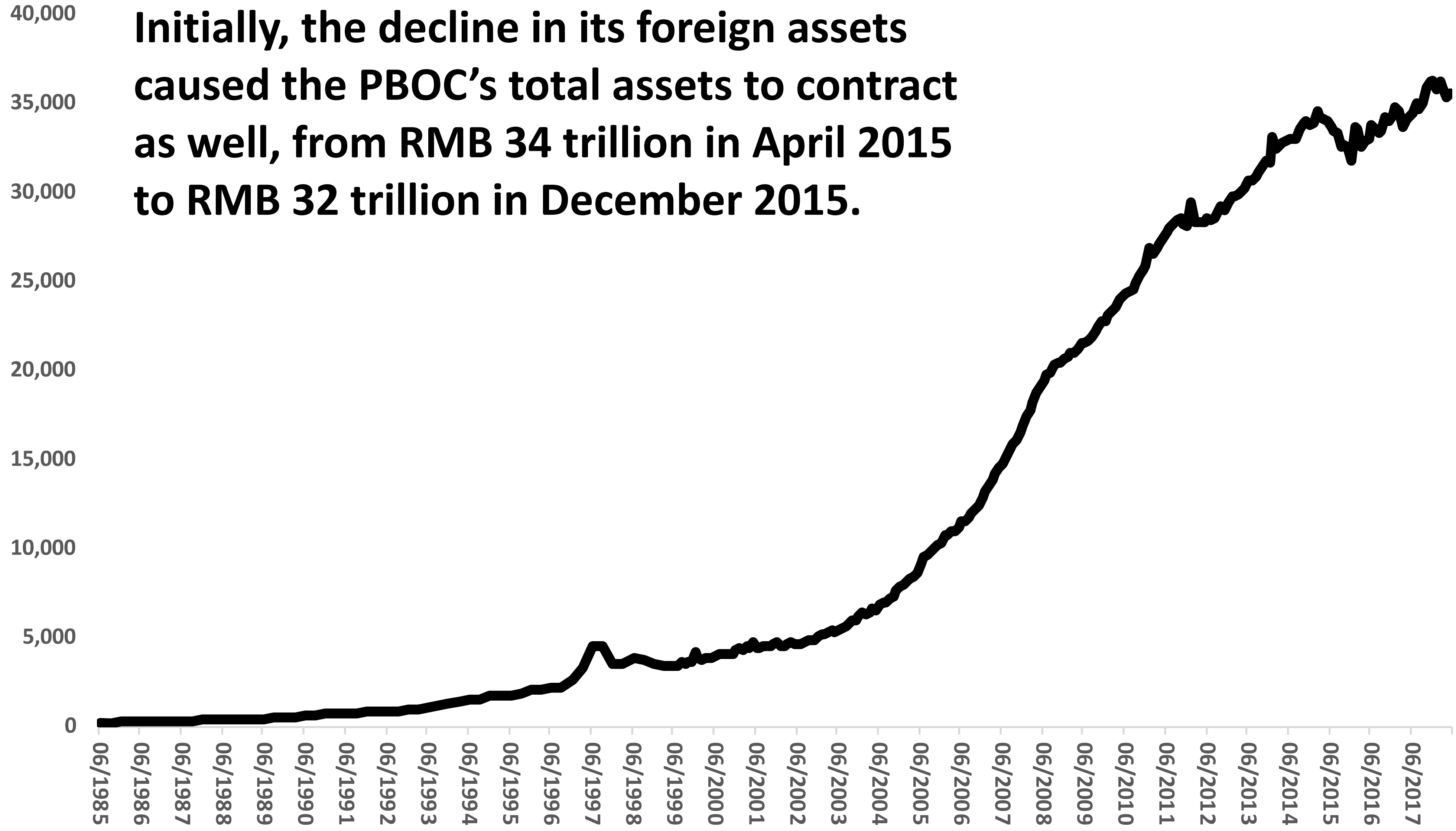
06/2007
06/2008
06/2009
06/2010
06/2011
06/2012
06/2013
06/2014
06/2015
06/2016
06/2017
Foreign Assets
Claims on Central Government
Claims on Private Sector
Claims on Deposit Money Banks
Claims on Other Banking Institutions or Other Financial Institutions
Claims on Nonbank Financial Institutions
Source: CEIC

The PBOC's Total Assets

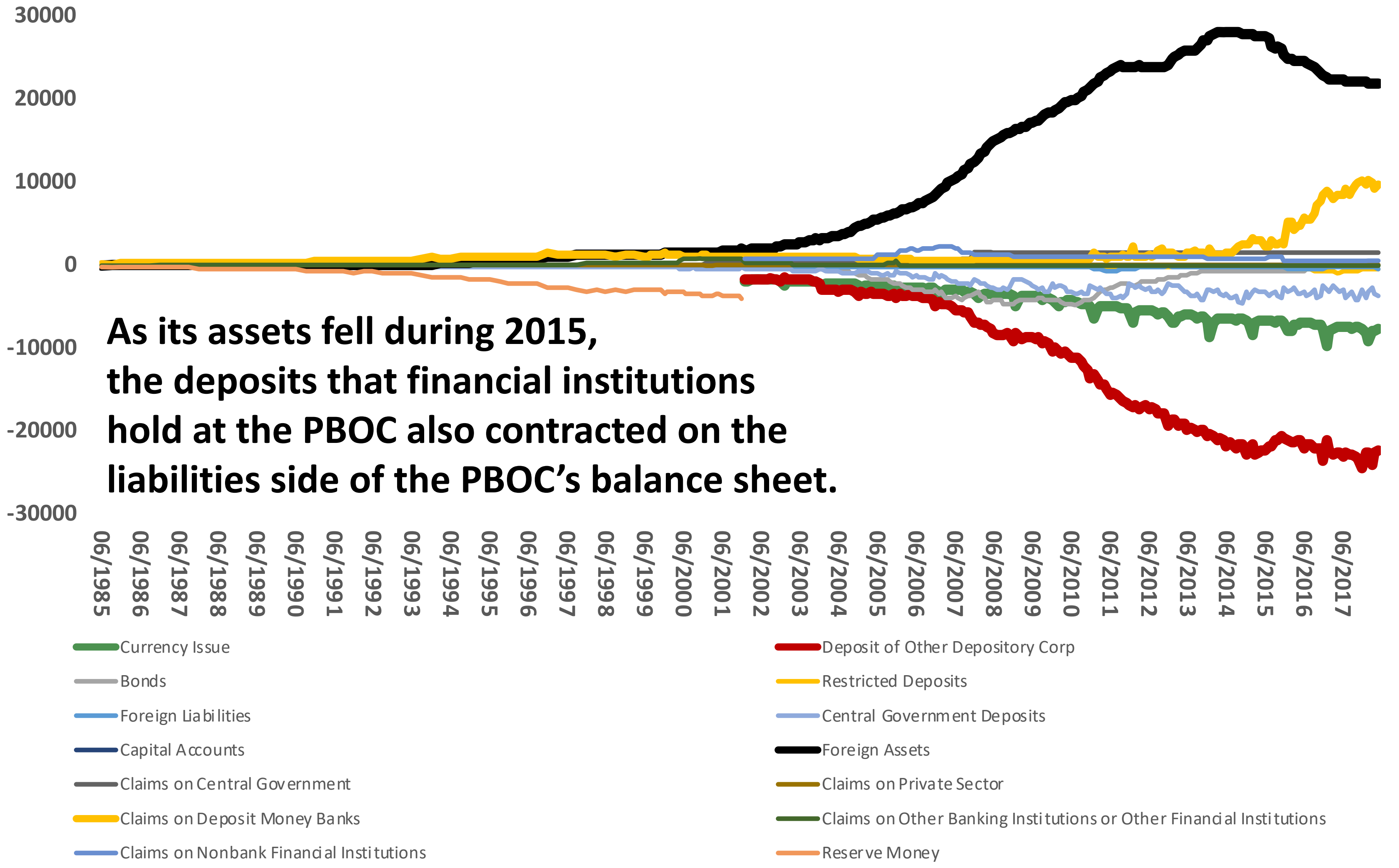
RMB Billions, 1985 to May 2018



Source: CEIC

A Breakdown Of The PBOC's Assets & Liabilities

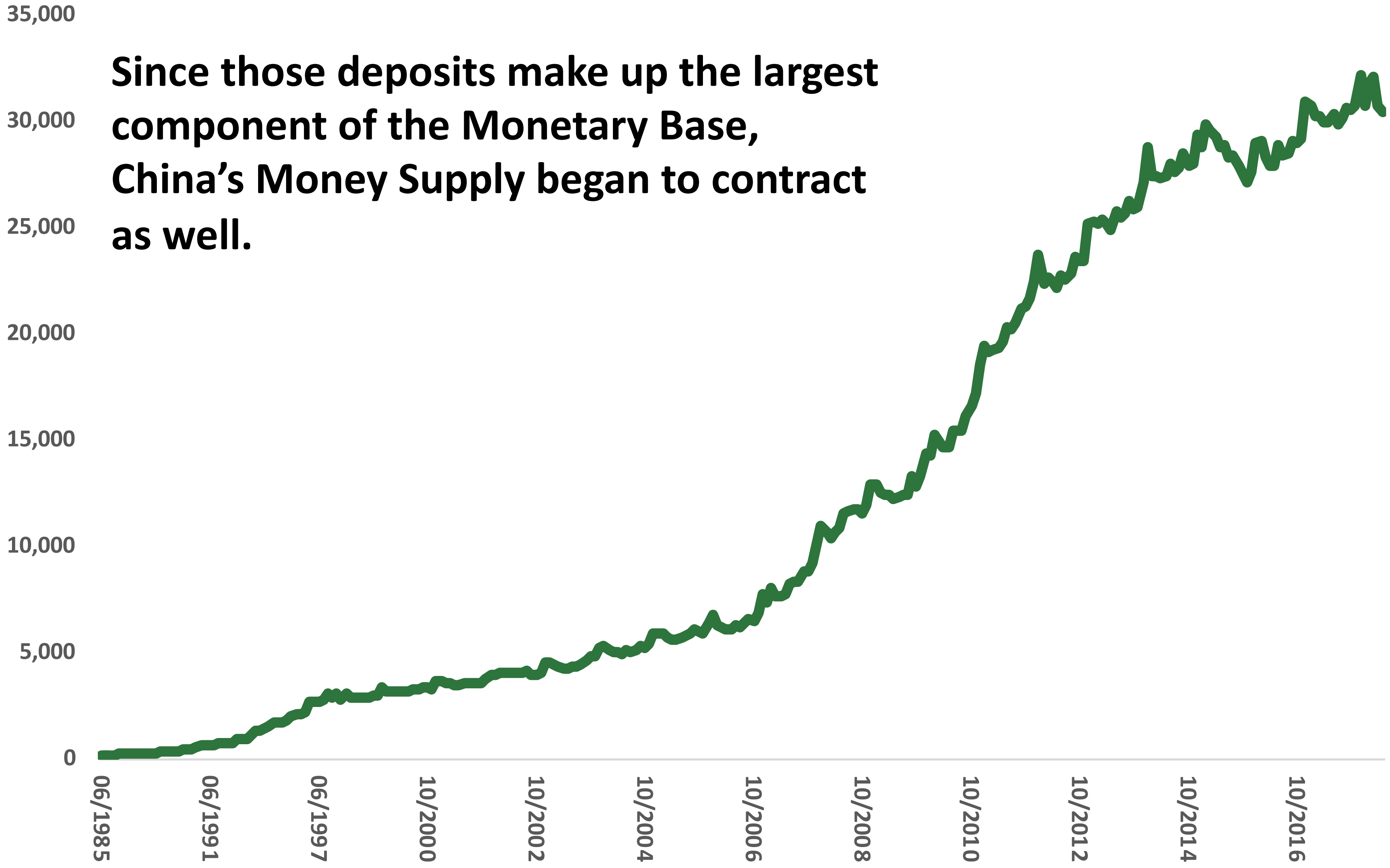
RMB Billions, 1985 to May 2018



Source: CEIC

Monetary Base (i.e. Reserve Money)

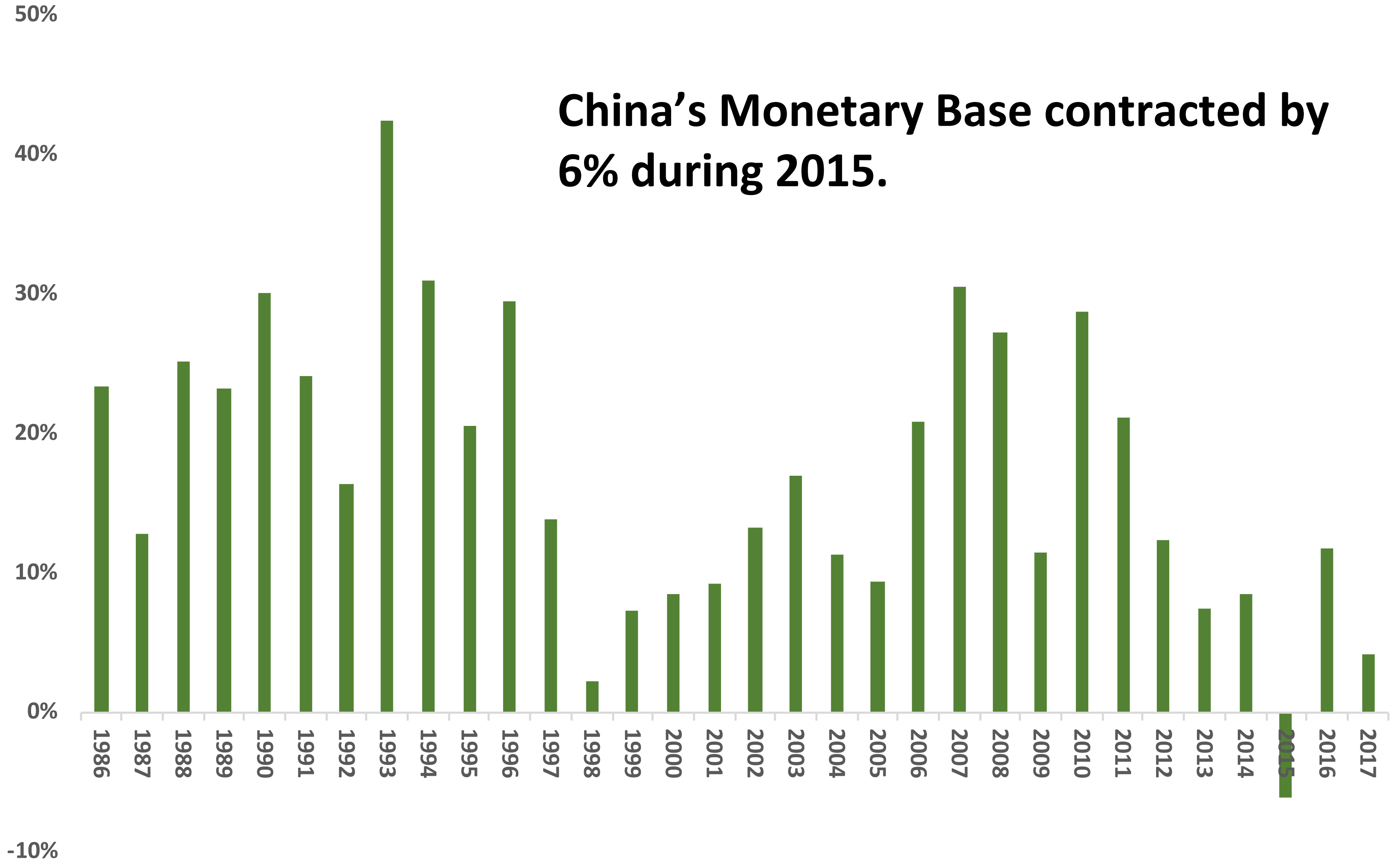
RMB Billions, 1985 to May 2018



Source: CEIC

Monetary Base, Annual % Change

%, 1986 to 2017



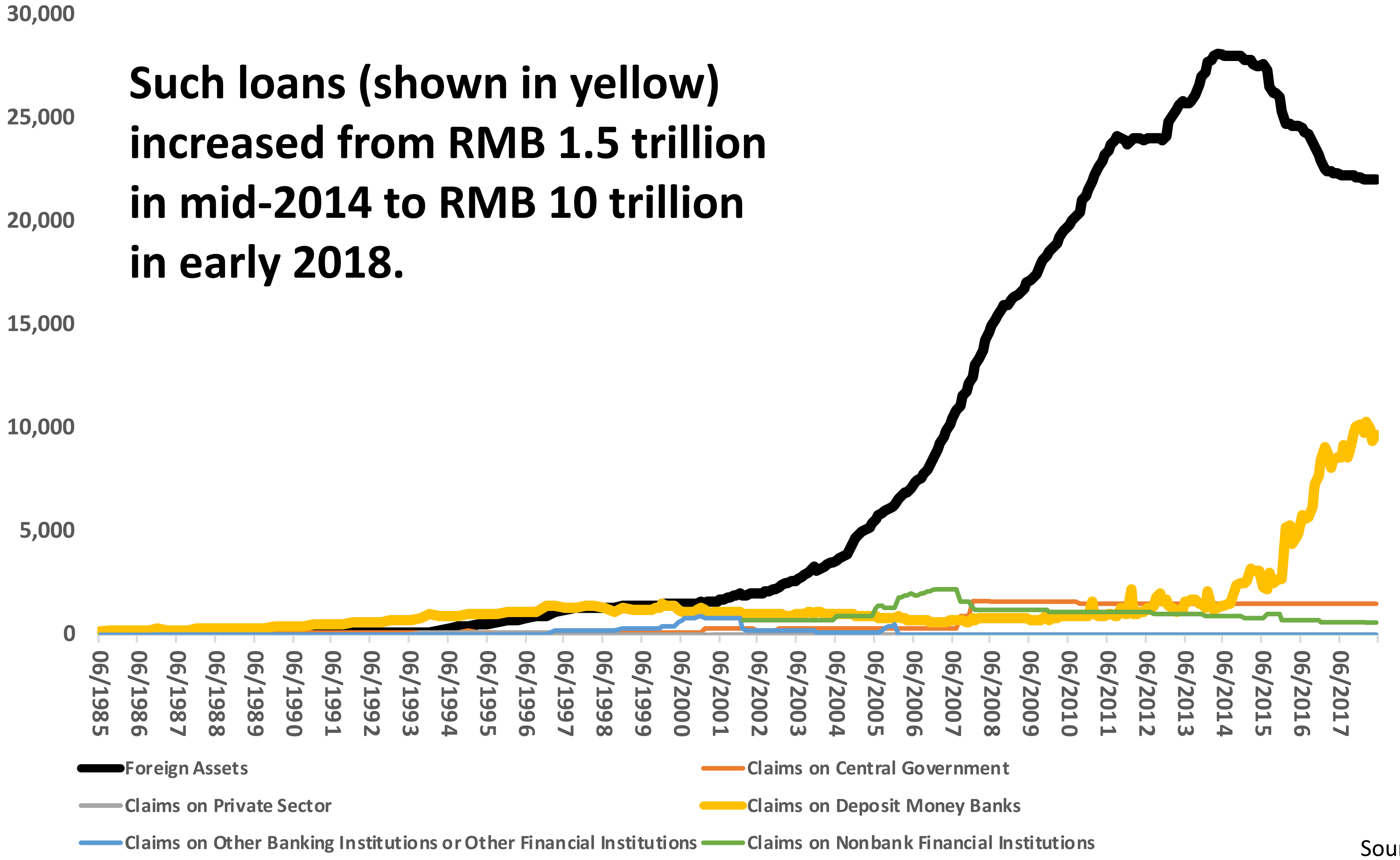
Source: CEIC

Liquidity

- Had the contraction of the Money Supply persisted, interest rates in China would have risen and inflicted significant damage on China's already fragile economy.
- To prevent the Monetary Base from contracting further, the PBOC made loans to Chinese banks (in exchange for collateral).

A Breakdown Of The PBOC's Assets to 2018

RMB Billions, 1985 to May 2018



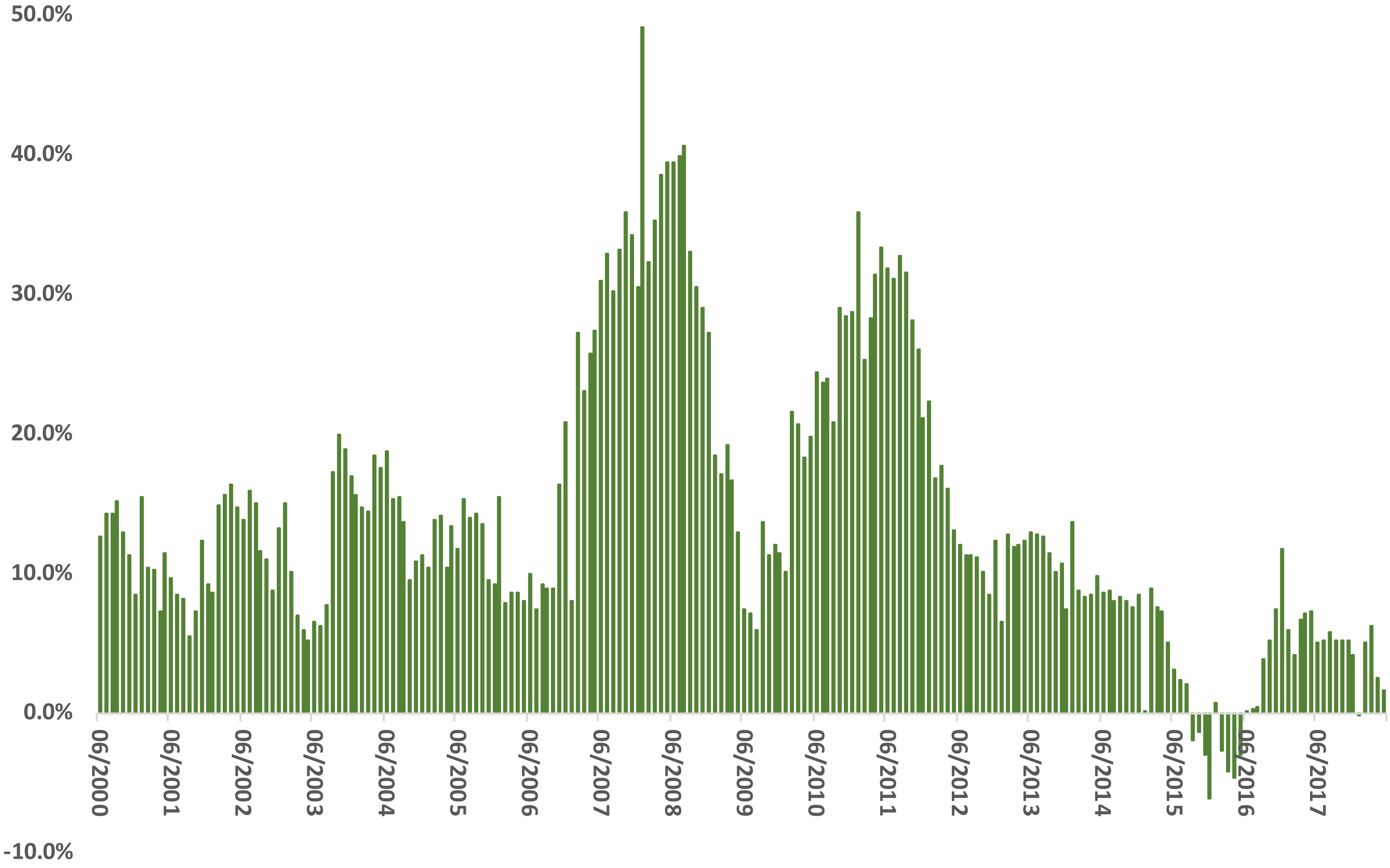
Source: CEIC

Money Creation Through Lending

- The RMB 6 trillion decline in foreign assets was thus more than offset by the RMB 8.5 trillion increase in loan assets.
- The PBOC paid for those loan assets by making deposits into the accounts that Chinese banks hold at the central bank.
- Consequently, those deposits – and China's Monetary Base – stopped contracting and began growing again from early 2016, although at a significantly slower pace than in the past.

Monetary Base, Annual % Change

%, monthly data, 2000 to May 2018



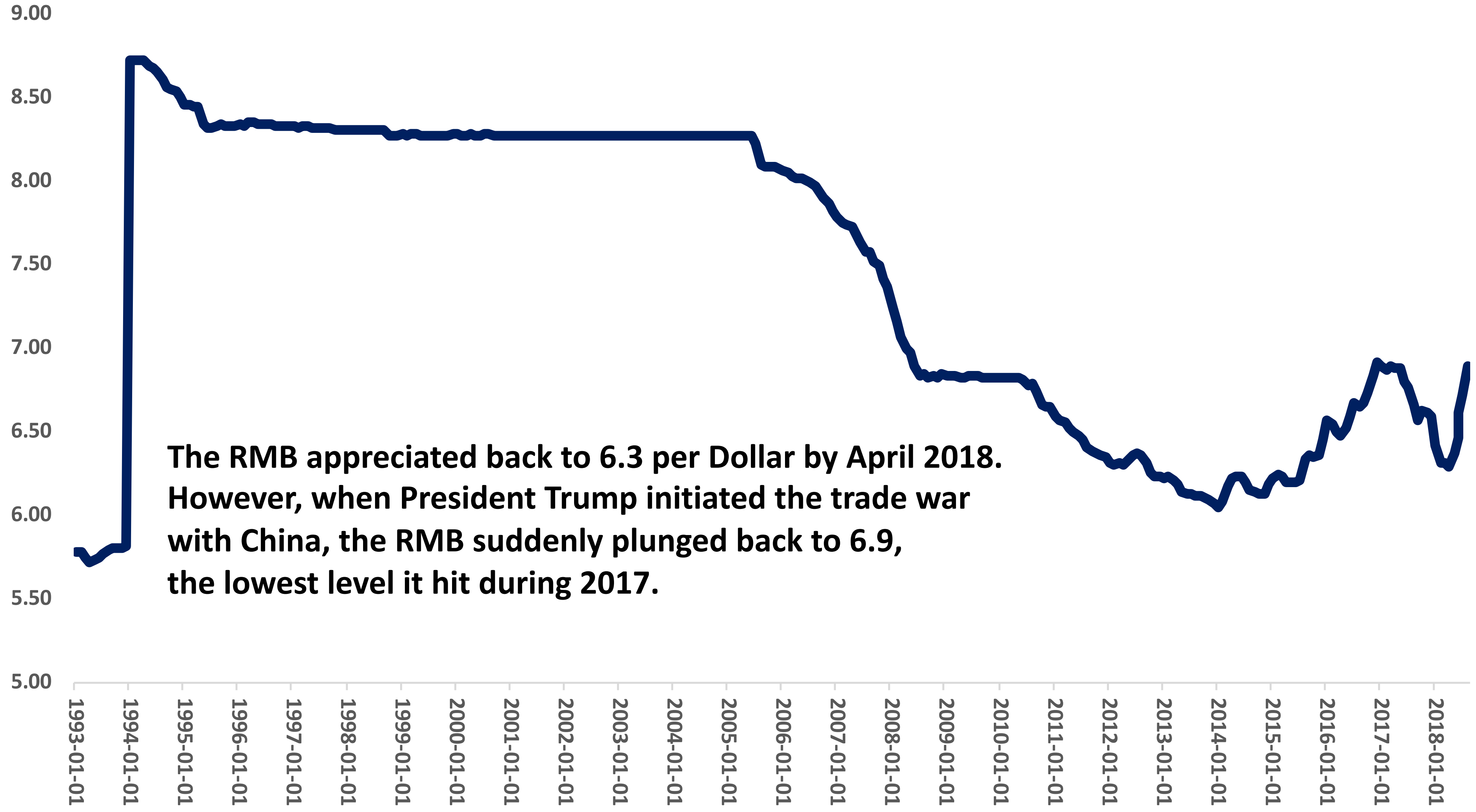
Source: CEIC

Vulnerable

- In early 2017, the RMB stabilized and then began to appreciate again.
- Capital outflows slowed to just $73 billion during 2017 and foreign exchange reserves began to recover.
- Stability returned, but vulnerabilities remained.

RMB per US Dollar

1993 to August 2018



Source: St Louis Fed

Now, More Capital Flight?

- This new plunge in the RMB is likely to cause a new round of capital flight out of China.
- The PBOC will have to counter the tightening liquidity conditions by:

1. Making additional loans to Chinese financial institutions and by
2. Lowering the Required Reserve Ratio that regulates (through the money multiplier inherent to fractional reserve banking) how much credit the Chinese banking system can create per each RMB of deposits.

PBOC Lending

- Technically, there’s no limit as to how much money the PBOC can create and lend to Chinese banks.
- However, it should be understood that the quality of the PBOC’s assets will deteriorate as its foreign exchange assets, which are comprised of high quality assets such as US government bonds, decline, while its holding of collateral of questionably quality from Chinese banks expands.

Limits To Credit Creation

- Similarly, there are no technical limits to the amount of credit that the Chinese banking system can create if the Required Reserve Ratio is reduced to 0%.
- However, there is a definite limit as to how many of those loans the people and corporations of China can repay.
- That limit is set by the income of the Chinese people. And that limit may very well have already been breached.
- When it is, a severe systemic financial sector crisis involving a government bailout of the financial system, deposit destruction or both is likely to ensue.

The Ultimate Costs

- The PBOC’s extraordinary Monetary Policy turned China into an economic superpower, but one that is reliant on external demand.
- That's why a trade war with the United States represents an existential threat to China’s government-directed economic system.
- What the ultimate costs of the PBOC’s policies will be remains unknown.
- However, there’s a real possibility that they will involve a severe economic depression, in China and around the world.

- Now, a final word on Money and Inflation.

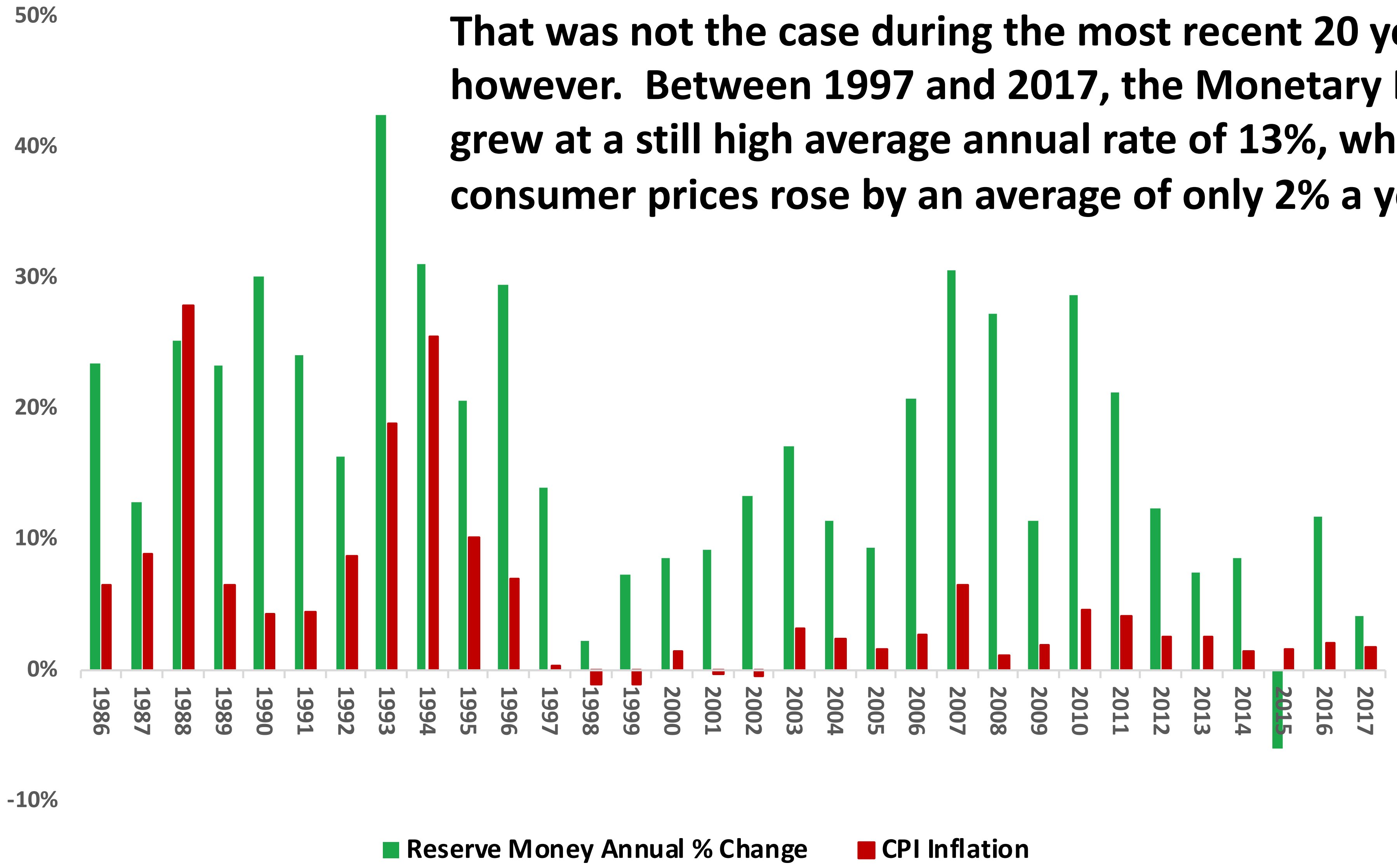
Money & Inflation

- Between 1986 and 1996, China’s Monetary Base grew at a very rapid average annual rate of 25%.
- Consumer price inflation was high, averaging 12% a year.
- Inflation peaked at 28% in 1988 and was a leading cause of the political demonstrations that ended in the tragedy in Tiananmen Square the following year.
- Therefore during that ten year period, it does appear that rapid Money Supply growth fueled inflation.

Monetary Base Growth vs. Consumer Price Inflation

Annual % Change, 1986 to 2017

That was not the case during the most recent 20 years, however. Between 1997 and 2017, the Monetary Base grew at a still high average annual rate of 13%, while consumer prices rose by an average of only 2% a year.



Source: CEIC, IMF

Not Always & Not Recently

- Economic theory teaches that rapid Money Supply growth inevitable causes inflation.
- Milton Friedman famously said that “Inflation is always and everywhere a monetary phenomenon.”
- However, during the last two decades that theory has been repeatedly proven to be untrue.
- This video has shown that rapid Money Supply growth has not caused high rates of inflation in China during the past 20 years.
- Earlier videos demonstrated that even extraordinarily large spikes in Money Supply growth have not caused high rates of inflation in the United States, Japan or Europe during the last 10 years.

It’s Time To Reconsider Monetary Theory

- It’s now certain that inflation is not *always* and *everywhere* a monetary phenomenon.
- In light of this fact, all assumptions about monetary policy constraints must be reexamined.
- By employing significantly more aggressive monetary policy than thought possible in the past, we may find that it’s possible to generate much higher rates of economic growth than we have come to expect.