China may see mild deflation as its credit bubble deflates and money supply growth slows

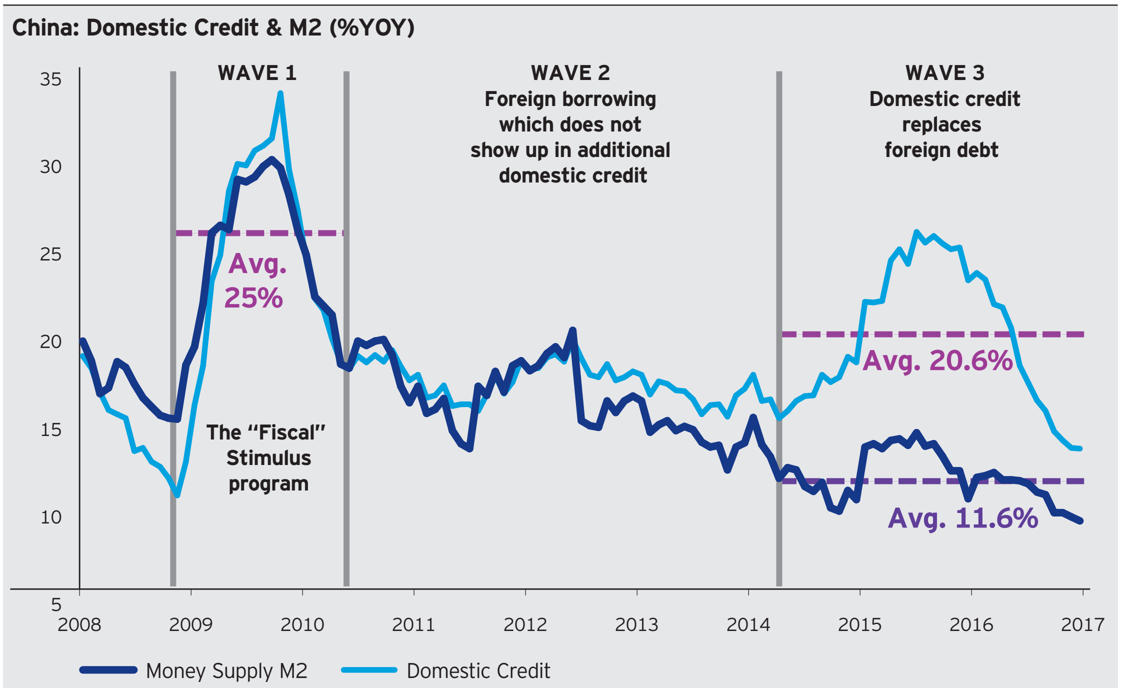
John Greenwood
Chief Economist
Invesco Ltd.

In the years since the Global Financial Crisis (GFC), China experienced an exceptional credit surge in three waves, raising many eyebrows over the resulting credit bubble. However, in the past year, this surge has slowed down substantially. As China's credit bubble deflates, it is likely that China will experience mild deflation in coming two years.

The first two waves

The first credit bubble following the GFC was after the Chinese authorities announced a CNY 4 trillion "fiscal stimulus" program in November 2008, increasing the quantity of credit in the economy massively and financing the program through the banking system. This led to a 25% rate of growth of bank credit and M2 (money supply) over the period from January 2009 to July 2010 (Figure 1).

Figure 1: China's domestic credit has grown far faster than the conventional money supply (M2) since 2014



Source: Thomson Reuters, Datastream, September 2017

Following this initial increase, there was a second wave of credit expansion when Chinese companies shifted from domestic borrowing to foreign borrowing from 2010 to 2014. Taking advantage of the low borrowing cost of foreign currencies and investing the proceeds in steadily appreciating RMB (renminbi), Chinese companies gradually increased their foreign currency debt until it peaked at US$677 billion in 2014 Q2. This was a classic carry-trade: to take advantage of the appreciating RMB between June 2010 and mid-2014 by borrowing low yielding US dollar or Hong Kong dollar and holding the proceeds in appreciating and higher yielding CNY (onshore RMB) or CNH (offshore RMB). At the same time non-mainland residents and foreign companies took advantage of the appreciating RMB to rapidly increase their holdings of RMB deposits in 2010-11 and 2013-14 until the RMB peaked in 2014 when the value of foreign-held deposits also topped out at US$503 billion.

However, after the RMB peaked in 2014 and started depreciating, it no longer made sense to continue to finance such borrowing with appreciating foreign currencies. Foreign currency borrowing fell to US$299 billion in 2016 Q1 as Chinese entities repaid US dollars and other credit borrowed from abroad, and the offshore RMB (CNH) market shrank significantly as foreign RMB deposits also declined to US$363 billion in 2017 Q1.

The third wave: domestic credit replaces foreign currency borrowings

Net outflows and a decline in China's foreign exchange reserves ensued. This period was also characterized by easing interest rates from 2014 to 2015 and accelerating domestic credit. To prevent domestic interest rates from rising and to prevent the drain of funds abroad from causing a credit crunch at home, Chinese domestic credit needed to accelerate. The People's Bank of China (PBoC), China's central bank and the state-owned banks, accordingly provided ample credit to the financial system with the result that the volume of credit in the financial system as a whole rose by 20.6% per annum on average from 2014 to 2016. In other words, China replaced credit borrowed abroad with credit generated at home to refinance these debts as foreigners pulled back their loans and deposits. If the PBoC and the Chinese banks had not taken further action to expand domestic credit, the repayment of overseas loans and the capital outflow would have reduced domestic credit and caused an acute squeeze in the money markets, and possibly a recession.

Now that the bulk of overseas borrowing by Chinese companies has been repaid, the capital outflows have largely ceased and there is no longer any need for rapid credit growth at home to refinance the maturing debt. Domestic credit growth has therefore slowed significantly from a peak of over 25% growth in early 2016 to only 13% in July 2017. This explains the reason behind the 2014-16 domestic credit surge, and hence the concerns about the credit bubble in recent years. But it also explains why the credit bubble is now ending.

Going forward, with the credit bubble now deflating and money (M2) growing at the lowest recorded rates since China's economic reforms in 1978, it is unreasonable to expect a commodity boom or a major upswing in domestic spending or inflation at any time in the next year or two. On the contrary, unless there is a radical policy shift after the Communist Party Plenum this autumn, it is much more likely that China will experience another episode of mild deflation – at least at the producer price level -- during the next two years.