Mizuho Flash: China

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Why China Stimulus May Stumble

"You will only find what you bring in with you" **– Master Yoda (paraphrased)**

Market exuberance ignited by *stimulus bets,* extrapolated from **China's sputtering economy**, is **not just perverse, but dangerously misguided**. And to be sure, knee-jerk market disappointments to stimulus falling short of expectations (as evidenced by "risk off" on smaller than expected LPR cuts yesterday), while an inconvenience, is far from the biggest worry here.

Instead, and more importantly, **desire for, and addiction to, stimulus** to the point of **overlooking underlying structural economic malaise**, *celebrates short-lived relief over durable resilience*. Moreover, **markets** appear to be *primed for deeper and greater disappointment* (of outcomes over response) in **misjudging, more precisely overestimating, durable uplift from any stimulus** boost. **Crucially**, **sharpening policy trade-offs involved inevitably imposes a cost** on, and beyond, the economy.

Whereas, pre-existing *structural impediments* exacerbated by a confluence of *self-inflicted socio-political pain* and *geo-economic headwinds* invariably pose China's **three most daunting macro challenges/threats**. Especially as the trinity of risks conspire to **dampen and diminish not just growth-boosting impulse from stimulus**, but underlying growth potential as well.

"Common Prosperity" Confidence Overhang

- Property & Tech **Relaxations don't negate risks**.
- "Common Prosperity" not abandoned ➔ **Uncertainty**
- Businesses: "Confiscation risks" dent investments.

Property: "for living, not speculation" fundamentally shifts psyche; inflicts adverse wealth-confidence effects.

Binding Structural Impediments

i) **Elevated Leverage**: Structurally higher credit intensity conspires with growing risks to financial stability (dreaded "Minsky moment"), resulting in more subdued, if not sub-par growth outcomes.

ii) **Confidence Deficit**: By-product of uncertainty about far-reaching "Common Prosperity" campaign policy shifts (motivated by *complex socio-political objectives that might at times supplant outright economic pursuits*) that remains intact even if not in the spotlight; confidence overhang hampers big-ticket spending and investments, *compromising growth multipliers*.

iii) **Geo-politics**: Crucially, intensifying, unremitting high-tech US' embargos challenges China's industries. Arguably posing the most binding threat. Policy and/or diplomatic options are precious few; with unforgiving margins for miscalculation. Crucially, resultant adverse impact may be exceptionally large and far-reaching.

"Geo-political Premium"

i) **Security Costs**: China's fight for high-tech survival will inevitably lead to higher "security" on resources, know-how, innovation; thereby driving up the cost of businesses ➔ leading to higher costs and/or diminished margins.

iii) **Barrier Levy**: This pertains to the cost of circumnavigating sanctions, restrictions, tariffs and such; including, but not limited to higher costs from trans-shipping, disguised/offshore operations.

iii) **Acquisition Premium**: Whether entire firms, technology or talent, China will be forced to be more acquisitive, often paying a premium. Again, involving increased costs from bidding wars and possibly monopolistic premium thereafter.

iv) **(Strategic) Duplication Overheads**: Planned spare capacity and duplication of capabilities due to strategic need. This will include ring-fencing production/markets to circumvent sanctions over and above safe-guarding supply-chain resilience.

Technology Fragmentation: Unwillingness to "share" and/or cooperate could result in multiple technology blocks; requiring duplication and/or compatibility fixes.

Upshot being, **failing the most desperate and potentially de-stabilizing pump-priming**, policy stimulus attempts will **at best cushion the bruises from a landing, not conjure a lift-off**.

Most notably as the **three most daunting macro threats manifest as**;

i) *binding credit constraints;*
ii) *confidence deficit,* significantly compromising growth multipliers;
iii) *pervasive property drag,* and;
iv) *geo-political "premium"* robbing growth. That is, threat mitigation costs in various forms (security costs, barrier levy, acquisition premium, duplication overheads, etc.).

Put another way, there are **five main take-aways** **about the** ***scope for, and limitations of, China stimulus****;* which one must appreciate to derive pertinent context

1) Cushioning a Landing, Not Conjuring a Lift-Off: First, the *best case* appears to be one where Beijing *cushions a landing*; and certainly *not a "lift off",* which is unrealistically optimistic.

   Point being, given *pre-existing structural impediments*, *policy* (growth vs. stability) *conflicts* and *resource constraints*, **neither the size nor the breadth of stimulus is set to be tectonic**. As such, the **inherent checks and constraints on stimulus** further **compromised** by impaired stimulus transmission means that **averting a hard landing is a high enough bar**.

2) Credit Constrained: Second, *faith in the* **ability to fuel credit-driven growth are overblown once inherent constraints are considered**.

   For one, being highly leveraged, **considerably higher credit intensity*** conspires with **financial (in)stability risks**** translates into *credit stimulus that is constrained* (in quantum) and *compromised* (in efficacy). And **consequent trade-offs** in credit allocation may **favour large SOEs** (state-owned enterprises) **at the expense of smaller private enterprises; disproportionally undermining growth boost** *due to allocative inefficiencies.*

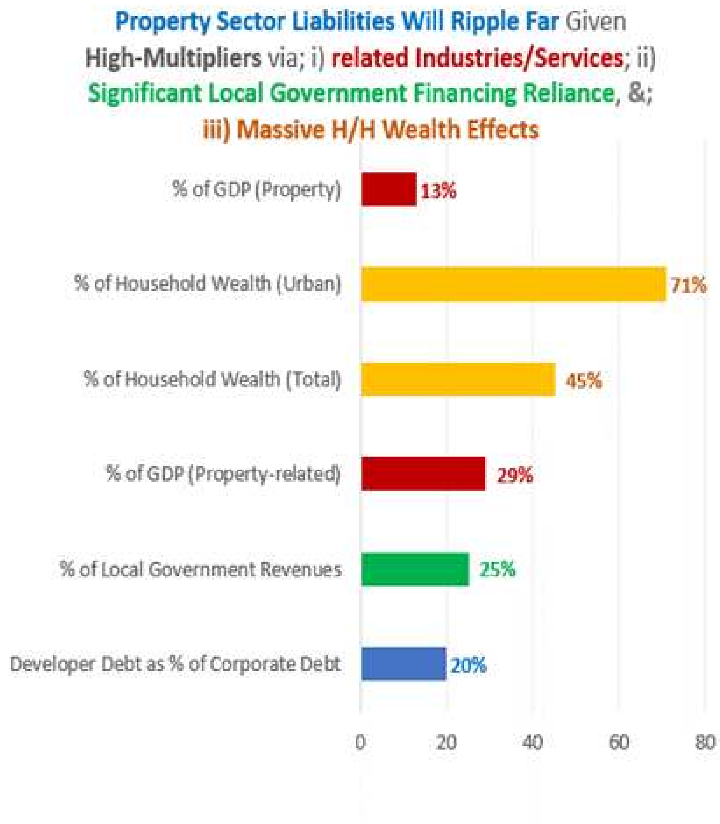
3) Confidence Deficit from "Common Prosperity": What's more, **confidence deficit** as a consequence of *economic interests subordinated to socio-political ideologies* (such as "**Common Prosperity**") inevitably undermine the underlying growth drivers/multipliers; invariably muting stimulus effects.

   Especially as worries of socio-economic policies gain prominence again cast doubts on private sector prospects, claims on profits and property rights.

   Arguably, this hobbles commitment to longer-term investments, compromising both immediate growth multipliers and longer-term growth potential. And the confidence drag imposes on consumers via jobs/wage.

4) Pervasive, Persistent & Acute Property Pain: Moreover, the **intensity, profusion** (far beyond the epi-centre of developers) and **persistence of pain warns of imposing and lingering drag from China's beleaguered property sector**; via adverse balance sheet shocks and wealth effects.

   By virtue of accounting for almost a third of growth and constituting some ~70% of household wealth, the **debilitating wealth/balance-sheet effects** of the property market may prove notoriously **hard to offset, much less, reverse**.



In fact, *dispelling the drag to revive "animal spirits" may perversely require* stimulus so forceful that it borders on *fuelling another property bubble*.

Being neither politically palatable nor financially tenable, that means the property sector continues to cast a long shadow on China's (durable) growth turnaround prospects as it continues to adversely impact cash-flows as well as balance sheet effects; with a much wider spill-over.

5) (Geo-political) Security Premium on Tech: Finally, policy stimulus in isolation cannot surmount **growth erosion from "geo-political" premium associated with US-China geo-economic tensions**. Specifically, involving **direct and unmitigated US challenge** to China's aspirations **for further advancement in high-tech as well as strategic industries**. In fact, the **unavoidable costs of threat mitigation** *will by definition rob growth* by diminishing profits/value-add.

The **higher threat mitigation costs/expenses/premiums** *involve all manner of insurance/assurance* to work around sanctions, tariffs and all other direct or indirect impediments comprising:

i) "*security costs*" involving securing/stockpiling resources, key inputs and "intelligence";
ii) "*barrier levy*" that entails costs of circumnavigating sanctions/restrictions imposed;
iii) "*acquisition premium*", which includes increasing cost of acquiring (organic and inorganic) access to resources/know-how/innovation and;
iv) "*duplication overheads*", derived from necessary excess/diversified capacity relevant in a geo-politically charged global order.

China's *structurally-challenged socio-economic conditions in a geo-politically charged global order* means that **compromised growth potential** is not just a relevant risk for China, but more likely **an unavoidable economic reality**; echoing Master Yoda's wisdom on "*only find(ing) what you bring*". Inevitably, **overarching structural, socio-economic and geo-political impediments, geo-economic forces** *compromise policy boost* expected from, and *sharpen trade-offs* associated with, policy stimulus.

* Higher the credit intensity, the greater the credit stimulus that is required to eke out the same quantum of growth
** In particular, the so-called "Minsky moment" (of a financial unravelling on unsustainable credit dynamics).