

hq@triviumchina.com

Trivium China

Markets Note

Interest rate cuts – Time to get unconventional?

June 30, 2023 / No. 171

On June 19, the People's Bank of China (PBoC) announced a drop in the loan prime rates – the benchmark interest rates at which banks lend to firms and households – by 10 basis points. The cuts were small but are widely expected to mark the start of a rate cutting cycle.

However, additional interest rate cuts of a similar magnitude will do little to revive China's economy. Marginally lower rates aren't going to incentivize households to buy homes, and firms have little need for new credit until consumer confidence returns.

Could monetary policy nonetheless play a central role in China's economic recovery? High-profile voices in China are arguing large interest rate cuts should be part of the solution to sluggish growth.

- The well-respected China Finance 40 think tank is calling for repeated 25 bps cuts until unemployment has subsided and the economy has recovered.
- An economist at the China Academy of Social Sciences (CASS) wants to cut the Chinese equivalent of the Fed funds rate to zero.

Advocates for sharper rate cuts aren't claiming it will immediately stimulate more borrowing, but rather it will reduce debt servicing costs for households, firms, and local governments, thereby freeing up cash that can be used more productively.

However, Beijing doesn't appear ready to pursue such a drastic approach.

We expect incremental, small-scale rate cuts to be part of a broader economic support package Beijing will roll out over the coming month.

- But if those measures fail to revive growth adequately, calls for more radical monetary policy – bordering on unconventional – will become louder.

Slashing interest rates isn't without costs – notably a weaker yuan and lower bank profits – but it might prove to be a practical policy choice in the absence of better options.

We suspect authorities have been struggling to agree upon a package of measures that will meaningfully boost domestic demand.

- Policymakers typically rely on supply-side economic stimulus. However, the economy is facing a lack of aggregate demand, blunting Beijing's typical supply-side policies.

The beauty of interest rate cuts is that they've traditionally been used as a supply-side tool. But if rates are reduced enough, they could also deliver a demand-side boost.

When a cut isn't really a cut – the challenge of real rates

On June 19, the PBoC lowered the one-year and five-year loan prime rates (LPR) by 10 bps, kicking off what many expect to be a rate cutting cycle.

However, the modest drop in the LPR highlights policymakers' reluctance to pursue aggressive interest rate cuts, particularly when compared with earlier periods.

- During the economic downturn in 2015, the PBoC cut the one-year year lending rate – the central bank’s benchmark rate at the time – by a total of 185 bps.
- Since the outbreak of COVID – a period of more than three years – the one-year LPR has declined 50 bps, and the 5-year LPR by 60 bps.

Beijing is wary of downward pressure lower rates will have on the yuan, but it’s also concerned about squeezing bank profits if lending rates decline faster than funding costs, as has been the case over the last couple of years.

- Data from the National Financial Regulatory Administration (NFRA), China’s new financial regulator, shows bank’s net interest margin in Q1 was 1.74%, down from 1.91% in Q4 2022, and 2.08% in Q4 2021.

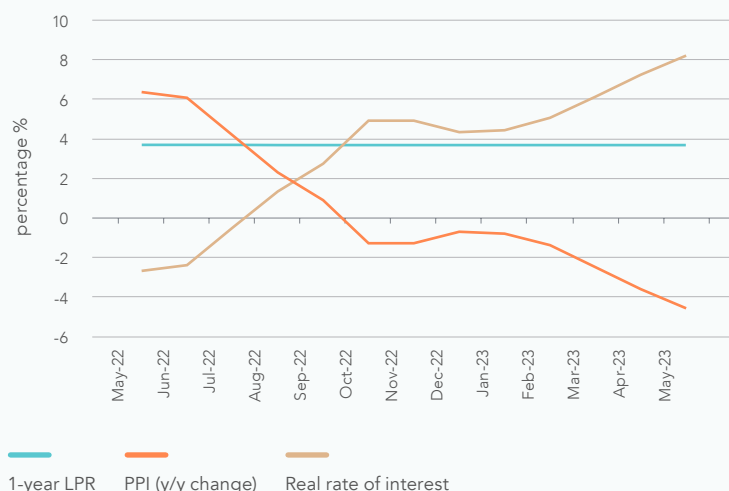
The interest rate margin is a major determinant of banks’ profitability, which is needed to replenish core tier-1 capital, used for disposing of nonperforming loans.

- Additionally, bank profits contribute significantly to local and central government finances, through taxes and dividends. Given the financial pressure local governments are under, Beijing may be reticent to further erode an important source of income.

Nonetheless, the case for further rate reductions is strong. Given producer price deflation, real interest rates in China remain cripplingly high for firms.

- The purchasing price index (PPI) in May fell by 4.6%, the eighth consecutive month of falling prices.
- The one-year LPR dropped to 3.55%, putting the real rate of interest at 8.15%. **[Fig. 1]**

Fig. 1 – Real interest rates have soared as producer prices continue to fall



Source: CEIC, NBS, PBoC, Trivium

However, the June cut will do little for firms.

- In May, the fall in PPI resulted in real interest rates rising by 100 bps. Consequently, a 10 bps reduction in the LPR brings only minimal relief.

Meanwhile, the cut is unlikely to change household behavior.

- Authorities hope that interest rate cuts will revive demand for new housing, which has been a drag on growth for over a year.
- However, local and central governments have deployed multiple measures to revive housing demand over the past year, ranging from lower down payments, easier access to housing provident funds, subsidies for new home loans, and the partial dismantling of restrictions against the purchase of investment properties. The cumulative impact on home sales has been underwhelming.
- A 10 bps cut to mortgage rates is therefore unlikely to move the needle.

Are bigger cuts the answer?

Some well-respected voices are starting to call for sharper cuts.

- In a June 21 interview, **Liu Yuanchun**, president of Shanghai University of Finance and Economics and a trusted economic advisor to Xi Jinping, recommended cutting rates by 100 bps.
- On June 15, **China Finance 40** – a mainstream think tank that includes some of China’s most respected economic thinkers – [recommended](#) cutting interest rates in 25 bps increments “*until the employment target and satisfactory economic growth are achieved.*”
- But perhaps the [most radical suggestion](#) is from **Zhang Bin**, deputy director of the Institute of World Economics and Politics at CASS, who advocates cutting the seven-day reverse repo rate to zero.

Some context: The seven-day reserve repo is the PBoC’s main tool for providing liquidity to the interbank market and is broadly equivalent to the Fed funds rate in the US.

- On June 13, the PBoC reduced the interest rate on seven-day reverse repos from 2% to 1.9%. **[Fig. 2]**

The case made by these thinkers for cutting interest rates more sharply isn’t that they’ll immediately stimulate home purchase or boost corporate investment.

- Rather, it’s that lower funding costs will repair balance sheets.

We wrote about the concept of damaged balance sheets in our June 8 report, [Damaged balance sheets: The challenge of designing effective consumption support](#), in which we argued that stagnating income growth and households’ expectations of stagnating or falling wealth are the greatest impediment to reviving the economy.

While we focused our report on households, it’s widely argued among Chinese economists that the economy is contending with three sets of damaged balance sheets:

- Households
- Local governments
- Private sector firms

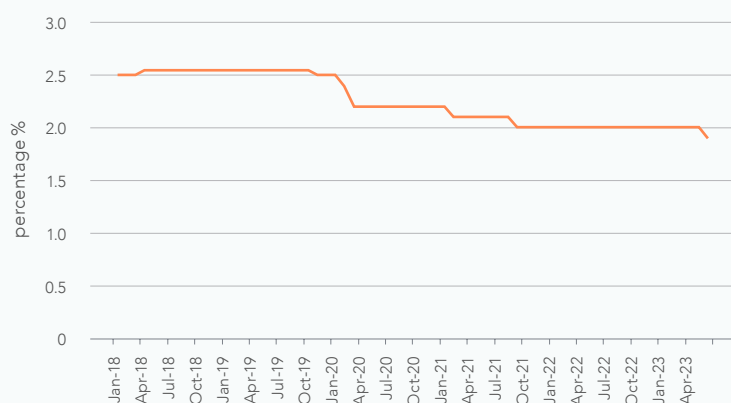
All three sets of economic actors have too much debt relative to current income or expectations of future income/wealth. Consequently, they are reluctant to borrow or to spend discretionary cash, and in the case of local governments, simply have no spare cash to spend. This crimps domestic demand.

According to Zhang, cutting the reverse repo rate from 2% to zero (he wrote the article before the rate was cut on June 13) will eventually feed through into other key rates, reducing interest payments throughout the economy by RMB 7.1 trillion a year. Interest payments will decline by:

- RMB 2.4 trillion for local governments
- RMB 1.48 trillion for households
- RMB 3.22 trillion for non-financial companies

Fig. 2 – Interest rate on funds lent by the PBoC under seven-day reverse repo agreements

Under a zero-interest rate policy (ZIRP), the seven-day reverse repo rate would have to fall a further 1.9 percentage points



Source: CEIC, PBoC, Trivium

How might these savings translate into an economic recovery?

Local governments:

China's local governments are under heavy financial stress.

- Interest payments on bonds issued by local governments increased 21% last year to RMB 1.12 trillion (that doesn't capture implicit debts borrowed by LGFVs).

Those costs are starting to be passed on to the public. In recent months, Chinese media has reported instances of:

- State employees having their wages cut or delayed
- The cost of government provided services – like parking or transport – increasing
- Increases in the frequency and severity of fines – such as harsh penalties imposed on restaurants for minor regulatory infringements, or excessive parking fines

Reducing interest payments would free up local government resources to help pay employees, provide public services, and stop gouging the public and businesses through unfair fines.

- There's no way of quantifying how much that will boost consumption, but it will unquestionably help.

Households:

Almost all home mortgages in China have an adjustable interest rate. When the floor under mortgage rates changes, the increase or decrease is applied to all existing mortgages from the start of the following year.

Mortgage rate cuts increase the disposable income of people with home loans. However, only a fraction of household savings on mortgage payments will translate into higher consumption.

- According to an academic research paper published in 2020, Chinese households typically only spend about 36% of the monthly mortgage payment saved from an interest rate reduction.
- According to the paper, Chinese homeowners tend to save the majority of any windfall from lower rates so that when rates rise in the future, they have a buffer to soften the blow.

That limits the impact lower mortgage payments will have on consumer spending. Sadly, we don't have data on how Chinese households with consumer loans respond to changes in interest rates. Nonetheless, assuming Zhang Bin's estimate that households will save RMB 1.48 trillion in interest payments is correct, cutting the policy rate to zero would increase consumer spending by at least RMB 500 billion next year.

Asset price inflation:

Significantly lower interest rates will increase companies' profitability by reducing expenses – and as a result, boost stock prices.

- Zhang also argues that lower borrowing costs will feed through into higher asset prices more broadly, pointing to the experience of the US when it cut rates to zero.

Beijing has been focused on reining in asset price bubbles since launching its crackdown on shadow banking in 2017.

- It would be a radical pivot to now embrace a policy designed to inflate asset prices.

However, as we outlined in our June 8 report, [Damaged balance sheets: The challenge of designing effective consumption support](#), household balance sheets are damaged because:

- The collapse in demand for new housing has lowered households' expectations about the future value of their homes, lowering their sense of financial wellbeing.

Higher asset prices could inflate household wealth, thereby boosting households' willingness to spend.

Will the PBoC embrace a zero-interest rate policy (ZIRP)?

Maybe, but it will take great pains to deny that it's doing anything that smacks of unconventional monetary policy.

- Beijing has repeatedly called out the US for irresponsible monetary policy and held up China as a paragon of responsible policy making. To implement ZIRP – or something close to it – would be a bitter pill to swallow.

However, China's growing debt problems may make aggressive interest rate cuts an inevitability.

- One of the easiest ways to alleviate pressure on local government finances is to reduce debt servicing costs.
- Any solution to the local government debt problem will likely involve the central government absorbing some of the debt onto its own balance sheet. But it can kick the can down the road by pushing interest rates toward zero.

We don't know if Beijing will still start pushing interest rates toward zero. Nor do we know how long it might take for China's authorities to warm to the idea.

- However, radically lower interest rates are now part of the policy debate. If the economy continues to struggle, we expect to hear more voices calling for ZIRP or a policy equivalent.¹

1 The research is based on mortgage repayment data from 2010-2014. Zhao D, Chen Y, Shen JH. Mortgage payments and household consumption in urban China. Econ Model. 2020 Dec;93:100-111. doi: 10.1016/j.econmod.2020.07.008. Epub 2020 Aug 7. PMID: 32834334; PMCID: PMC7413101.

Need anything more?

Send us mail

No.10 Jintong West Rd, Building A/B, Floor
7, Chaoyang District, Beijing, 100020

策纬(北京)管理咨询有限公司
北京市朝阳区金桐西路10号远洋光华国际
AB座7层

Email us

hq@triviumchina.com

Follow us

www.triviumchina.com

Twitter: [@triviumchina](https://twitter.com/triviumchina)

Facebook: [/triviumchina](https://facebook.com/triviumchina)

LinkedIn: [/company/trivium-china/](https://linkedin.com/company/trivium-china/)