



CHINA ECONOMICS WEEKLY

Case for rate cuts fades as financial stability concerns return

The People's Bank last cut policy rates in August. Worries about currency weakness then stayed its hand – plus a view that supply-side disruption linked to COVID would render further easing ineffective. Those concerns have since gone away. We had thought the PBOC might therefore resume rate cuts as part of the broader government push (visible in fiscal and property policy) for growth. But that now seems unlikely.

First, a recovery in business confidence and activity is already well underway. Expectations for a pick-up in service sector activity over the coming year are the strongest they have been in over a decade. Manufacturers have a smaller hole to climb out of, but are still upbeat.

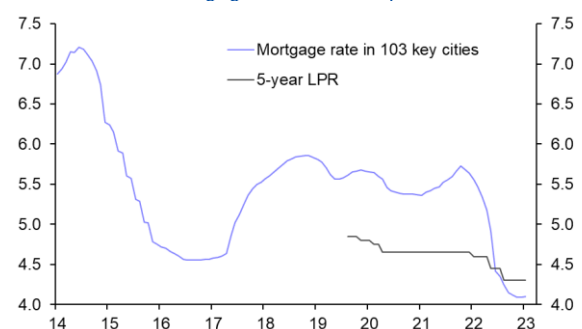
Second, as confidence in the near-term recovery grows, the PBOC already appears to be shifting its focus: it reportedly told banks to slow their lending this month, suggesting some discomfort with January's surge in borrowing. We had thought that a pivot back to containing debt risks would only happen later in the year.

Third, rate cuts could exacerbate the recent wave of mortgage prepayments, which threaten bank profits and have triggered regulator concerns. The increase in prepayments is linked to the [jump in bank deposit balances](#) and the poor performance of alternative investment options over the past year.

Interest rates on outstanding variable-rate mortgages are adjusted based on changes to the 5-year Loan Prime Rate, which was only cut by 35 basis points this cycle. Households that took out mortgages between 2018 and 2021 at the prevailing market rate of around 5.5% are still paying in excess of 5%. Crucially, any LPR cuts enacted now wouldn't be applied to existing mortgages until the annual pricing reset next January. That makes prepayment an attractive proposition for those with cash to spare given low deposit rates and the declining risk-adjusted returns on wealth management products.

The cost of new borrowing is a factor too. It has fallen by far more than the LPR, as banks adjusted spreads relative to the benchmark in response to wider policy easing. For example, interest rates on new mortgages are now more than 160 basis points lower than in late 2021. (See Chart 1.)

Chart 1: Mortgage Rates and 5-year LPR (%)



Sources: CEIC, Beike, Capital Economics

Mortgage refinancing is not widely available in China. So, instead, some homeowners are opting to fund mortgage prepayments by taking out short-term consumer loans, the cost of which has also fallen – some banks now offer loans at rates below 4%. And unlike rates on existing mortgages, rates on new loans fall immediately when policy rates are cut. Returns on fixed income products fall too, thereby further incentivising mortgage prepayment.

Given all this, we now expect policy rates to be kept on hold for the foreseeable future. Admittedly, with the PBOC's top leadership about to change, there is greater uncertainty about the central bank's reaction function than usual. But even if the new appointees push the bank to pay less immediate attention to financial risk, the apparent strength of the ongoing rebound in economic activity has clearly diminished the case for rate cuts.

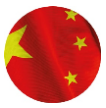
The week ahead

The key release next week is of the PMIs. But the main focus will be the National People's Congress that starts on Sunday (5th March) and the personnel and policy change that it will bring.

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Data Previews

Manufacturing PMIs (Feb.)

Wed. 1st Mar.

| Forecasts | Time (China) | Previous | Consensus | Capital Economics |
|--|--------------|----------|-----------|-------------------|
| “Official” PMI (1 st Mar.) | 09.30 | 50.1 | 50.7 | 51.5 |
| Caixin/S&P Global PMI (1 st Mar.) | 09.45 | 49.2 | 51.3 | 51.0 |

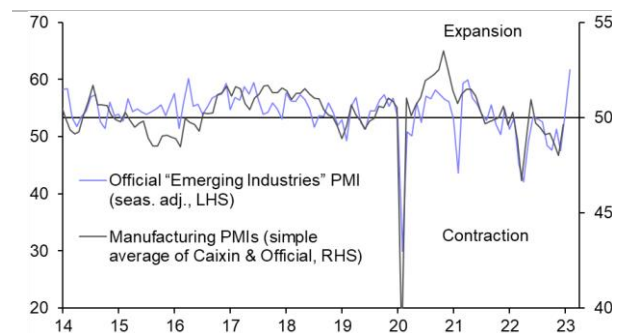
Domestic boost helping to offset external weakness

Both manufacturing PMIs rose in January, though the increase in the Caixin survey was more modest than that in its official counterpart. We suspect that’s because it skews toward smaller firms and exporters that are facing the greatest headwinds from weaker foreign demand.

Early signs suggest that conditions improved further in February. The external picture is no better: the new order and export order indices of China’s major trading partners’ *flash PMIs* point to a further softening in foreign demand this month. But domestic demand is rebounding and supply-side issues have continued to dissipate. The official Emerging Industries PMI – which covers high-tech

parts of manufacturing – jumped to its highest on record this month. (See Chart 2.)

Chart 2: Manufacturing & Emerging Industry PMIs



Sources: CEIC, S&P Global, Capital Economics

Non-manufacturing PMIs (Jan.)

Wed. 1st Mar. / Fri. 3rd Mar.

| Forecasts | Time (China) | Previous | Consensus | Capital Economics |
|--|--------------|----------|-----------|-------------------|
| “Official” PMI (1 st Mar.) | 09.30 | 54.4 | 55.0 | 55.0 |
| Caixin/S&P Global PMI (3 rd Mar.) | 09.45 | 52.9 | 54.8 | 54.5 |

More firms benefitting from reopening rebound

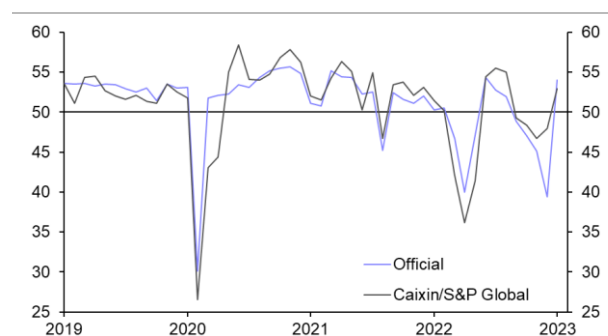
The services PMIs jumped in January as consumers returned to the streets after recovering from COVID. (See Chart 3.) We expect both indices to have risen further in February.

Admittedly, mobility was already back to normal by the end of January, which suggests that the most rapid stage of the recovery has already passed. But as diffusion indices, the PMIs don’t directly measure the scale of changes in activity but rather their breadth – i.e. the share of firms seeing a rise or fall in sales. And with the impact of reopening still rippling through the economy, we think more firms will have seen improvements in activity compared to January.

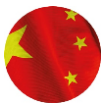
Construction activity, which is part of the official non-manufacturing PMI, probably picked up too. This will reflect easing labour shortages at building

sites and recent policy support – funding for infrastructure has been stepped up while financing to help developers complete stalled projects has increased.

Chart 3: Services PMIs



Sources: CEIC, S&P Global, Capital Economics



Economic Diary & Forecasts

Upcoming Events and Data Releases

| Date | Country | Release/Indicator/Event | Time (China) | Previous* | Median* | CE Forecasts* |
|-------------------------------------|---------|--|--------------|-----------|---------|---------------|
| February | | | | | | |
| 26 th – 28 th | | Chn Second Plenary Session of the Central Committee | - | - | - | - |
| Mon 27 th | | HK Exports (Jan.) | (16.30) | (-28.9%) | - | (-28.0%) |
| | | HK Imports (Jan.) | (16.30) | (-23.5%) | - | (-24.5%) |
| March | | | | | | |
| Wed 1 st | | Chn “Official” Manufacturing PMI (Feb.) | (09.00) | 50.1 | 50.7 | 51.5 |
| | | Chn “Official” Services PMI (Feb.) | (09.00) | 54.4 | 55.0 | 55.0 |
| | | Chn Caixin Manufacturing PMI (Feb.) | (09.45) | 49.2 | 51.3 | 51.0 |
| Thu 2 nd | | HK Retail Sales (Jan.) | (16.30) | (+1.1%) | - | (+12.0%) |
| Fri 3 rd | | Chn Caixin Services PMI (Feb.) | (09.45) | 52.9 | 54.8 | 54.5 |

Selected future data releases and events:

March

| | | |
|---------------------|--|---|
| Sat 4 th | | Chn Start of Two Sessions – National Committee of the CPPCC |
| Sun 5 th | | Chn Start of National People’s Congress (including the presentation of government work reports and the budget) |
| Tue 7 th | | Chn Foreign Exchange Reserves (Feb.) |
| | | Chn Trade Data (Feb.) |
| | | Chn Inflation Data (Feb.) |

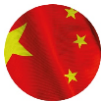
Also expected during this period:

| | | |
|------------------------------------|--|---|
| 9 th – 15 th | | Chn Aggregate Financing “AFRE” (Feb., RMB) |
| | | Chn M2 Money Supply (Feb.) |
| | | Chn Net New Lending (Feb., RMB) |

Main Economic & Market Forecasts

| %q/q annualised (%y/y), unless stated | Latest | Q1 2023 | Q2 2023 | Q3 2023 | Q4 2023 | Q1 2024 | 2022 | 2023f | 2024f |
|--|-------------|---------|---------|---------|---------|---------|--------|---------|--------|
| Official GDP | 0.0(+2.9)* | (3.4) | (7.6) | (5.1) | (6.4) | (5.6) | (3.0) | (5.5) | (5.0) |
| GDP (CE CAP-derived estimates) | -2.6(-5.9)* | (-0.9) | (7.2) | (5.9) | (10.3) | (6.7) | (-2.4) | (5.5) | (5.0) |
| Consumer Prices | (+2.1)*** | (2.8) | (2.1) | (2) | (2.2) | (2) | (2.0) | (2.4) | (1.6) |
| Producer Prices | (-0.8)*** | (-1.2) | (-3) | (-0.7) | (0.1) | (0.1) | (4.1) | (-1.0) | (0.5) |
| Broad Credit (AFRE) | (+9.4)*** | (9.1) | (9.2) | (9.8) | (10.4) | (10.4) | (9.6) | (10.4) | (9.2) |
| Exports (US\$) | (-9.9)** | (-14.2) | (-16.4) | (-18.3) | (-8.4) | (-1.2) | (7.0) | (-14.5) | (0.0) |
| Imports (US\$) | (-7.5)** | (2.9) | (-3.4) | (-8) | (1.2) | (1.2) | (1.1) | (-2) | (3.5) |
| RMB/\$ [†] | 6.91 | 6.75 | 6.80 | 6.65 | 6.50 | 6.48 | 6.95 | 6.50 | 6.40 |
| 7-day PBOC reverse repo [†] % | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| 1-year Loan Prime Rate [†] (LPR) % | 3.65 | 3.65 | 3.65 | 3.65 | 3.65 | 3.65 | 3.65 | 3.65 | 3.65 |
| 1-year MLF Rate [†] % | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 |
| 10-year Government Bond Yield [†] % | 2.92 | 2.80 | 2.70 | 2.90 | 3.10 | 3.10 | 2.85 | 3.10 | 3.10 |
| RRR (major banks) [†] % | 11.00 | 10.75 | 10.75 | 10.75 | 10.75 | 10.75 | 11.00 | 10.75 | 10.75 |
| CSI 300 Index [†] | 4,093 | 4,150 | 4,300 | 4,550 | 4,770 | 4,850 | 3,872 | 4,770 | 5,110 |
| Hong Kong GDP | (-4.2)* | (1.5) | (2.3) | (7.4) | (9.8) | (9.5) | (-3.5) | (5.5) | (9.5) |
| Hang Seng Index [†] | 20,169 | 21,000 | 23,250 | 24,500 | 26,000 | 26,375 | 19,781 | 26,000 | 27,500 |

Sources: Bloomberg, Refinitiv, CEIC, Capital Economics *Q4; **Dec.; ***Jan.; [†] End of period



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