CHINA RAPID RESPONSE

Policy Rates (Jun.)

Monetary easing to provide modest support to growth

- **The PBOC has lowered its policy rates for the first time since last summer, reflecting growing concerns among policymakers about the health of China's recovery. Friday's State Council meeting signalled that further support measures are on their way. But we think that a sharp acceleration in credit growth is still unlikely and that the recovery will continue to mostly depend on the service sector.**

- The one-year and five-year Loan Prime Rates (LPR) were lowered for the first time since last August today, from 3.65% to 3.55% and from 4.30% to 4.20%, respectively. The LPR is the reference rate against which all new loans, and outstanding floating rate ones, are priced. In particular, the 5-year rate is the benchmark for pricing most mortgages.

- The reduction was widely anticipated following the 10bps cut to its 1-year Medium-term Lending Facility (MLF) rate, 7-day reverse repo rate and standing lending facility (SLF) rates last week. This is the third round of across-the-board rate reductions this easing cycle. (See Chart 1.)

- We had expected some further monetary support this quarter but thought that, in order to avoid putting pressure on interest margins at commercial banks, it would take the form of a required reserve ratio (RRR) reduction rather than rate cuts. The PBOC has not divulged the reasons for the rate cuts. But **wider policy statements, including the readout from Friday's State Council meeting, make it clear that officials are increasingly concerned about the economy and that supporting growth is now taking precedence over other concerns, including those about bank profitability**.

- The cuts will lower interest payments on existing loans, taking some pressure off indebted firms. It will also nudge down the price of new loans. However, homebuyers with existing mortgages will have to wait until the start of next year for the change to affect them.

- On their own, 10bps cuts are too small to make a great deal of difference to monetary conditions, especially since market interbank rates are already below policy rates. (See Chart 2.) But **the PBOC tends to use changes in policy rates as signalling tool, with the heavy lifting being done by other tools such as adjustments to reserve requirements and bank loan quotas**. The latest round of rate cuts suggests that these tools will be deployed too. The key unknown is whether increasing the supply of available credit will succeed in boosting lending or, as was the case last year, the main constraint will be weak credit demand. Businesses do appear slightly more willing to invest than when they faced the uncertainty of zero-COVID. But sentiment is still weak by historic standards.

- All told, we think monetary easing will provide some modest support to credit growth and wider economic activity. **We anticipate at least one more cut to policy rates and reserve requirements during the rest of this year.** However, small tweaks to interest rates and reserve requirements won't drive much of a pick-up in household or corporate borrowing and spending on their own. We expect fiscal policy to offer additional support – there is already talk of a RMB1trn sovereign special bond issuance (0.8% of GDP) to fund infrastructure spending.

- But stimulus looks set to be fairly modest and so the near-term outlook still depends primarily on the extent of second-round effects on consumer confidence and spending from relatively tight labour market conditions. We remain cautiously optimistic that this will provide greater support to the recovery than most anticipate. Nonetheless, given the sharp slowdown in credit growth and weaker momentum across the board in May, we recently lowered our annual GDP growth forecast from 6.5% to 6.0%.

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Chart 1: PBOC Policy Rates (%)

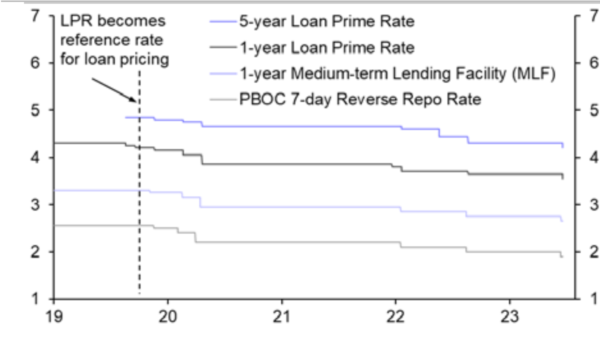
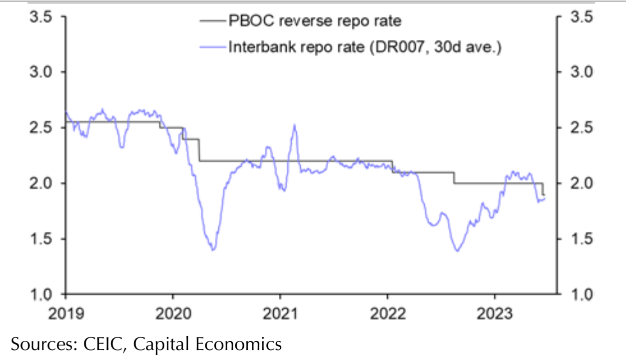


Chart 2: 7-day Pledged Repo Rates (%)



Sources: CEIC, Capital Economics

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