CHINA RAPID RESPONSE

Policy Rates (Aug.)

LPR follow-up disappoints after largest MLF cut since initial pandemic hit

- *This report was first published on Tuesday 15th August, covering the reduction to the Medium-term Lending Facility rate. We added commentary following the cut to the 1-year Loan Prime Rate on Monday 21st August.*

- **The PBOC has lowered its policy rates for the second time in three months, amid growing concerns among policymakers about the health of China's economy. A larger-than-usual MLF cut had hinted at a step-up in the scale of easing, but the change was not fully carried over to the Loan Prime Rate (LPR) that underpins loan pricing. The big picture is that the PBOC's approach to monetary policy is of limited use in the current environment and won't be enough, on its own at least, to put a floor beneath growth.**

- The 1-year Loan Prime Rate (LPR) was lowered on Monday, from 3.55% to 3.45%, while the 5-year LPR has been left on hold at 4.20%. The LPR is the reference rate against which new loans, and outstanding floating rate ones, are priced. The 1-year rate is used for pricing most corporate loans, while the 5-year rate is the benchmark for most mortgages.

- A reduction was widely anticipated following the 15bps cut to the PBOC's 1-year Medium-term Lending Facility (MLF) rate last Tuesday. At the time, the PBOC also cut the rates on its 7-day reverse repo operations and standing lending facility (SLF) by 10bps. The cuts take the 1-year LPR and the PBOC's policy rates to new lows. This is the fourth round of rate reductions this easing cycle, coming after a round of rate cuts in June. (See Chart 1.)

- The 15bps MLF cut was its largest since April 2020 and came as a surprise to most analysts – we were the only forecasters polled by Bloomberg to correctly anticipate a cut. Other analysts had presumably assumed that downward pressure on the renminbi, which hit its weakest level against the US dollar in nine-months in the run up to the MLF decision, would convince the PBOC to hold back. But **although policymakers still care about the exchange rate** – as evidenced by recent state intervention in the FX markets – **they now appear more worried about the economy**. That's not surprising given negative CPI, extremely subdued credit growth and stagnant activity and spending.

- **The PBOC still appears to be taking a cautious approach to monetary support, however**. Following the 15bp MLF cut, most forecasters assumed they would trim the 1-year and 5-year LPR by the same amount. But in the event, only the one-year LPR was reduced and by a smaller margin of 10bps. This suggests that the PBOC is trying to balance its desire to shore up economic activity against the concerns of the banks, who suffering from narrowing interest margins and declining profitability.

- **On its own, the latest round of cuts is too small to have a big impact.** It only partially reverses the recent increase in real interest rates due to lower inflation. (See Chart 2.) 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 cuts suggest that these tools will be deployed too, consistent with the PBOC's promise of further monetary easing.

- But we think this will provide only modest support to credit growth and wider economic activity**.** Weak credit demand means that easier availability of credit probably won't drive much of a pick-up in credit growth. Instead, the additional liquidity is like to remain trapped in the banking system, as was the case last year. **Reviving demand would take much larger rate cuts, or regulatory measures to effectively restore confidence in the housing market**.

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- Efforts toward the latter will be hampered by Country Garden's recent financial troubles. And the former would require the PBOC to ditch its adherence to the "attenuation principle", which favours moving in tiny increments. The central bank took a small step in that direction by opting for a 15bp MLF cut instead of a usual 10bp reduction. And we expect a further 20bp in policy rate cuts during the remainder of the year. But **the disappointing follow-through from the MLF cut to the LPR strengthens our view that the PBOC is unlikely to embrace the sizeable declines needed to revive credit demand**.

- The upshot is that while monetary easing will provide some relief to indebted firms and households, it won't be enough to put a floor beneath growth. **Instead, the key will be the extent of fiscal support.** Policymakers have taken some steps in that regard, telling local officials to fully utilize their annual quotas for special bonds by the end of next month, which implies a short-run spike in issuance. But more measures will be needed to drive a turnaround in economic activity.

Chart 1: PBOC Policy Rates (%)

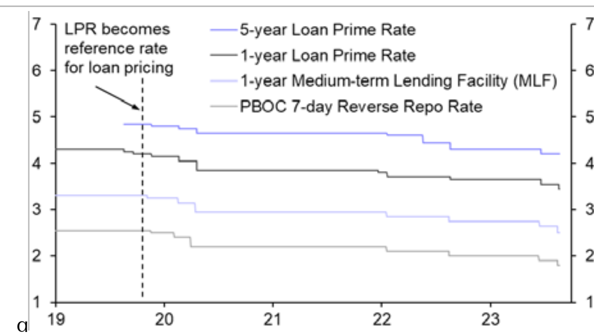
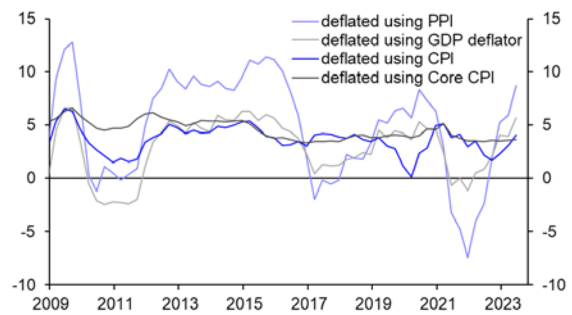


Chart 2: Bank Lending Rates (%)



Sources: CEIC, Capital Economics

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