CHINA ECONOMICS UPDATE

PBOC rate cuts: Go big or go home

- **The quantitative tools that the PBOC relied on to pump up credit growth during previous downturns have become ineffective due to weak demand. That leaves interest rates as the main avenue for monetary support. But bank lending rates need to decline to a much larger extent, by a further 100bps or more, to have a meaningful impact. The main barrier to doing so is the PBOC's focus on exchange rate stability.**
- The PBOC cut its 1-year Medium-term Lending Facility (MLF) rate by 15bps last month. This was the largest cut since the initial pandemic hit but only takes the cumulative decline this year to 25bp. (See Chart 1.) That's far smaller than the typical policy rate response to downturns in other countries.
- But it is par for the course in China these days. The current PBOC leadership adheres to the "attenuation principle", which favours small adjustments in the face of uncertainty about the consequences of policy changes. When other central banks were slashing rates in response to the initial COVID hit, the PBOC only nudged rates down by 30bps. In the past, small cuts were often sufficient because they were mostly being used as a signalling tool. With rates kept structurally low, policy control over the pace of credit growth was managed with quantitative tools, such as adjustments to reserve requirements and bank loan quotas.
- However, these quantitative tools are of limited use in the current environment. **Surveys suggest that loan demand is almost as weak as it was during last year's COVID-19 disruptions**. (See Chart 2.) At that time, banks were unable to make use of the additional loan quotas provided by regulators. The situation is similar right now, with the level of bank lending far weaker than what would normally be implied by survey measures of loan approval conditions – a proxy for how loose or tight loan quotas are. (See Chart 3.)

Chart 1: PBOC Policy Rates (%)

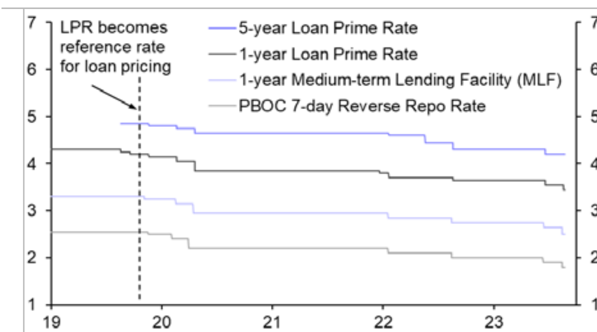


Chart 2: PBOC Banking Survey - Loan Demand (diffusion index)

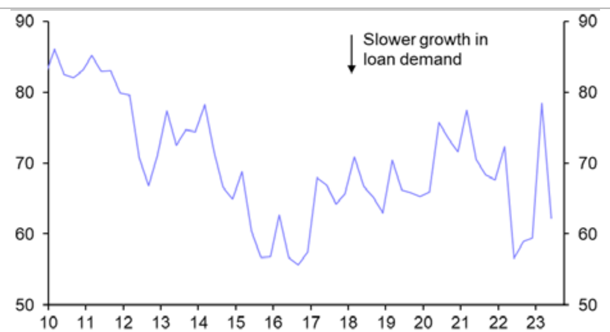


Chart 3: PBOC Lending & Loan Approval Conditions

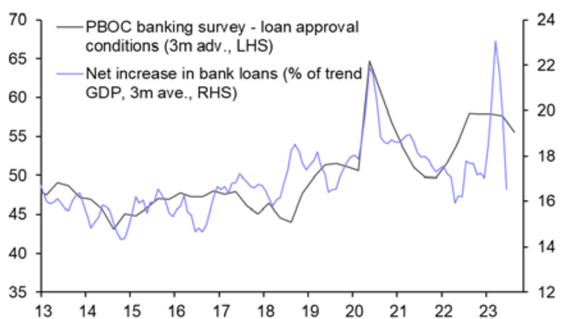
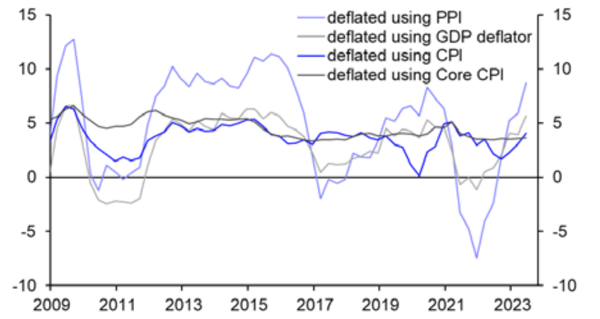


Chart 4: Bank Lending Rates (%)



Sources: CEIC, Capital Economics

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- That leaves policy rates as the main channel through which the PBOC can influence credit growth. But **in the absence of a wider turnaround in sentiment, engineering a meaningful revival in credit demand would require much larger rate cuts than seen so far**, not least because the recent decline in inflation has pushed up real interest rates for both firms and households. (See Chart 4.)

- The primary mechanism by which policy rates can influence credit growth is through their impact on bank lending rates. **Faced with a similar situation of cooling inflation and weak loan demand back in 2014/15, bank lending rates eventually fell by 200bps.** In the current easing cycle, bank lending rates have declined by about 80 bps so far. Loan demand isn't quite as weak this time, but **we think at least a further 100bps decline in bank lending rates is needed to have a noticeable impact on borrower behaviour**.

- **This would probably require the PBOC to cut its policy rates by a similar magnitude.** Last year, the PBOC put pressure on the banks to reduce their lending rates by more than the decline in policy rates. (See Chart 5.) But this approach led to a wave of mortgage prepayments and isn't sustainable – it has narrowed bank interest margins to just 1.7%. That has attracted the attention of the PBOC. **In its Q2 quarterly report, the PBOC devoted a special section to discussing the need to defend bank profitability**.

- **These concerns about bank profitability are one roadblock to larger cuts**. In China, policy rate adjustments have historically had a larger impact on the return on banks' assets than on the cost of their liabilities. **But this isn't an insurmountable problem**. It is possible for the PBOC to mitigate the impact on banks' interest margins by guiding them to lower deposit rates in unison. That is exactly what the central bank has now started doing in order to give banks room to lower existing mortgage rates.

- **A more fundamental constraint on PBOC action is its desire to avoid too much downward pressure on the renminbi**, which would be a natural consequence of larger rate cuts. Admittedly, a weaker renminbi wouldn't necessarily be a bad thing. In fact, we think it would accentuate the economic benefits from rate cuts, supporting exports and encouraging the consumption of domestic goods and services over foreign alternatives. The usual reasons to avoid currency depreciation in emerging economies – foreign currency debt vulnerabilities and inflation risks – largely don't apply to China. The country has relatively little FX debt and a bit more imported inflation would, if anything, be welcome amid concerns about deflation.

- **But the PBOC appears to take a different view. It is wary of stoking financial market volatility and places value on exchange rate stability for its own sake**. It wants to avoid a repeat of 2015, when a poorly communicated change to the renminbi fixing mechanism caused market expectations to become unanchored. This led to a jump in capital outflows and forced the PBOC to burn through a sizeable chunk of its FX reserves to stabilise the currency.

- **The PBOC's decision to cut policy rates last month even as the renminbi approached a multi-year low against the US dollar hinted at a slightly greater tolerance for currency weakness. But the significant step-up in FX intervention since then makes it clear that this tolerance is still limited. For this reason alone, it seems unlikely that the PBOC will embrace large-scale rate cuts.**

- **Some further monetary easing still looks likely**, not least because we think a fall in US bond yields will soon take some pressure off the renminbi. **But our base case is that the PBOC will continue to move in small increments** - we've pencilled in a further 20bp in policy rate cuts and a 50bps cut to reserve requirements during the remainder of the year.

- **On its own, this will have a limited impact on the real economy.** A cumulative decline in policy rates of 45bps won't make much difference to loan demand. And the liquidity unleashed by a RRR cut may remain stuck within the financial system until there is a catalyst for stronger loan demand. This was the case last

year, when market interbank rates stayed well below the PBOC's policy rates for a prolonged period. (See Chart 6.) Much of the excess liquidity stemming from any near-term RRR cut is likely to flow into the bond market, which is one reason we expect the yield on 10-year CGBs to fall to 2.40% by year-end, down from 2.67% currently.

- **The lack of more substantial rate declines doesn't preclude a cyclical rebound in credit growth**. But it does put the onus on non-monetary policy tools, such as fiscal support and property easing, to generate a revival in credit demand. There have been some positive developments in these areas recently, including the easing of downpayment requirements and an acceleration in local government bond issuance. The latter meant that credit growth ticked up in August for the first time in nine months. **But without monetary policy pulling its weight, there is a greater risk that wider stimulus measures may struggle to deliver a meaningful turnaround.**

Chart 5: Average Interest Rate and 1-year LPR (%)

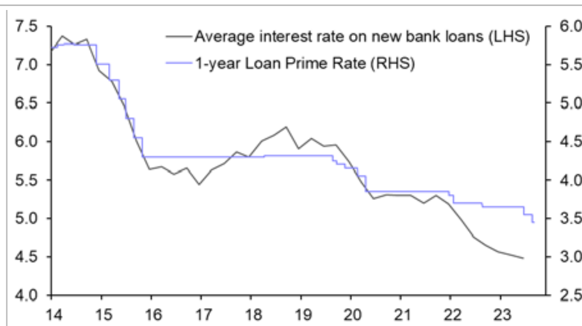
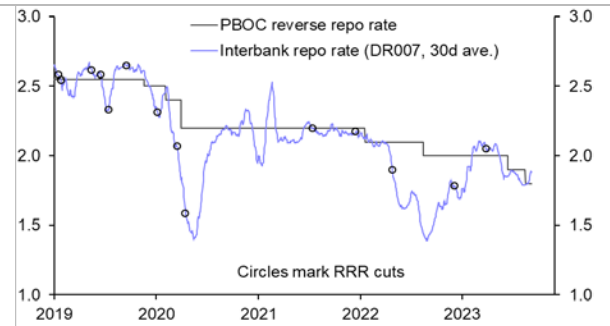


Chart 6: 7-Day Pledged Repo Rate (%)



Sources: CEIC, Capital Economics

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