CHINA ECONOMICS UPDATE

China to buck the trend of rising equilibrium rates

- **In much of the world, interest rates are likely to settle at higher levels than was the case prior to the pandemic. But China is a key exception, with its shrinking population, slowing productivity gains, low inflation rate and increasingly-heavy debt burden putting it on a path toward ultra-low rates. We think the country's short-term real equilibrium interest rate will fall from 1.4% currently to zero by 2030.**

- We recently published an in-depth report that discusses the outlook for r* – the equilibrium (or natural) level of short-term real interest rates – in advanced economies out to 2030. And we published a follow-up piece on r* in emerging economies last week. The key takeaway is that several of the structural forces which have weighed on equilibrium interest rates globally over the past two decades are easing, with r* rising since the start of the pandemic and on course to climb further over the coming years. That conclusion holds for advanced economies and most emerging ones but not, we think, for China.

- **r* is the level of real interest rates that balances planned investment and desired savings, keeping an economy operating at its potential with stable inflation**. r* is unobservable and there are two approaches to estimating it. The first is to use theoretical models to estimate r* ex-ante - i.e. where real interest rates should be given economic fundamentals. The second is to empirically deduce r* ex-post by examining what level of observed rates has been consistent with the economy operating at potential over time.

- There are no official estimates of r* for China. And pervasive state intervention in the economy and financial system means the assumptions that underpin theoretical models of r* clearly don't hold in China's case. Symptomatic of this, the link between potential growth and observed interest rates that is present in developed countries has not been visible in China over the past few decades. With this in mind, we have taken a purely empirical approach to estimating r* in China, using an HP filter to extract the trend of the 7-day interbank repo rate deflated by core CPI. The results suggest that **China's r* averaged between 5% and 6% in the late 1990s. This was followed by a decline in the early 2000s. After a rebound in the late 2000s, it declined again in the mid-2010s but has since held broadly steady between 1.0-1.5%**. (See Chart 1.)

- **The most straightforward framework for thinking through the future trajectory of r* is to consider the outlook for desired savings and planned investment**. **China's savings rate, which is elevated by global standards, is likely to decline over the medium term**. This will primarily be due to population ageing (retired workers typically run down their savings). (See Chart 2.) But the leadership's common prosperity agenda, and related policies aimed at reducing inequality and improving social benefits, may add to the decline by lowering precautionary savings.

- **Upward pressure on r* from a lower savings rate is likely to be more than offset by a faster decline in planned investment, however**. The AI revolution and green transition will boost investment in some areas, just as it will in developed economies. But in China's case this will be overwhelmed by the pullback in spending on real estate and wider infrastructure now that the population is in decline and migration from rural areas to urban areas is slowing to a crawl. And while China's pandemic export boom has driven a pick-up in manufacturing investment lately, growth is likely to slow over the medium-term. China is simply too big to lean on foreign demand to the same extent that its neighbours did during their catch-up growth. (See Chart 3.) That is not least because geopolitical tensions with the West, where much of the final demand for China's exports still lies, will make it harder for the country to continue gaining global export market

Zichun Huang, China Economist, zichun.huang@capitaleconomics.com
Julian Evans-Pritchard, Head of China Economics, julian.evans-pritchard@capitaleconomics.com

share. And since domestic demand growth is unlikely to accelerate to make up for softer export growth, the net result is that fewer new factories will need to be built.

- Admittedly, China has been able to sustain a very high investment rate for longer than many thought possible. That may remain the case in the near-term as policymakers continue to rely on state-directed investment to support growth. But with the capital intensity of China's economy already very high, even exceeding that in many advanced economies (see Chart 4), doing so will almost certainly result in over-investment, causing a further increase in the already high debt ratio. (See Chart 5.)
- As a result, **interest rates in China will probably trend down even if policymakers keep the investment rate elevated**. In order for the financial system to cope with lots of debt-financed projects with low returns, financing costs will need to be lowered even further. Inflation is unlikely to pose a constraint on doing so given that over-investment is disinflationary. This approach is not sustainable in the long run, however, and the government will eventually have to allow a sharp decline in the investment rate.
- Japan's experience in the 1980s and 90s provides a cautionary tale. The country kept its investment rate too high for too long, ignoring demographic headwinds, rising debt levels and wider evidence of declining investment efficiency. This ultimately led to a sharp downturn in investment and marked decline in r*. Greater state involvement in the economy means the process is likely to be more gradual and drawn-out in China's case. But the outcome is likely to be similar – **we think that China's r* will fall to zero in 2030, converging with Japan**. (See Chart 6.)
- We expect China's inflation rate to be held down by persistent overcapacity but to remain positive over the long-run. As such, **the equilibrium interest rate will be a bit higher in nominal terms – we forecast it be around 1.5% in 2030, down from 2.0% currently**.
- **Long-term interest rates may decline by a larger margin** given that policy efforts to manage the rising debt burden are likely to involve not just lower policy rates but also forms of financial repression that shrink the term premium. **We expect the 10-year yield on Chinese government bonds to fall to 2% by 2030, down from an average of 2.9% since the start of the pandemic**.

Chart 1: R* in China (CE estimates)

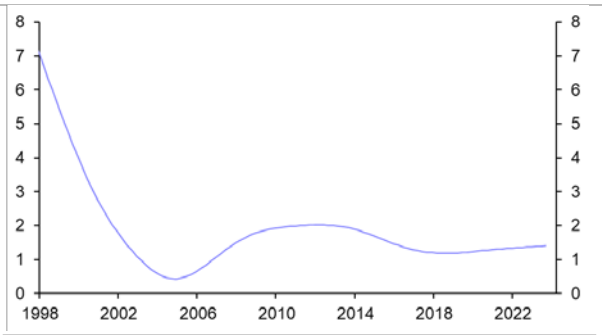


Chart 2: Consumption Share & Dependency Ratio

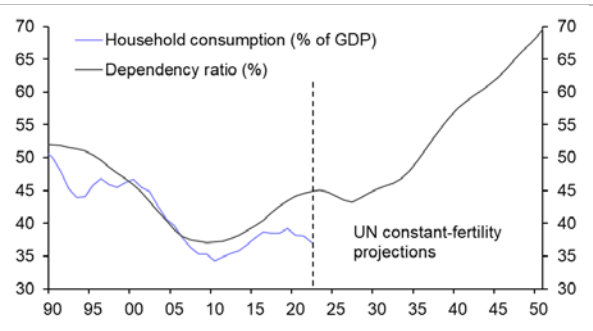


Chart 3: Export Growth vs Income Level

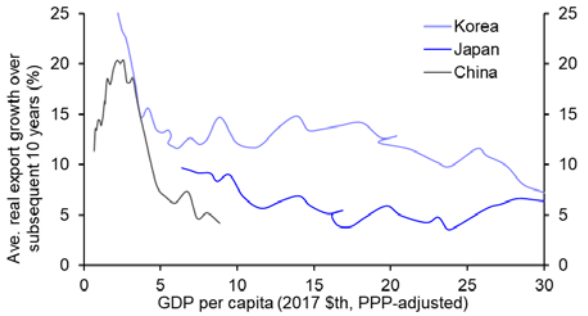


Chart 4: Capital Stock (% of GDP, PPP-adjusted)

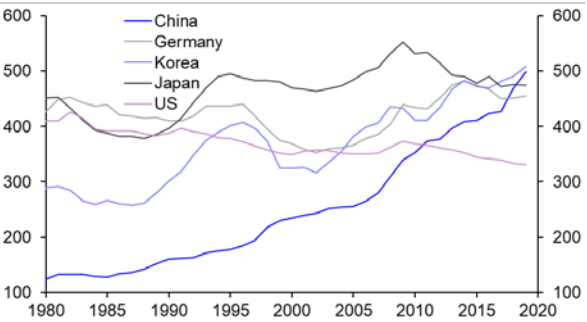


Chart 5: Broad Credit Outstanding (% of GDP, SA)

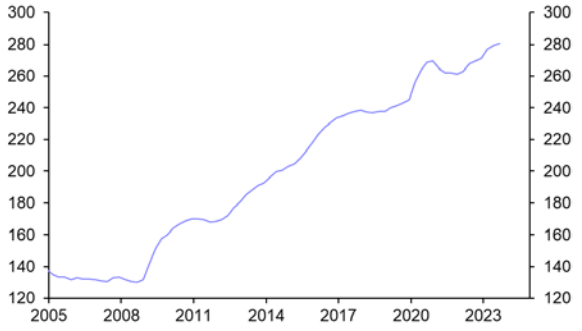
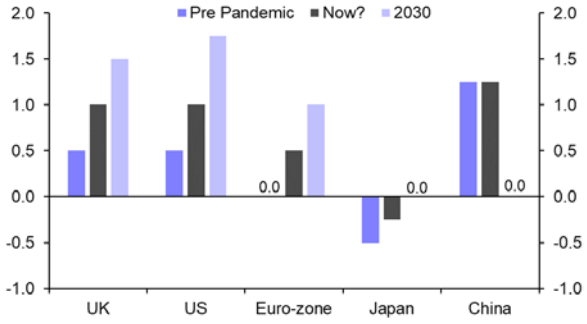


Chart 6: Real Equilibrium Interest Rates (%)



Sources: CEIC, United Nations, IMF, PWT, Capital Economics

Email **sales@capitaleconomics.com** Visit **www.capitaleconomics.com**