Economic watch

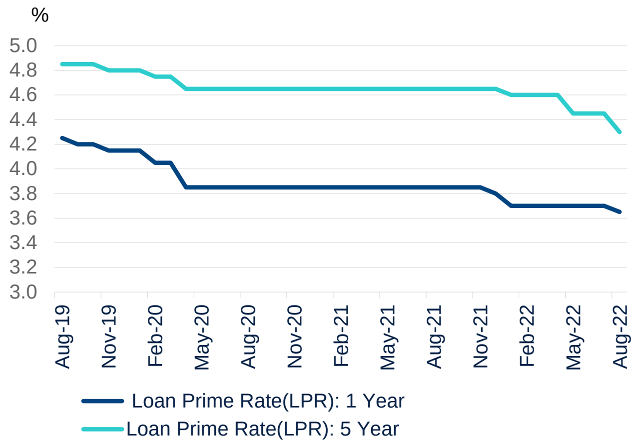
China | What do we expect of China's policy rate in 2022?

Jinyue Dong

August 22, 2022

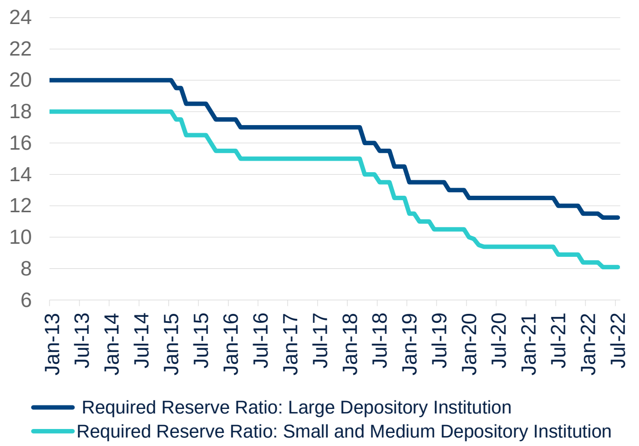
Amid the recent economic growth slowdown, after the PBoC announced the cut for MLF (medium-term lending facilities) rate and repo rate by 10 bps on August 15th, the authorities cut the LPR (loan prime rate) asymmetrically today as LPR is artificially linked to MLF plus some adding points. In particular, the one-year LPR (loan prime rate) was cut by 5 bps from 3.7% to 3.65% and the five-year LPR was cut by 15 bps from 4.45% to 4.3%. Today's interest rate cut signals the determination of the central bank to continue to support growth recovery. However, we expect monetary policy will continue be in an accommodative but more prudent way in the rest of the year. (Figure 1)

Figure 1. **THE PBOC CUT LPR TODAY ASYMMETRICALLY…**



Source: CEIC and BBVA Research

Figure 2. **…TOGETHER WITH THE RECENT RRR CUT, INDICATING AN ACCOMMODATIVE MONETARY STANCE**



Source: CEIC and BBVA Research

Indeed, today's interest rate cut is based on the economy's bumpy recovery since Shanghai lockdown was lifted. Four main factors dragged the economic growth in the past months: (i) The authorities intrinsically gave up the 5.5% growth target which was set in March 2022 "two sessions" before Shanghai lockdown, indicating monetary and fiscal stimulus will become more prudent without deluge of massive stimulus; (ii) China still sticks to "Zero Covid" policy which dragged consumption recovery; (iii) Real estate crash with main housing indicators staying in negative territory for the past months adversely spilled over to upstream and downstream sectors. It also triggered regional financial instability, such as home-buyers stopped paying mortgage and bankruptcy. (iv)The historical high temperature in some regions of China encumbered hydroelectricity production, and the authorities restricted electricity for industrial and residential usage.

On the other hand, China's interest rate cut indicates again the PBoC unsynchronized its monetary policy with that of the main economies in the world. To deal with the historical high inflation, the US FED has pushed forward the most hawkish interest rate hike in the recent months; the 75 bps FED Fund Rate hike in July was the largest hike since 1994. While in Europe, the ECB and BOE have also moved ahead for more aggressive interest rate hike to deal with high inflation stemmed from energy crisis and supply-demand gap after the Covid-19 pandemic. As we mentioned in our previous economic watch (Economic Watch: China | "Impossible Trinity" of 2022 Chinese economy), the divergence of China's monetary policy with the main economies led China's 2022 policy-setting to face "Impossible Trinity" among three policy targets: "zero Covid", financial stability and 5.5% growth target.

Under these complicated circumstances, there should be quite a number of interesting questions to be addressed regarding today's interest rate cut:

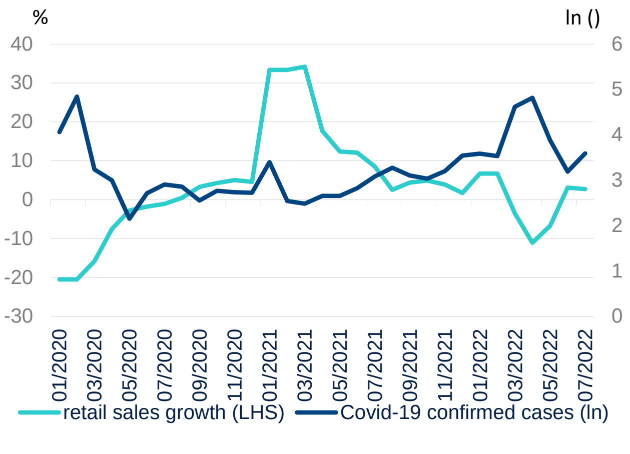
- First, is today's interest rate cut enough to alter the economic slowdown, particularly to address the housing market crash and lackluster consumption stated above?
- Second, how large is China's policy room for conducting easing monetary measures while other main economies are pressing ahead interest rate hike? And how much the authorities could tolerate capital outflows and RMB depreciation stemmed from interest rate cut?
- Third, what are the main obstacles for monetary policy transmission mechanism in China?
- Finally, what do we expect the monetary policy stance in the rest of the year and what do we expect of the policy rate at the year end?

The interest rate cut has more signal effect than real effect which is not enough to alter the growth headwinds…

It is true that economics theory always tells us the direct effect of cutting interest rate is to lower the household leverage by reducing their mortgage pressure and to stimulate investment as borrowing from banks is cheaper. However, most growth headwinds of Chinese economy at the current stage cannot be exclusively addressed by the interest rate cut, let alone the monetary transmission mechanism is not smoothly going which means although the central bank could lower the policy rate and interbank rate, it is still difficult to direct the credit to enterprises and households.

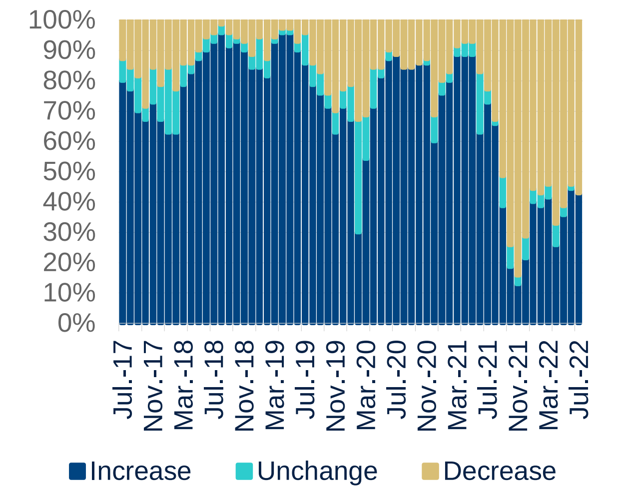
First, what most significantly dragged Chinese economy comes from two perspectives at the current stage: a sluggish consumption led by "zero Covid" policy and the housing market crash caused by the regulatory storms back to 2021. From consumption perspective, we find obvious evidence that consumption dipping has been highly correlated with the pandemic cases. (Figure 3-4) The larger number of Covid-19 cases, the tighter restrictive measures of social distancing policy, thus a lower retail sales growth figure. However, interest rate cut is of very little help under the framework of "zero Covid" policy. As long as social distancing and forced quarantined measures imposed to pursue "zero Covid" target, no matter how low the interest rate is, consumption is expected to remain lackluster.

Figure 3. **THE CONFIRMED COVID CASES HAVE NEGATIVE CORRELATION WITH RETAIL SALES FIGURES**



Source: CEIC and BBVA Research

Figure 4. **MORE AND MORE CITIES REPORTED HOUSING PRICE DECLINING**



Source: CEIC and BBVA Research

Figure 5. **BUILDINGS SOLD AND LAND PURCHASED HAVE BEEN NEGATIVE FOR PAST MONTHS…**

Source: CEIC and BBVA Research

Figure 6. **…SO DID NEW FLOORS STARTED AND COMPLETED**

Source: CEIC and BBVA Research

Second, from the housing market side, although the interest rate cut may encourage potential house-buyers and developers to purchase and to invest, what really triggered the housing market crash is all about the confidence. People expect housing price slowdown with the fear of policy uncertainties and common prosperity reform as what it happened in 2021, and as long as this kind of expectation forms, it is very difficult to be altered. In addition, all housing indicators, such as housing sales, new floors started and completed as well as real estate FAI etc. have been in negative territory for quite a long time. (Figure 4-6) That means, the effect of interest rate cut is quite marginal on rebuilding housing market confidence, thus, China's housing market soft-landing will take a longer time to materialize.

Third, the monetary transmission mechanism has been weak in China. Although the PBoC pressed ahead with monetary easing, credit data such as new yuan loans and total social financing remained lackluster, indicating a weak monetary policy transmission mechanism due to weak sentiments both from credit demand and supply side amid growth slowdown. In other words, interest rate cut could only lower the borrowing costs of banks from the central bank but difficult to transmit to real economy; that means, although it is cheaper to borrow, enterprises and households are still reluctant to do so.

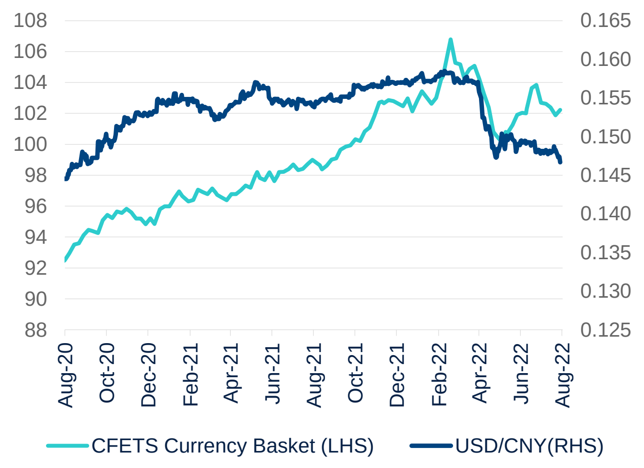
…in addition, the policy room for further monetary easing measures is also limited

It is not difficult to understand that it is neither possible nor sustainable for Chinese central bank to start a massive easing cycle by cutting interest rate continuously when the US and other main economies are pressing ahead hawkish interest rate hike. After all, the diverging monetary policy between emerging economies and the US has always been the key reason for financial crisis which happened in Turkey and Russia recently as well as in Asian economies back to 1997.

China is not the country with a strictly closed capital account and its exchange rate regime is management floating. That means, by theory, a massive easing which is unsynchronized with the US monetary policy could trigger a sharp RMB depreciation and capital outflows. In addition, China's CPI increased to 2.7% recently, although lower than the CPI figures in US and EU, its trending-up will shrink the policy room as well.

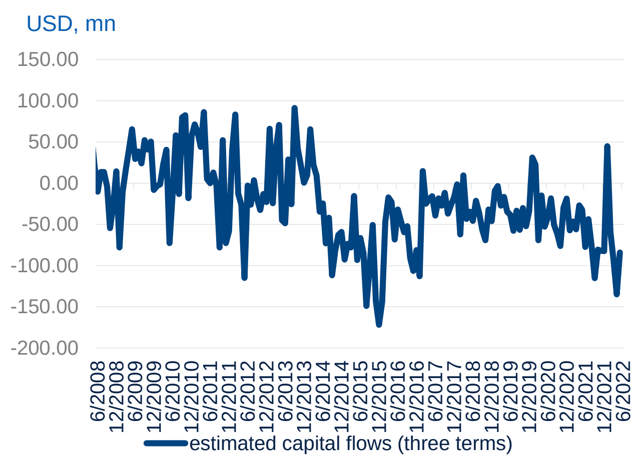
Now, the key point is to what extent RMB will depreciate and how large capital outflows it will be, and more importantly, to what extent the authorities would tolerate it.

Figure 7. **RMB DEPRECIATED AFTER THE PBOC ANNOUNCED THE MLF AND REPO RATE CUT**



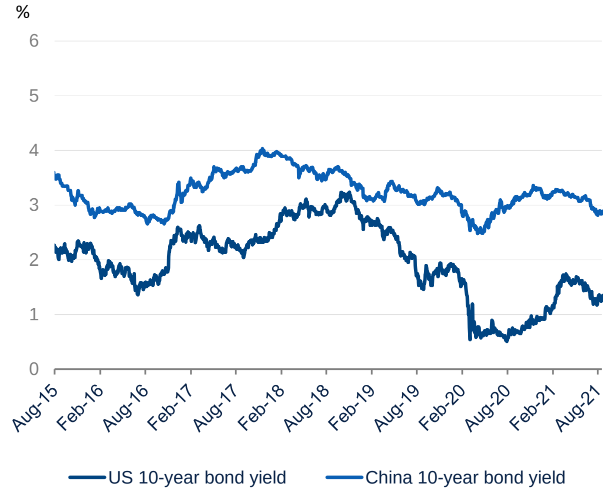
Source: CEIC and BBVA Research

Figure 8. **ALTHOUGH A DEVASTATING CAPITAL FLIGHT IS NOT IN OUR BASE SCENARIO, THE PBOC HAS TO CLOSELY MONITOR IT**



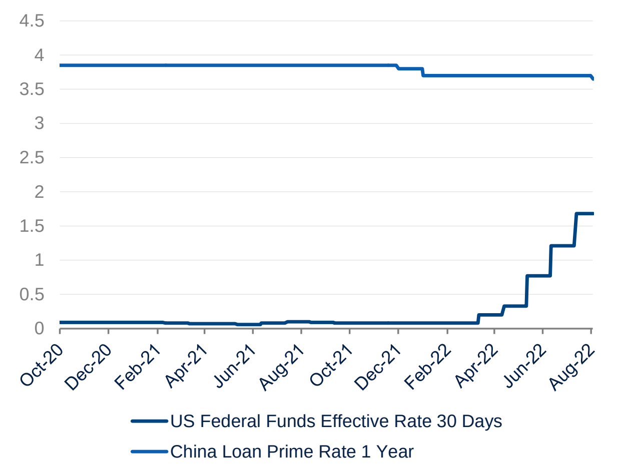
Source: CEIC and BBVA Research

Figure 9. **THE UNSYNCHRONIZED POLICY LED A DIVERGING OF CHINA-US 10-YEAR BOND YIELD**



Source: CEIC and BBVA Research

Figure 10. **IN HISTORY, CHINA HAS NEVER CONDUCTED CONTINUOUS RATE CUTS AMID FED INTEREST RATE HIKE CYCLE**



Source: CEIC and BBVA Research

There are some trackers of financial stability measures, particularly RMB exchange rate and capital outflows. (Figure 7-8) Indeed, they are moving to the direction as what economics theory tells us. It looks like the current cut has not triggered massive outflows and a devastating RMB depreciation yet which we believe are still under the central bank's tolerance. Although the PBoC still has the room from this perspective, they have to closely monitor the currency depreciation and the capital flight situation to secure financial stability maintains; and it is mostly certain that if the PBoC continues to conduct interest rate cut for many times, the situation will quickly deteriorate.

Except for the financial stability concern, the history of China's monetary policy conduct also suggests that the continuous interest cuts in China during FED's interest rate cycle, as some market participants expect, have never happened in the past decades. (Figure 10) History repeats, with the concern of financial stability, we do not anticipate a continuous multiple times of rate cut amid the ongoing US interest rate hike cycle.

Summary

We believe that today's LPR cut is more of a signal effect than a real effect. Given that the factors that dragged China's economic recovery come from sluggish consumption amid "zero Covid" policy and real estate crash stemmed from 2021 regulatory storms which significantly deteriorated housing price expectation, the impact of interest rate cut might be marginal to offset all of these headwinds. In addition, a weak monetary policy transmission mechanism in China also reduces its effectiveness.

Look ahead, we believe today's interest rate cut does never suggest a start of China's massive easing cycle amid the US FED interest rate hike. The PBoC has to closely monitor RMB exchange rate and capital outflows to make further potential moves. In addition, we anticipate the monetary policy in the rest of the year will be more relying on quantity tools, such as RRR cuts, and on targeted instead of universal easing measures. Under this circumstance, we only predict at most another asymmetric cut in the rest of the year.

BBVA Research

Creating Opportunities

DISCLAIMER

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Any estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

With regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

ENQUIRIES TO:
BBVA Research: Level 95, International Commerce Centre, Austin Road West, Kowloon, Hong Kong.
Tel. + 2582 3111 / Fax. +852-2587-9717
bbvaresearch@bbva.com www.bbvaresearch.com