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Regional analysis

China | The PBoC cut 5-year Loan Prime Rate to support housing market and growth

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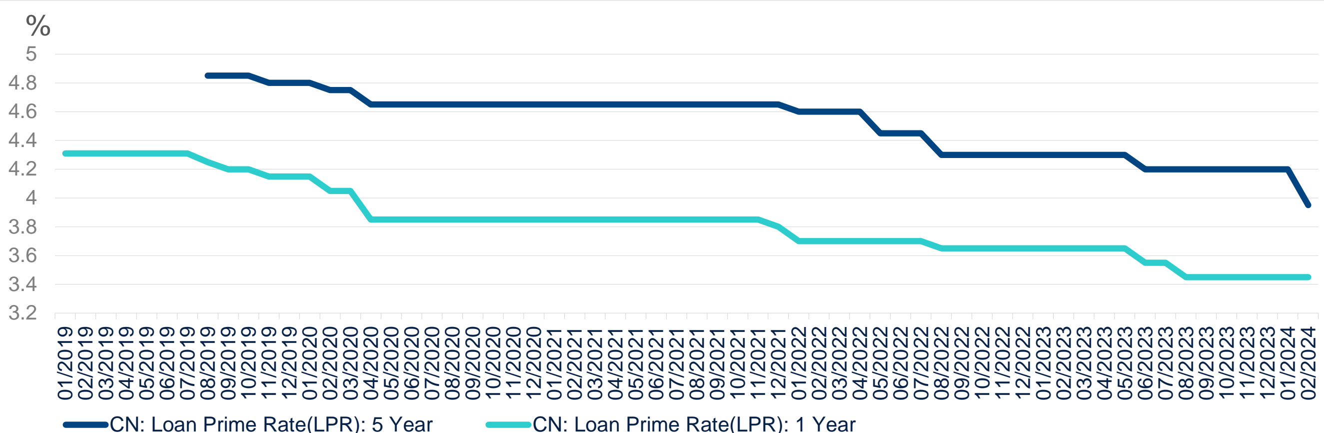
Today, China's central bank The People's of China (PBoC) announced a cut of 25 bps in the 5-year Loan Prime Rate (LPR), a key reference rate for housing mortgages and long-term loans. The magnitude of the cut amounted to a record 25 bps from 4.2% to 3.95%. Meanwhile, the one-year Loan Prime Rate (LPR) which is deemed to be the main policy rate is kept unchanged at 3.45%.

The 25-bps cut in the 5-year LPR has been the first change since June 2023 and the largest one since a revamp of the rate was rolled out in 2019, suggesting that the authorities are ramping up support for the falling property sector and reviving domestic demand. (Figure 1)

The 5-year LPR cut was somewhat unexpected, as the central bank kept medium-term lending facilities (MLF) rate unchanged over the weekend. Moreover, the authorities have just lowered the required reserve ratio at the beginning of February 2024 by 50 bps. Nevertheless, the recent weak sentiments and deteriorating housing market woes in China have prompted more investors to position for more monetary easing.

Meanwhile, the PBoC's intention to maintain one-year LPR unchanged indicates that the pace of ongoing monetary expansion is still measured to avoid lax credit in the market, taking the lesson of the 4-trillion stimulus package unveiled during the 2008-2009 Global Financial Crisis. The package was widely believed to give rise to a number of series financial vulnerabilities in the ensuing years including property market bubbles, local government debt overhang etc.

Figure 1. **THE PBOC TODAY ANNOUNCED TO CUT 5-YEAR LPR WHILE MAINTAIN ONE-YEAR LPR UNCHANGED**



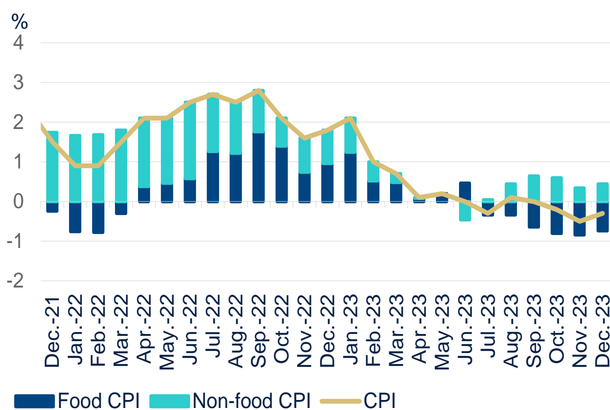
Source: CEIC and BBVA Research

The policy rate cut comes at a good timing

The policy rate cut is deployed amid deteriorating deflationary pressure in the economy. Weak domestic demand and dampened confidence failed to elevate domestic demand to a level matching the country's fast-expanding supply side in the aftermath of the pandemic. The unique pork cycle, due to Chinese strong preference for pork in their consumption, added to the CPI volatility. Moreover, falling global commodity prices dragged down the PPI, which in turn weighed on CPI further through spillovers. (Figure 2 and 3)

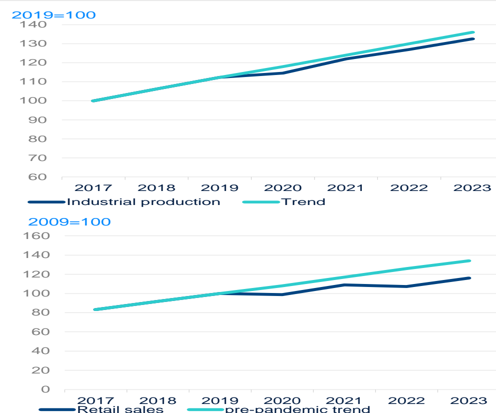
On top of the domestic factors, the US FED's interest cut expectation also provides policy room of China's policy loosening measures. In 2023, the overseas high interest rate environment restrained the PBoC from using monetary policy tools to spur the anemic economy.

Figure 2. **CHINA'S HEADLINE CPI HAS BEEN IN THE NEGATIVE REGION FOR A LONG TIME**



Source: WIND and BBVA Research

Figure 3. **THE MAIN REASON OF DEFLATION IS THE SUPPLY SIDE RECOVERY HAS BEEN MUCH FASTER THAN DEMAND SIDE**



Source: BBVA Research and CEIC

Monetary policy outlook in 2024

We believe the 2024 monetary policy outlook remains expansionary as FED rate cut and China's continuing deflationary environment provides room for monetary expansion. However, the PBoC will not conduct QE-like measures like what the central banks of US, EU and Japan did back to Covid-19 pandemic period, taking the lesson from RMB 4 trillion stimulus in 2008-09 GFC which caused a large amount of local government debt overhang and housing bubbles in 2010s.

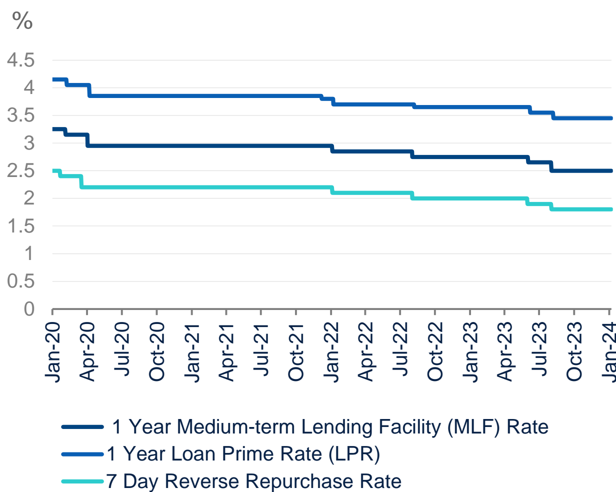
In particular, we expect there will be another 2-3 one-year LPR cuts in 2024 and 2 more RRR cut as well. (Figure 6-7) In addition, there will be more targeted easing instead of universal easing to support SMEs, agricultural sector and green economy etc. The PBoC will also ensure the total social financing and M2 to be in line with economic growth rate and inflation in 2024.

Right after the announcement of the policy cut, the RMB to USD exchange rate immediately depreciated from 7.1 to 7.2. That being said, the PBoC still need to walk a line between ramping up policy easing and guarding against currency depreciation and capital exodus. We reckon that the PBoC's policy room will widen after the US Fed

started to low their fund rates in mid-2024. As such, the RMB exchange rate is even expected to have a small appreciation towards the end of the year.

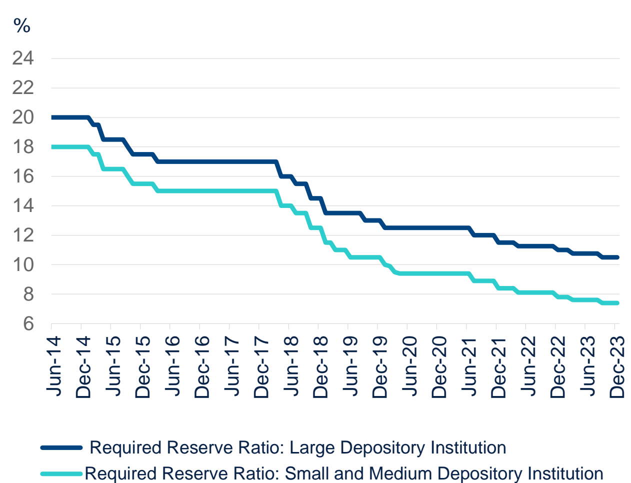
Moreover, the prospective improved market sentiments, the stabilized economic growth outlook as well as the normalized global financing costs will help to anchor capital flows in the coming months. (see our recent China Economic Watch: China | Should we worry about falling FDI?)

Figure 4. **WE FORECAST THE PBOC WILL CUT MLF AND LPR 2-3 TIMES IN 2H 2024 AFTER FED CUT**



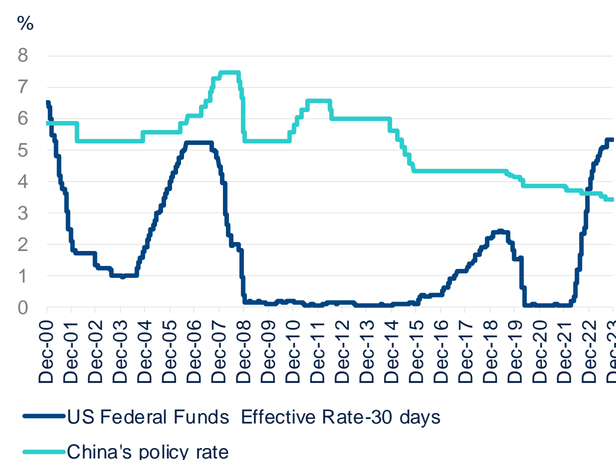
Source: WIND and BBVA Research

Figure 5. **…ALSO TO CUT RRR THREE TIMES IN 2024, PROVIDING SUFFICIENT LIQUIDITY FOR RECOVERY**



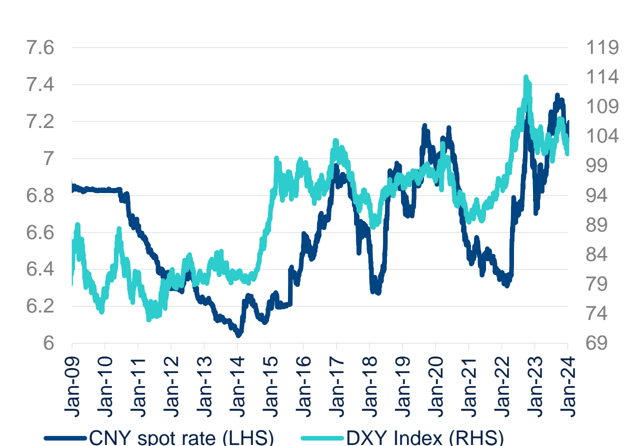
Source: BBVA Research and CEIC

Figure 6. **CHINA-US INTEREST RATE REVERSION INDEED GIVES PRESSURE ON RMB AND CAPITAL FLOWS**



Source: CEIC and BBVA Research

Figure 7. **RMB AND USD DXY MIRROR EFFECT REMAINS**



Source: CEIC and BBVA Research

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