Cutting interest rates to boost consumption and investment may have limited effect

Weaker-than-expected economic indicators since the second quarter of this year reflect the uneven recovery of China’s economy. The central bank in June cut the policy interest rate, and the loan prime rate (LPR) was also lowered, a move seen by some market analysts as the beginning of a downward policy interest rate trend. However, would further interest rate cuts effectively stimulate consumption and investment in the short term?

Given that the expectations of economic entities have not substantially improved, risk aversion has increased, and asset prices remain relatively low, we believe that further interest rate cuts have limited effect on stimulating consumption and investment in the short term. In particular, consumption and investment are not simply a sum of the interest elasticity of consumption and that of investment, but is more likely to have a multiplier effect. Weak household consumption will reduce business investment demand and lead to sluggish employment, incomes, and consumption, ultimately affecting aggregate demand. Considering the current social, economic, and livelihood developments, China does not have the macro conditions and foundation for sustained interest rate cuts.

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Consumption and investment more sensitive to interest rate changes during economic expansion

Based on China’s past experience, the interest rate elasticity tends to be higher when the country maintains a strong momentum of growth, and vice versa. This is because during economic upturns, when people have higher household income, they are more willing to consume and pursue investment returns, making the impact of interest rate adjustments on consumption and savings more pronounced. During economic downturns, however, people tend to increase savings and delay consumption as a result of weakened household income growth, which limits the effectiveness of interest rate cuts in stimulating consumption.

Similarly, during economic expansion, businesses generally enjoy higher returns, and their financing needs are more sensitive to interest rate changes. However, risks weigh more heavily on businesses when making investment decisions during economic downturns, and they may be reluctant to borrow even if financing costs are lower. Therefore, the investment elasticity of interest rates is also low during economic downturn.

Risk aversion limits the interest rate elasticity of household consumption

Since the beginning of this year, interest rates have been declining while consumption growth has slowed, indicating that relying solely on lowering deposit rates may be insufficient to boost household consumption. There are several reasons behind this conundrum.

First, in anticipation of future income declines, people tend to be cautious about current consumption choices. Second, low asset prices will reinforce households’ willingness to reduce leverage, further suppressing consumption. Lastly, residents’ gradually accumulated precautionary savings will also create a drag on current consumption. In recent years, deposit rates have tended to decline, but household savings keep rising. From 2018 to 2021, the average annual increase in deposits for households was 9.5 trillion yuan. Last year, this number surged to 17.84 trillion yuan. The very first quarter of this year witnessed a 9.9 trillion yuan increase in household savings, which is partly due to deposit rates decline eroding household wealth income and accelerating precautionary savings.
Weak private sector financing supply and demand makes it difficult to translate financing into effective investment, thereby reducing the interest rate elasticity of investment.

Despite reasonable and ample liquidity in China’s financial market and sufficient funding supply in commercial banks, as well as the stable growth of the social financing scale and broad money supply since the outbreak of the COVID-19 pandemic, China didn’t see a significant increase in investment growth (around 5%).

From the perspective of financing demand, private and small to medium-sized enterprises (SMEs) hold relatively smaller assets and are less resilient to risk shocks. Therefore, they’re more likely to suffer from shrinking financing demand during economic downturns as their investment decisions are driven more by risk considerations rather than profit. In contrast, state-owned enterprises (SOEs) possess relatively larger asset sizes and are more resilient to shocks. The interest rate level is not a core consideration for SOEs' investment and financing decisions; hence, their loan decisions are not sensitive to interest rate levels.

In terms of funding supply, economic downturns are often accompanied by asset price adjustments, which reduces the willingness of funding providers (especially banks) to provide funds to businesses based on mechanisms such as collateral channels and financial accelerators. Compared to SOEs with ample financing channels, these mechanisms tend to be more definitive in determining the business operations of the private sector.

Given the current low interest rate elasticity of investment and consumption in China, further interest rate cuts will have limited effect in stimulating consumption and investment in the short term. Therefore, sustained interest rate cuts for the time being may not necessarily produce positive policy results, but could instead lead to certain distributional issues and side effects.

How are foreign companies doing in China?

Multinational corporations (MNCs) have been operating in the Chinese market for more than three decades. There are at least two distinct dimensions of their activities in China, both of which are now experiencing headwinds for different reasons.

First, China has long been considered “the world’s factory” – that is, MNCs have been manufacturing and processing products in China and exporting them to foreign markets since the 1980s.

Second, MNCs have long regarded China as an essential consumer market. Around the beginning of the 21st century, foreign brands started to sell products in China (some of which were also manufactured here). From the 2000s to the late 2010s, foreign consumer brands continued to grow in China, demonstrating the willingness of Chinese consumers to purchase foreign products during that period.

Beginning in 2008, policies intended to boost domestic demand also encouraged foreign brands to enrich their product portfolio in China, moving from selling basic products to high-end offerings.

The appeal of undifferentiated global products started to wane in the late 2010s, however, fuelled partly by the growing popularity of traditional Chinese culture and domestic brands, such as Hanfu (a style of traditional Chinese clothing) and Chinese sportswear brand Li-Ning. The COVID pandemic further disrupted retail and logistics operations, weakening the development of foreign brands in the country, while geopolitics gave rise to a number of popular domestic products.

As a result, MNCs are now much more pragmatic about doing business in China – and gone is the euphoria of the “indispensable” Chinese market.