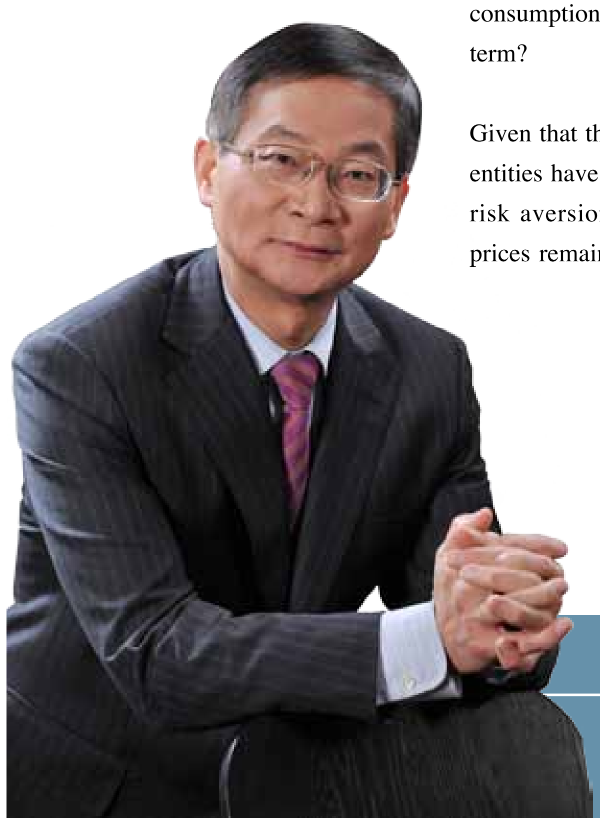
Cutting interest rates to boost consumption and investment may have limited effect

> *China does not have the macro conditions and foundation for sustained interest rate cuts.*

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 isolated from each other; they each promote and complement the other. Simply put, the interest elasticity of demand is 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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01

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.

02

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.

03

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.

04

Distributional effects of continued interest rate cuts deserve closer scrutiny

Due to low interest rate elasticity, sustained policy interest rate cuts would not strongly impact consumption, savings, or the scale of investment and financing, but will instead manifest itself in the redistribution of profits among economic entities. On the one hand, commercial bank loans currently mainly flow to SOEs. On the surface, interest rate cuts will reduce interest expenses and increase the profits that SOEs contribute to the government's coffers. However, a continuous interest rate cut would drag the loan prime rate (LPR) down, narrow the interest rate spread for commercial banks, leading to a decline in their profits and an increase in the potential financial risks. This means that continuous interest rate cuts could result in a situation where money is transferred from one pocket to another within the government's finances. On the other hand, to maintain a certain interest rate spread, commercial banks tend to gradually reduce deposit rates, shifting the pressure of decreasing interest income onto households, which in turn reduces their deposit returns. This runs counter to stimulating household consumption, especially at a time when households have a strong inclination to build precautionary savings, and it could further hinder the willingness of businesses to increase investment.

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.