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A closer look at China's interest rate cut

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Last week China cut interest rates for the first time in more than two years. The move was rather unexpected as no recent official comments hinted in this direction. Some observers have stated that China will now soon join the club of countries that are betting heavily on monetary stimulus to revive growth. However, a closer look at last week's rate cut suggests that this view is not very convincing. It is more likely instead that this is not the start of a large stimulus program. Indeed, policymakers are still concerned about the rapid pace of credit growth and determined to rebalance the economy. That's the main reason why growth will continue to slow down from here.

Chinese policymakers cut interest rates last week. At face value, it's tempting to see the latest move as an indication that officials are becoming increasingly worried about the state of the economy. After all, economic growth (down to 7.3% from 7.5% in the first half of the year) is decelerating and inflation (at 1.6%) clearly stays below the target (3.5%). Some even argue that this could mark the start of a rather aggressive monetary policy stimulus program. Others warn about the looming dangers of a renewed surge in the already unsustainable pace of credit growth. In reality, the situation is a bit more complex. In our view, this is not a change of policy direction. Chinese leaders have repeated over and over again that the main focus remains the search for sustainable growth. The former Chinese strategy of channeling saving deposits towards infrastructure investment and rapid export growth underpinned by an undervalued exchange rate has lifted an enormous amount of people out of poverty. That said, with parts of the industrial sector suffering from overcapacity this policy, which was accompanied by unsustainable credit growth, has clearly reached its limits. That's why the government will remain focused on the much needed shift towards domestic consumption. Importantly, the latest rate cut does not automatically result in faster credit growth. While it is likely that credit demand will pick up, it's much less clear what will happen to credit supply. The reason is that in China the pace of credit growth is very much determined by loan quotas. In practice this comes down to the government deciding how much the state-owned banks can lend to their customers. Given the government's concerns about the rapid pace of credit growth, it's unlikely that these conditions will be loosened significantly in the near future. Hence, a sustained acceleration in credit growth and thus economic growth should not be expected. The question then of course is why interest rates were cut in the first place. The most convincing explanation is that the rate decision is mostly a response to the high financing costs weighing on several large firms. As the prime lending rate serves as a close proxy for interest costs this should help alleviate the financial burden on heavily indebted companies. With this in mind, it's reasonable to expect more action on this front next year. This could mean that inefficient firms remain in business for longer. However, reducing the imbalances built up in the economy over the last decade was never going to be easy anyway. The future remains challenging in this respect but at least policymakers have ample room for policy manoeuvre should the situation deteriorate too quickly.

With inflation set to remain low, real interest rates are likely to stay relatively high in the foreseeable future. This will not change all of a sudden with one or two more rate cuts. All in all, authorities are still very much focused to bring credit growth down over time. That's why the latest policy action will not boost economic activity. Higher living standards, more measures to rebalance the economy and a rapidly ageing Chinese population imply that slower future growth is inevitable.