REALTIME ECONOMICS

China's stimulus measures to boost troubled economy may fall short

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In late September, China's government launched its biggest monetary stimulus measures since the Covid-19 pandemic—and signaled that more fiscal support was on the way, reflecting leaders' new urgency in reviving the country's troubled economy. Although the announcements lifted market sentiment, caution is warranted: The central bank's interest rate cuts and other policy moves could be ineffective —"pushing on a string"—at a time of weak credit demand, as monetary easing during a downturn does not always work as well as tightening during a boom. Moreover, the steps announced so far do not address the deep-rooted problems in China's economy that weigh on its growth, including Beijing's increasing prioritization of national security over economic development, its discrimination against the private sector, and its inadequate fiscal policies.

A BOLD STIMULUS PACKAGE

The monetary stimulus package announced by the People's Bank of China (PBOC) includes three main parts. First, the PBOC will cut reserve requirement ratios (RRR) by half a percentage point and the main policy interest rate by 0.2 percentage points. The scale of both the RRR and the policy rate cut is larger than usual. The PBOC governor also indicated that additional RRR cuts are possible by year-end, depending on the economic situation.

Second, the PBOC will cut mortgage rates for existing home loans by roughly half a percentage point and reduce the nationwide minimum down payment requirement for second homes from 25 percent to 15 percent. It will also raise its funding support from 60 percent to 100 percent for commercial banks extending loans to locally owned state firms purchasing excess housing inventory to convert into affordable housing units.

Third, the PBOC is creating a pair of new structural monetary policy tools to support the stock market. Eligible institutional investors will be able to borrow liquid assets such as Treasury bonds and central bank bills directly from the central bank, using assets like stock exchange-traded funds (ETFs) as collateral, and then sell them to get the cash they need to invest more in equity markets. The central bank will provide refinancing loans for banks extending credit to publicly traded companies aiming to buy back their own shares. These tools complement the policy package already introduced by China’s securities regulator aimed at reviving investor confidence and shoring up stock values.

BUYERS BEWARE

The Chinese stock markets reacted to the stimulus plan with the best weekly rally in more than a decade, with the frenzy overwhelming the stock trading system in Shanghai, causing delays in processing orders. But buyers beware: The measures’ economic effects may turn out to be limited, for several reasons.

To start, although the monetary easing measures will lower borrowing costs, which have remained high in China because of falling prices, credit demand is now so weak that households and corporations may still not want to borrow and banks may not want to lend. Some of the additional liquidity released into the banking system could flow into central government bonds, because of the lack of investment opportunities in the economy.

Housing demand is unlikely to see any meaningful revival just because of lower mortgage rates and down payment requirements, as experience shows. After the huge property market bust, Chinese households stopped viewing housing as a preferred asset class. That perception will be extremely hard to reverse. (To be fair, lowering mortgage rates on existing home loans will discourage households from repaying their mortgage debt early, which will relieve some pressures on bank profitability. Lower mortgage rates will also raise household disposable income, which can raise private consumption on the margin.)

The increased level of funding support from the central bank for the modified relending facility for affordable housing is also not going to turn things around in the housing market, largely because of the mismatch between localities that have strong housing demand and localities with excess supply. In addition, rental yields of any affordable housing units in major Chinese cities are likely to be too low to convince banks and state firms to respond to the PBOC's initiative.

Finally, without addressing the many structural issues in the economy and returning to the path of market liberalization, the new central bank tools to support the stock market could risk creating a bubble in Chinese equities down the road. Moreover, given the long-time bias of state-owned banks in favor of state firms, state firms are likely to benefit more from the central bank's schemes than private firms.

MORE FISCAL STIMULUS ON THE HORIZON

Any effects of the monetary stimulus measures will be offset by contractionary government spending until leaders deliver the stronger fiscal support they suggested was coming but did not publicly detail. Government spending has fallen significantly short of the budget level and is lower than it was last year, largely because of declines in government revenue and the lack of capital investment projects available for funding by central and local governments' special bonds. That fiscal contraction is exacerbating China's deflationary pressures.

China's leaders are reportedly considering issuing additional special sovereign bonds worth about RMB 2 trillion in the coming weeks, to make up for the spending gap by stimulating household consumption and helping local governments tackle their debt problems. Doing so would give a helpful boost to the economy, although the reported scale of the fiscal stimulus is modest.

Only part of the RMB 2 trillion can be spent this year; fiscal spending this year will probably still fall short of the budget level. The earliest occasion at which a midyear budget adjustment could be made would be the next National People's Congress Standing Committee meeting, in late October. Given the lag between announcement and issuance, the additional government funds might not become available until December. Moreover, if China's leaders resort to their old playbook of stimulating the economy through infrastructure development, most of the stimulus funds may not be deployed until next spring, when the weather allows construction in much of the country.

The direct effect of such a fiscal stimulus may thus not show up until next year. The indirect effect of such efforts—namely, increased confidence of firms and households, leading them to boost investment and consumption—is likely to be more important.

DATA DISCLOSURE

This publication does not include a replication package.