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CF40 Policy Brief

A More Clearly Defined Commitment to Stabilizing Growth: Detailed Analysis of the Central Bank's New "Three Arrows"

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Abstract: *The Central Political Bureau meeting on September 26th demonstrated the government's determination to stabilize growth, with achieving the "three stabilities"—stable growth, stable real estate market, and stable stock market—becoming the main theme of current macroeconomic policies. "Ensuring necessary fiscal expenditure" remains key to boosting aggregate demand at this stage, and there is a necessity and feasibility for fiscal policy to exert marginal strength. "Promoting the stabilization and recovery of the real estate market" is an important marginal change, indicating the central government's attention and expectations regarding real estate issues. To achieve the stabilization and recovery of the real estate market as soon as possible, in addition to implementing the requirements of the Party Central Committee, it is also necessary to quickly deal with and resolve the risks of real estate companies, carry out classified disposal of real estate companies, and allow high-quality real estate companies to emerge from difficulties first.*

Lowering the benchmark interest rate and the interest rate on existing housing loans is the most direct and effective policy. Interest rate cuts can at least play a role in boosting aggregate demand through three channels: reducing real interest rates, improving cash flow, and reducing early loan repayments, and these three transmission channels are still valid and unobstructed. Reducing reserve requirements is not as effective as increasing the use of structural monetary policy tools, and the key is for structural monetary policy tools to reflect cost advantages.

By analyzing the mechanisms of two new tools, we believe that the new tools will play a positive role in stabilizing the capital market and asset valuations, but there are also characteristics worth noting. The swap facility is generally liquidity neutral and may increase the volatility of related assets. Some objective factors may affect the actual application scenarios of "stock repurchase and increase special reloans." At the same time, the scale of use of the two new tools will be somewhat constrained under the goal of maintaining external and internal balance.

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The Central Political Bureau meeting held on September 26th clearly proposed to “increase the counter-cyclical adjustment of fiscal and monetary policies and ensure necessary fiscal expenditure,” “reduce the reserve requirement ratio and implement a strong interest rate cut,” and “promote the stabilization and recovery of the real estate market.” These expressions demonstrate the government’s determination to stabilize growth.

We believe that “ensuring necessary fiscal expenditure” remains key to boosting aggregate demand at this stage, but there is no significant marginal change in the expression of fiscal policy. Next, in addition to arranging the use of national debt and special bonds, “striving to achieve the fiscal budget expenditure target at the beginning of the year” should be the main task. Fiscal policy has the necessity and feasibility to exert marginal strength, and relevant policy ideas and implementation plans should also be announced in a timely manner to further boost market confidence. It can also better achieve the “monetary policy and fiscal policy work together to support active fiscal policy to better exert its strength and effectiveness” mentioned by the central bank at the press conference.

“Promoting the stabilization and recovery of the real estate market” is an important marginal change, indicating the central government’s attention and expectations regarding real estate issues. In conjunction with our previous research, to achieve the stabilization and recovery of the real estate market as soon as possible, in addition to implementing requirements such as “strictly controlling the increase in commercial housing construction, optimizing the stock, improving quality, and increasing the loan allocation for ‘white list’ projects to support the revitalization of idle land,” it is also necessary to quickly deal with and resolve the risks of real estate companies, especially improving the cash flow situation of real estate companies, carrying out classified disposal of real estate companies, and allowing high-quality real estate companies to emerge from difficulties first, becoming an important force to drive the recovery and rise of the real estate market.

In conjunction with the new “three arrows” introduced by the central bank at the State Council’s press conference, we believe that achieving the "three stabilities"—stable growth, stable real estate market, and stable stock market—has become the main theme of current macroeconomic policies. Among them, reducing the reserve requirement ratio, reducing the benchmark interest rate, and reducing the interest rate on existing housing loans can all be seen as the first step in implementing "reducing the reserve requirement ratio and implementing a strong interest rate cut." At the same time, the central bank's policies to reduce the interest rate on existing housing loans and extend the support plan for the special project of ensuring the delivery of buildings are also efforts to promote the stabilization and recovery of the real estate market.

Next, this article starts from the specific mechanism, analyzes the impact mechanism and policy logic of the new "three arrows" in detail, especially the mechanism of the two newly created monetary policy tools, and proposes policy implications based on this.

I. Lowering the Benchmark Interest Rate and Existing Mortgage Rates is the Most Direct and Effective Policy.

Lowering interest rates can boost overall demand through three channels, all of which remain effective and open.

Firstly, by reducing real interest rates, it helps rebalance investment and savings, driving the economy towards its potential growth rate. Our estimates suggest that China's neutral interest rate may have entered negative territory, while the real interest rate is close to 6% (see CF40 research briefing "Rethinking CPI and Real Interest Rates," "Estimating China's R*"). The recent 20 basis point cut in the policy rate by the central bank is significant, as it also lowered deposit rates simultaneously. This can directly lead to an overall decrease in the central interest rate in China and improve inflation expectations, effectively lowering the level of real interest rates.

Secondly, lowering existing mortgage rates directly improves cash flow for households. Our previous research has indicated that the importance of lowering existing mortgage rates is not in stimulating new home sales, but rather in alleviating cash flow constraints for households by reducing principal and interest payments, thereby increasing consumption. Especially as household spending rigidity increases, timely improvements to cash flow and the price structure of balance sheets will have a more pronounced marginal effect on stabilizing household consumption (see CF40 research briefing "Rigid Demand Begins to Emerge: Balance Sheets Shift from Repair to Consumption—Observations on the Financial Flows and Balance Sheets of Various Sectors in the First Half of 2024").

Thirdly, lowering existing mortgage rates helps stabilize household loans and reduce credit contraction pressures. Since 2022, the return on assets for households has continued to decline, leading to a noticeable inversion between asset-liability ratios and debt costs. In this situation, more households have started to repay loans early, resulting in a net decrease in new household loans at one point. It should be noted that the behavior of reducing early repayments is equivalent to the impact of new loans on the overall credit volume. Therefore, lowering existing mortgage rates can reduce the motivation for early repayments, which directly helps stabilize existing household loans and alleviate current credit contraction pressures. **In contrast, lowering the down payment ratio also helps to release housing demand among households. However, given the still weak expectations in the housing market, the actual effectiveness of this policy remains to be seen.** Similarly, increasing the central bank's funding support ratio for affordable housing refinancing may struggle to achieve results. First, the commercial model of government purchasing existing properties is difficult to implement in reality; most real estate projects in various regions are unlikely to effectively participate in such a plan, and the banking sector should not bear excessive risks as a result (see CF40 research briefing "What if the Government Starts Purchasing Properties"). Second, the funding cost of this policy tool is essentially aligned with market financing rates (1.75%), which does not demonstrate any advantage in terms of financing costs.

II. Increasing the Use of Structural Monetary Policy Tools is More Effective than Lowering the Reserve Requirement Ratio, with the Key Being to Ensure a Price Advantage.

According to the data released by the central bank at the press conference, the recent cut in the reserve requirement ratio is expected to release approximately 1 trillion yuan in long-term liquidity, effectively increasing the bank system's base money by the same amount. In previous briefings (see CF40 research briefing "The Methods and Effects of Central Bank Balance Sheet Expansion"), we analyzed in detail the actual effects of the central bank using different policy tools to create base money. The basic conclusion is that lowering the reserve requirement ratio does not necessarily have a clear impact on credit expansion and overall demand. In contrast, structural monetary policy tools, particularly the PSL (Pledged Supplementary Lending), have a quasi-fiscal nature that allows them to play a more direct role in promoting credit expansion and stabilizing demand.
However, structural monetary policy tools no longer have a cost advantage, and endogenous contraction may occur next. The structural impact of these tools primarily arises from two factors: the restrictive nature of funding usage and the cost advantages. The former serves as a constraint, while the latter acts as an incentive. However, as the 7-day OMO and 1-year MLF rates have already fallen to 1.5% and 2%, respectively, existing structural monetary policy tools lack a significant advantage in terms of funding costs. Among the 18 structural monetary policy tools, 13 have rates at 1.75%, while the PSL rate is 2.25%. The funding costs of these 14 tools are now quite comparable to the costs for banks to obtain funds from the market (such as DR007 and interbank certificates of deposit), with the PSL rate being even higher.

Among the remaining four structural monetary policy tools, the rates for the Inclusive Micro and Small Loan Support Tool and the Inclusive Micro and Small Loan Interest Reduction Support Tool are both 1%, the toll road loan support tool is at 0.5%, and the pre-sale housing fund support is at 0%. However, as of June 2024, the actual balance of these four structural monetary policy tools combined is only 110.8 billion yuan, which may indicate that banks face other obstacles in utilizing these tools, such as a lack of direct projects, leading to insufficient realization of the funding cost advantages. Therefore, in the context of changing relative interest rate costs for different types of funds, structural monetary policy tools may experience endogenous contraction, partially offsetting the long-term liquidity released by the reserve requirement ratio cut.

III. The Swap Facility is Generally Liquidity-neutral and May Increase the Volatility of Relevant assets.

According to the central bank's statement, the newly established "Swap Facility for Securities, Funds, and Insurance Companies" primarily aims to assist financial institutions in converting less liquid assets into more liquid ones, thereby enhancing their ability to hold stocks. During the 2008 global financial crisis, some financial markets experienced severe liquidity shortages, making it difficult for many liquidity-constrained financial institutions to liquidate their assets. At that time, the Federal Reserve also created similar policy tools to help financial institutions achieve asset liquidity conversion, ultimately alleviating market liquidity tensions and asset valuation pressures. In the context of a sluggish capital market, the central bank's introduction of such policy tools that can help financial institutions improve asset liquidity holds certain positive significance for stabilizing the market and asset valuations.

Ideally, the process for using this tool would be as follows:
A securities company wants to increase its stock holdings but lacks excess funds and can only raise money by selling other assets. Among the non-stock assets held by the securities company, there is a type of asset with very poor liquidity. If the company needs to sell it quickly, it would incur significant liquidity premium losses. In this situation, the securities company can pledge this asset and use the swap facility to obtain more liquid assets, such as government bonds, from the central bank. After receiving the government bonds, the securities company sells them in the open market for cash and then uses that cash to purchase stocks.

As the swap tool matures, the securities company will sell stock or other assets and purchase government bonds from the bond market to return to the central bank, thereby reclaiming its less liquid assets and completing the round of swaps with the central bank.

Reviewing the above process, we can identify three characteristics of the tool's usage.

Firstly, for the tool to be effective, it relies on two initial conditions: (1) the securities company has the willingness to actively increase its stock holdings while facing liquidity constraints; (2) the securities company holds a type of asset with very poor liquidity. In other words, if either of these two factors is not met, there is no need for the securities company to use this tool.

Secondly, the tool is liquidity-neutral, meaning the central bank does not release or retract liquidity throughout the process. However, since the securities company must first sell government bonds and then buy them back, and these government bonds are assets held by the central bank, the overall liquidity supply does not increase, but there will be fluctuations in the total liquidity, leading to increased volatility in short-term funding rates.

Thirdly, the securities company is effectively leveraging its stock allocation, but this is only a temporary strategy. As the swap begins and ends, it will directly increase stock price volatility. Additionally, if the securities company obtains government bonds through the swap, the volatility of those bonds will also increase as the swap commences and concludes.

IV. The Actual Application Scenarios for "Stock Repurchase and Increase in Special Refinancing" May Face Certain Limitations.

According to the central bank's statement, the "stock repurchase and increase in special refinancing" aims to encourage banks to provide loans to listed companies to increase their funding for stock buybacks. This process is not complex and effectively provides listed companies with financing at around 2.25%, primarily for increasing holdings and repurchasing stocks.

Unlike the previous tool, the central bank can create new liquidity through this mechanism, enhancing the market value management capabilities of listed companies, which may have a positive impact on stabilizing the stock market and improving stock valuations. However, some objective factors may affect the actual effectiveness of this tool and deserve consideration.

Firstly, for listed companies that have the willingness and ability to repurchase, a loan rate of 2.25% may not offer a cost advantage. These companies usually have good cash flow and performance, making them the best clients for commercial banks, and their normal borrowing costs from banks may not exceed 2.25% significantly.

Secondly, for listed companies that wish to repurchase but lack the capacity to do so, they are likely facing cash flow difficulties and operational pressures, lacking the ability to further leverage. Providing ample funds for stock buybacks to these companies, regardless of whether it leads to overvaluation, will inevitably increase their leverage, which is precisely what should be avoided. This is especially concerning considering that the cost of refinancing may not be that low.

Finally, regardless of whether the funds are ultimately used for stock purchases or other means, the central bank will create new base money in the process. Any attempt to create base money will influence the foreign exchange market through liquidity spillover mechanisms. Therefore, to maintain internal and external balance, both the special refinancing and the previous swap facility may face certain scale constraints, making it difficult to achieve an “unlimited” effect.

V. Conclusion and Policy Insights

In summary, we believe that the most direct and effective policy among the new “three arrows” introduced by the central bank is to reduce the benchmark interest rate and the stock interest rate, and its mechanism of action is very clear. Increasing the scale of structural monetary policy tools may promote credit expansion and aggregate demand more than reducing reserve requirements, but structural monetary policy tools face the problem of diminishing or even disappearing cost advantages of funds. From a mechanism perspective, the swap facility does not really create new liquidity and may increase the volatility of short-term interest rates and related asset prices, while the stock repurchase and increase in special reloans tool faces some limitations in application scenarios, and its ultimate actual effect remains to be observed.

At present, China's macroeconomy still faces the challenge of insufficient effective demand, and the most important reason for insufficient effective demand still comes from the continuous adjustment of the real estate market, compounded by fiscal policy expenditure strength being much lower than the budget target at the beginning of the year, resulting in a low level of price levels. Therefore, the focus of current macro policy is to change the low inflation environment and stabilize real estate market expectations, for which more supportive macro policies are needed.
Firstly, fiscal expenditure should be increased to strive to complete the budget expenditure targets set at the beginning of the year, and issue additional national debt at appropriate times to make up for revenue gaps. Based on the fiscal revenue trend in the first half of this year, and assuming that the 2.1 trillion yuan of various funds transferred and 4.06 trillion yuan of official deficit arranged at the beginning of the year can all be in place and spent within the year, there is still a gap of about 1 trillion yuan to complete the annual expenditure target. If the growth rate of general budget revenue in the second half of this year cannot rebound significantly, it is necessary to timely increase the deficit and issue additional national debt to make up for the revenue gap.

Secondly, draw on the experience of risk disposal in the banking industry to carry out differentiated disposal of real estate companies. At present, the policies on the demand side of the real estate market have reached the most relaxed point in nearly ten years, and on the supply side, although policies including the "white list" and housing acquisition are being implemented, there is still room for improvement in policies regarding the risk disposal plans of real estate companies. Considering that real estate companies in China are closer to shadow banks, we believe that the experience of risk disposal and transformation in the banking industry can be drawn upon, and real estate companies can be divided into "good real estate companies - bad real estate companies" according to a certain price, and the non-performing assets held by real estate companies can be stripped to a "bad real estate company", which will be combined with the construction of affordable housing in subsequent asset disposal; and the liabilities will all remain in the "good real estate company", and the "good real estate company" will be restructured and recapitalized as a whole under the guidance of the government, and the government's equity will be gradually exited after the real estate market returns to normal (for details, see CF40 Research·Briefing "Good Real Estate Companies-Bad Real Estate Companies: A Real Estate Company Risk Disposal and Transformation Plan"). The introduction and implementation of this disposal plan can achieve the minimization of disposal costs and the effective use of resources, and it is also conducive to breaking the self-fulfilling pessimistic expectations of the new housing market as soon as possible, while providing possibilities for the benign survival of real estate companies under the new model of real estate development.

Thirdly, there is a further need for monetary policy to lower interest rates, and the interest rates of structural monetary policy tools should be reduced below the policy interest rate level to better play their dual role in adjusting structure and stabilizing growth. As mentioned earlier, China's real interest rate is significantly higher than the neutral interest rate, and there is still a gap of 5-6 percentage points between the two. Therefore, the "strong interest rate cut" should aim to reduce the real interest rate as an important goal, and this interest rate cut should be taken as a starting point, through a larger reduction in the policy interest rate and clearer market communication, to drive the recovery of inflation expectations and nominal growth expectations, and achieve the goal of reducing the real interest rate. According to our calculations, to significantly improve the expectation of nominal GDP growth, it is necessary to reduce the policy interest rate by at least 100 basis points in two to three times within about half a year, and to drive the LPR to decrease by at least 100 basis points through reducing the policy interest rate. **At the same time, it should be considered to quickly reduce the financing interest rate of structural monetary policy tools to below the OMO benchmark interest rate as soon as possible, such as OMO-25bp.** The existing 18 structural monetary policy tools, some were established earlier, such as agricultural and small business reloans, and some were established at the end of 2021 and the beginning of 2022, such as policy tools supporting carbon reduction and scientific and technological innovation. At the beginning of the establishment of these policy tools, their fund interest rates were significantly lower than the short-term policy interest rates at the same period, that is, the 7-day reverse repurchase interest rate, which is an important factor for these tools to attract banks to use. Therefore, at this stage, the financing interest rate of structural monetary policy tools should be quickly reduced to below the 7-day reverse repurchase interest rate, at least based on the 7-day reverse repurchase interest rate, to better play their dual role in adjusting structure and stabilizing growth.

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