The Impact and Prospect of China's Low Interest Rates on the Economy

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Abstract. This article explores the impact of China's long-term low-interest-rate policy on its economy and its future development direction. While the low-interest-rate policy has stimulated investment and consumption, it has also led to risks such as rising asset prices, real estate market bubbles, and increasing debt levels. The squeeze on bank profit margins may affect the stability of the financial system. The article reviews the development of China's interest rate policy since 1949, analyzes the impact of low interest rates on consumption and investment, and predicts the trend of future interest rate changes. The study shows that a decrease in deposit interest rates may reduce the willingness to save, and increase consumption and investment, but may also increase market volatility and investment risks. Changes in the global economic environment and the need for domestic economic structural adjustment make it particularly important to study the impact of low interest rates on China's future economic development.

1 Introduction

In recent years, China has implemented a long-term low-interest rate policy aimed at stimulating economic growth and coping with external economic pressures. While this policy has been effective in promoting investment and consumption, it has also created potential risks and challenges. The low interest rate environment has driven up asset prices and exacerbated the real estate market bubble, and the debt levels of enterprises and residents have continued to climb. In addition, the economic impact of low interest rates is not sufficient. Low interest rates have put a squeeze on banks' profit margins, which may weaken the stability of the financial system. With the changes in the global economic environment and the demand for domestic economic restructuring, it is particularly important to study the impact of low interest rates on China's economy and its future development direction. Exploring this topic will not only help to understand current economic issues but also provide a reference for future policymaking.

The current academic research on the relationship between low interest rates and employment rates shows a variety of perspectives. Some studies suggest that low interest

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rates may stimulate economic growth by reducing the cost of borrowing, thereby indirectly promoting employment. For instance, businesses are more likely to invest and expand in a low-interest-rate environment, which could lead to an increase in job opportunities. However, this relationship is not always direct, as low interest rates may also reflect a sluggish economic state, which could suppress businesses' willingness to hire. For example, Roberts reexamined the prospective cost and frequency of events like the recurrent approach of nominal interest rate to the Effective Lower Bound (ELB) by utilizing models, such as DSGE and FRB models. He deduced four main results, respectively the original elementary monetary policy had a less effective implementation, the creators of the monetary policies should be indulgent to guarantee the monetary easing will not be lifted, and ultimately, if the real interest rate is low and the monetary policy was applied in the original method, the influences on economy and price stability might be dreadful [1]. Rogoff focused on the two most significant schemes for alleviating or terminating the zero bound, which are increasing the inflation objective from 2% to 4%, and enacting systematic modifications that guarantee the efficiency of negative interest rate policy. He concluded that in order to deal with almost zero interest rate, the negative interest rate policy is more likely to be selected rather than raising the aim of inflation, and how to carry out this policy and function similarly to typical monetary policy in an electronic currency prevailing background [2]. Therefore, this article will study the impact of China's low interest rates on the economy and its outlook.

2 The development history of interest rates in China

China's interest rate policy has undergone a number of adjustments since 1949, mainly in response to economic needs and market changes at different times. In the early years of New China, the People's Bank of China (PBOC) adopted an extremely high interest rate policy in order to stabilize prices, curb speculation and restore the economy [3-5]. For example, the interest rate on six-month time deposits was as high as 150% in 1949, and the interest rate on loans was even higher. This policy was effective in curbing price rises and attracting large amounts of capital. However, as the economy gradually stabilized in 1950 and prices fell, high interest rates were no longer appropriate, and the PBoC promptly lowered interest rates to 7.5% for deposits by 1952. With the implementation of the First Five-Year Plan, the country's focus shifted to large-scale economic construction, and the interest rate policy was adjusted again. From 1953 onwards, the interest rate on loans dropped sharply, and the interest rate on loans to state-run enterprises in particular was lowered to 4.5 percent. This differential interest rate policy not only supported the development of state enterprises but also promoted the socialist transformation of private enterprises. However, during the period 1958-1978, due to the left-leaning policy, the interest rate policy was greatly simplified and lowered and even denied the existence of interest for a time during the Cultural Revolution [6-8]. This extreme policy seriously weakened the role of interest rates as an economic lever and led to economic chaos. To summarize, China's interest rate policy from 1949-1978 underwent frequent adjustments, gradually transitioned from transitional high interest rates to more stable low interest rates, and was accompanied by the implementation of a planned economy, in which the function of interest rate policy was greatly weakened. Since 2010, China's interest rates have generally been on a downward trend, accompanied by a slowdown in economic growth, a decline in inflation and changes in the savings rate [9]. The slowdown in China's economic growth and the inflation rate remaining low have led to an overall downward trend in market interest rates. However, the decline in the savings rate has slowed down the downward trend in interest rates. After the financial crisis in 2008, China's current account surplus/GDP ratio declined from 10% to around 2%, reducing the impact of foreign

exchange inflows on money supply. The volatility of interest rates in the money and bond markets is also influenced by a number of factors [10]. The volatility of money market interest rates has been high, especially during 2011-2014. For this reason, in 2015, the PBoC introduced the interest rate corridor mechanism to mitigate short-term volatility in the market. The bond market, on the other hand, is subject to the economic cycle, with the 10-year treasury bond yield reaching a peak of 4.72% in 2013 before falling to a low of 2.64% and 2.48% in 2016 and 2020, respectively. To better reflect the supply and demand of funds in the market, in 2019, the PBoC reformed the lending base rate (LPR) mechanism and strengthened the pricing role of the medium-term lending facility (MLF) rate. This reform has stabilized the fluctuations in the gap between lending rates and bond yields, and lending rates have declined and come closer to market demand.

3 The impact of declining interest rates on the economy

3.1 Consumption

Lower deposit rates may reduce people's willingness to save and thus increase consumption. This is because lower deposit rates may cause people to perceive saving as no longer an attractive investment option and thus be more inclined to spend their funds on consumption.

The downward trend in interest rates will also lead to a synchronized decline in mortgage interest rates, thus reducing the pressure on interest payments of residents with stock of mortgage loans and boosting consumption. Calculated based on the mainstream mortgage interest rates, down to a lower level, the bank will let more interest income each year.

On May 17, 2024, the People's Bank of China and the State Financial Supervision and Administration Bureau released several financial initiatives to support real estate, and since its release, mortgage interest rates in 100 cities have further declined, and the first mortgage interest rates in most cities have now dropped to between 3.1% and 3.5%, which is much lower than the previous market average. The reduction in mortgage rates has indeed provided homebuyers with benefits and reduced their burden. Recently, homebuyers in many parts of the country have enjoyed the policy dividend of falling mortgage rates. At present, except for Beijing, Shanghai and Shenzhen, the rest of the cities in the country have canceled the lower limit of mortgage interest rates.

On June 26, Beijing issued the Notice on Policies and Measures to Optimize the Stable and Healthy Development of the Real Estate Market in the City. After the current round of adjustments, the lower limit of interest rates for loans for the purchase of first homes in Beijing is 3.5%.

For consumption, from the point of view of the total, 23 years of the national social zero total of 47.15 trillion, 240 billion only pull growth 0.5%, 24H1 social zero growth rate of 3.7%, lower interest rates will theoretically social zero growth rate increased by 13.5%. If you consider reducing the deposit mortgage interest rates to reduce the leverage of residents, maybe a certain degree will pull the marginal propensity of residents to consume the impact of lowering the deposit mortgage on consumption will be higher than 0.5%. For real estate, lowering the deposit mortgage rate will not be a big boost to new home sales because real estate, as a large investment consumption, will not increase investment consumption by lowering interest payments by a few hundred dollars per month. A more effective transmission path is to ease the sell-off of second-hand properties by lowering the holding costs of landlords, improving the supply and demand relationship in the second-hand property market to a certain extent, and easing the decline in second-hand property prices.

3.2 Investment

Lower deposit rates may prompt people to look for other investment opportunities, such as stocks, funds, and real estate. This is because lower deposit rates may lead people to believe that the returns on their savings are too low to meet their investment needs. Lower deposit rates may have some impact on the stock market. Lower deposit rates may make people more inclined to invest in risky assets such as stocks, thus increasing demand in the stock market. However, it may also lead to increased volatility in the stock market and increase investment risks. Specifically:

The impact of falling interest rates on investment is multifaceted and includes the following:

Declining interest rates usually cause bond prices to rise because new issues offer lower interest rates, making older bonds relatively more attractive. As a result, investors may increase their exposure to bonds, especially corporate or government bonds with higher credit ratings and longer maturities. Meanwhile, bond funds may also become a consideration for prudent investors as they mainly invest in fixed-income assets such as treasury bonds and corporate bonds. Insurance financial products combine insurance and financial management functions, such as universal life insurance and participating insurance. Investors should pay attention to the insurance terms and the way of income distribution when purchasing, and avoid purchasing products with too long a closed period so as not to affect the liquidity of funds. In a low interest rate environment, investors may increase the proportion of allocation to equity assets such as stocks and equity funds. Despite the risks in the equity market, high-quality blue chips tend to have high investment value and long-term growth potential, and investors may consider purchasing some bank shares to receive dividend distributions. Lower interest rates may lead to higher asset prices as investors will shift their funds from low-yielding bank deposits to other higher-yielding assets such as stocks, bonds, funds, real estate, etc., thus pushing up the demand and prices of these assets. Lower interest rates on deposits mean lower returns on deposits, which may reduce interest income for investors who rely on interest on deposits. Lower interest rates may lead to currency depreciation as investors tend to take their money out of the bank and look for higher-yielding investment avenues, which may lead to an increase in the supply of money in the market, thus affecting the value of money. Lower interest rates may affect the investment behavior of individual investors, such as increasing the demand for high-dividend stocks and high-yield bonds, which may further affect the allocation of resources in the capital market and the effectiveness of monetary policy. For foreign currency deposits, such as US dollar deposits, the impact of falling interest rates needs to be considered in the context of exchange rate fluctuations. If the interest rate on US dollar deposits falls while the exchange rate of RMB against the US dollar rises, then investors' real returns may be affected.

3.3 Employment

Low interest rates can have a profound impact on employment rates, albeit indirectly. By reducing the cost of borrowing, low interest rates can encourage businesses to invest in new projects or expand existing ones, which may lead to increased hiring and thus lower unemployment rates. However, the relationship is not always straightforward and can be influenced by various economic factors.

Firstly, lower interest rates can stimulate economic growth by making loans cheaper for consumers and businesses, potentially leading to higher spending and investment. This increased demand can create new jobs and reduce unemployment rates. For instance, businesses may be more inclined to take on large projects or expand their operations when

they can secure loans at lower interest rates, which can translate into job creation. On the other hand, a low-interest-rate environment can also signal weak economic conditions, which might discourage businesses from hiring. If businesses are uncertain about the future economic outlook, they may hold off on hiring new employees, despite low borrowing costs. Moreover, persistently low interest rates can lead to a misallocation of resources, as they might encourage excessive risk-taking and speculative investments. This can result in bubbles in certain sectors of the economy, which, when burst, can lead to job losses.

In summary, while low interest rates can provide an incentive for businesses to invest and hire, their overall impact on employment rates is complex and depends on the broader economic context. The effectiveness of low interest rates in stimulating job growth can be limited if businesses are not confident in the economic outlook or if the low rates are indicative of underlying economic weakness.

4 Prospect

In the future, interest rate changes in China is influenced by a variety of factors, including economic growth, inflation, monetary policy, and the international economic environment. Its future trend is difficult to predict. The monetary policy implementation report released by the People's Bank of China indicates that monetary policy will continue to support economic recovery and improvement while focusing on balancing the relationship between short-term and long-term, stable growth and risk prevention, and internal and external equilibrium. This suggests that China's monetary policy will remain robust while strengthening counter-cyclical adjustments to support the continuous recovery and stable development of the economy. Some experts predict that China's future interest rates may remain stable with a possibility of reduction, in order to concentrate efforts on the real economy. This could mean that while maintaining overall stability, there may be moderate interest rate cuts to stimulate economic activity. The monetary policy orientation of the world's major economies may affect China's interest rate trends. For example, if the monetary policies of global economies shift towards easing, the market may anticipate that China's monetary policy environment will also relax, thereby affecting interest rates. Changes in the exchange rate of the renminbi may provide room for relaxation of interest rate policy. If the renminbi exchange rate is supported, it may offer more flexibility for domestic interest rate policy. Therefore, the outlook for future interest rate changes in China may be affected by factors such as the domestic and international economic environment, adjustments in monetary policy, and exchange rate fluctuations. It is expected that under the robust monetary policy framework, interest rates may remain relatively stable, and there may be moderate adjustments to support economic growth and the stability of the financial market.

5 Conclusion

China's interest rate policy is expected to remain robust while strengthening counter-cyclical adjustments to support the continuous recovery and stable development of the economy. Experts predict that future interest rates may be moderately reduced on the basis of maintaining overall stability to stimulate economic activity. The direction of monetary policy in the world's major economies and the fluctuation of the renminbi exchange rate may affect China's interest rate policy. It is anticipated that under the robust monetary policy framework, interest rates will remain relatively stable, and there may be moderate adjustments to support economic growth and the stability of the financial market.

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