Chinese monetary policy is rarely straightforward. This weekend’s interest cut was no exception. The third loosening move in little more than three months, it should be evident that China is now in all-out easing mode. But in describing its actions, the central bank insisted that its policy stance remains “prudent”. This is the same definition it has applied for four years, supposedly connoting neutrality (neither loose nor tight), though in fact it first signalled a shift to tightening. Language is important, not least when it comes from the mouths of central bankers, so it is worth looking more closely at why the People’s Bank of China (PBoC) says it is still vying for the middle ground. Three points stand out.

First, there is a clear give-and-take in Chinese economic policy at the moment. Central banks never operate in isolation. That is even more the case in China where big monetary decisions, including rate cuts, must be approved by the State Council, or cabinet. Rate cuts would normally be expected to spur more borrowing as funding costs fall. But in China, interest rates are not the main determinant of credit growth. Rather, the direct lending controls that regulators impose on commercial banks are more important. The government has gradually lifted the amount that banks are allowed to lend; the total should exceed 10 trillion yuan ($1.6 trillion) this year, up from last year’s record high of 9.8 trillion yuan. At the same time, however, it has dramatically tightened their ability to lend via off-balance-sheet shadow vehicles. The result has been a steady slowing of overall credit growth. The broadest measure, known as ‘total social financing’, has declined from a 17.3% year-on-year increase in January of 2014 to 13.5% this past January.

Second, the environment framing China’s monetary policy has changed dramatically over the past year. The slowdown in economic growth has been only gradual, from 7.7% in 2013 to 7.4% in 2014,
but that is not the most pressing concern. In announcing the rate cut, the PBoC emphasised that it was focused on the sharp drop in inflation, which has led to an increase in real funding costs (see chart). The average of consumer price inflation has fallen by 170 basis points since the start of the fourth quarter, while average lending rates have declined by just 20 basis points since then, estimates Wang Tao of UBS, a Swiss bank. The outcome has been a tightening of real lending costs of more than one percentage point, even as industrial profits are slumping. From this vantage point, cutting rates is really about restoring them to more reasonable levels rather than an outright easing. Similarly, with capital outflows shooting up in recent months, cuts to banks’ required reserve ratios (the first came in early February and more are expected) should be seen as moves to maintain liquidity in the financial system, not to increase it.

Finally, the Chinese government is determined to avoid a repeat of the credit binge of 2009. At that time, the message from on high was that every effort should be made to arrest the slowdown in growth. Local governments, state-owned enterprises and banks lost all inhibition, piling on debt in pursuit of an investment-led recovery. The bills for that are just starting to come due. China’s overall debt load (public and private) has reached roughly 250% of GDP, up 100 percentage points in five years. With companies and municipalities struggling to service their existing liabilities, they have far less appetite to take on yet more. The government wants to keep them on the straight and narrow, and it is doing so by repeatedly talking of the ‘new normal’ of slower growth and of its still-prudent monetary policy.

Yet this begs the question of whether Chinese officials are doing enough to combat the economy’s slowdown and deflationary pressure. Even with the various easing moves, the cost of money is still far too high. Interbank lending rates on Monday morning stood at 4.7% (annualised) for one week, up about 150 basis points from the start of the easing cycle in late November. If the central bank’s goal is to maintain neutral policy settings, quite a bit more is still needed in the way of rate cuts and liquidity injections.

The government could also do more with fiscal policy. Well-intentioned moves to limit the build-up of municipal debt are acting as fiscal tightening at a time when public investment should be ramped up to compensate for shortfalls in private investment. The central government has a chance to address that lacuna in its budget at the end of this week. Last year it aimed for a deficit of 2.1% of GDP. China should raise that ceiling to 3% this year. Otherwise, it will be in a position of tightening during a disinflationary slowdown, and that would be imprudent.