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INTERNATIONAL ECONOMIC REPORT

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CHINA RAISES POLICY INTEREST RATES AFTER FED HIKE TO DISCOURAGE CAPITAL OUTFLOWS AND STABILIZE THE EXCHANGE RATE

SUMMARY

- China raised several benchmark policy rates 0.10 percentage point on the heels of the Federal Open Market Committee's (FOMC's) 0.25 percentage point March rate hike.
- Chinese policy is prioritizing exchange rate stability over economic growth, which in 2016 was the slowest since the 2008-2009 global financial crisis, despite a record Chinese fiscal stimulus program.
- China has room to make measured increases in interest rates. However, if the Federal Reserve raises US rates significantly faster than expected, China could be forced to choose between rapidly raising Chinese interest rates and potentially causing corporate defaults, or allowing its exchange rate to freely float.
- PNC Economics is forecasting continued managed depreciation of the yuan in 2017-2018, but the possibility of a yuan free float and sudden devaluation is China's most immediate risk to the global economic outlook.

The People's Bank of China (PBoC) raised benchmark rates on its open market operation facilities on March 16 by 0.10 percentage points, on the heels of the FOMC's 0.25 percentage point increase in the federal funds target range the day before (See chart on page 2). The PBoC made 0.10 percentage point increases to the 7-day, 14-day and 28-day reverse repurchase facility rates, raising them to 2.45 percent, 2.60 percent, and 2.75 percent respectively, and also made 0.10 percentage point increases to the 6-month and 1-year medium-term lending facility rates, to 3.05 percent and 3.20 percent, respectively. The PBoC had previously made staggered 0.10 percentage point hikes in all of these interest rates in late January and early February. The prior change was a 0.05 percentage point cut to the 28-day reverse repurchase rate in September 2016. China's open market facility rates influence the cost of funding for Chinese commercial banks, and indirectly affect the interest rates on loans to Chinese corporations and household borrowers.

In a statement, the People's Bank of China explained its rate hikes as a response to an "improving growth outlook, higher [domestic Chinese] inflation which has lowered inflation-adjusted interest rates, strong credit issuance by financial institutions, rising property prices in some cities, improving foreign economies, **and especially the two US interest rate hikes in December 2016 and March 2017 which have pulled global yield curves higher"** [emphasis added].

These Chinese rate hikes demonstrate that the People's Bank of China is prioritizing exchange rate stability over domestic growth in setting monetary policy. Higher Chinese interest rates will discourage capital outflows, helping China's central bank to conserve the foreign reserves that it uses to manage the exchange rate and prevent the yuan from depreciating even faster. The yuan has depreciated significantly less against the US dollar than other major currencies have over the last three years; the euro, yen, Canadian dollar, and Mexican peso have all depreciated by more. While Chinese economic growth has picked up slightly in recent months, it is still slow by historical standards. Real GDP grew 6.8 percent in year-ago terms in the fourth quarter of 2016, up from 6.7 percent in the third quarter, which had been the slowest since the trough of the global financial crisis. Late 2016's faster growth was only made possible by the largest central government fiscal deficit relative to GDP since at least 1995. If China's policymakers did not feel pressured

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by the Fed to raise interest rates, they would probably react to recent better growth by reining in fiscal stimulus instead of raising rates.

Higher Chinese policy rates will eventually pass through and raise borrowing costs for Chinese corporations and households. If China continues to try to match US interest rate hikes, higher interest rates would eventually squeeze the cash flow of highly indebted Chinese corporations. The total borrowing of Chinese non-financial corporations rose to 166 percent of GDP in the most recent data for the third quarter of 2016, according to the BIS (a credible non-Chinese source), up sharply from about 100 percent of GDP in 2007, the last time monetary policy was tight in China. But in the short run China probably has room to raise interest rates before corporate cash flow suffers inordinately. Average lending rates for credit to the real economy fell 1.75 percentage points in the fourth quarter of 2016 from two years earlier, and net profits of Chinese industrial enterprises grew 6.7 percent in 2016.

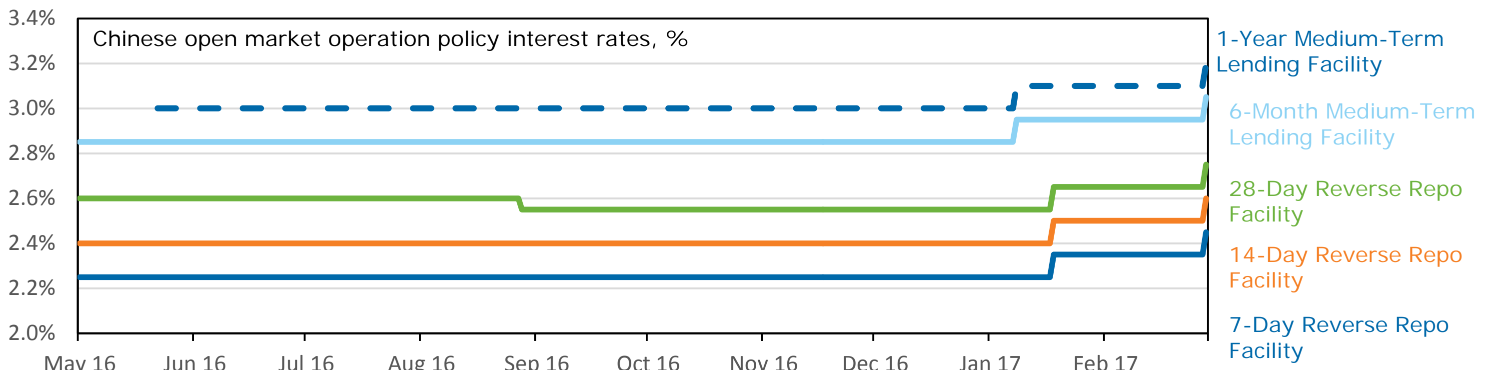
The tail risk scenario for China is that, if the Federal Reserve raises US interest rates significantly faster than currently expected, China would be forced to choose between making similarly rapid interest rate hikes that could cause a wave of corporate defaults on the one hand, or allowing the yuan to freely float on the other hand. In such a scenario, Chinese policy makers would likely see a freely-floating yuan as the lesser of two evils, and the yuan could suddenly depreciate by 10-20 percent against the dollar. The repercussions of such an event for the US economy would be significant, putting sharp downward pressure on currencies of other Asian exporters and commodity-exporting economies, squeezing profit margins for US manufacturers, and intensifying US-China trade frictions. The probability of such an event in 2017 seems low. But if the global economy continues to heat up in 2018 and beyond, US interest rates are likely to rise further, and China may have to face these long-deferred risks.

Market-determined Chinese interest rates suggest financial markets are preparing for additional Chinese policy rate hikes in the coming 12 months that will maintain Chinese interest rates at a stable premium above US rates. The premium of the 12-month Shanghai interbank lending rate above the overnight lending rate has increased 0.83 percentage points between November 7 (just prior to the US election) and mid-March, suggesting markets anticipate about eight more 0.10 percentage point rate hikes in the coming 12 months. This is pretty close to the 0.70 percentage point increase in US interest rates that financial markets anticipate over the same period.

Regarding the yuan, the People's Bank of China's March rate hikes reinforce PNC's expectation that China will continue to manage the yuan-dollar rate in 2017, and resist market forces pushing the yuan toward a free float and devaluation. PNC Economics forecasts for the yuan to undergo a managed depreciation to 7.2 per US dollar by mid-2017 and 7.4 per dollar by year-end 2017 from 6.9 today.

The Federal Reserve's March 15 FOMC statement reiterated that the Fed is closely monitoring "global economic and financial developments," which the Fed has emphasized, during recent periods of global financial volatility, include risks from China. US financial markets have been buoyant in early 2017 and Chair Yellen made little mention of global risks at her March 15 press conference, but China's economic vulnerabilities are still present. A renewed episode of China-related global growth fears or financial volatility would come as little surprise in 2017.

CHART: CHINA RAISES POLICY INTEREST RATES FOR OPEN MARKET OPERATIONS ON THE HEELS OF THE FED'S MARCH RATE HIKE



Sources: The People's Bank of China, CEIC, The PNC Financial Services Group

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