

China: 5bp increase in policy rates - why bother?

The PBoC raised several open market operation interest rates by five basis points, hours after the Fed hiked. But why did the PBoC bother raising by just 5 basis points?



The mysterious five basis point interest rate hike

On 14 December 2017, after the Fed announced it raised the policy rate by 25 basis points, the PBoC raised several of its policy rates by five basis points.

The PBoC has raised 7D and 28D reverse repo rates by five basis points, from 2.45% to 2.50%, and from 2.75% to 2.80%, respectively. The central bank also raised 1Y medium-term-lending-facility rates from 3.20% to 3.25%. Later the media reported that the central bank also raised the overnight standing-lending-facility rate from 3.30% to 3.35%.

In short, the PBoC has shifted the policy rate curve in parallel by five basis points.

Why five basis points? It is so little that it brings into question how the interest rate transmission mechanism would have any impact from policy rates to wholesale rates (interbank), and further to retail interest rates at the retail bank level. This is the conventional motivation behind an interest rate hike. But we conclude that this is not necessarily what the PBoC is doing.

+5bp PBoC rate hike

Conveying a tightening message but not to rock the boat

This is the second day of the rate hike - by now if there was any impact on the interbank (the wholesale transmission channel), then we should have seen it. So far, there have been no special movements in various 7D interbank rates. It seems to us that a 5 basis point hike is not enough to move the market. The repo fixing even dropped from 3.44% on 14 December to 3.40% on 15 December.

Rates, including SHIBOR, pledge repo, repo fixing, and repo, have increased since 8 December. This has been the result of tighter interbank liquidity. The central bank has been intentionally tightening liquidity to fulfil its objective of financial deleveraging.

If the rate hike by the PBoC were 10 basis points, as in the past, then we might have seen a more obvious market reaction. It is not difficult to imagine why the PBoC would take a 5 basis point hike rather than to follow the history with a 10 basis point hike. The interest rate trend is already rising, and a 10 basis point hike might be considered to be a too "big" surprise for the market as the consensus has been for no rate hike this month.

This leads us to think that the PBoC rate hike action is to convey a tightening message only and the central bank has taken advantage of the timing of the Fed rate hike. The PBoC does not really want to raise interest rates through policy rates. They still prefer to do this through daily open market operations where they have more control on the level of tightness. They can then make sure that they can achieve financial deleveraging without creating a liquidity crisis linked to deleveraging reform.

3X5bp Forecast for PBoC rate hikes in 2018

For 7D reverse repo

Would the PBoC follow the Fed in 2018?

It is now even more difficult to predict the PBoC's next rate hike action. Apart from timing, for example whether it will follow the Fed (the PBoC has not followed the Fed every time), we also need to consider the scale of any policy rate hike. Although this might be a more difficult task for economists and interest rate strategists, a very flexible central bank may not be bad for the economy.

Market participants had already expected tightening of liquidity and the resultant increase in interest rates. It is also expected that this would continue in 2018. We can expect that the PBoC will be soft on policy rate hikes even if it follows the Fed with an expected 3 hikes in 2018.

Our view is that when the central bank purposely tightens liquidity, which is what we expect in 2018, it will follow the timing of Fed rate hikes but only increase interest rates by 5 basis points.

One thing we are not certain of is that the slope of the policy curve. This time the rate hike of 5 basis point applies from the short end to the long end. But the central bank may increase rates more on the long end if it finds that controlling liquidity via open market operations alone does not achieve the objective of financial deleveraging. Then the policy curve would be steeper.

Interest rate spread between China and major economies to be stable in 2018

With a rising Mainland interest rate trend, we expect stable interest rate spreads between China and the other major economies which are also tightening their monetary policies.

A stable interest rate spread would keep China from the worry of capital outflow. Moreover, increasing Mainland interest rates should be able to support the attractiveness of yuan assets from a foreign investor perspective. We expect more demand for yuan denominated assets offshore, including Dim Sum bonds.