China refrains from following Fed

It is the first time that the Chinese central bank (PBoC) has not followed the Fed's rate hike. It shows that credit and liquidity are tight in the middle of financial deleveraging reform. But the breathing room is a tiny five basis points. We do not think this is enough. The PBoC needs to inject more liquidity into the system to avoid interest rates rising

Source: istock

Financial deleveraging reform prevents a PBoC rate hike

The PBoC not following the Fed is more symbolic than significant. Even if it had acted, the hike would have only been five basis points.

Still, the signal is loud and clear. The central bank is worried that market risks could escalate.

Currently, financial deleveraging reform is adding pressure to squeeze out low-quality credit. Still, the central bank does not want a crunch-type crisis created by its own tightening policy.

Targeted RRR cut for SMEs becoming more likely

A targeted RRR cut for banks that lend out loans to SMEs is becoming increasingly possible. As tightening measures continue to be in place for financial deleveraging reform, the central bank does not want to add pressure to SMEs, which have already had difficulty getting credit from banks.

If the targeted RRR cuts combine with a repayment of expensive MLF then interest costs for banks would be lower if banks lend more to SMEs.

We expect this policy to repeat in 2H18. Implementing this monetary policy at quarter-end would send a confusing signal to the market that the central bank uses targeted RRR cuts to smooth out quarter-end liquidity tightness, which should not be the policy intention.

Future Fed rate hike may not bring a PBoC hike

The fact that the PBoC did not follow the Fed rate hike last night reduces the chances of it copying future Fed hikes. And we would rely more on future liquidity tightness and targeted RRR cuts to gauge the possibility of the PBoC's rate hike of interbank rates.

Yuan strengthens to offset outflow pressure from the narrowing interest rate gap between China and the US

It seems puzzling that when the PBoC does not follow the Fed in hiking rates, the yuan strengthens against the dollar.

This demonstrates that interest rates and the exchange rate in China don't have a strong relationship because China exercises control over its interest rates, exchange rate (through the daily fixing mechanism) and capital controls.

One of our concerns is that capital outflows may return due to the narrower interest rate gap between China and the US, especially when the yuan weakens. If the central bank is also worried about capital outflows then that could explain today's yuan strength.

Looking forward, as we expect the dollar to continue to rise due to escalating trade tensions and uncertainty from European politics, China needs more inflow channels to offset outflows. Opening up more markets to foreign investors could be one solution.