PBoC follows the Fed by 5 basis points, what's next

The PBoC raised the 7D open market rate by 5 basis points this morning. This has been expected. Would it extend it to other interest rate tools like last time? How would trade tensions affect interest rates and the exchange rate path?

Source: istock

Demonstrating policy continuity

As expected, the People's Bank of China (PBoC) raised the 7D reverse repo open market rate today by 5 basis points from 2.50% to 2.55%. We wrote on 21st March that this is our view. This shows that there is policy continuity in the central bank in terms of interest rate policy.

The objective of raising 5 basis points is to stabilise China-US short term interest rate as raising 25 basis points would be overdone as the central bank has tightened liquidity through daily open market operations. Short-term rates have already gone up. That explains why PBoC raised rate by 5 basis points.

However, we expect more than that.

We are looking at other short-term interest rates to rise 5 basis points as well, so that the interbank rate curve would move up in parallel by 5 basis points. The interest rate tools that we expect to move up by 5 basis points are the Medium Lending Facilities (MLF) and the Short-term Liquidity Operation (SLO).

If these do not move up, then the short-term interest rate curve would be flattening, which we think is not the objective of the central bank.

For the rest of the year, PBoC would still follow the Fed by 5 basis points as financial deleveraging would mean tighter open market operations and would continue to push up short end rates in China.

Future interest path depends on risks from trade tension

How China reacts to US trade protection actions would affect not only trade but also US companies operating in China.

Overall, trade protection actions affect the supply chain of US and China goods as well as consumer and production prices of the goods. This means the impact is not just limited to the two economies, but to the rest of the world as well.

Goods produced in China ship to many countries, and companies in China could look for markets outside the US to reduce the risk of trade tension. We believe that the Belt and Road initiative may help China exporters to diversify, but results are still to be seen.

This explains why we are not particularly concerned the yuan exchange rate would be affected. But this would affect the interest rate path if economic growth is largely impacted by trade protection actions.

> All in all, PBoC shows policy continuity, and we expect future Fed rate hikes to be followed by 5 basis points hikes by the Chinese central banks to avoid overdoing the tightening, which is already in every day's open market operations. If there is anything that would slow down interest rate hikes that would be increasing negative impact on economic growth from trade tension.
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> The dollar has been largely weak when there has been trade protection actions from the US government, and the trade tensions from the US on China is escalating, so we expect a stronger yuan against the dollar. This is in line with our yuan forecasts. We keep our view that USD/CNY could reach 6.1 by the end of 2018.

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