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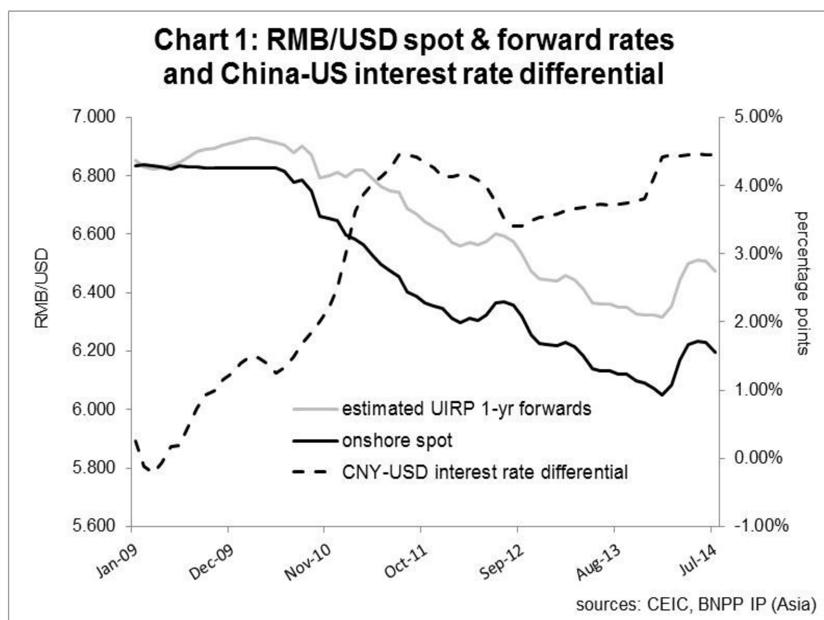
US RATE HIKE AND THE IMPACT ON CHINA

Some investors are concerned about the potential of a US interest rate hike wreaking havoc on China's economy and financial system just when China's growth momentum is slowing, its property market is entering a correction and the risk of credit default in its shadow banking market is rising. The logic behind such concerns is simple. When the US finally raises interest rates, probably sometime in the second half of 2015, capital will flow out of China. The resultant downward pressure on the renminbi (RMB) would force China to raise interest rates to protect the currency, adding liquidity stress to an already fragile economy that is struggling with the impact of structural reforms.

Such conventional wisdom misses the point, in our view, and the fear should not be exaggerated. It is far from certain that the US Fed will be able to raise rates as early as expected because the US economy is still stuck with a post-balance-sheet recession adjustment, which could keep its growth below potential for longer than most analysts might imagine[1]. Even if the Fed does raise rates next year, the ultimate impact on China may be muted. The magnitude of the potential US rate hike will be limited, with the market expecting no more than 50 bps in 2015. *Ceteris paribus*, that will still leave a large interest rate spread of four percentage points to prevent capital outflow from China (Chart 1).

[1] For example, see "*The Greater Depression*", J. Bradford DeLong, Project Syndicate, August 28, 2014, and "*The Stall-Speed Syndrome*", Stephen S. Roach, Project Syndicate, August 27, 2014.



More importantly, such a rational analysis of capital flows is based on the uncovered interest rate parity (UIRP) theory, which is not applicable to China's situation. UIRP dictates that home interest rate is equal to foreign interest rate adjusted for expected changes in the exchange rate (i.e. exchange rate risk). For example, if China's interest rate is higher than the US rate, its interest rate should equal to the US rate plus the expected rate of depreciation of the RMB. Otherwise, arbitrage will take place to push the exchange rate and interest rate to the "equilibrium" levels determined by UIRP.

In other words, UIRP is a no-arbitrage condition representing an equilibrium state under which investors are indifferent to interest rates in two countries. Suppose China's interest rate is 5.0% and the US's rate is 0.5% (which is the current spread between one-year Chinese SHIBOR and US LIBOR). Since an investor can earn 450bps more in China, he/she should invest in China and not the US. But if the RMB is expected to depreciate by 4.5% in a year's time, then the investor would be indifferent between investing in China and the US so that there would be no capital flows from the US to China.

If the RMB was not expected to depreciate, arbitrage activity would make capital flow from the US to China, putting downward pressure on the USD. This would, in turn, prompt the US to raise interest rate to diffuse the depreciation pressure, thus raising market expectation of RMB depreciation to restore the UIRP no-arbitrage condition.

However, UIRP does not apply to China. If it did, the RMB-USD forwards should be trading at a discount to the spot exchange rate (see Chart 1). In fact, RMB forwards both in the offshore (CNH) and onshore markets have almost always traded at a premium until recently. This is because a critical condition for the UIRP forces to work is free capital flows, which China does not yet allow. So arbitrage cannot take place.

This situation will change as China opens its capital account in the longer-term. The fact that RMB forwards have traded sometimes at a discount to the spot rate recently is a reflection of China's gradual capital account opening, which is also a step towards deeper RMB internationalisation and a floating exchange regime[2]. But in the short-term, very limited capital mobility will likely mute the impact of a US rate hike on China.

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[2] See also "*Chi Time: The Endgame for the RMB*", 6 August 2014.

Last but not least, capital flows to China depends on investors' sentiment which will continue to improve, in our view. Technically, there is reason to be positive on Chinese stocks. The onshore A-share market may be close to breaking out of its four-year correction/consolidation and transitioning to a medium-term uptrend. After dropping for more than four years between 2001 and 2005, the Shanghai Composite shot up in the following two years before dropping again during the 2007-08 global financial crisis. It then entered another period of protracted decline for more than four years between July 2009 and late 2013. The two periods of correction resemble each other not only in their time span but also in their consolidation pattern (Chart 2).

This positive technical signal is supported by economic fundamentals. China is the largest country in the world to have the most significant amount of economic restructuring unfolding. Growth is bottoming out, systemic risk and inflation are under control and macroeconomic policy is striking a balance between growth and structural reforms. If these trends are sustained, capital inflows to China may even overwhelm the negative impact of a US rate hike on its economy.

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