Economic Watch

China | What does China-US interest rate reversion mean for China's credit market?

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The diverging monetary policy between China and the US in the post-pandemic time has led to historical large China-US rate reversion

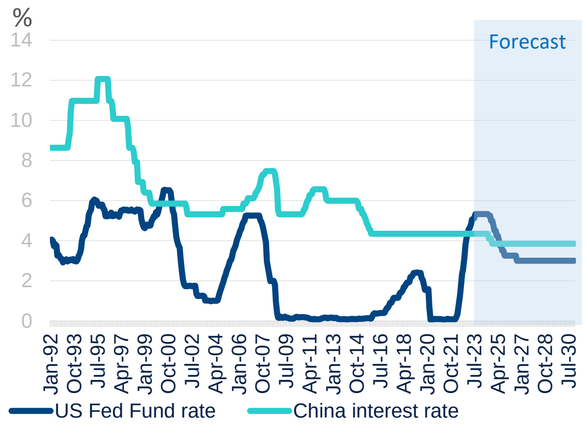
The unsynchronized monetary policies of China and the United States, resulting from their differing business cycles during and after the Covid-19 pandemic, have led to significant abnormalities in the dynamics of interest rates between the two countries. These abnormalities have triggered numerous changes in China's onshore and offshore credit markets. One notable change is that both domestic and foreign corporations have started to finance their businesses in Chinese yuan (RMB) due to its lower funding costs compared to the US dollar (USD), which had been the historical norm for financing.

In the macroeconomic theory, a country's natural interest rate (namely, the equilibrium interest rate, which is the benchmark of the policy rate) should be equivalent to a country's natural growth rate (potential growth rate). As China's potential growth which is estimated to be around 4.5% is higher than that of the US (around 2%) at the current stage, China's equilibrium interest rate should, in theory, be higher than that of the US. (Figure 1) Indeed, except for a short lull of 1999-2000 featured by the US FED aggressive rate hikes in response to the dot com bubble burst and the other short period ensuing 1997-98 Asian Financial Crisis, China's policy rate was always higher than that of the US over the past few decades.

However, the recent unprecedented interest rate hikes in the US, following aggressive rate cuts by the Federal Reserve to combat the pandemic, have disrupted this "normal" scenario of China-US interest rate dynamics. Since May 2022, the Federal Reserve has continuously raised interest rates 11 times, driving the Fed Funds Rate from 0% to 5.25%. By contrast, during the same period of the US aggressive rate hike cycle with tightening monetary policy, the People's Bank of China (PBoC) implemented monetary easing policy and lowered interest rates since 2021 in support of its pandemic-hit economy. The one-year loan prime rate (LPR), which represents China's policy rate, has been reduced from 4.25% to 3.45% to date.

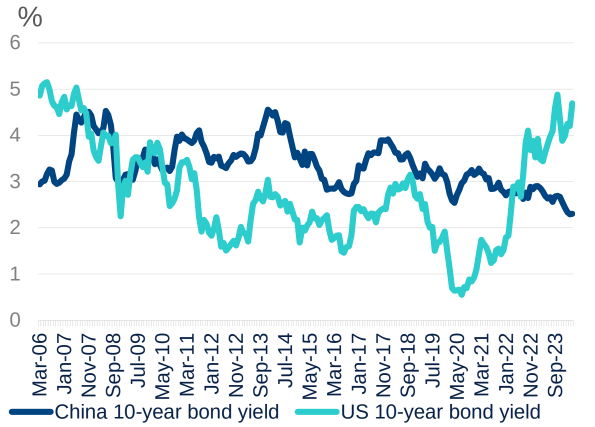
Consequently, the diverging monetary policies between China and the US, with the PBoC cutting rates while the Federal Reserve hikes them, has led to a historical reversion of China-US policy rate. As the policy rate serves as a benchmark for various interest rates in the market, including bond yields, lending and saving rates, interbank market rates, re-lending, and refinancing rates, the China-US policy rate reversion has triggered the various kinds of rate reversion in the bond market, credit market and interbank market in the US and China. (Figure 2)

Figure 1. **THE HISTORICAL LARGE REVERSION OF CHINA-US POLICY RATE**



Source: CEIC and BBVA Research

Figure 2. **THE POLICY RATE REVERSION HAS ALSO TRIGGERRED VARIOUS KINDS OF RATE REVERSIONS, SUCH AS IN BOND MARKET**



Source: CEIC and BBVA Research

In addition to China, similar interest rate dynamics and abnormities can be observed in other Asian countries, albeit with more diverse patterns. There are generally three situations across Asia: (Figure 3 and 4)

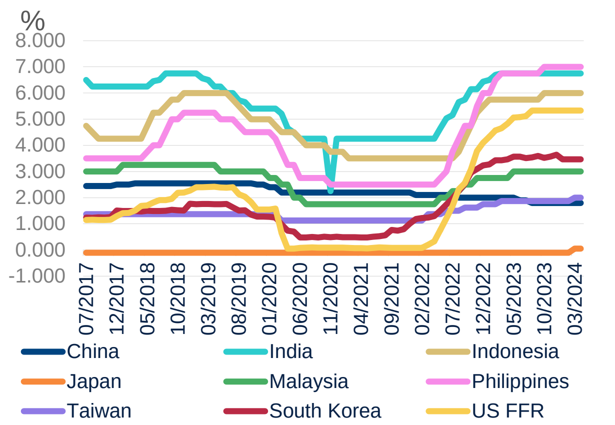
1. In countries such as India, Indonesia, and the Philippines, their potential growth rates exceed that of the US, and their central banks have also raised interest rates more aggressively compared to other Asian nations. As a result, their policy rates are still higher than those of the US. In these countries, the USD remains the primary funding currency, although the interest rate differentials with the US Federal Funds Rate (FFR) have been narrowing in recent years.

2. In the second category, which includes countries like South Korea, China, Malaysia, and Taiwan, their policy rates are lower than those of the US due to less aggressive interest rate hikes (or even the rate cut, such as China) compared to the US. Consequently, funding currencies in these countries are expected to shift towards local currencies due to the lower funding costs.

3. Japan's case is unique. The Bank of Japan has maintained a prolonged policy of negative and zero interest rates, along with yield curve control (YCC). As a result, Japanese policy rates have remained close to zero or negative for an extended period. Consequently, we exclude Japan from our discussion on interest rate dynamics between Asia and the US.

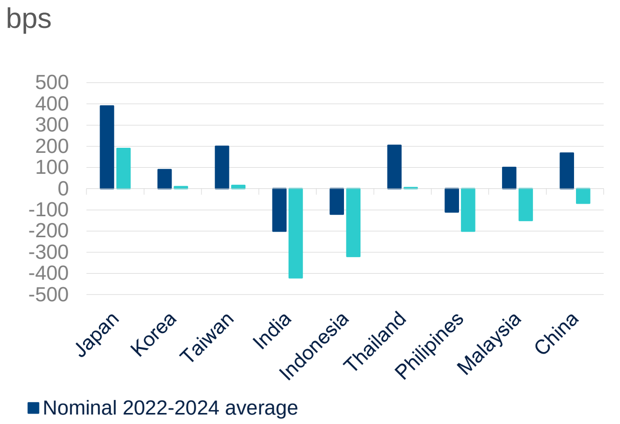
In summary, the interest rate dynamics in Asian countries, including China, exhibit variations based on their potential growth rates and the extent of interest rate adjustments compared to the US. This leads to different patterns of funding currency preferences and interest rate differentials across the region.

Figure 3. **THE HISTORICAL LARGE REVERSION OF CHINA-US POLICY RATE**



Source: CEIC and BBVA Research

Figure 4. **ASIA-US POLICY RATE DIFFERENTIALS (ON AVERAGE)**



Source: CEIC and BBVA Research

China-US rate reversion urged the change of funding currency to RMB in corporate finance business

The recent reversion of policy rates between China and the US since March 2023, along with the resulting changes in various rates across bond markets, bank lending, and the interbank market, has had a significant impact on corporate finance business in China.

Traditionally, when Chinese corporates sought financing outside of China, they would borrow in USD from banks or issue offshore USD-denominated bonds. This was primarily due to the historically lower interest rates (lower funding costs) associated with USD compared to RMB, as the US rates had consistently been lower than those in China due to its lower potential growth than that of China. However, the China-US rate reversion over the past year exerted two related impacts on corporate financing market in China, in particular the long-term one:

First, there has been a notable decline in total USD loans, encompassing both conventional loans and syndicated loans. This decline can be attributed to the higher funding costs associated with USD borrowing, which has made it less attractive for corporates in China.

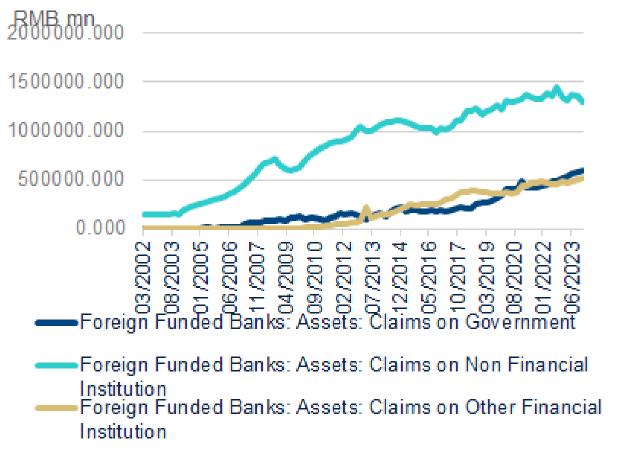
Second, Chinese corporates have shifted their focus towards financing their business in RMB, as the funding costs of RMB have now become lower than those of USD. This means that corporates are increasingly opting for RMB financing over USD financing due to the favorable interest rate differentials.

The above two points are corroborated by a number of stylized facts that we observe recently in several sub-markets, not only in the onshore market but also in the offshore market; also, not only in the bank lending but also in bond financing market:

1. For foreign-funded banks in mainland China, in their asset side of balance sheet, their claims on non-financial institutions (such as corporates) significantly dropped since the beginning of 2023. (Figure 5) Usually, foreign banks provides USD funding for Chinese corporates to fund their overseas business as the USD funding cost has been traditionally lower than that of the RMB. However, when the rate reversion between USD and RMB, due to lack of RMB liquidity, these foreign banks' asset significantly shrank.

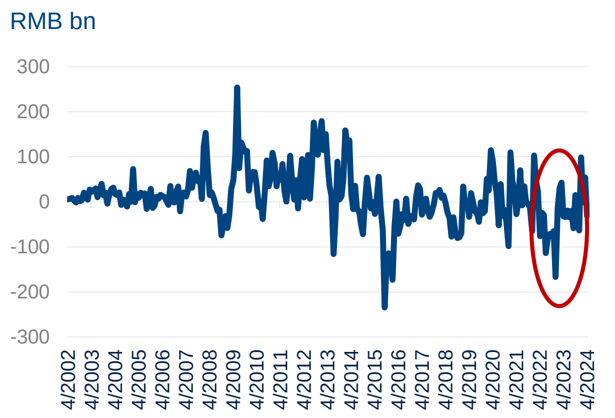
2. Regarding China's year on year change of foregn currency loans, we also observe a significant drop to negative since 2022. (Figure 6 and 7) And the drop for foreign currency loans applied to both short term and medium to long-term loans. (Figure 8)

Figure 5. **FOREIGN BANKS' CLAIMS ON NON-FINANCIAL INSTITUTIONS DROPPED IN 2023**



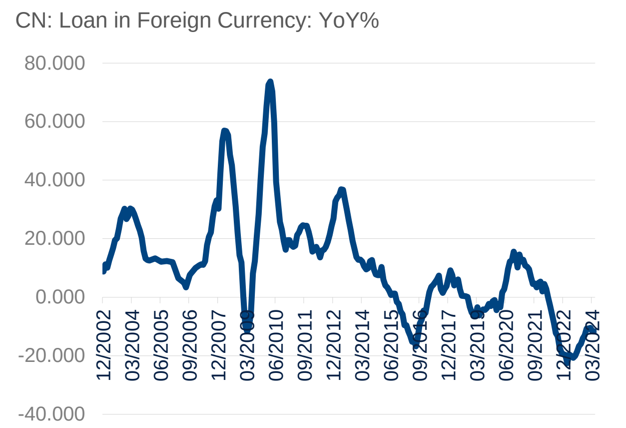
Source: CEIC and BBVA Research

Figure 6. **CHINA'S FOREIGN CURRENCY'S FINANCING ALSO SEE A SIGNIFICANT DROP SINCE 2023**



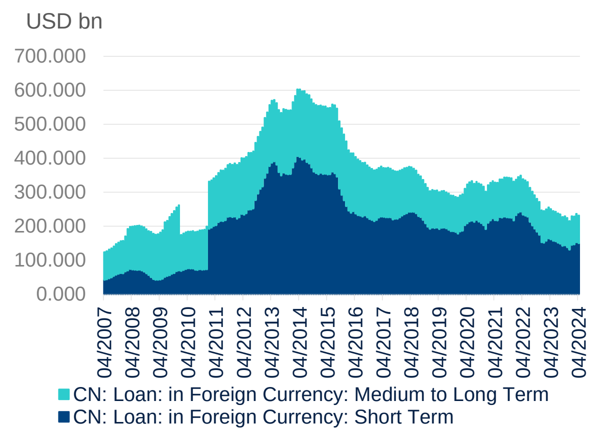
Source: CEIC and BBVA Research

Figure 7. **CHINA'S FOREIGN CURRENCY LOANS IN TERMS OF YEAR OF YEAR GROWTH DIPPED TO NEGATIVE SINCE 2022**



Source: CEIC and BBVA Research

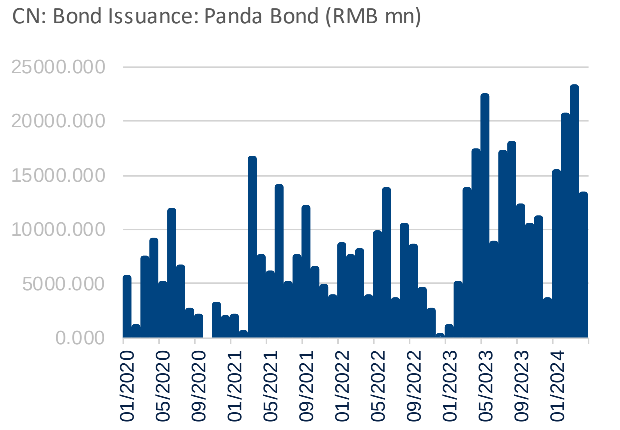
Figure 8. **...THE DROP OF FOREIGN CURRENCY LOANS APPLIED TO BOTH SHORT TERM AND LONG TERM LOANS**



Source: CEIC and BBVA Research

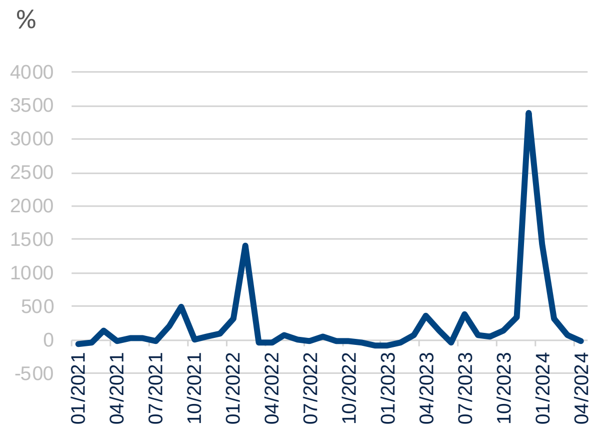
3. Regarding bond financing, the Panda bond, which is the RMB denominated bond isssued by foreign institutions in China sees a significant jump in 2023 and also this year due to the China-US rate reversion and the low funding cost of RMB. In particular, after its historical pick of issuance in the 2023, from the beginning of this year till April 2024, Panda bond altogether has issued 29 bonds with total issuance amont at 66 billion RMB, 128.37% growth from the same period of 2023. (Figure 9 and 10)

Figure 9. **PANDA BOND ISSUANCE REACHED HISTORICAL HIGH IN RECENT MONTHS**



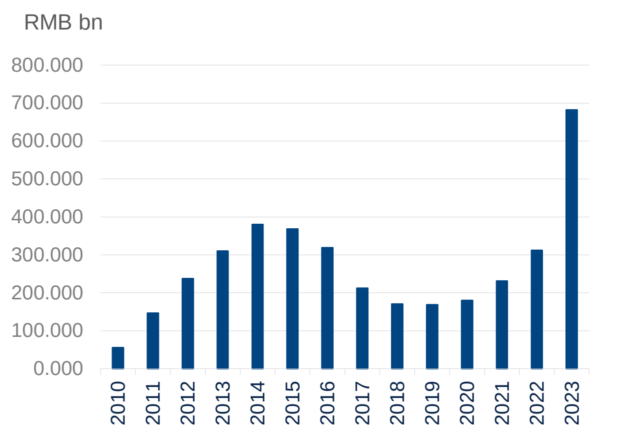
Source: CEIC and BBVA Research

Figure 10. **…ITS YEAR ON YEAR ALSO PICKED TO HISTORICAL HIGH DURING END-2023 AND BEGINNING OF 2024.**



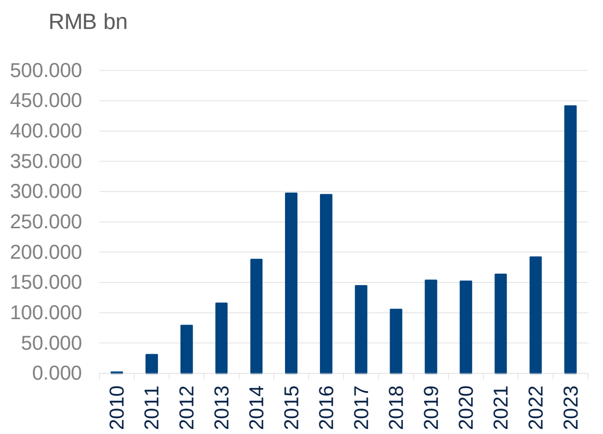
Source: CEIC and BBVA Research

Figure 11. **DIM SUN BOND ISSUANCE IN HK SEES A SIGNIFICANT JUMP IN 2023…**



Source: CEIC and BBVA Research

Figure 12. **…SO DID THE RMB LOANS IN HK AS THE LARGETS RMB OFFSHORE MARKET**



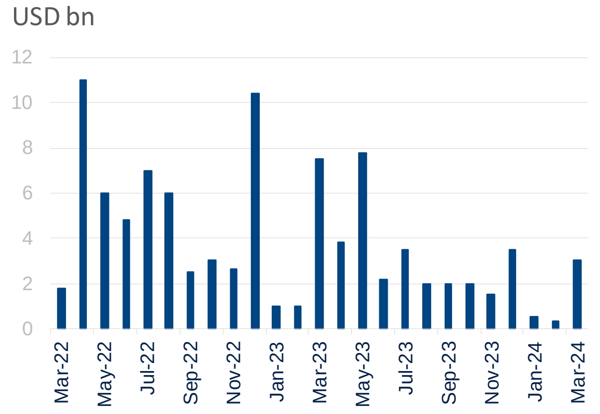
Source: CEIC and BBVA Research

4. Regarding the offshore RMB financing in Hong Kong which is one of the most important RMB offshore market, the dim sum bond which is the offshore RMB bond issuance also sees a significantly expansión recently in 2023, with its outstanding size almost doubled from that of 2022, reaching RMB 700 billion. (Figure 11)

5. Not only the dim sum bond issued in Hong Kong sees a significant jump in 2023, but also the RMB loans in Hong Kong which is the largest RMB offshore center. (Figure 12) In 2023, its size of RMB loan outstanding in Hong Kong almost doubled from that of 2022, reaching RMB 450 billion.

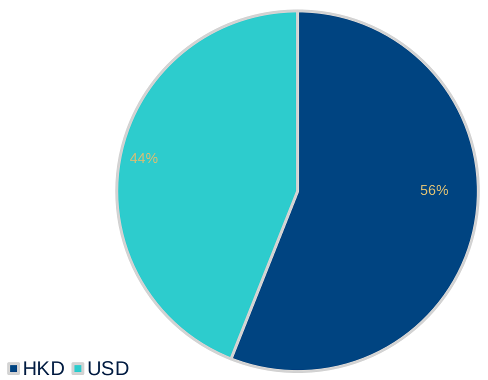
6. China's syndicated loan volume in the offshore markets got a significant dipping since 2023. And the volume even shrank more in 2024 as the USD (and its pegged HKD) funding cost goes up. (Figure 13 and 14) Currently, many firms would rather scale down their USD borrowings and defer their financing plan to a later stage. In addition, anecdotal evidence shows that some Chinese companies leverage the arbitrage opportunties to swap RMB loans to USD loansto meet their financing demand. Concretely, they borrow RMB loans at favorable rates and then use cross currency swaps to obtain the USD funds they need. The overall cost of such exercises is even lower than directly borrowing the USD loans in the offshore market.

Figure 13. **CHINA'S OFFSHORE SYNDICATED LOAN SHRANK SIGNIFICANTLY SINCE 2023**



Source: CEIC and BBVA Research

Figure 14. **CHINA'S OFFSHORE SYNDICATED LOANS DENOMINATED BY USD OR HKD**



Source: Bloomberg and BBVA Research

Will the China-US rate reversion persist? If not, when will it normalize?

Currently, we are experiencing the largest interest rate differential reversal in history, but we believe that the current situation of China-US rate reversion is abnormal and will not persist for the long term.

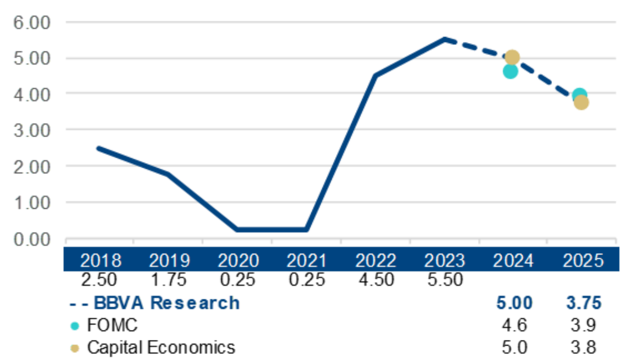
As we mentioned earlier, the fundamental factor in macroeconomic theory that determines the China-US policy rate (or equilibrium rate) should be the potential growth in both countries. Most macroeconomic models predict that China's potential growth, averaging around 4-4.5% in the next decade, will be higher than that of the US, which is projected to be around 1-2% on average. In normal circumstances and considering these growth differentials, China's policy rate (along with various other rates) should be higher than that of the US in the foreseeable future. Therefore, sooner or later, China's rate should surpass that of the US once the Fed's monetary policy normalizes.

However, there are some caveats that are also noteworthy. Firstly, the macroeconomic theory mentioned above applies to the long-term equilibrium level, which is model-based and subject to variations depending on different macroeconomic models. Secondly, in reality, the time required for China-US rates to normalize may be longer due to unsynchronized monetary policies and different inflation expectations between the two nations.

Looking ahead, the current situation is expected to persist in the short term until the Fed cuts the Fed Funds Rate below China's policy rate. This means that, for the time being, the current situation will continue. From China's perspective, the policy rate is likely to remain unchanged or have, at most, one more rate cut this year. Significant cuts to the Chinese Yuan (CNY) rate are not expected due to concerns about financial stability, such as housing bubbles, capital outflows, currency depreciation, and local government debt. Additionally, there is no reason for a rate hike amid an economic downturn, especially considering that China's central bank did not pursue aggressive easing during the pandemic. Therefore, Chinese rates are expected to remain on hold.

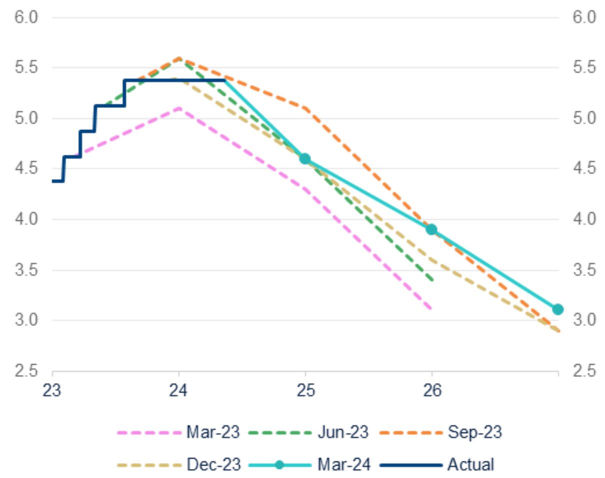
The first rate cut in the US is expected to come in November as most market participants forecast (Figure 15 and 16). Looking forward, we believe the normalization of the current situation will happen after a series of US rate cut till its rate goes below Chinese policy rate. That means, the current interest rate differential (China rate is lower than the US) is expected to reverse back (CNY rate above USD rate) in mid-2026, and the accurate timing is definetly depends on the initial time and the pace of the FED's interest rate cut.

Figure 15. **FED FUND RATE FORECAST BY DIFFERENT INSTITUTIONS**



Source: CEIC and BBVA Research

Figure 16. **FOMC PARTICIPANTS PROJECTED FED FUNDS RATE (MEDIAN PROJECTION, %)**



Source: CEIC and BBVA Research

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