Economic Watch

China | China-US rate gap is set to last longer amid FED "recalibration"

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Diverging monetary policy between China and the US remains after Trump's victory

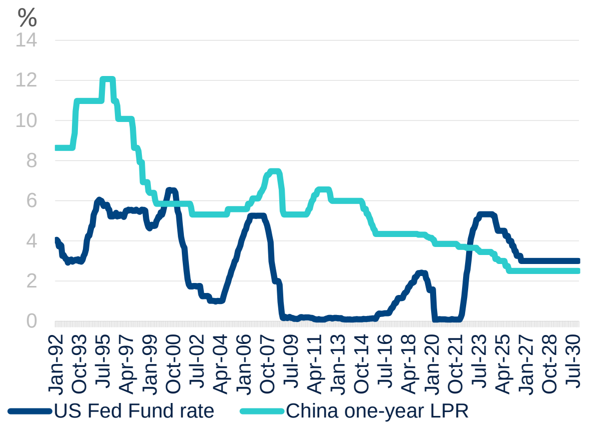
As the two largest economies in the world, China and the US's unsynchronized monetary policy due to the unsynchronized business cycles led to a reversion in their policy rates in recent years. (Figure 1) In theory, a country's natural interest rate (namely, the equilibrium interest rate, which is the benchmark of the policy rate) should be equivalent to a country's natural growth rate (potential growth rate), implying a higher interest rate in China than in the US. However, the Fed's unprecedented interest rate hikes in the aftermath of the Covid-19 pandemic and Chinese central bank's policy easing forced China's policy rate to hover below the US policy rate for quite a time.

Previously, we forecast that economic forces will correct this reversion in the next couple of years. However, some recent developments make us believe that the correction will take a longer time than we anticipated. First, Trump's success in US president election in November 2024 could inject new momentum to the US inflation, due to certain policy initiatives advocated by the President- elected, such as restricting illegal immigrations, imports tariffs etc. Meanwhile, the US tight labor market and elevated inflation expecations has prompted the Fed to announce a "recalibration" of its rate cut path in December 2024. It means that the high interest rate in the US is likely to last longer than previously expected. As a result, the expected rate cuts in 2025 could be significantly trimmed to 1-2 times from previously 6 times.

Second, China's jumbo-size stimulus package to stimulate lackluster economy indicates continuous rates cut ahead. (see our recent Economic Watch: China | Here comes China's Draghi moment) Since China's jumbo-size stimulus package was announced on September 24, 2024, the PBoC continuously signals further rate cuts. Now we expect will be at least 2-3 cuts in 2025, leading to historical low policy rates (2.5% by end-2025) and long-term bond yields in China.

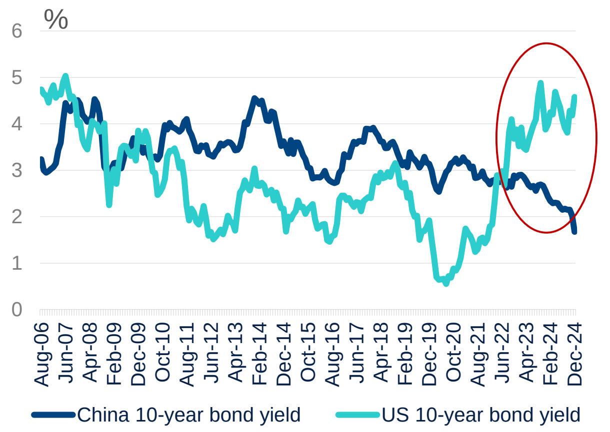
In sum, the continuing diverging China-US monetary policy has led to the continuing historical large of China-US policy rate reversion. As the policy rate is the benchmark for all kinds of interest rates in the markets, such as the bond yields, lending and saving rate, interb ank market rates, re-lending and re-financing rates etc., the China-US policy rate reversion has triggered the various kinds of rate reversion in the bond markets and interbank markets in the US and China. (Figure 2)

Figure 1. **THE HISTORICAL LARGE REVERSION OF CHINA-US POLICY RATE CONTINUES AFTER TRUMP'S WIN**



Source: CEIC and BBVA Research

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

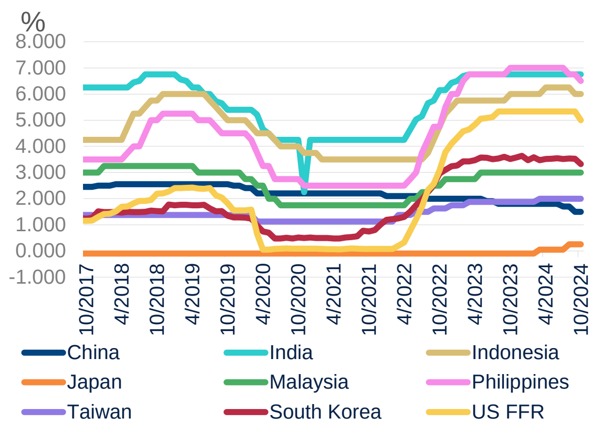


Source: CEIC and BBVA Research

Rate reversion continues not only in China, but also in other Asian economies

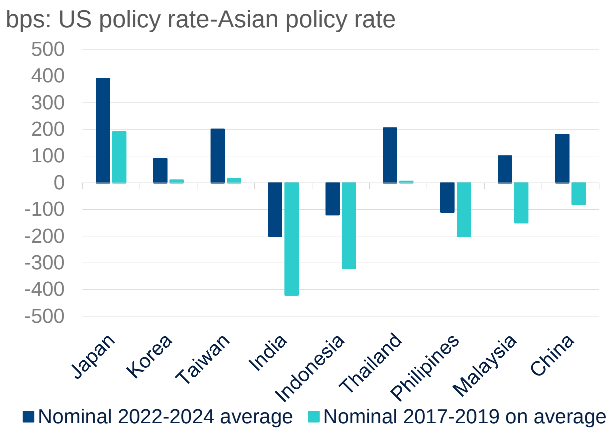
The rate reversion situation not only happens in China, but also in other Asian countries, although Asian countries display a more diversified pattern of interest rate dynamics versus the US rates. (Figure 3 and 4) There are basically three categories of rates dynamics in Asia which we summarized below:

Figure 3. **ASIAN RATES COMPARISON WITH US FFR**



Source: CEIC and BBVA Research

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



Source: CEIC and BBVA Research

In the first category, countries such as India, Indonesia and Philippines, their potential growth is higher than that of the US and their central banks also hiked interest rate more aggressively than other Asian countries in the aftermath of Covie-19 pandemic. Thus, their policy rates are still higher than that of the US. In these countries, it is anticipated that their major funding currency is still the USD which is cheaper than their local currencies as their policy rates are still higher than the US rates, although their interest rate differences with the US FFR has been shrinking over time in the recent years. That means, we should not observe rate reversion, but only observe shrinking rate differentials with the US for these three economies.

In the second category, such as South Korea, China, Malaysia and Taiwan, their situation of rate reversion is quite similar. These economies' current policy rates are lower than that of the US because of less aggressive interest rate hike compared with the US hike in the aftermath of pandemic, their credit markets' funding currencies should have transferred to their local currencies due to the lower funding costs. That means, the rate reversion situation is the most significant in these economies. (Figure 4)

In the third category, Japan's case is very special. As Bank of Japan has long-lasting negative and zero interest rate policy and YCC (yield curve control), Japanese policy rate has long-lasting approaching zero or negative. That means, although Bank of Japan has already announced to marginally hike their policy rate this year in a very moderated pace to get out of negative policy rate and YCC, Japanese policy rate should be still significantly lower than that of the US in a long term. Thus, we exclude Japan in our Asia-US rates reversion discussion.

Corporate financing for Chinese firms has got adapted to China-US rate reversion and changed the funding currency from cheap USD previously to cheap RMB

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 markets, has had a significant and long-term impact on corporate finance business in China.

Traditionally, when Chinese corporates sought financing channels 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 in the past decades. However, the China-US rate reversion over the past years have lead to some changing patterns of corporate financing behaviors for both Chinese and foreign corporates:

First, there has been a notable decline in total USD loans in China's onshore and offshore market, encompassing both conventional USD 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 overseas business in the RMB, as the funding costs of RMB have now become lower than those of USD. This means that Chinese corporates are increasingly opting for RMB financing over USD financing in the offshore market due to the favorable interest rate differentials. Such borrowings could also be carried out in the onshore market. Some large corporates, mainly SOEs, can move their borrowed RMB funds to the offshore market and exchange them for the USD. Or they can directly borrow cross-border loans from Chinese financial institutions and then make the exchange.

Third, more and more multinational firms have become more active in issuing RMB-denomiated bonds in the onshore(Panda Bonds) and offshore market (Dim Sum Bonds).

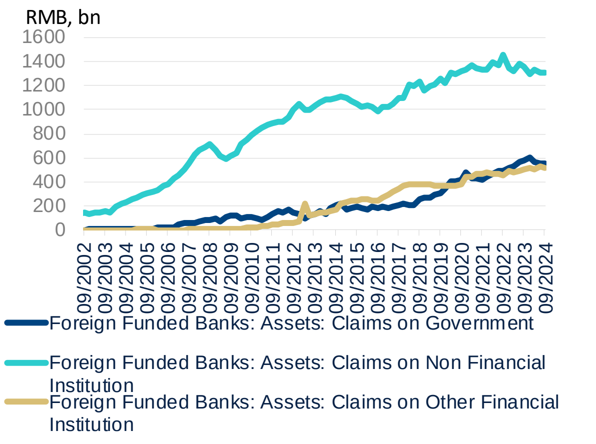
As we predict the China-US rate reversion will continue in the following several years, although the differential will shrink over time, corporate financing business in China seems like to already adapt to this new business model to finance their business by cheap RMB instead of cheap USD previously.

The above two points are corrobated by a number of stylized facts in several sub credit markets from different perspectives, which we analyze and summerize below:

1. For foreign banks in mainland China, in their asset side of balance sheet, their claims on non-financial institutions (such as corporates) both in onshore and offshore markets 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 happens, due to lack of RMB liquidity, these foreign banks asset significantly shrank since 2023.

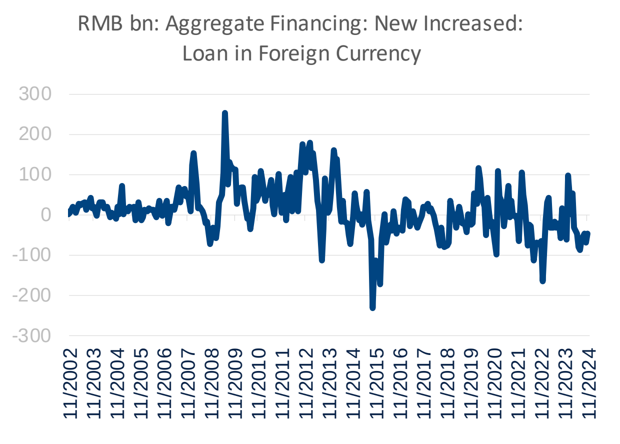
2. Regarding China's year-on-year change of foreign currency loans, we also observe a significant drop to negative since 2022. (Figure 7) And the drop for foreign currency loans applied to both short term and medium to long-term loans. (Figure 8) In addition, China's foreign currency's aggregate financing also sees a significant drop since 2023. (Figure 6)

Figure 5. **FOREIGN BANKS' CLAIMS ON NON-FINANCIAL INSTITUTIONS IN ONSHORE AND OFFSHORE MARKETS DROPPED SINCE 2023**



Source: CEIC and BBVA Research

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



Source: CEIC and BBVA Research

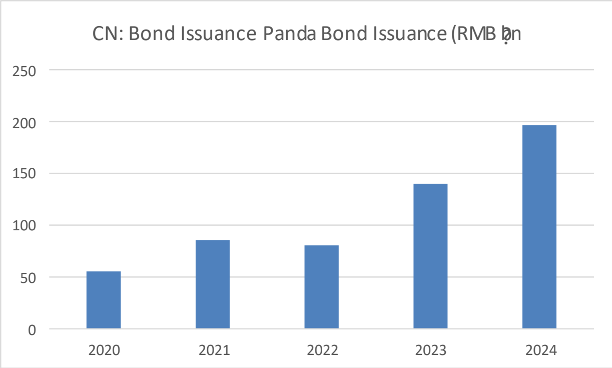
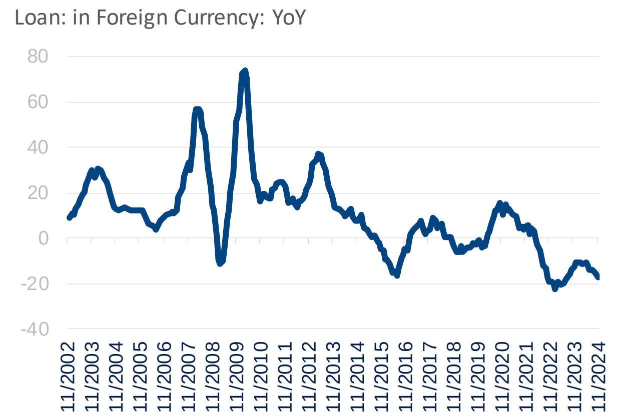
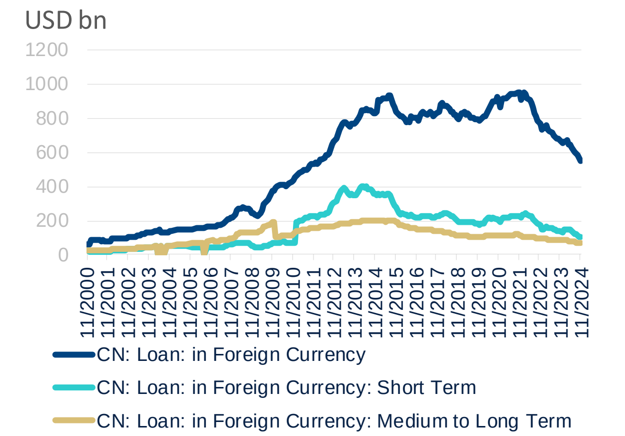


Figure 7. **CHINA'S FOREIGN CURRENCY LOANS IN TERMS OF YEAR OF YEAR GROWTH DIPPED TO NEGATIVE SINCE 2022**



Source: CEIC and BBVA Research

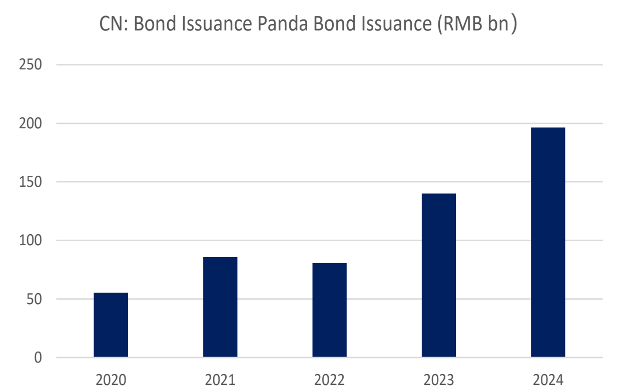
Figure 8. **…THE DROP OF FOREIGN CURRENCY LOANS APPLIED TO BOTH SHORT TERM AND LONG TERM LOANS**



Source: CEIC and BBVA Research

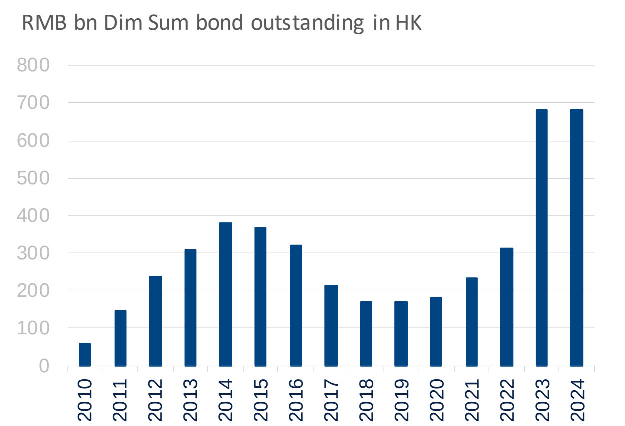
3. Regarding to bond financing, the Panda bond, which is the RMB denominated bond isssued by foreign institutions in China sees a significant jump in 2023 and 2024 due to the China-US rate reversion and the low funding cost of RMB. In particular, after its historical peak of issuance in the 2023, in 2024, Panda bond which was issued by foreign financial institutions aggregately reached approximately RMB 200 billion, 32% increase from 2023. (Figure 9)

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



Source: CEIC and BBVA Research

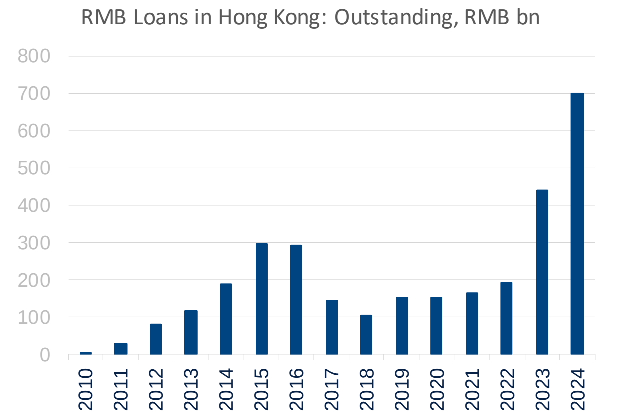
Figure 10. **DIM SUN BOND ISSUANCE IN HONG KONG SEES A SIGNIFICANT JUMP IN 2023 AND 2024…**



Source: CEIC and BBVA Research (2024 data is estimated based on the first 9 months Dim Sum bond data)

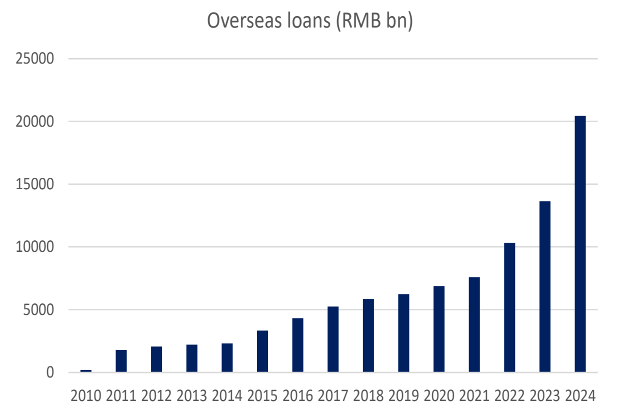
4. Regarding the offshore RMB financing in Hong Kong which is one of the most important RMB offshore market, the dim sum bond which is the offshore RMB bond issuance also sees a significantly expansión recently in 2023, with its outstanding size almost doubled from that of 2022, reaching RMB 700 billion. (Figure 10)

Figure 11. **...SO DID THE RMB LOANS IN HK AS THE LARGETS RMB OFFSHORE MARKET**



Source: CEIC and BBVA Research

Figure 12. **OVERSEAS RMB LOANS ALSO INCREASED SIGNIFICANTLY DUE TO LOW COST OF RMB**



Source: CEIC and BBVA Research

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 11) In 2023, its size of RMB loan outstanding in Hong Kong almost doubled from that of 2022, reaching RMB 450 billion.

6. Cross-border RMB loans also sees a significant jump in 2023 and 2024 due to the lower funding cost of RMB compared with USD. Based on the “Summary of Sources And Uses of Credit Funds of Financial Institutions” provided by the PBoC, overseas RMB Loans increased sharply from RMB 1006.2 in January 2023 to RMB 2054.8 billion in December 2024. (Figure 12)

How long will the China-US rate reversion persist?

Currently we are at the largest interest rate differential reversal in history and it will last at least for the next couple of years. On China’s end, the authorites are likely to cut the policy rate deeper to 2.5% by end-2025 and then keep it throughtout the entire year of 2026. From the US perspective, as our US Research team predicted, there will be only two cuts in the second half of 2025 compared to 6 times predicted previously. The Fed will continue to cut policy rate four times in 2026 so that the end-2025 and end-2026 Fed Fund Rate will be 4% and 3% respectively.

Having said that, we believe the China-US rate reversion will last throughout 2025 and 2026 at least. The normalization of the current situation will come sometimes in 2027 if the Chinese economy regains momentum from the current downturn.

Creating Opportunities

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