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China's Monetary Policy – Scope for an Asset Price Upswing?

By John Greenwood

Introduction and Overview

- Since Deng Xiaoping's Four Modernisations in 1978 and the subsequent opening of the Chinese economy to global trade and investment, the People's Bank of China (PBC) has pursued three distinct monetary policy regimes.
- The first phase (1978-2005) saw a nominally fixed exchange rate regime, albeit with numerous devaluations due to the RMB rate having become massively overvalued under the closed economy prior to modernisation.
- In the second phase (2005-2016), the PBC moved to a managed exchange rate system that enabled improved monetary control thanks to the introduction of sterilisation techniques.
- In the third, current phase (2016-2022) monetary control has improved again due primarily to the PBC providing credit via domestic asset purchases instead of foreign assets derived from FX intervention. But not all problems of monetary management have been resolved.
- Despite a moderate upswing in M2 growth to 12%, numerous headwinds confront investors in Chinese assets – including continuing lockdowns due to Covid, the crisis from unwinding of leverage in the property market, and constraints imposed on China's leading tech companies by domestic and foreign governments. Moreover, China is unlikely to buck the trend of declines in Wall Street-correlated markets on any sustained basis.

"*Monetary policy is not about interest rates; it is about the growth of the (broad) quantity of money*" (Milton Friedman)

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The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor Ltd. John was also the publisher, editor and lead author of **Asian Monetary Monitor**, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. He was a pioneer of monetary research in Asia. From 1999 to 2021 he was Chief Economist at Invesco, based in London.

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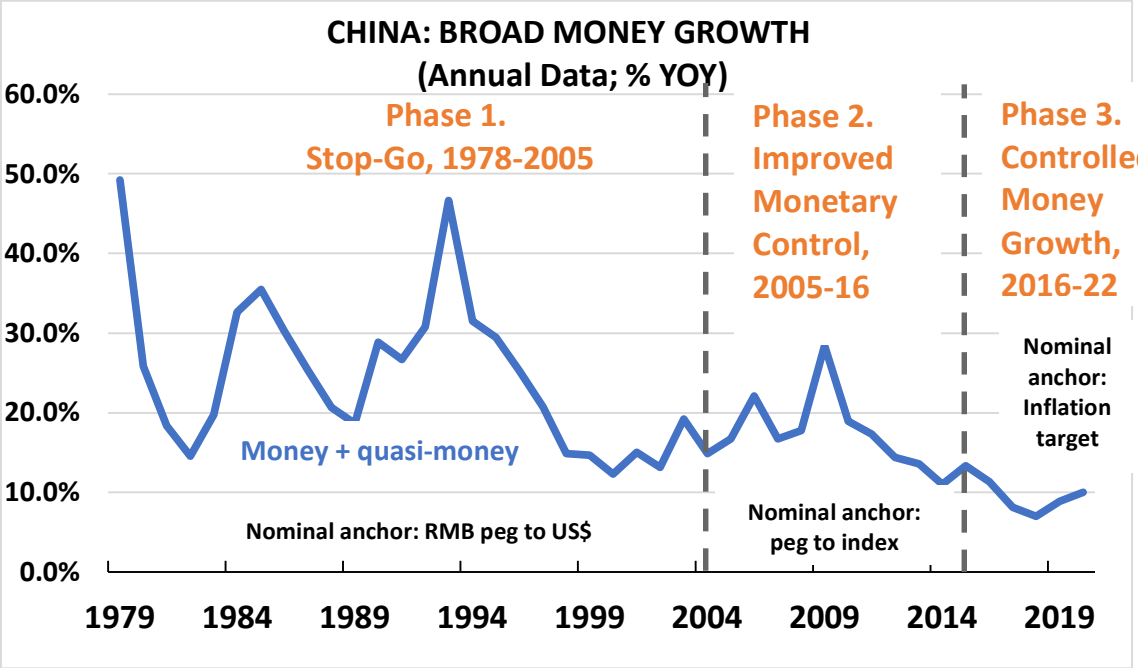
Introduction: China's Three Monetary Policy Regimes

During the period since Deng Xiaoping's Four Modernisations in 1978 and the subsequent opening of the Chinese economy to global trade and investment, the People's Bank of China (PBC) has pursued three distinct monetary policy regimes. In the first phase (1978-2005), the PBC pursued a nominally fixed exchange rate regime, albeit with numerous devaluations due to the RMB[1] rate having become massively overvalued under the closed economy prior to modernisation. In the second phase (2005-2016), the PBC continued to maintain a managed exchange rate but was able to achieve improved monetary control thanks to the introduction of sterilisation techniques which were able to offset foreign exchange intervention. The third and current phase (2016-2022) features a further improvement in monetary control due primarily to the use of domestic elements of the PBC's balance sheet substituting for or replacing intervention in the foreign exchange market.

Figure 1: China's Three Monetary Policy Regimes



I shall first briefly describe each of these regimes and their key features before turning to concentrate on the current policy regime. Notice that I am describing and judging each regime in terms of its impact on the broad quantity of money, or M2. Consistent with my monetary framework, since it is broad money[2] (M2 in China) that is the primary driver of spending on nominal GDP or on aggregate demand, it is

[1] RMB (renminbi) and CNY (Chinese yuan) are used interchangeably. In this paper I generally use RMB.
[2] Broad money refers to currency plus all deposits of the non-bank private sector, or M2 in China. The IMF uses the term "money plus quasi-money" for the same concept, where "money" refers to M1.

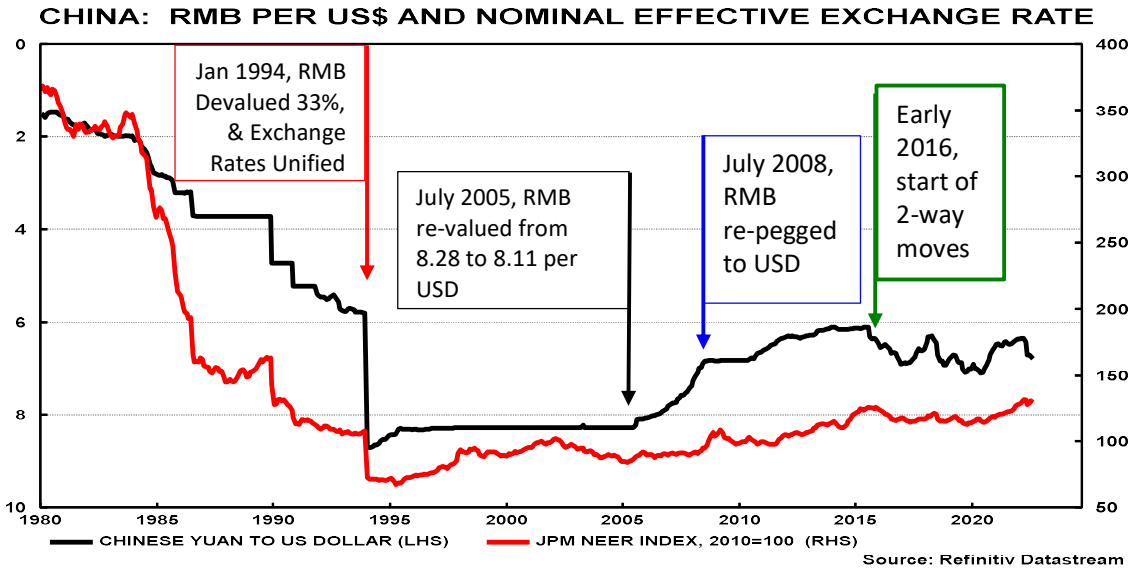
particularly important to understand how the present set of arrangements impacts the growth of the broad quantity of money in China. I will also attempt to correct some common misunderstandings about the current monetary policy regime.

1. The Fixed Exchange Rate, Stop-Go Phase, 1978-2005

During the early stages of liberalisation of the Chinese economy, the main nominal anchor for China's monetary policy was the nominal exchange rate which was pegged to the dollar until July 2005. As shown in Figure 2, a series of devaluations was needed in the 1980s and 1990s to bring the official market value of the exchange rate into line with its purchasing power on international markets, notably the 33% realignment implemented by Premier Zhu Rongji in January 1994. This devaluation was accompanied by the elimination of multiple exchange rates such as that for Foreign Exchange Certificates (FECs), the rate that had applied for foreign tourists in China.

Following a period of minor adjustments to the currency in 1994-95, the RMB remained fixed at RMB 8.27-8.28 against the USD until July 2005.

Figure 2: China's Currency – From Pegged Rate (with devaluations) to Managed Rate (with appreciation and depreciation)



The result of this system with its large-scale, crude interventions in the foreign exchange market was a stop-go pattern of growth in the money supply, economic activity, and inflation, reminiscent of Japan under the Bretton Woods system of fixed exchange rates between 1955 and 1971.

2. The Shift to a Managed Exchange Rate, 2005-16

A break in monetary management came with the decision in September 2002 to begin sterilisation operations, indicated in Figure 3, and described below. Although this decision was successful in preventing another episode of runaway M2 growth and hence inflation in 2003-04, I have chosen to date the shift of monetary policy regime from July 2005 when the PBC revalued the RMB *upwards* against the USD by about 2 percent. The reason is that July 2005 marked the State Council or PBC's public commitment to a combination of a more flexible currency ***and*** the parallel domestic operations required to minimise the destabilising effects of the foreign exchange interventions which had previously disrupted monetary growth.

Thereafter the RMB was managed against an undisclosed basket of currencies. Officially the China Foreign Exchange Trade System (CFETS) had been created in April 1994. In practice, the renminbi remained tightly managed against the USD, with the PBC subsequently indicating that on any given trading day the bilateral exchange rate would be allowed to float within a band of 0.3 percent relative to the closing price of the previous day. The RMB was repegged to the dollar in July 2008 during the global financial crisis (GFC) and then once again allowed to appreciate against the dollar starting in June 2010. In April 2012, the floating band was widened to 1.0 percent per day.

The importance of these changes in the management of the foreign exchange rate for the RMB is the extent to which they eased or restricted the PBC's ability (1) to manage the money supply (M2), and (2) to begin to use conventional monetary policy instruments such as interest rates or open market operations.

Figure 3. Three Phases of China's Monetary Growth

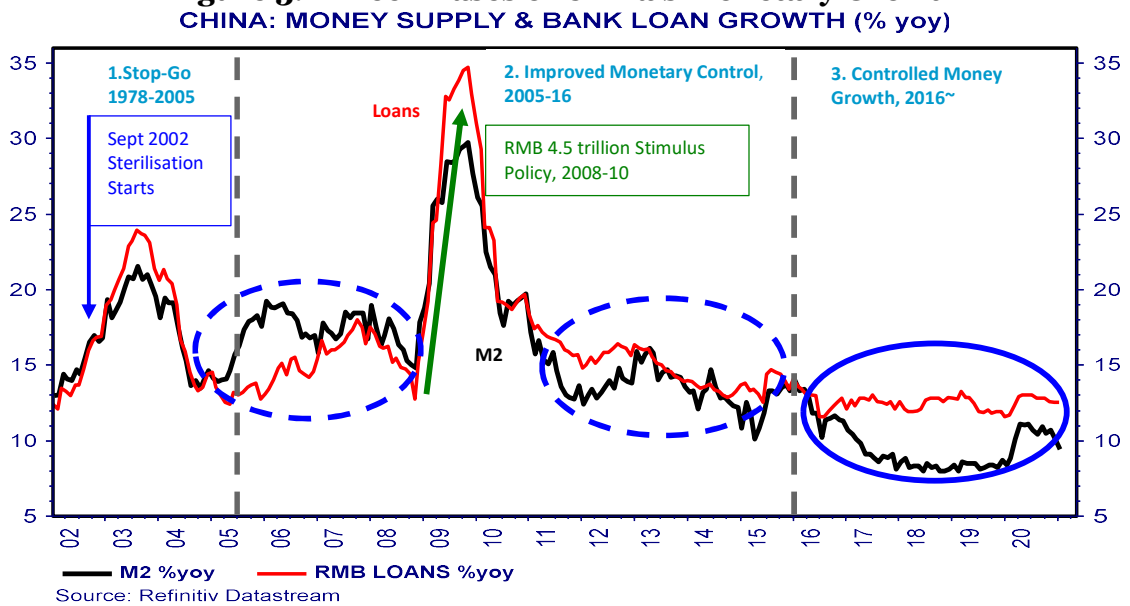
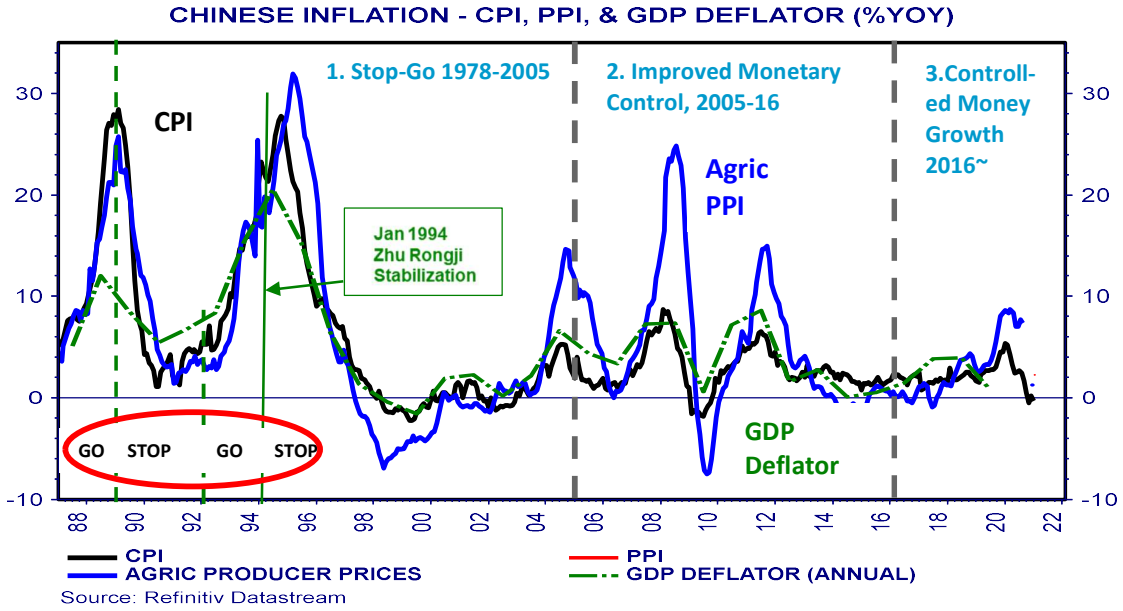


Figure 3 illustrates the gradual improvements in monetary control. First, sterilisation was begun in September 2002 at a time when M2 was accelerating sharply as a result

of growing external surpluses. Past experience had taught that such episodes led to surging money growth and inflation (see Figure 4), something the authorities clearly wished to avoid. The effect of sterilisation was that M2 was brought under control in the years highlighted by the two blue dashed ovals (2005-08 and 2011-16). The solid blue oval in Figure 3 illustrates the continued controlled M2 growth in recent years to be discussed in Section 3 below.

Figure 4. Under "Stop-Go" Inflation had Fluctuated Widely, but under Controlled M2 Growth Overall Inflation Fluctuated much less.



The results of the various phases of monetary control are shown in Figure 4. The "Stop-Go" phases under rigidly fixed exchange rates with no sterilisation resulted in at least two episodes of high inflation – the first coinciding with the Tiananmen Square protests of 1989 and the second leading to the drastic exchange rate adjustment in January 1994 by Premier Zhu Rongji[3]. Note that in this period as well as subsequent periods food and agricultural prices dominate the consumer price index in China.

The rigid commitment to a particular foreign exchange rate had required potentially large-scale interventions by the PBC implying, for example, simultaneous purchases of foreign exchange and sales of (i.e., creation of) domestic currency. The latter inevitably had a disruptive impact on the growth of the quantity of money, leading to expansion and ultimately to inflation (and the opposite for interventions on the other side). A less rigid commitment to any particular foreign exchange rate became necessary for domestic stability, but the question was how to achieve it?

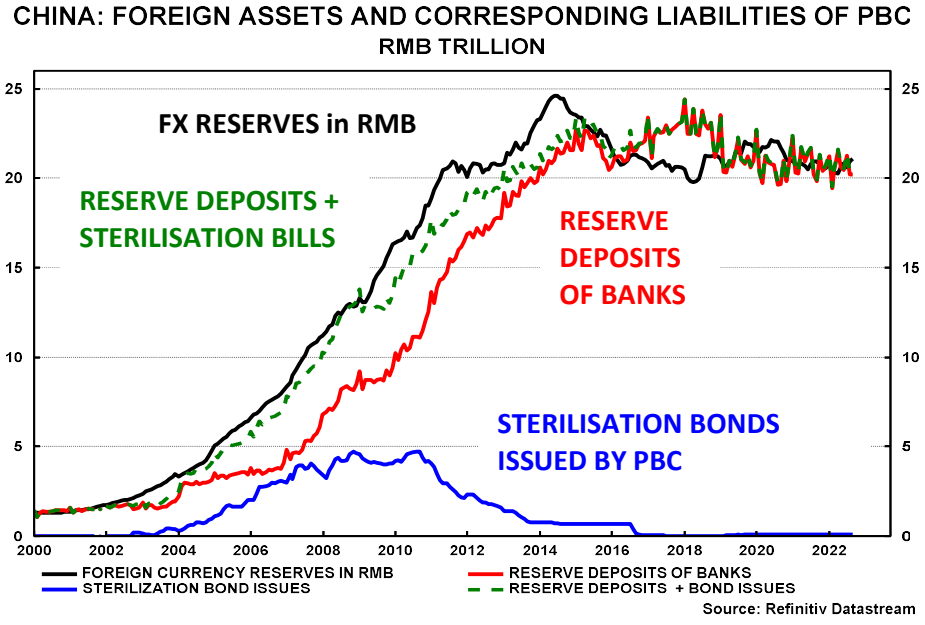
[3] There was at least one earlier episode of inflation between 1978 and 1987 but I was unable to obtain consistent data from standard sources.

The first technique adopted to sterilise the disruptive effect of inflows and outflows of foreign exchange on domestic monetary growth was a carbon copy of the devices used by other Asian central banks such as the Bank of Korea, the Central Bank of China in Taiwan, and the Bank Negara Malaysia in the 1980s and 1990s.[4] Each of these central banks had issued locally-denominated bills, bonds or other short-term instruments to sell to the domestic money markets, thereby absorbing excess liquidity from the banking system.

In the case of the PBC, the instruments were called Bond Issues (发行债券), sold primarily to the banks. In effect, having purchased foreign exchange from the banks and provided them with new RMB reserve deposits in exchange, the PBC was then selling them a bond to "absorb" the excess liquidity that the banks now had on their balance sheets. However, it soon became apparent, as had happened in Malaysia and elsewhere, that the issuance of local paper was expensive in interest rate terms and an alternative technique was sought.

The solution, and the second sterilisation technique adopted by the PBC from mid-2006, was to use changes in reserve requirements in place of sterilisation or PBC bonds since banks' reserves at the PBC were unremunerated and in that sense costless to the PBC. Accordingly, and as illustrated in Figure 5, sterilisation bond issues gradually built up to RMB 4.7 trillion (about US$ 700 billion) by 2008-10 but were then systematically reduced to cut the interest expense to the authorities.

Figure 5. The Policy of Full Sterilisation

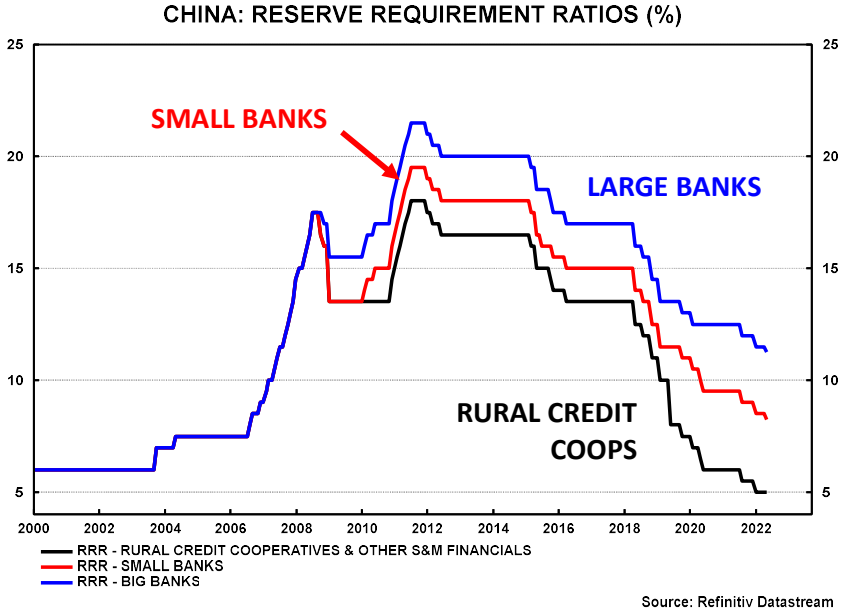


[4] The Bank of Japan had adopted sterilisation techniques in the mid-1960s when the economy began to experience large external surpluses. The purpose was to minimise the impact of foreign exchange inflows on the growth of M2 and thus avoid the inflation that was starting to accelerate in the US. At this time BOJ sterilisation consisted mainly of sales of JGBs to the banks rather than the issuance of new liabilities by the BOJ. It is my view that these operations helped to precipitate the break-up of the Bretton Woods agreement.

If we add the sterilisation bills together with the reserve requirements (both in RMB) and compare with the total foreign exchange reserves expressed in RMB we find that China was effectively following a policy of full sterilisation. In other words, virtually all the inflows of foreign currency accumulated by the PBC between 2006 and June 2014 (the peak in FX reserves) were prevented from having an expansionary effect on the money supply (M2) initially by the issuance of PBC bonds, and then from 2006 onwards by repeated increases in reserve requirement ratios imposed on the banks.

To reinforce this point, it is worthwhile to review the history of changes in the so-called "triple R" or reserve requirement ratios in China since 2000. Figure 6 shows these ratios for three different categories of banks. The biggest increases in the RRR were between June 2006 and June 2008, followed by another series of increases

Figure 6. The PBC's Active Use of Reserve Requirement Ratios



between December 2009 and June 2011 when the rate reached an astonishing 21.5% for large banks. Since then, however, the ratios have been consistently lowered, though in slightly varying amounts depending on the category of the banks concerned.

Before turning from the second phase of China's post-reform monetary policy to the current or third phase of monetary policy in China (2016-22), there are two other topics that need to be understood by students of Chinese monetary policy: the departure from monetary control due to the GFC, and the problems generated by the PBC's policy of an "upward crawl" for the exchange rate its interaction with the carry trade.

2.1 The GFC-Induced Departure from Monetary Control

Between the periods designated by the two dashed ovals in Figure 3, there was a temporary but deliberate departure from the regime of **monetary control through full sterilisation.** The purpose was to counter the effects of the GFC. China's prosperity at this time had been largely built on manufacturing export success. In the six years preceding the GFC (2003-2008) China's exports of goods had grown at an amazing average rate of 29.5% p.a. in US$ terms. Seeing global trade volumes plummet in 2008, the Chinese authorities therefore responded with a huge fiscal stimulus of RMB 4.5 trillion, or about 6% of GDP. In practice the stimulus was implemented at local rather than central government level by instructing the state-owned banks to fund deficit spending programmes by provincial and municipal entities. By funding the fiscal stimulus programme through lending or money creation by the banks, China was almost the only country in the world to implement a **monetary stimulus** in response to the GFC – even though it continued to be described by the Chinese authorities as a "fiscal stimulus".

The stimulus from a year and a half of 25% M2 growth between January 2009 and June 2010 showed up in exactly the way monetary analysis would have predicted. The first effect was on asset markets: the Shanghai Stock Exchange Composite Index doubled from 1,729 in October 2008 to 3,412 by July 2009, while home prices increased at double-digit rates in the year to spring 2010. The second effect was on the economy where GDP recovered strongly in 2009-10, from a trough of 6.4% year-on-year in 2009 Q1 to reach 12.2% year-on-year by 2010 Q1. Finally, CPI inflation surged from -1.8% in July 2009 to 6.5% year-on-year in July 2011.

The downside from this brief period of successful policy stimulus was the impact on the shadow banking market – a development which was much more sustained. Because interest rates had not been liberalised, real returns on deposits turned negative as inflation rose, encouraging banks and other lenders to offer off-balance sheet Wealth Management Products (i.e., high risk, high return securities, loans or trust products), in turn spawning a big increase in leverage across the corporate and household sectors. The surge in leverage dating from the authorities' post-GFC policy errors is precisely what lies behind the real estate crisis in China today.

2.2 The Problem of the Carry Trade and its Impact on China

The second phase of post-reform monetary policy, which I have called "Improved monetary control, 2005-16," had been prompted by the start of a renewed upward surge in M2 growth in 2002. The PBC was able to prevent a repeat of the inflationary episodes of 1989 and 1993-94 first by introducing sterilisation tools (from September 2002), and second by making upward adjustments in the exchange rate (from July 2005). However, it was by no means all smooth sailing from 2005 onwards. Aside from the non-negligible costs of sterilisation – i.e., the distortions to interest rates, the cost to consumers of not allowing the RMB exchange rate to appreciate, and the resulting misallocation of capital from these first two effects – another major problem turned out to be unexpectedly large capital inflows. The inflows were

prompted first by the PBC's policy of steady RMB appreciation and second by the ability of Chinese firms to borrow currencies such as the USD, HKD, or JPY at interest rates significantly lower than mainland Chinese rates, convert these to RMB, and remit them to the mainland. Chinese corporates proved highly adept at engaging in large-scale, highly profitable carry trades.

What brought the second phase of Chinese monetary policy to an end was the sudden depreciation of the RMB in 2015 and the associated loss of close to US$ 1 trillion of foreign exchange reserves in 2015-16 as the PBC intervened to prevent too large a depreciation of the currency. Carry trades are notoriously vulnerable to any appreciation of the funding currency, but this was exactly what happened from August 2015. Having built up carry trades amounting to close to $1 trillion (based on BIS figures), numerous Chinese firms realized that they would be suddenly and seriously exposed if the RMB stopped appreciating and/or the funding currencies appreciated.

Over the ten year period 2005-2015, China's currency had appreciated 33% against the U.S. dollar, giving carry traders guaranteed profits. However, on August 11, 2015, the PBC surprised markets with three consecutive devaluations of the Chinese yuan renminbi (or CNY), knocking more than 3% off its value. The initial devaluation, though small, marked the most significant single drop in 20 years. This was enough to frighten speculators who promptly started to reverse their carry trades, precipitating a surge of RMB sales to generate the foreign currency with which to repay the lenders. In the space of just over a year China's foreign exchange reserves fell by $1 trillion.

From a monetary management perspective, there had to be a better way to manage China's currency. Effectively the PBC had been guaranteeing the carry-traders' profits by offering an easy one-way bet – a continuously appreciating currency with a consistently higher interest rate at home than was available on foreign currencies. The one-way inflows had added to the already large current account surplus, requiring increased sterilisation (by now implemented by means of RRR hikes) and a potentially greater risk to the PBC of losing control of money growth again. To resolve the problem the PBC was forced to act: stop the one-way appreciation of the currency by introducing two-way movement of the currency, and/or find an alternative way of sterilising any inflows other than by ever-higher RRR levels.

3. The Pivot to Better Controlled Money Growth, 2016-22

The PBC solved its dilemma by pivoting to a third regime for monetary control. This time, instead of relying on foreign currency reserves to form the bulk of the PBC's asset counterpart to the monetary base (its monetary liabilities), the authorities evidently realised that they could achieve the same result **by using domestic assets** as one of the main counterparts to monetary base growth. Exactly what triggered the change in management style we shall probably never know, but my guess is that as the $1 trillion of foreign exchange reserves flowed out, PBC officials must have been concerned that if they allowed those outflows to translate into a

decline in banks' reserves at the PBC, leading in turn to slower broad money (M2) growth, this could have a drastic contractionary effect not only on the rate of growth of the quantity of money, but on the economy itself.[5]

Figure 7. The PBC Pivots to Domestic Assets to Manage Monetary Growth

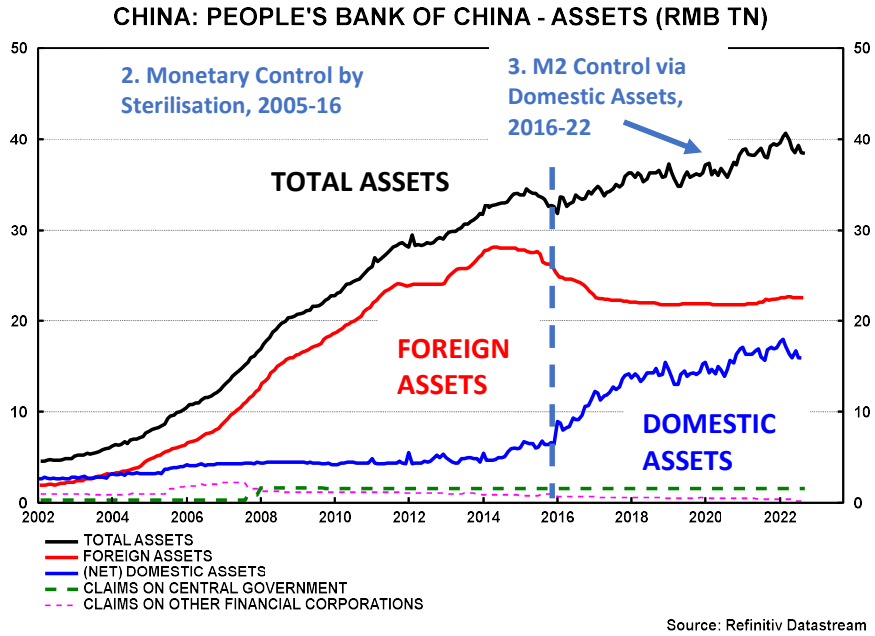


Figure 7 shows the development of the PBC's asset mix since 2002. As set out in my explanation of the PBC's policy of **"full sterilisation"** (pp. 6-7), until 2016 the asset counterpart to the monetary liabilities of the central bank was almost entirely comprised of foreign exchange reserves. With the $1 trillion carry-trade unwind and the associated outflows and depreciation of the RMB in 2014-16, the PBC pivoted from managing the currency within very tight ranges by means of interventions in the FX market plus sterilisation to:
(1) allowing the FX rate to fluctuate (slightly) more freely and more widely, while
(2) refraining from FX intervention, and
(3) using domestic credit instruments to create the reserves for banks which would in turn allow or encourage the requisite growth of the quantity of money.[6]

What are the domestic instruments which the PBC uses for these monetary purposes? In recent years, starting prior to its "pivot" to using domestic instruments, the PBC has introduced numerous new lending facilities. These include:

[5] The relevant figures here are as follows. Banks' reserves at the PBC in 2014 were close to RMB 22 trillion. If the PBC had sold $1 trillion in FX to banks and debited banks' reserves in RMB an equivalent amount during the period that the carry trades were being unwound (June 2014 to January 2017) and the RMB was depreciating, this would have depleted banks' reserve balances at the PBC by approximately RMB 6.40 trillion i.e., $1 trillion times the average RMB/USD rate during the period of currency depreciation and reserve losses, or by over one third of banks' reserve balances.

[6] Note that this does *not* mean that banks would lend reserves. Reserves are used for settlement among banks, not for lending. An increase in reserves generally lowers money market rates, and it is the lower rates that encourage borrowers to borrow or lenders to lend, not the additions to reserves.

- **Reverse repos** to inject funds temporarily . These self-liquidate on maturity.
- **Repos** to withdraw funds temporarily.
- **a Standing Lending Facility (SLF)** for 1-3-month loans to banks introduced in 2013
- **a Medium-term Lending Facility (MLF)** for 3-12-month loans to banks, introduced in 2014. This rate now serves to guide the loan prime rate (LPR), China's benchmark lending rate.
- **Pledged Supplementary Lending (PSL)** for long-term loans to "policy banks" such as the China Development Bank, the Agricultural Bank of China, and the Export-Import Bank of China
- **"Structural Monetary Policy Tools"** to lend to specific sectors. For example, on May 6, 2022, PBC announced a RMB 100 billion relending facility ($15 billion) to support the transport, logistics and storage sectors. On May 3, it announced it had lent an additional RMB 100 billion to coal production and storage.

Except for repos, all of these are designed to inject funds. The blue line in Figure 7 shows the sum of all these types of lending facility plus some residual domestic assets held by PBC. In August 2022, these facilities amounted to nearly RMB 16 trillion, or 41% of the PBC's RMB 38.5 trillion balance sheet, a decisive break from the previous pattern before 2015 when FX assets accounted for almost its entire asset base.

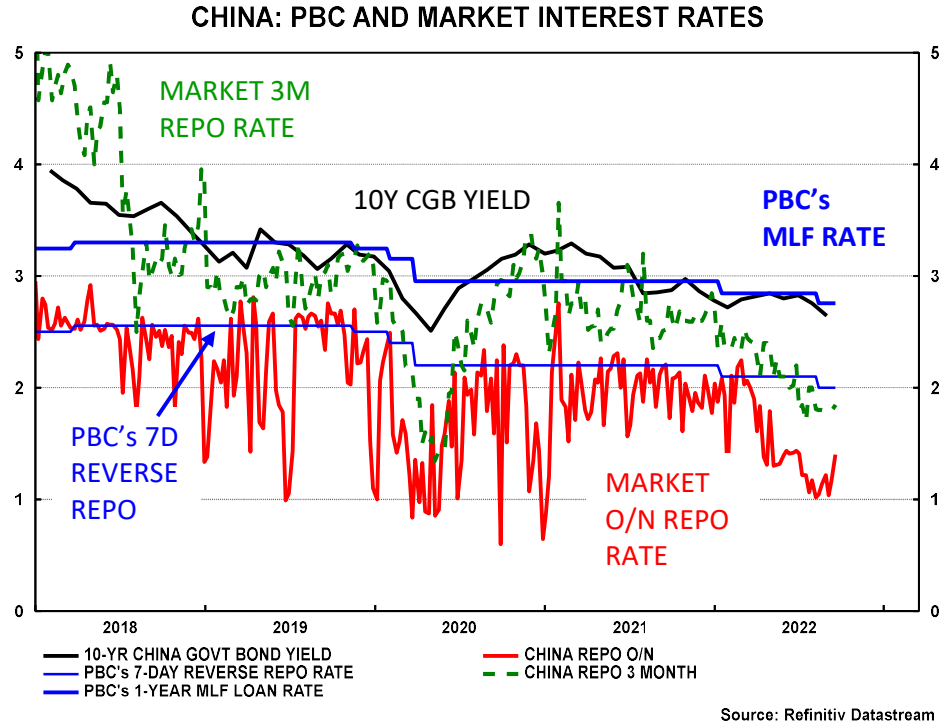
Does the change in composition of the PBC's assets change or in any way undermine the safety or stability of the value of the RMB – as some analysts have claimed? The answer is a definitive "No!" What matters is the quantity of RMB issued relative to domestic and foreign demand for RMB money balances, not the assets backing the currency or the assets corresponding to the monetary base. Readers should also note that it is not even correct to say that the growth of the monetary base is any guide to the strength or weakness of the RMB since the ratio of the monetary base to broad money (M2) can and does change. For confirmation, consider the widely differing currency performances of the USD, the GBP, the EUR, or JPY – all currencies that have seen big increases in the ratio of the monetary base to broad money since the GFC and again since the onset of the Covid-19 pandemic. In 2021-22 the strength of the USD is completely at odds with any calculus of the growth of the Fed's balance sheet (which has roughly doubled since February 2020) and the amount of money (M2) created (which is up 41% since February 2020).

Contrary to the analysis presented here, numerous commentators have also asserted that the PBC has been easing policy persistently since the start of the Covid pandemic. These commentaries typically focus on injections of new loans via the facilities listed above, or rate cuts by the authorities and changes to official administered rates, together with changes to the RRR.

Taking each in turn, the problem with looking at the injections of new lending by the PBC is that unless these figures are offset daily against maturing loans by the PBC or cancellations of any outstanding loans, the total injection may well be overstated, giving an impression of greater easing than is warranted.

Rate cuts may or may not be stimulatory, depending on the going market rates (see IMM Newsletter #4, Figure 2, p. 4) . During the calendar year so far, the PBC has lowered its one-year MLF loan rate and its 7-day reverse repo rate twice, the most recent cut in August taking the rates to 2.75% and 2.0% respectively, as shown by the blue lines in Figure 8. The chart also shows that free market rates have fallen much more than the PBC's reverse repo rate, suggesting that the PBC may be falling behind the curve – i.e., not be cutting rates sufficiently rapidly to ensure that money growth accelerates further. In short, in China as elsewhere, judging monetary policy only on the basis of the level or change in interest rates is a risky business. It is always better to judge the stance of monetary policy based on broad money growth, assessing whether the growth rate of money is stable, accelerating or decelerating.

Figure 8. Chinese Rates are Falling, but is Money becoming Easier?



Turning to RRR cuts, as shown in Figure 6 the authorities have been cutting the required reserve ratios for the past decade (since November 2011), but again, does that make money market conditions easier in the sense of ensuring a faster rate of growth of broad money? Given my interpretation of the RRR changes over the previous decade when they moved steadily upwards as part of the PBC's policy of "**full FX sterilisation**", we can analogously interpret the reductions in the RRR not necessarily as a liquidity-enhancing device, but as a mechanism for unwinding the previous policy of sterilisation.

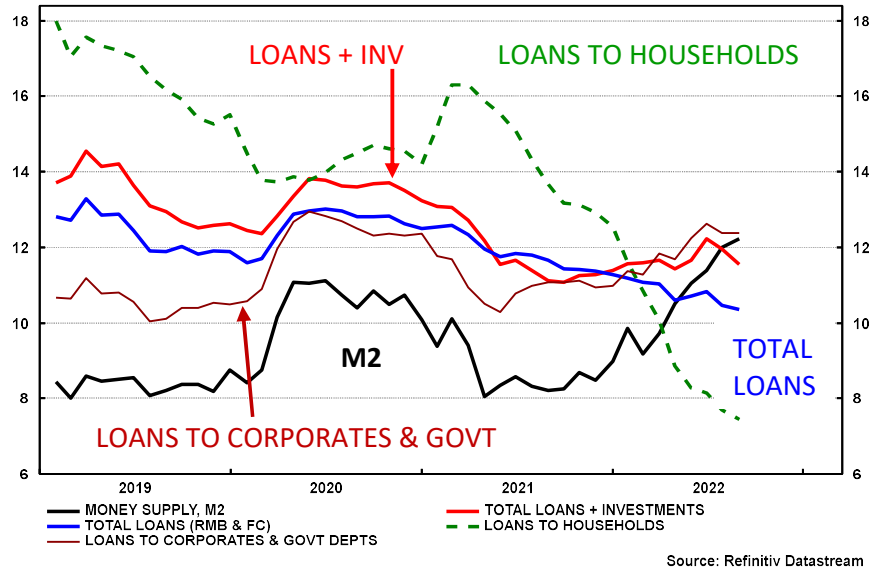
In other words, in a strategic sense RRR cuts are a way to change the backing for the monetary base from predominantly foreign assets to domestic assets. As the PBC reduces the RRR, it is simultaneously shifting the composition of its assets from FX

to domestic assets. The central bank needs to do this to prevent a slump in M2 growth.

Viewed differently, having been under pressure during the decade to 2011 to limit monetary expansion by sterilisation, in the past few years the pressures are now in the opposite direction: deleveraging, slower economic growth due to lower population growth, less migration to the cities, and the shutdowns due to the pandemic are all taking their toll. It is therefore proving hard for bank lending and rate adjustments by the PBC to promote adequate money growth. Against this backdrop, RRR cuts are not a panacea that will ensure an acceleration of monetary growth.

Figure 9. M2 Money Growth Peaking at 12%

CHINA: M2 & BANK LENDING AFTER ONSET OF COVID (% YOY)



Source: Refinitiv Datastream

Since September 2021, M2 has accelerated from 8.3% year-on-year to 12.2% in August 2022. Normally one would expect this kind of acceleration to create scope for a Chinese asset price recovery – and maybe there will be one as and when the current crop of problems – the continuing Covid pandemic, the property market crisis, the domestic regulatory squeeze on tech companies, and the restrictions imposed by foreign governments on access by China's tech giants to foreign technology – have been overcome. However, sentiment is poor, and economic growth has plunged, while interest rates (read monetary growth) is tightening elsewhere in the world. It is therefore hard to hold out much hope that Chinese asset prices will be rising independently from Wall Street.

Moreover, as shown in Figure 9, against the background of the crisis in China's property market, bank lending to households (for mortgages) has plunged. The modest rise in lending to the corporate and government sectors is so far barely compensating for that decline. However, we should not exaggerate the extent of the liquidity squeeze or the slowdown. For an economy that grows at 5% p.a. in real terms, where citizens are adding to their real money balances at a rate of 2.7% p.a.

(the trend since 1997), and where the central bank has a 2% inflation target, the optimum M2 growth rate is close to 10% (5+2.7+2=9.7%). The PBC should therefore be careful not to repeat the mistake of 2008-10 when the authorities injected or allowed too much money growth, but equally it must also cut rates enough to prevent the opposite mistake – i.e., causing M2 to slow sharply .

Summary and Market Implications

- Since Deng Xiaoping's Four Modernisations in 1978 and the opening of the Chinese economy to global trade and investment, the PBC has pursued three distinct monetary policy regimes.
- The first phase (1978-2005) saw a nominally fixed exchange rate regime, albeit with numerous devaluations due to the RMB rate having become massively overvalued under the closed economy prior to modernisation.
- In the second phase (2005-2016), the PBC moved to a managed exchange rate system that enabled improved monetary control thanks to the introduction of sterilisation techniques.
- In the third, current phase (2016-2022) monetary control has improved again due primarily to the PBC providing credit via domestic asset purchases and loans instead of from foreign assets derived from FX intervention. But not all problems of monetary management have been resolved.
- Despite a moderate upswing in M2 growth to 12%, numerous headwinds confront investors in Chinese assets – including continuing lockdowns due to Covid, the crisis from the unwinding of leverage in the property market, and constraints imposed on China's leading tech companies by domestic and foreign governments.
- Moreover, Chinese equities are unlikely to buck the trend of declines in Wall Street-correlated markets on any sustained basis.
- Whereas most western central banks will be ***raising*** interest rates over the next 6-12 months, the PBC probably needs to be ***reducing*** rates, which will likely exacerbate the downward pressure on the RMB.
- These trends imply a favourable environment for investment in Chinese government bonds (thanks to low inflation and falling interest rates), but corporate bonds will remain exposed to the risks of economic slowdown and corporate over-indebtedness. For the next few months at least, any holdings of CGBs should be hedged against further weakening of the RMB.
