CHINA REMOVES INTEREST RATE FLOOR IN NEXT STEP OF CURRENCY LIBERALIZATION

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As we mentioned in a publication last year, a necessary step along the internationalization glide path of the Chinese yuan requires the liberalization of interest rate policy. In effect, market forces, not government policy initiatives, should be relied upon to set borrowing and lending rates. On July 19, the Chinese government announced that they would be removing the floor on loan rates in China[1]. By taking this step, policy makers are signaling that market-determined interest rates may be coming sooner rather than later. This recent announcement appears consistent with the reform-minded agenda mentioned by Premier Li Keqiang in April. To paraphrase, the government needs to "get out of the way" in order to allow the Chinese economy to rebalance and grow. For investors, however, this recently announced policy change appears more symbolic than market moving. Over a month ago, investors were put on edge after a series of spikes in the Shanghai Interbank Offered Rate (SHIBOR) rattled markets. These rates have since normalized, but to many market participants the move proved that the Chinese government was willing to tolerate short-term volatility for long-term gain. However, Premier Li also clarified that China would not tolerate economic growth below 7% (compared to the government's current 7.5% target)[2]. But what do these new policy announcements ultimately mean for investor portfolios? As many economists have noted, the impact of the Chinese government's recent move is probably less important for the short term but could have more significant ramifications in the long run. In the coming months, we are anticipating a series of market-oriented reforms relating to Chinese economic policy. These reforms have been noted by many sources but include: • Longer-term certificate of deposit (CD) rates may be liberalized to be determined by market forces; this change could offer Chinese savers the prospect of positive real interest rates • Expansion to 2.00% in the daily trading band (from 1.00%) for the Chinese yuan These developments could prove significant for a couple of reasons. Given China's historically high savings rates, many middle-class Chinese savers have had limited investment options. The prospect of positive real interest rates could further incentivize saving and also act as a way for the Chinese government to gradually dampen the residential real estate market. Critics of China's housing market claim that prices have appreciated too quickly due to a lack of other investment options in China. A slowing in the pace of real estate price increases could accomplish yet another government policy initiative: a broadening of middle class access to affordable housing. The widening of the trading band to 2.00% could represent another step in China's gradual and pragmatic approach to a "free-floating" Chinese yuan. When Chinese policy makers announced that the band would be widened to 1.00% in April 2012, many investors assumed that policy makers would tolerate the potential for increased volatility in the Chinese exchange rate. Should this reform occur, the 2.00% trading band could be similar to other "managed-float" currencies in Asia. Ultimately, both policies appear consistent with the government's stated policy goals of reducing risk in the financial system and creating a development glide path to a more broadly accessible Chinese yuan that also promotes its wider use for international trade. So far in 2013, the Chinese yuan has been one of the best-performing emerging market currencies against the U.S. dollar. Continued policy reforms may create a situation where short-term pain (via slower economic growth) ultimately leads to a more efficient and healthy economy in the long run. [1]Source: http://news.xinhuanet.com/english/china/2013-07/20/c_132557311.htm [2]Source: http://www.bloomberg.com/news/2013-07-23/li-s-government-sees-7-as-growth-bottom-line-chinese-media-say.html

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free-floating : an exchange rate regime whereby the value of the currency is determined by supply and demand against other currencies.

Managed-float : an exchange rate regime whereby the value of the currency is allowed to float around a proscribed range. The central bank intervenes in the market to maintain the trading range or to limit volatility.