

## ***Chinese Yuan Continues to be Stable Even after Downgrading of China's Credit Rating and U.S. Rate Hike***

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10 JULY 2017

(ORIGINAL JAPANESE VERSION RELEASED ON 23 JUNE 2017)

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China's most recent economic data shows that its economy remained stable in May. Exports accelerated from the previous month and showed stable growth at +8.7% YoY (see table 1). Retail sales also continued double digit growth at +10.7% YoY, unchanged from the previous month, although faced with a head wind from the reduction in tax cut on small-engine automobiles that started in the beginning of the year. Fixed asset investment slightly slowed down to +8.6% YoY growth. Growth of fixed asset investment was hampered by a slowing of infrastructure investment which grew by more than 20% YoY and a tightening of regulations to avoid a property bubble, while fixed asset investment in the machinery industry is accelerating.

The robust economy of China has been supported by credit growth. Chinese authorities have started to engage in deleveraging since the beginning of the year by increasing the operation interest rates and tightening regulations on shadow banking activities. However, outside of China, the Bank of International Settlements (BIS) and IMF have warned of China's growing debt since last year. U.S. rating agency Moody's downgraded China's credit sovereign rating on May 24 for the first time in 28 years mainly due to concerns over rising debt across the country and deteriorating financial conditions.

In response to the downgrading of China's credit rating, the People's Bank of China (PBOC) took immediate actions to prevent the depreciation of the yuan and capital outflows from the country. The China Foreign Exchange Trade System, a subsidiary of the PBOC, announced on June 26 that Chinese authorities are considering adding a "counter-cyclical factor" to its existing pricing model of the daily yuan reference rate against the US dollar, which uses the previous day's official closing price and changes in baskets of currencies. However, the details of the counter-cyclical factor are not clear yet. The new reference rate formula is considered to be introduced to give more discretion to the PBOC in pursuing its efforts to reduce exchange-rate volatility. In fact, the PBOC set the daily yuan reference rate further stronger against the USD in June (see chart 1). This action by the PBOC can be seen as demonstrating its intention to protect the yuan with a view to future interest rate hikes in the U.S. There is a criticism of the government-controlled market. However, the result of these actions has, in fact, been to stabilize the yuan's exchange rate.

Markets continue to show expectations of a future depreciation of the yuan due to fundamentals such as fears over slowing Chinese economy and rising interest rates in the U.S. Since China will have decreased the need for measures to stabilize the yuan rate including capital controls, after the National Congress of the Communist Party in autumn, there is a good possibility of returning to the declining trend.

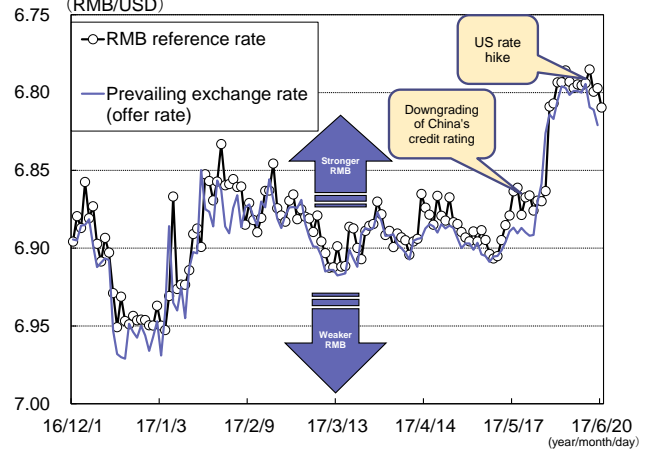
Table 1: Main Economic Indicators (China)

	2016	2017				
	Dec	Jan	Feb	Mar	Apr	May
Exports (YoY, %)	-6.2	3.8	16.4	8.0	8.7	
Imports (YoY, %)	3.1	26.3	20.4	11.9	14.8	
Fixed Assets Investment (YTD, YoY, %)	8.1	8.9	9.2	8.9	8.6	
Retail Sales (YoY, %)	10.9	9.5	10.9	10.7	10.7	
Industrial Production (YoY, %)	6.0	6.3	7.6	6.5	6.5	
Manufacturing PMI	51.4	51.3	51.6	51.8	51.2	51.2
Non-manufacturing PMI	54.5	54.6	54.2	55.1	54.0	54.5
CPI (YoY, %)	2.1	2.5	0.8	0.9	1.2	1.5
PPI (YoY, %)	5.5	6.9	7.8	7.6	6.4	5.5

Note: 1) Manufacturing PMI and Non-manufacturing PMI are from China National Bureau of Statistics.  
 2) Shadowed portion indicates lower growth rates or decline in indicators from previous months.

Source: China National Bureau of Statistics, BTMU Economic Research Office

Chart 1: Changes in RMB/USD Exchange Rate (RMB/USD)



Source: The China Foreign Exchange Trade System, BTMU Economic Research Office

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