



Flash note

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Ya-Lan Liu

Economic Research

yalan@grupobbva.com

What happens to China when the US cut rates?

- The rate cut in the US should help sentiment on the stock market, but it will probably have a limited impact on China's real activity for the time being. Potential risks on growth outlook should arise from a weakening external demand with China's export growth being negatively affected in the near-term. In addition, domestic demand could be negatively affected contingent upon a sharp and/or prolonged external economic slowdown.
- A widening China-US interest rate differential is likely to increase pressure on the renminbi to appreciate. The People's Bank of China (PBC) is likely to be more reluctant to raise interest rates and to rely more on administrative measures to control both prices and bank credit growth. However, PBC's monetary stance will maintain a "tightening" bias as real savings rate remains negative and will not start to ease until macro indicators point to a sharp downturn.
- Under the constraint imposed on Chinese monetary policy, the authorities will probably rely more on administrative measures such as the recent halt to domestic price increases for oil products, energy, public utilities and transportation. Without faster renminbi appreciation, it will be more difficult for the government to bring down the inflation rate in China in a short period of time.
- The eye of the hurricane lies in the US but assuming a more open and globally integrated China than ten years ago, she is not completely insulated. But, there are strong forces that should mitigate the impact on i.economic growth and ii.financial markets.
 - i. China's economic growth could be sustained by domestic demand in 2008 as a new cabinet takes place and historically it has coincided with increased public expenditure and infrastructure investments. Also, China has room to launch fiscal stimulus, though a large-scale fiscal package would need to be approved by the National People's Congress (which starts on March 5th this year) and it usually takes a longer time to become effective so it could be a policy tool for the medium term.
 - ii. Financial markets should be supported by China's existing controls on capital outflows. Overall, China is a net lender, not a borrower; its current account is in massive surplus, not in deficit; domestic banks earnings rely on financial margin, not on subprime investments and in a ironic twist of events, China's and other Asian sovereign wealth funds or banks are sought after to inject capital in US financial institutions unlike some ten years ago.
- Fundamentals in the rest of the Asian region are in better shape, monetary conditions are still supportive to growth and financial and corporate sectors have been conservative rather than aggressive since the Asian financial crisis.

- **In addition to global developments, a close monitoring to the next economic data releases in the region will help to assess the resilience of exports and domestic demand contingent upon the magnitude and duration of the external shocks.**