Does the Chinese Interest Rate Follow the US Interest Rate?

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Summary

One argument for floating the Chinese renminbi (RMB) is to insulate China's monetary policy from the US effect. However, we note that both theoretical considerations and empirical results do not offer a definite answer on the link between exchange rate arrangement and policy dependence. In this paper, we examine the empirical relevance of the argument by analyzing the interactions between the Chinese and US interest rates. The bounds test proposed by Pesaran, Shin and Smith (2001) is employed to test the interest rates' dependence, based on an autoregressive distributed lag model. Our empirical results, which appear robust to various assumptions of data persistence, suggest that the US effect on the Chinese interest rate is quite weak. Apparently, even with its *de facto* peg to the US dollar, China has alternative measures to retain its policy independence and de-link its interest rate from the US rate. In other words, the argument for a flexible RMB to insulate China's monetary policy from the US effect is not substantiated by the observed interest rate interactions.