China and the Fed: how different this time?

by GAVYN DAVIES∗

Exactly a year ago, the markets were entering a melt-down because of fears of inappropriate Fed tightening and a sudden devaluation of the Chinese RMB. Within weeks, global equities had fallen by 13 per cent. There are some similarities this year, but also important differences. Although the Fed has tightened again, the Fulcrum “economic shock” models suggest that markets are being driven by a positive shock to global activity, not an adverse monetary shock from the Fed. In China, the risks of a sudden RMB devaluation seem less than they did a year ago, but there is a new source of worry – the attitude of the incoming Trump administration to protectionist measures aimed at China and Mexico. This seems to be the main risk facing global risk assets at present.

Exactly a year ago this week, the mood in the financial markets started to darken markedly. As 2015 had drawn to a close, financial markets had seemed to have weathered the first increase in US interest rates since 2006 in reasonable shape. The Federal Open Market Committee had telegraphed its step to tighten policy in December 2015 with unparalleled clarity. Forewarned, it seemed, was forearmed for the markets.

Meanwhile, China had just issued (see Davies 2016) some new guidance on its foreign exchange strategy, claiming that it would eschew devaluation and seek a period of stability in the RMB’s effective exchange rate index. This had calmed nerves, which had been elevated since the sudden RMB devaluation against the dollar in August 2015.

A few weeks later, however, this phoney period of calm had been completely shattered. By mid February, global equity markets were down 13 per cent year-to-date, and fears of a sudden devaluation of the RMB were rampant. It seemed that the Fed had tightened monetary policy in the face of a global oil shock that was sucking Europe and China into the same deflationary trap that had plagued Japan for decades. Secular stagnation was on everyone’s lips.

We now know that the state of the global economy was not as bad as it seemed in February, 2016. Nor was the Fed as determined as it seemed to tighten US monetary conditions in the face of global deflation. And China was not set upon a course of disruptive devaluation of the RMB. Following the combination of global monetary policy changes of February/March last year, recovery in the markets and the global economy was surprisingly swift.

A year later, the key question for global markets is whether the Fed and the Chinese currency will once again conspire to cause a collapse in investors’ confidence. There are certainly some similarities with the situation in January 2016. The Fed has, once again, tightened policy, and China is battling a depreciating currency. But there are also some major differences that should protect us this time.

First, consider the attitude of the Federal Reserve. The main problem, a year ago, was that the FOMC seemed hell-bent on a pre-set course to “nor-
malise” US monetary policy, almost regardless of events in the US economy and, especially, in the rest of the world. Of course, there were many caveats in the Fed’s communication (see Yellen, 2015) of its intentions at the time, but the basic message was that the US economy had returned close to “normal”, while the setting of monetary policy was still highly abnormal.

The Fed believed that the headwinds that had slowed US growth for so long were waning, and was reluctant to believe that the equilibrium real interest rate ($r^*$) had permanently dropped. There was scant belief in secular stagnation within the corridors of the Board’s headquarters on Constitution Avenue.

The markets, however, did not agree. The large gap between the FOMC’s predictions for US short rates, and the markets’ far lower expectations, proved that investor confidence was fragile. The collapse in markets in early 2016 was driven largely by widespread fears that US monetary tightening would persist in the face of an economy that was already slowing and vulnerable.

In short, the Fed seemed determined to administer an adverse monetary shock—an inappropriate tightening—on the slowing US economy, and this was spreading to the rest of the world via a possible devaluation of the RMB.

This year, the FOMC once again seems fairly hawkish, to judge from the FOMC minutes published last week. However, there is much less concern that the rise in US interest rates is inappropriate this time (see Duy, 2016). In particular, according to the Fulcrum nowcasts, the US and Chinese economies are considerably more robust than they were a year ago, and even the Eurozone is doing quite well (see Figure 1).

Instead of the adverse monetary shock that was happening a year ago, there has been a positive shock in global economic activity. Markets have reacted accordingly.

In both the monetary shock of 2015 and the activity shock of 2016, real bond yields and the dollar increased. But elsewhere the differences in market behaviour have been stark: inflation expectations have risen this time, instead of falling; and equities have surged, instead of collapsing. These are clear signs of a positive activity shock, not an adverse monetary shock.

Using the “economic shocks” model developed by Juan Antolin-Diaz and colleagues at Fulcrum (see Davies, 2015), the difference between last year and this year in the shocks that have been driving US equities is clear. Last year, Fed tightening, weak foreign demand and weak domestic supply pushed stocks down. This year, a positive domestic demand shock, and reduced risk premia, have triggered a bull market (see Figure 2).

According to the model, the markets have not perceived the Fed tightening to be an adverse monetary shock this time. The FOMC is raising rates, but it appears much more concerned about foreign risks and the dollar than was true a year ago, and is less convinced about the need to return to a historic level for $r^*$. Policy is genuinely “data determined” this year, which I think makes a hawkish monetary mistake far less likely.

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1 “Minutes of the Federal Open Market Committee December 13-14, 2016”, Federal Reserve Board, December 2016
Figure 1: Estimate of Underlying Activity Growth (\% MoM Ann.) around Fed hikes

Note: The charts show the evolution of the estimates of underlying activity for the US, the Euro Area and China in the periods Jul-15 to Mar-16 (in blue) and Jul-16 to Mar-17 (in red). The black dotted lines mark the December FOMC meetings.
Figure 2: Decomposition of the SP-500 into macroeconomic shocks

Early 2016 Bear Market

Fall 2016 Bull Market

Note: The coloured bars represent the cumulative contribution of each structural shock to the observed movement. The dashed black line represents the expected path of the variable at the beginning of the period. Estimated using an identified Bayesian Vector Autoregression model over the sample 1999 to 2016. See Antolin-Diaz and Rubio-Ramirez (2017) for details.

What about China? Here, too, the strength of economic activity is clearly helping, and the Chinese authorities have shown a readiness to protect the RMB and stimulate the domestic economy when necessary (see Figure 3). This makes the China factor less poisonous than it was last year.

However, the behaviour of the exchange rate continues to cause nervousness in markets. Before last week, the RMB’s effective index had been broadly stable for some months, but the currency had depreciated against the rising dollar. The capital outflow from China has continued at an alarming rate,
caused mainly by domestic entities fleeing the currency, not by sales of the RMB by foreign investors.

The authorities have been forced to prop up the RMB by running down China’s foreign exchange reserves, and by tightening loopholes in outward capital controls. But this has not been sufficient, so last Wednesday the authorities intervened forcibly to buy RMB, and to squeeze liquidity in the offshore market for the currency.\(^2\) The result was the sharpest two-day rise in the Chinese currency in history as short term speculators were crushed.

This action was similar to that taken in January 2016, when the currency crisis last appeared to be getting out of hand.\(^3\) But it might also have been influenced by the possibility that incoming President Trump has threatened to label China as a currency manipulator as soon as he arrives in the White House on 20 January. Strong intervention to reverse the decline in the RMB would make this less likely in a rational world.

So will the events of early 2016 repeat themselves in the near future? Global economic activity and the changed attitude of the Fed argue not. And the gradual RMB depreciation of 2016 leaves China inherently less vulnerable than it was a year ago.

But the Trump/China nexus is the risk that investors should be watching. If President Trump defies economic logic by labelling China as a currency manipulator, global market confidence could swiftly suffer a major setback.

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**Figure 3: RMB: Effective and Dollar Exchange Rates**

![Chart showing RMB: Effective and Dollar Exchange Rates](image)


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**References**


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\(^2\)“PBoC raises renminbi’s daily fix by most since 2005”, Financial Times, 6 January 2017

\(^3\)“China Steps Up Yuan Intervention as Offshore Shorts Get Squeezed”, Bloomberg News, 12 January 2016
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