US Monetary Policy And Its Impact On China and Emerging Economies

by Simon Derrick

US Monetary Policy Since 1988 and Emerging Markets

The financial world is going through an interesting and volatile period.1 Not only are we seeing economic power moving eastward with the rise of China and Asian economies, the United States is looking to transition away from extraordinary monetary policies as its economy improves, while the central banks in Japan and the United Kingdom press on with quantitative easing. The predominant force that perturbed global markets through the first quarter of 2014 was undoubtedly US monetary policy and market expectations—both in emerging and developed markets— because of emerging market concerns about the tapering off of quantitative easing (QE) by the US Federal Reserve (the Fed).

The Fed has a history of eventful summer months, and we have seen fallout for emerging markets before now from changes in US monetary policy. In the summer of 1998—in the midst of an emerging market crisis—the then Fed Chairman Alan Greenspan gave his semi-annual testimony to the Senate's Committee on Banking, Housing, and Urban Affairs. He stated: "The Committee recognizes that significant risks attend the outlook: One is that the impending constraint from domestic labor markets could bind more abruptly than it has to date, intensifying inflation pressures. The other is the potential for further adverse developments abroad, which could reduce the demand for US goods and services more sharply than anticipated and which would thereby ease pressures on labor markets. While we expect that the situation will develop relatively smoothly, the Committee believes that, given the current tightness in labor markets, the potential for accelerating inflation is probably greater than the risk of protracted, excessive weakness in the economy."2

In the weeks following Greenspan's testimony the crisis spread to Russia, triggering the Russian default, and, by the following Jackson Hole gathering, the Fed had been forced to reverse policy and go for a much more accommodative policy. Arguably, the "loose money," easy credit approach which the Fed then deployed also had a major role in triggering the dot.com boom and subsequent bust in 2001—quite a chain of events.

More recently, the flow of funds to emerging markets triggered by the Fed's accommodative policies, introduced after the financial crash of 2008, began a multiyear bull run that only started to slow down in the summer of 2011. At that point India's rate of growth slowed and there were obvious signs that its economy was struggling. The economies of Brazil and Turkey also started to stutter badly. The structural weaknesses in their economies were thrown into sharp and unflattering focus by the slowing down in fund flows. The slowdown continued through 2012, even though most of Asia seemed to be holding steady despite the troubles in India, Turkey, and Brazil.

Notwithstanding these external developments, by May 2013 Fed chairman Ben Bernanke had begun to talk openly about the likelihood that the Fed would soon start reducing its purchases of US bonds and securities under its quantitative easing program. This left those emerging market nations that were running significant current account deficits exposed to the threat of US interest rate hikes. As a result, a number of Asian (and other) currencies started to plunge against the US dollar as soon as Bernanke indicated that "tapering" was under discussion. This was followed, in turn, by a number of emerging market central banks stepping into their local currency markets in order to support their own currencies (despite the fact that Bernanke was already backing away from his hawkish stance by as early as July 10). Between the start of 2013 and September, when the Federal Reserve put off tapering its bond market purchases until a later meeting, India's reserves had shrunk by US$17 billion and Indonesia's by US$14 billion.

Emerging Market Reserves and the US Dollar

The historic connection between the Fed running a highly accommodative monetary policy and the flow of funds into emerging markets is clear, as has been the negative effect on emerging markets since the Fed started to talk about tightening policy. What is less clear is the feedback loop back into US markets. According to the latest IMF COFER3 data (as of the end of the first quarter of 2013), around 60% of the known holdings of the emerging market nations' foreign exchange reserves are invested in US government and quasi-government securities along with dollar deposits.

However, if an emerging market central bank needs to defend its currency, it has to sell underlying assets to fund a foray into the foreign exchange markets to support its currency. Little wonder then that the periods of the most intense currency support operations by emerging market nations in 2013 coincided with sharp upward pressure on the yields of US government securities. Consistent with this, US yields also eased somewhat as the sharp emerging market crisis began to ease during September 2013.

There is, however, another longer-term issue that needs to be considered. This is the position that the largest foreign exchange reserve holders now find themselves in. After 11 years of highly accommodative monetary policy settings in the United States (since the start of 2002 the average level of headline inflation there has been 2.37%, while the average Fed funds target rate has been just 1.79%), the emerging market nations have seen their combined currency reserves jump (according to the IMF COFER data) from around US$800 billion to (as of the end of the second quarter of 2013) around US$7.47 trillion, an eightfold increase. China, of course, led the way, with its foreign exchange reserves rising from around US$227 billion to around US$3.6 trillion.

That is a huge volume of currency reserves, and they have to be used somehow. As already noted, some 60% of the known allocation of that pool is held in the US dollar. The remaining 40% of emerging market foreign exchange reserves are allocated to other currencies, with around 24% going into the euro, while sterling, the yen, the Australian dollar, and the Canadian dollar have also all benefited from emerging market diversification out of dollars. The natural home for this money is conservative assets, such as government bonds.

China

Despite diversifying its reserves over time, however, China has become increasingly concerned about its level of exposure to the United States in recent years. As long ago as April 2006, Yu Yongding of the Chinese Academy of Social Sciences told China Business News that "a large part of the reserves are being held in the form of US dollar assets. The assets are likely to lose their value if the US dollar weakens or inflation picks up in the United States. So we must make early preparations to prevent possible trouble."4 These worries continued to build through the summer of 2007 until they finally became part of the official stance in March 2008, when Premier Wen Jiabao noted (at the end of the closing session of the National People's Congress): "I am closely watching and feel deeply worried about the global economic situation, especially the US economy. What concerns me now is the continuous depreciation of the US dollar and when the dollar will hit bottom."5

Reaction to the S&P Downgrade of US Government Debt 2011

These concerns had deepened substantially by August of 2011 following that summer's debt ceiling crisis and the August 5 downgrade by Standard & Poor's of US government debt. After a month of mounting warnings from officials, China's anger over the news that the United States had finally been downgraded by S&P was palpable. The words from Xinhua, China's official news agency, were stark enough. It called for "international supervision over the issue of US dollars" and for the United States to "live within its means."6 It added: "The days when the debt-ridden Uncle Sam could leisurely squander unlimited overseas borrowing appeared to be numbered. … To cure its addiction to debts, the United States has to re-establish the common sense principle that one should live within its means."7 It argued that China "has every right now to demand the United States to address its structural debt problems and ensure the safety of China's dollar assets."8

An article written by Yu Yongding for the *Financial Times* on August 4, 2011 (the morning of the downgrade), was even more telling. He argued: "If there is any lesson China can draw from the US debt ceiling crisis, it is that it must stop policies that result in further accumulation of foreign exchange reserves. Given that many large developed countries are simply printing money (and the recent rumors are that the US might return to quantitative easing) China must realize that it can no longer invest in the paper assets of the developed world. The People's Bank of China must stop buying US dollars and allow the renminbi exchange rate to be decided by market forces as soon as possible. China should have done so a long time ago. There should be no more hesitating and dithering. To float the renminbi is not costless. However, its benefits for the Chinese economy will vastly offset those costs, while being favorable to the global economy as well.”9

China's frustrations with the Fed

Flash forward to 2013, and while the dominant narrative for the foreign exchange markets through the summer months might have been of the crisis that emerged in India, Indonesia, and Turkey, it was also clear that a number of other markets had benefited from an influx of international money from around July 10 onward following Ben Bernanke’s dovish comments at a conference sponsored by the National Bureau of Economic Research, Cambridge, Massachusetts (“…both the employment side and the inflation side are saying that we need to be more accommodating”10). China, in particular, appeared to have been a major beneficiary, forcing it to intervene aggressively to stop its currency appreciating. Foreign exchange reserve data for China showed that its holdings increased by US$163 billion (Thomson Reuters11) during the third quarter of the year, the fifth largest quarterly increase on record (only being beaten by Q2 2009, Q3 and Q4 2010, and Q1 2011). In other words, this was a return to the sort of conditions that prevailed during the height of the currency war in late 2010/early 2011 as expectations of the second round of QE, initiated in the fourth quarter of 2010, rose and were met.

China’s level of frustration at this turn of events was both clear to see and easy to understand when seen from its perspective. On the one hand, the Chinese authorities saw the Fed (whether by intention or not) sparking a fresh flow of money out of the US dollar and into their local markets. As China intervened to soak up these inflows, the authorities likely ended up recycling a substantial proportion of these fresh reserves back into US dollar deposits and US government and quasi-government securities (China is the biggest foreign holder of US Treasury bonds, worth a total of US$1.268 trillion as of August 2013 according to US Treasury data). However, having done so, they also found politicians in Washington flirting with the possibility of a default.

China’s Only Option: Currency Liberalization?

The answer to the Chinese authorities’ problem remains as clear as ever. China would probably love to move as much of its reserves out of the US dollar as possible. However, the sheer size of its reserves makes any meaningful move almost impossible to execute other than over the very longest of terms. Therefore the only practicable way that China can break the cycle in the foreseeable future is for it to liberalize its currency regime in order to reduce its need to accumulate reserves.

All the signs are that this is exactly what China is planning. While it seems clear that the pace of liberalization will be measured, and that the process will be flexible enough to allow the government to reimpose restraints should there be large capital movements into or out of China, it is also clear that the process is under way. In May of 2013 the State Council announced in a statement that the government would outline a plan for full convertibility of the renminbi (Chinese yuan) by the end of the year,12 while in September the Council announced that it planned to use the China (Shanghai) Pilot Free Trade Zone as a test bed for a convertible renminbi and liberalized interest rates according to a statement posted to the FTZ-ShangHai.com website.13

Conclusion

What happens to the currencies and government debt markets of the developed world when China finally liberalizes remains to be seen. However, given how much they have arguably benefited over the years from demand from the likes of China, this suggests that the time for action by the developed nations to bolster confidence in their underlying markets is now.

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More Info

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Notes

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"Testimony by the Chairman of the Board of Governors of the US Federal Reserve System, Mr. Alan Greenspan, before the Committee on Banking, Housing, and Urban Affairs of the US Senate on 21/7/98." Page 8. Bank for International Settlements, Basel. Online: www.bis.org/review/r980724b.pdf
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