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In this issue:

Special Focus: China's Devaluation – Effect On

by Gordon Kerr and John Butler, with Enrico Colombatto

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CENTRAL BANKS

FINANCIAL MARKETS

Big reaction to small change

On August 11, the People's Bank of China (PBOC - China's central bank) announced a 3% devaluation in the rate at which it pegs the yuan (renmimbi) to the dollar. It has been easy for the PBOC to maintain its chosen peg since 1994, because its booming export economy produced large US Dollar surpluses, to such a level that China's dollar reserves are equivalent to roughly three times its foreign public indebtedness. Whenever market speculators

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USA and EU: Understandable Turmoil

The most important point to take away from the tumultuous market reactions to China's devaluation, is that these reactions seemed to many to be out of all proportion to the scale of the event – a trivial 3% devaluation.

On closer analysis, however, it all makes sense. With rational, value-based investment policies having been seen off by loose money policies, circular carry trades, reliant on the continuation of minor price arbitrages and

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Emerging Market Currencies

For emerging markets, we look set for a repeat of the 1997 problems, in which the strong dollar also played a key triggering role .

The currencies of a host of commodity exporting countries have fallen substantially in the last 12 – 15 months, many dipped again on the Chinese news. Malaysia, Indonesia, Turkey, Colombia, Brazil, Mexico and Chile have all seen their currencies decline against the dollar by between 20 and 50 per cent.

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CENTRAL BANKS

(cont'd) China and Central Banks

bought yuan in the expectation of the currency strengthening, the PBOC was always able to sell yuan into this demand to counteract such upward exchange rate pressure. In this way the PBOC would accumulate even more dollars.

This policy has consistently raised the ire of US policymakers, who for years pleaded in vain that the yuan be allowed to float and appreciate to its natural level. China has thus been repeatedly officially blamed for the decline in US manufacturing.

The immediate response of the media and policymakers was to accuse the PBOC of being up to its old tricks, seeking even to start a new, beggar-thy- neighbours currency war. US Republican party presidential hopeful Donald Trump chose colourful language "They're destroying us….. they're doing a big cut in the yuan and that's going to be devastating for us".

The 3% devaluation should be seen in the context of a currency that has appreciated 50% on a trade weighted basis since 2004.

On a more sober analysis, the 3% devaluation should be seen in the context of a currency that has appreciated 50% on a trade weighted basis since 2004. After initial market turbulence, commentators began to point out that 3% would never have been enough for China to gain material export market share. Surprisingly, market confidence in China was shaken, and in the three ensuing weeks the PBOC felt compelled to spend $93 billion of its $3.7 trillion of mainly US dollar reserves in defending the yuan at its new, reduced level. Selling pressure still remains, as can be observed in futures markets price movements and in the easing of the offshore Hong Kong traded yuan.

So what prompted the PBOC to cut the exchange rate? Some opine that China seeks reserve currency status – membership of the small club of currencies that currently constitute the IMF's Special Drawing Rights basket: the yen, dollar, sterling and euro, and moving from a fixed peg to a managed float will help the PBOC achieve this.

But it seems more likely that the PBOC was reacting to Chinese problems. In a revealing admission to the early September meeting of

the G-20 leaders, Governor Zhou Xi-aochuan talked of the bubble in Chinese stocks. The benchmark Shanghai composite rose by 70% between March and June, and has since declined by 40% - back to March levels. According to Zhou this 'correction' is almost over, but what reliance should be placed on his remarks? Not only is it very difficult for any individual to opine as to the correct levels of market indices, but Zhou himself is a member of the club of central bankers who confuse stock market levels with the health of the "real economy". In March, he called for investment funds to pump money into equities to fuel the real economy, and he is generally believed to be behind domestic state run media's exhortations that companies should leverage up, buy equities, and pay down their debts with the hoped for profits. Whether the devaluation was because Zhou genuinely believes that the stock market decline indicates a weakening economy, or because of other structural problems in the Chinese economy, we do not know. But our main take on this is not the devaluation itself but the ramifications of the China crisis for financial markets, both in the developed world and in the poorer emerging market economies. See sections on financial markets... ■

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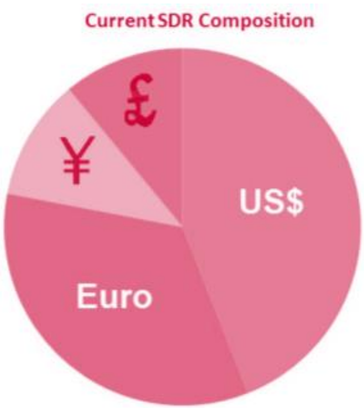

Rational, value-based investment policies having been seen off by loose money policies, circular carry trades, reliant on the continuation of minor price arbitrages and thus requiring high leverage, dominate investor and speculator strategies.

FINANCIAL MARKETS

(cont'd) Effect on USA & EU

thus requiring high leverage, dominate investor and speculator strategies. The scale of market declines and volatilities merely reflects what happens when investors realise that such strategies might at some point lose money. Panic sets in.

This is proof, if any more were needed, that both the Bank for International Settlements and your authors [have been consistently correct](); *banking, shadow banking, equity and bond markets are substantially over-leveraged and exposed to any blip in investor confidence that central bank easing will continue to prop up financial markets at these price levels.* ■

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(cont'd) Effect on Emerging Markets...

The South African rand is down 27% in the past year, as problems in its traditional gold mining industry depress its economy. Although some commentators such as Mohamed El-Erian, chief economic adviser to Allianz, call what is happening currency wars, the exchange value declines in these currencies is simply a reflection of the falls in commodity prices. Copper and iron ore are down about 50% and 70% from their peaks in early 2011. Oil is down over 50% from its June 2014 level. Even the exchange value of Russia's rouble has fallen back to its Xmas 2014 lows.

These currencies are falling because cash investors and currency speculators believe that none of the stimulus measures in the developed world are likely to boost demand for the commodity based exports which these countries sell. Monetary stimulus has left nothing sustainable behind, rather a legacy of sovereign and central bank debt and the associated imbalances and misallocations.

That emerging markets are in trouble is therefore another sign of the global interconnectedness of misguided central banking policies about which we, and the Bank for International Settlements, have been reporting. America is the biggest importer of commodity-based products upon which these emerging economies have been relying. August was the 80th month of US near zero interest rates (Federal Funds rate has been at 0.25% for much of this period). But this policy has failed to generate any American borrowing for productive commercial investment. In 2014, according to Federal Reserve data, US businesses spent $431 billion less on plant, equipment and software than in 2007. Nor have low rates stimulated consumer borrowing to buy goods and services and in that way help economic growth. In Q1 2008 total US household debt – credit cards, housing and car loans plus student debt was $14 trillion, compared with $13.6 trillion at the end of March 2015. Seven years of central bank driven incentives to borrow and spend have failed, and households have in net terms redeemed about 3% of pre-crisis debt.

Thomson/Reuters Core Commodity Index (CRB) is back to levels from the beginning of the century

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Evidence of the day-to-day impact in emerging market economies abounds. Brazil was hailed five years ago by The Economist magazine as the "country of the future" enjoying a growth rate of 7.6% in 2010. Expectations are that it will contract by 2% this year. A trade surplus of $20 billion in 2010 has turned into a deficit of $40 billion in the 12 months to July. Job losses are running at 150,000 per month.

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It is hard to see any upside for these countries. Not only have the sharp dips in value of their currencies done little to boost demand for their exports, they have resulted also in lower imports because a falling currency makes imports more expensive. Taken in the round, with emerging economies accounting for 38% of 2014 global GDP, these problems are starting to weigh negatively on Europe's economies as our exporters confront lower demand.

To put this in recent historical context, a basket of commodity prices is now cheaper than even in the trough of 2008-09. These are meteoric price declines and indicate arguably that the largest global stagnation in modern times has begun. What are the likely immediate next moves of policymakers? ECB President Draghi indicated early in September that the €1 trillion stimulus, whose inception (as we reported in January) was so controversial that it split the ECB board, will now be expanded. Ironically, reduced growth expectations from China and other emerging markets were quoted as behind this decision. ■

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