Weekly Market Flash

China, Reserve Club Dreams and the Fed

August 14, 2015

Ah, yes, it is turning out to be another one of those unpredictable Augusts. US East Coasters woke up Tuesday morning to news of a major devaluation of the Chinese currency, the renminbi (RMB). Global asset markets then spent several days lurching this way and that as investors attempted to divine the meaning behind the sharply lower RMB reference rate set by the People's Bank of China (PBOC), the nation's central bank. As another summer weekend approaches, the preliminary consensus appears to be of the "tempest in a teapot" variety. Most bellwether asset classes have stabilized over the past forty eight hours. But investors heading back out to their boats and beach houses will likely still be pondering the Chinese currency's near term prospects, and how this new twist adds to the brew of ingredients shaping possible Fed moves in September.

Market Adjustment or Currency War?

It is important to understand what did – and did not – happen this week. Every morning the Chinese monetary authorities set a reference rate for the RMB, and market makers are allowed to trade within a two percent range around that reference rate. Prior to Tuesday, the daily published reference rate had no explicit relationship whatsoever to market forces. There was no formula linking the reference rate to the previous intraday close or to perceived market supply and demand; rather, the reference rate was simply what the PBOC thought it should be.

Tuesday's reference rate set the RMB at a level 1.9 percent below the previous close, and that announcement unleashed a flurry of pent-up selling pressure to take the currency down the daily maximum two percent from the morning rate. By the end of the week the net effect of the PBOC's moves and market trading was a 4.4 percent decline in the value of the RMB versus the dollar. That was a move of a sufficient magnitude to push the topic of currency wars back into the discourse. However, the evidence so far does not support a clear-cut conclusion that China's actions are motivated primarily by goosing up its export competitiveness.

Admission to the Club

Chinese policymakers this week pointed to the goal of a more tangible link between market forces and the RMB as driving the recent reference rate policy decisions. There is some convincing logic behind these statements. It is no secret that China would like to see enhanced reserve status for the RMB and a more prominent role for the currency in global trade and finance. An important milestone for this goal would be to have the RMB admitted to the elite club of IMF Special Drawing Rights (SDR) currencies, taking a seat alongside the dollar, euro, yen and pound sterling. Engendering more market transparency for the RMB is seen by many as a necessary box to check off for admission to the SDR club. Of course, proof that this is in fact China's primary goal will require the People's Bank of China to allow the currency to strengthen (thus weakening exports) as well as devalue when market forces so dictate.

Back to the Fed

Whatever the reason, a weaker renminbi is likely to factor into the calculus of the Fed's forthcoming decision on whether to kick off its rate program in September. A rate hike that resulted in a sharply higher dollar, in the context of an already lower RMB, could have unfavorable economic consequences for US growth and prices. Such a scenario could give the Fed pause and push its decision back to December. The data would suggest this is likely, with recent headline GDP, employment and inflation numbers decent but certainly not indicative of an overheating economy. Alternatively, the Fed may simply want to get on with it and end the continual will-they-won't-they chatter. If it does come in September, though, the rate hike may possibly be the most dovish ever.

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