Chinese Monetary Policy

Part One

Transforming The World

Macro Watch

Third Quarter 2018

http://www.richardduncaneconomics.com

The PBOC

- If the PBOC could be judged based solely on what it had accomplished up to mid-2014, then, without question, it would deserve to be acknowledged as the most successful central bank in history.
- Its conduct of Monetary Policy literally transformed China from a very poor third world country into an economic superpower; it caused global economic growth to accelerate; and it pulled hundreds of millions of people out of poverty.

The Consequences

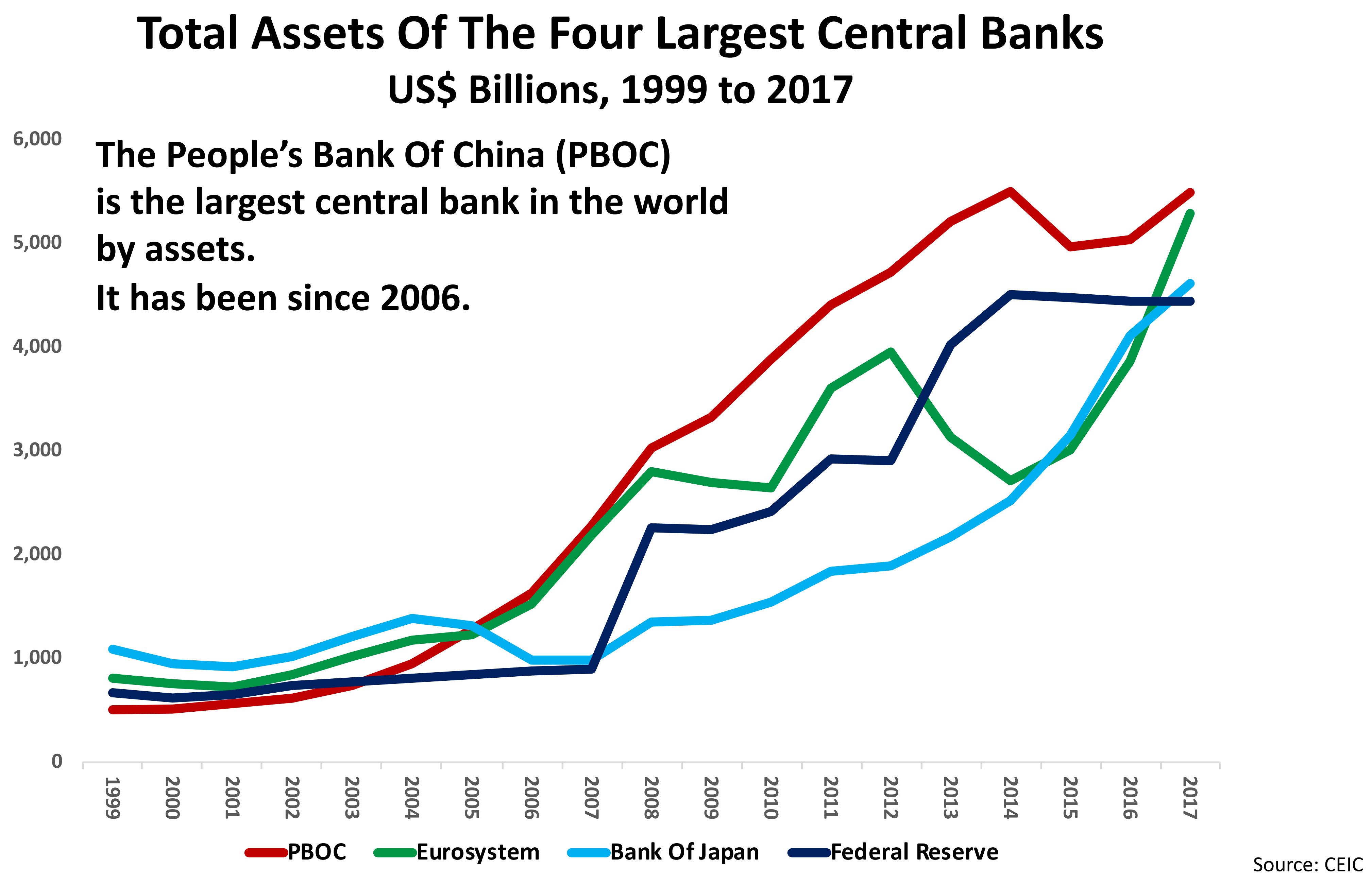
- However, Chinese Monetary Policy cannot be judged simply on the basis of what it had accomplished up to mid-2014 without considering the future consequences of that policy.
- The PBOC’s policies also produced an economic bubble in China on a scale the world has never witnessed before.
- Moreover, those policies played a leading role in creating the unprecedented global imbalances that led to the economic crisis of 2008, and to the political backlash that has begun to undermine the liberal economic world order during the years following the crisis.
- What the ultimate costs will is still unknown.

Two Phases

- There have been two distinct phases of Chinese Monetary Policy during the past quarter century.
- The first phase extended from the 50% devaluation of the RMB against the Dollar in December 1993 up until mid-2014.
- The second phase began in mid-2014 and is still ongoing.

Two Phases

- During the first phase, the PBOC’s balance sheet (and, consequently, China’s Monetary Base) grew rapidly as the central bank bought nearly $4 trillion of foreign currency to depress the value of the RMB.
- The second phase began in mid-2014 when large-scale capital flight out of China forced the PBOC to lend RMB 8.5 trillion (roughly US$1.3 trillion) to Chinese banks over the next three years to prevent China’s Money Supply from contracting.
- This video will describe the first phase and its accomplishments.
- The next video will examine how and why PBOC policy was forced to change beginning in 2014.



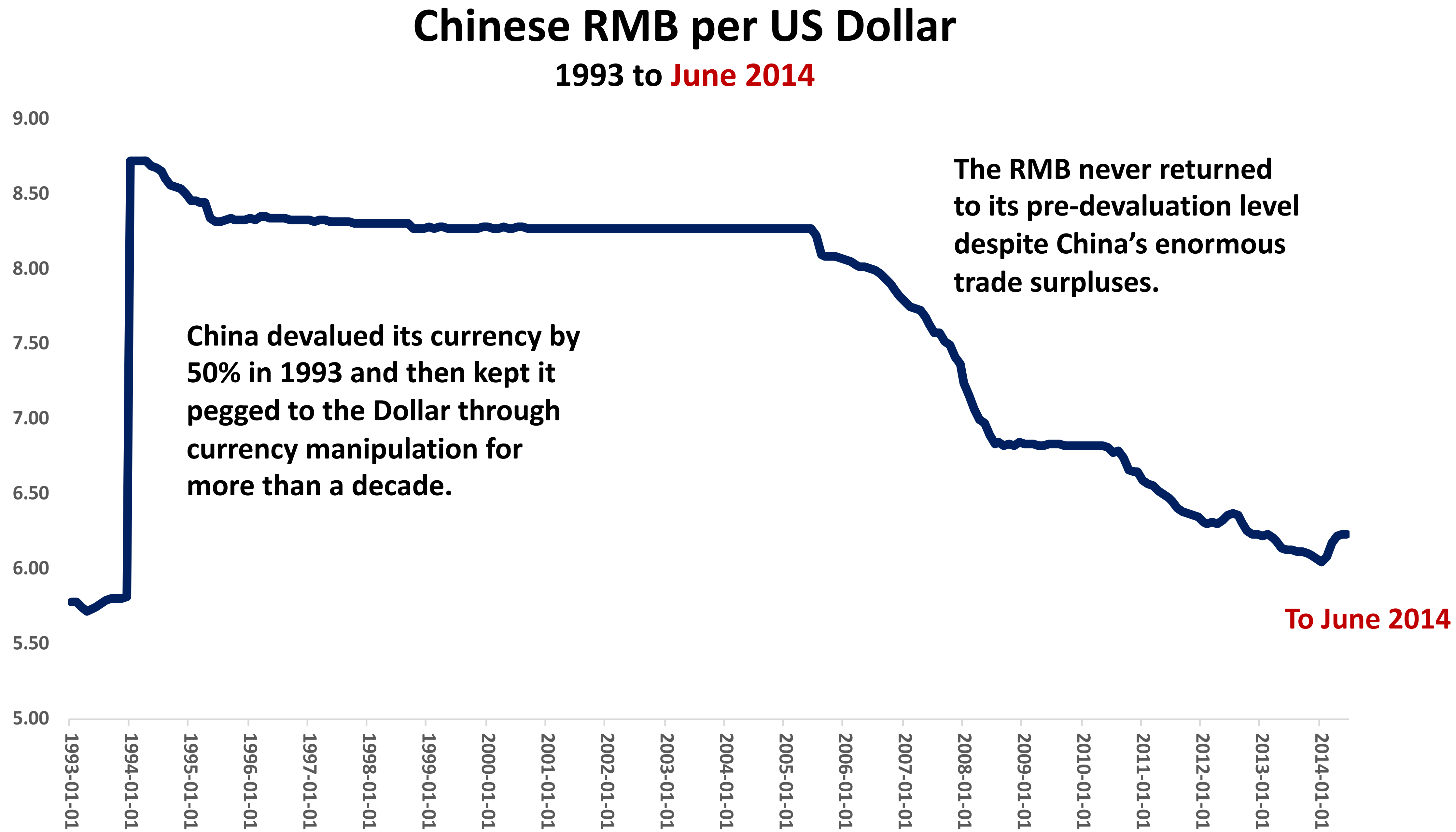
Total Assets Of The Four Largest Central Banks
US$ Billions, 1999 to 2017
The People's Bank Of China (PBOC)
is the largest central bank in the world
by assets.
It has been since 2006.
6,000
5,000
4,000
3,000
2,000
1,000
0
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
PBOC
Eurosystem
Bank Of Japan
Federal Reserve
Source: CEIC

Goals And Techniques

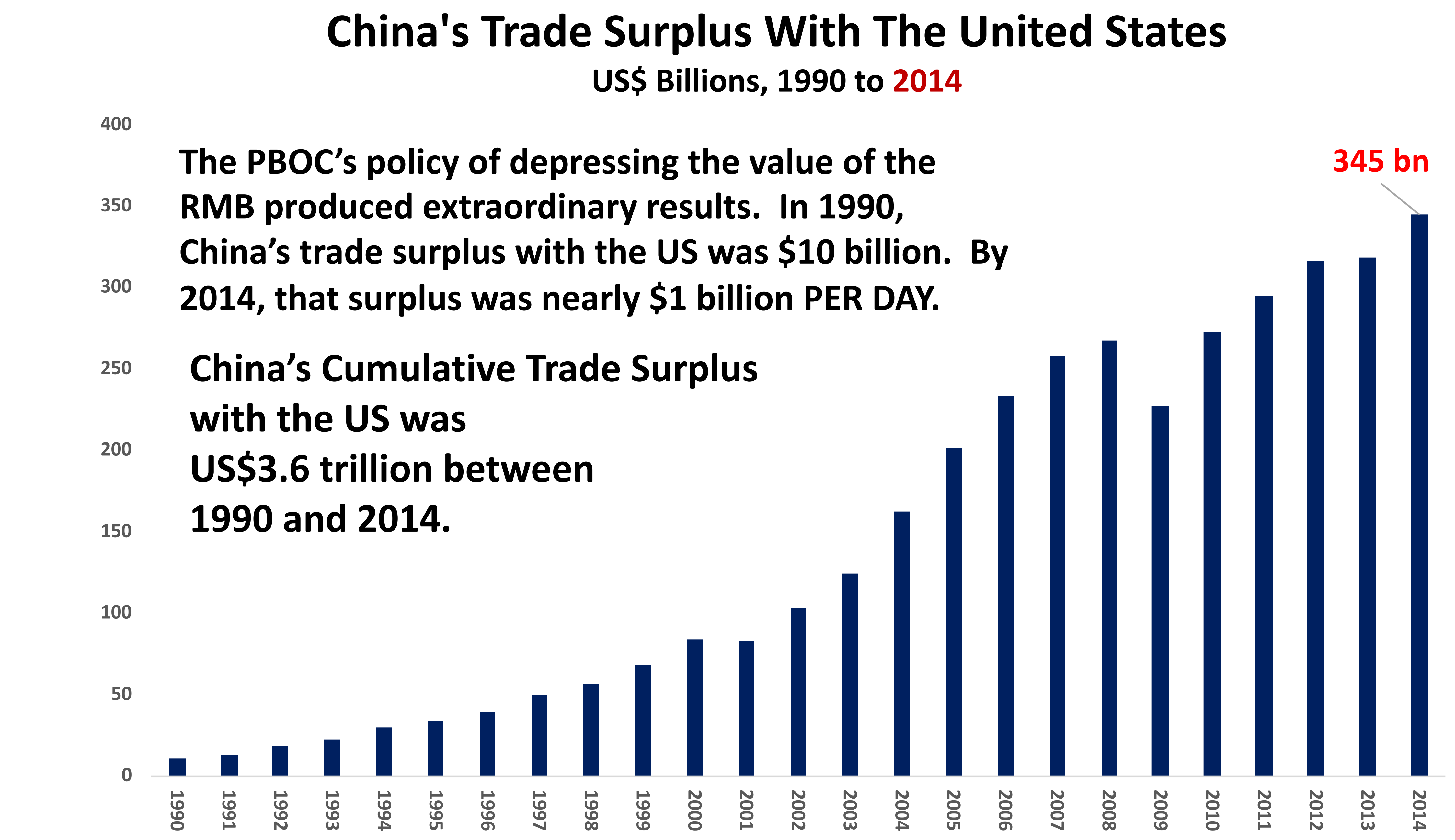
- The goals and techniques of China's central bank have been radically different than those of the Federal Reserve, the Bank Of Japan or the European Central Bank.
- Monetary policy in the United States, Japan and Europe has focused primarily on maintaining price stability by preventing too much inflation or deflation.
- Monetary policy in China has sought to promote China's export-led economic growth by holding down the value of the RMB in the face of strong market forces that would have otherwise caused China's currency to appreciate sharply.

Phase One

- Between the early 1990s and mid-2014, the overarching purpose of Chinese monetary policy was to hold down the value of the RMB in order to promote China's export-led economic growth.
- The PBOC held down the RMB by creating money (RMB) and using it to buy foreign currency (primarily US Dollars).
- In that way, it pushed up the value of the currencies of other countries and held down the value of the RMB.
- Had the PBOC not intervened, market forces would have pushed up the value of the RMB – and, therefore, the cost of Chinese exports - to the point where China's economy would not have been able to continue expanding through export-driven growth.



Source: St Louis Fed

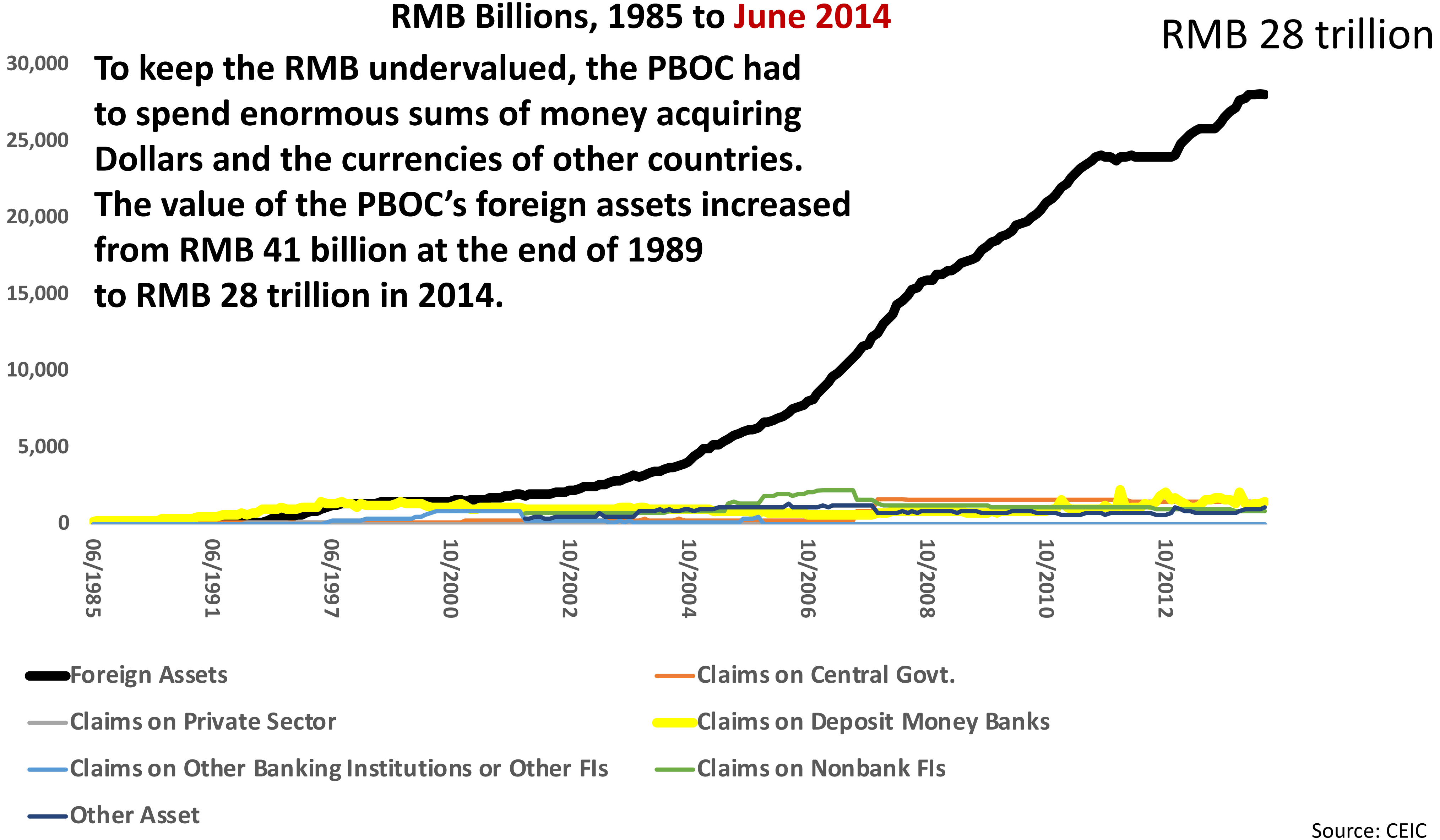


Source: U.S. Census Bureau

PBOC Breakdown of Assets

RMB Billions, 1985 to June 2014

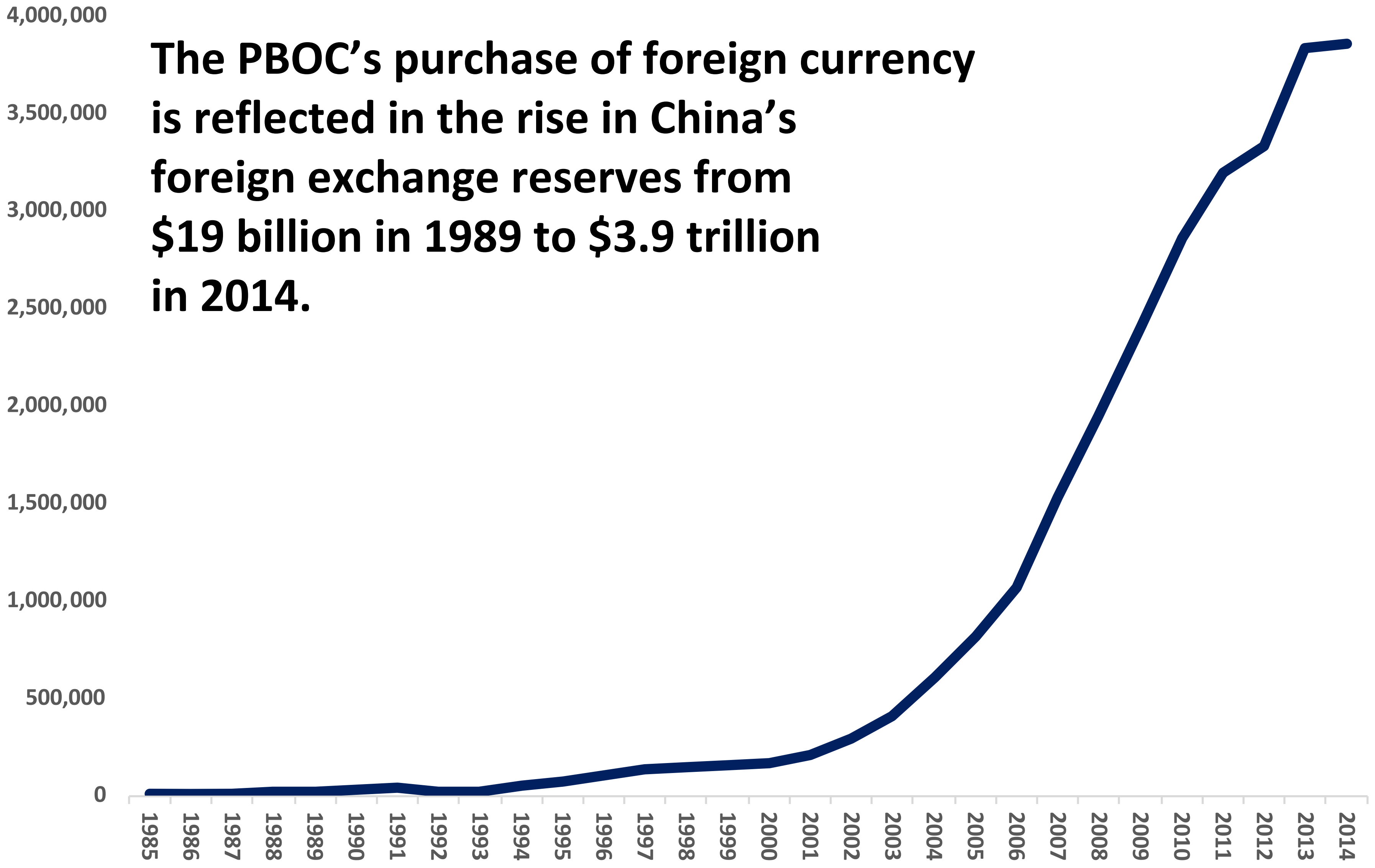
To keep the RMB undervalued, the PBOC had to spend enormous sums of money acquiring Dollars and the currencies of other countries. The value of the PBOC's foreign assets increased from RMB 41 billion at the end of 1989 to RMB 28 trillion in 2014.



Source: CEIC

China's Foreign Exchange Reserves (Excluding Gold)

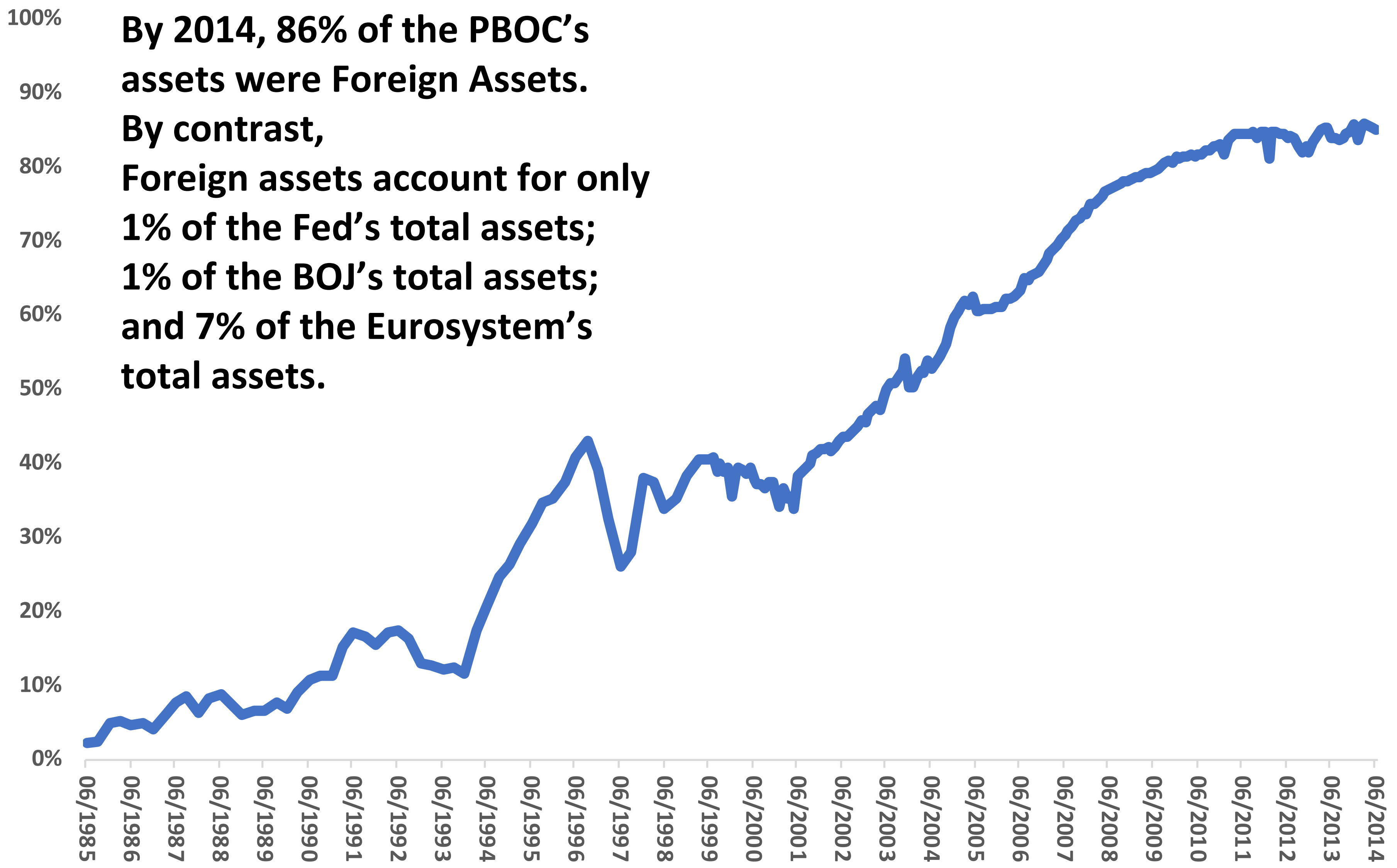
US$ Millions, 1980 to 2014



Source: CEIC

PBOC's Foreign Assets as a % of Total Assets

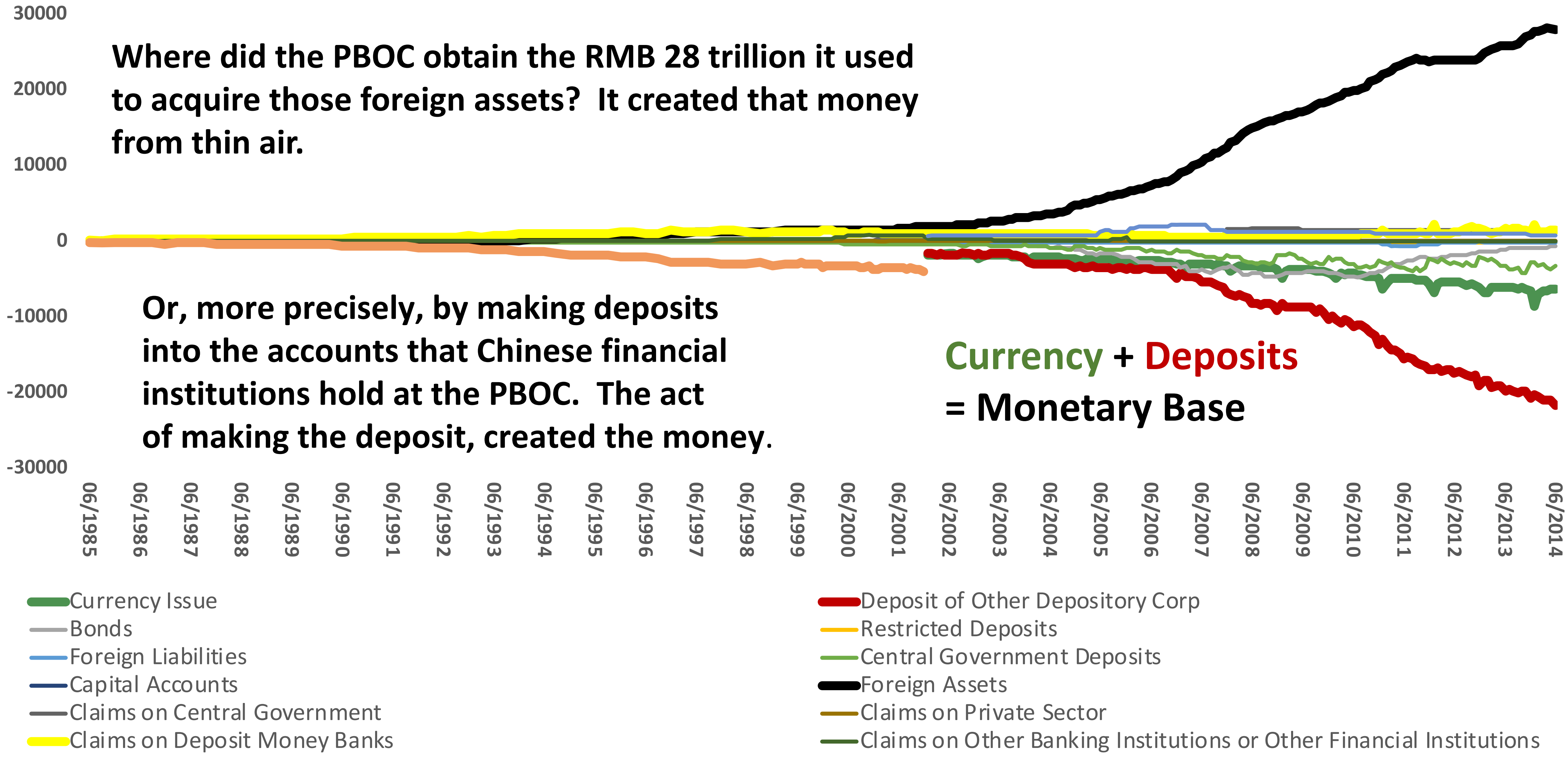
%, 1985 to June 2014



Source: CEIC

A Breakdown Of The PBOC's Assets & Liabilities

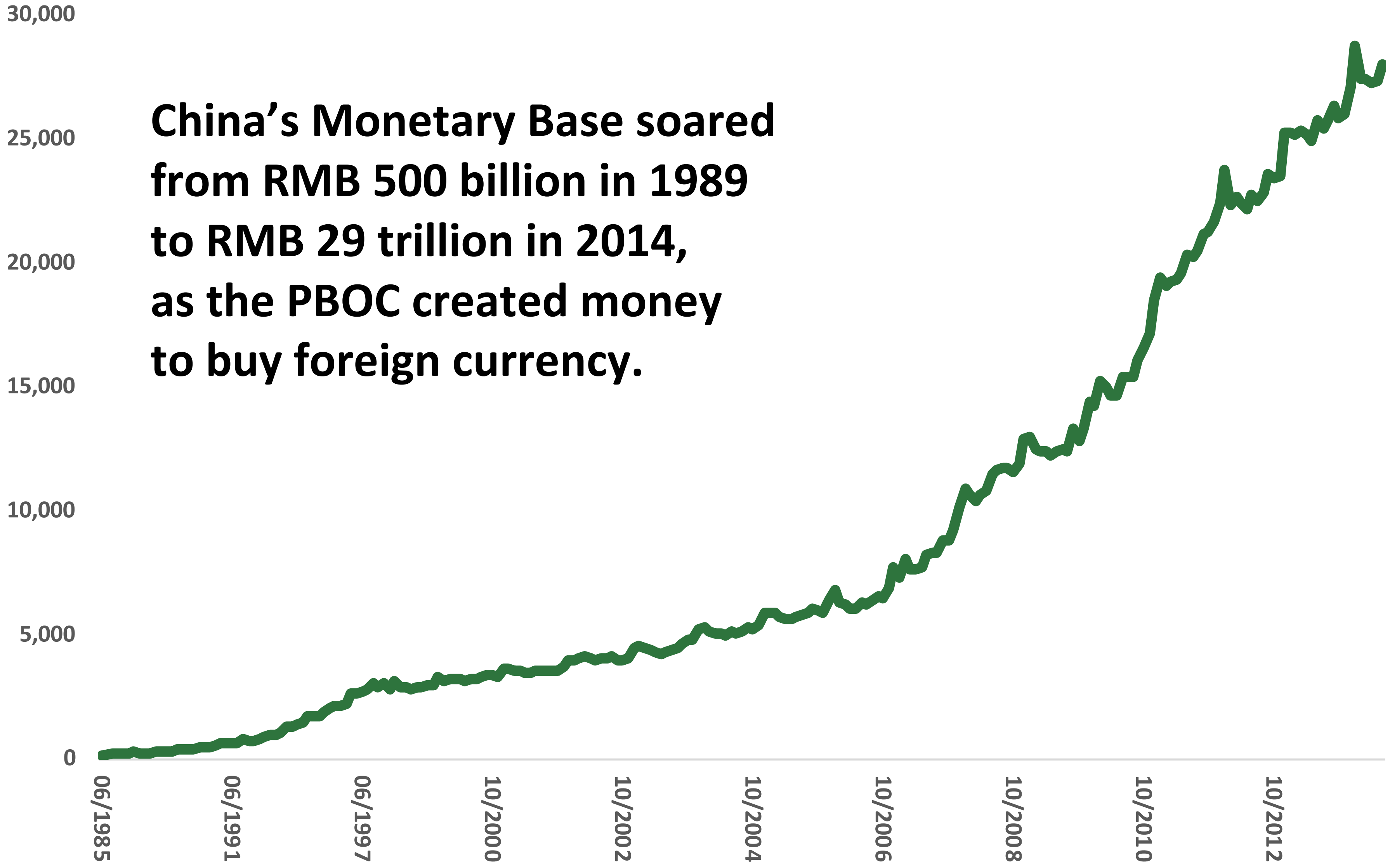
RMB Billions, 1985 to June 2014



Source: CEIC

China’s Monetary Base (Reserve Money)

RMB Billions, 1985 to June 2014

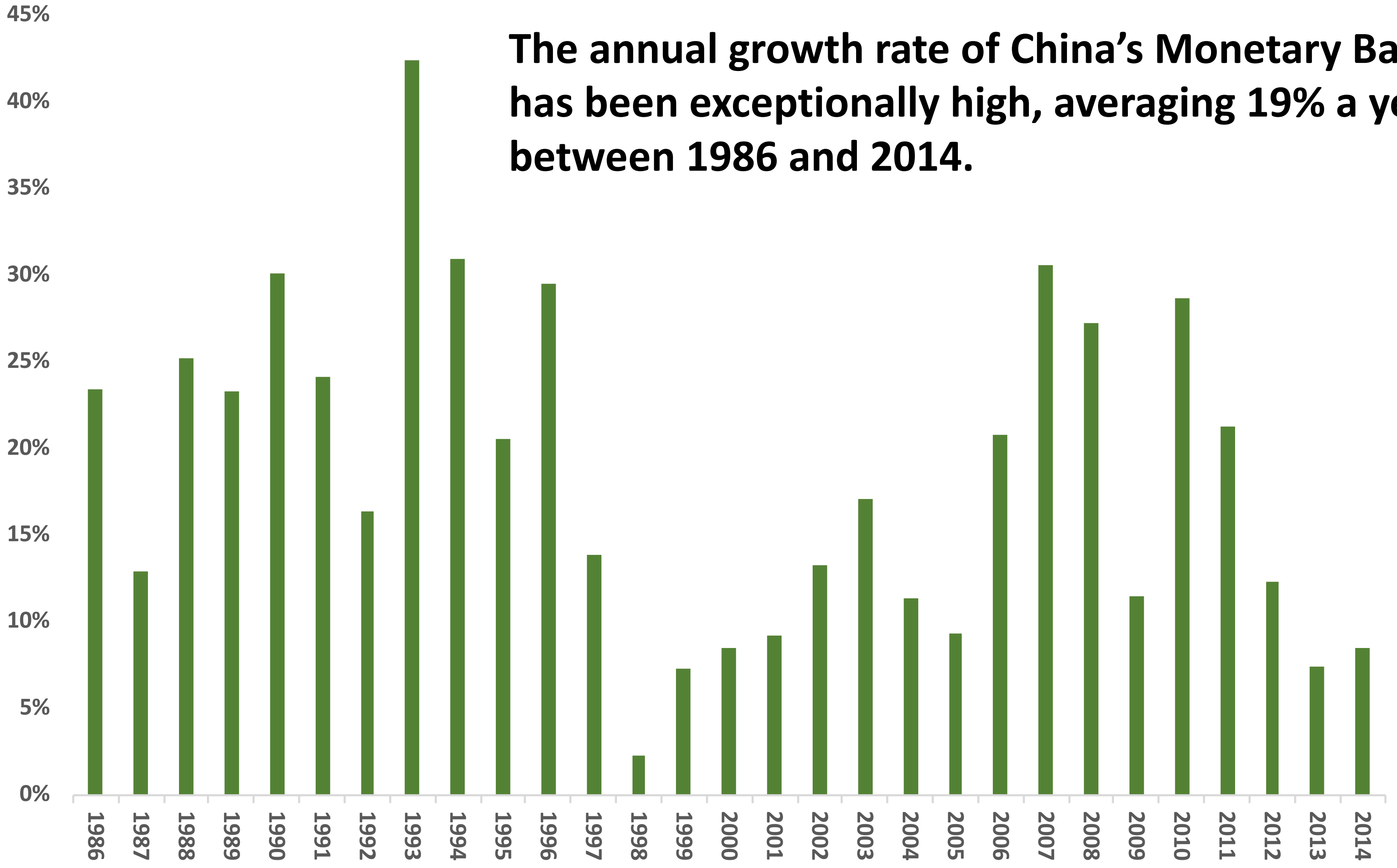


Source: CEIC

Monetary Base, Annual % Change

%, 1986 to 2014

The annual growth rate of China's Monetary Base has been exceptionally high, averaging 19% a year between 1986 and 2014.



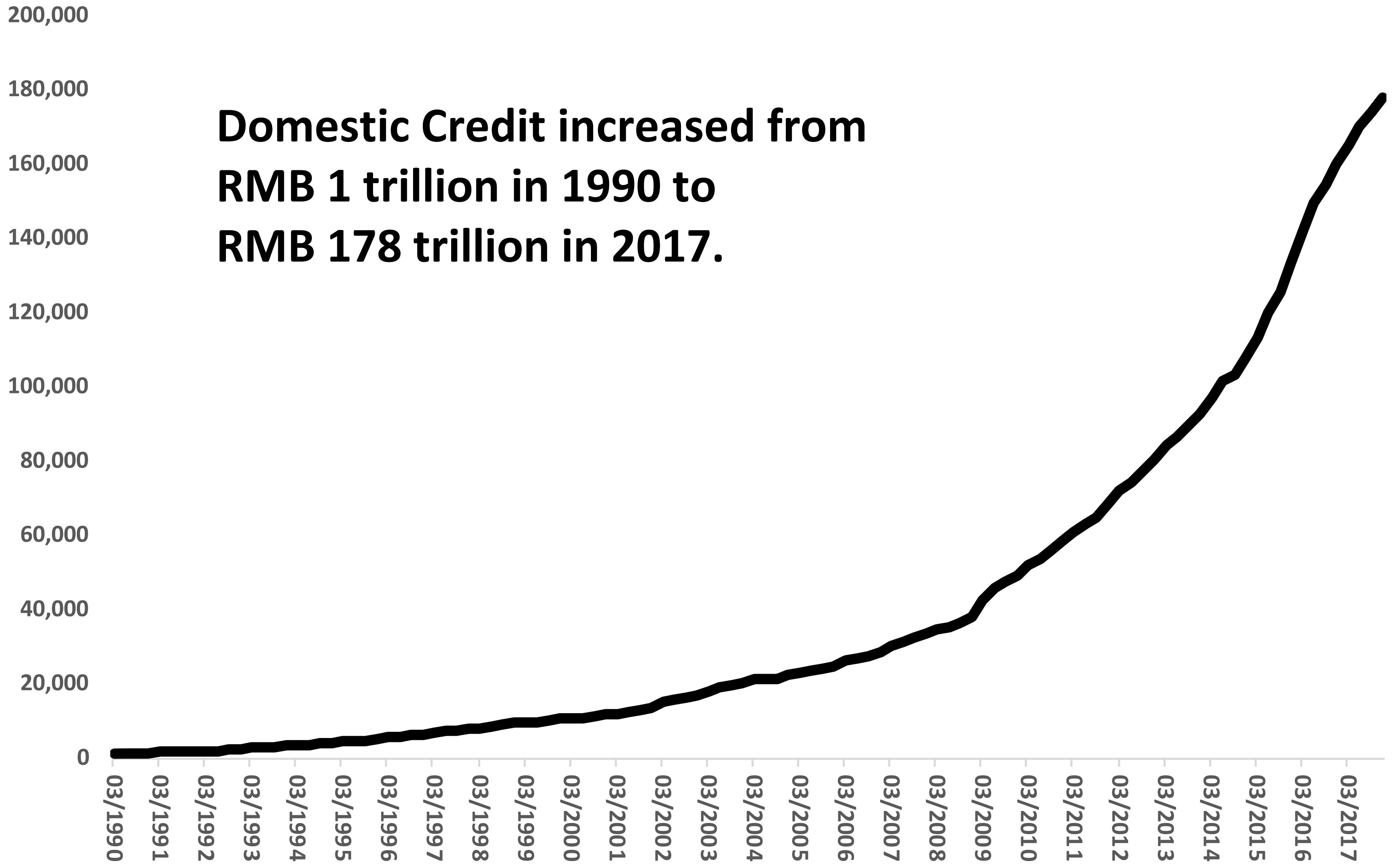
Source: CEIC

Phenomenal Results

- PBOC policy created phenomenal results.
- Between 1990 and 2017, China's cumulative trade surplus with the United States was $4.7 trillion.
- Each year, the money from that trade surplus found its way into China's banking system as deposits.
- Those deposits became the capital that transformed China.
- Every RMB 1 of new deposits permitted the creation of RMB 6.7 of credit through the magic of fractional reserve banking (assuming a Required Reserve Ratio of 15%) – and probably much more credit through less well regulated shadow banking institutions.

Domestic Credit

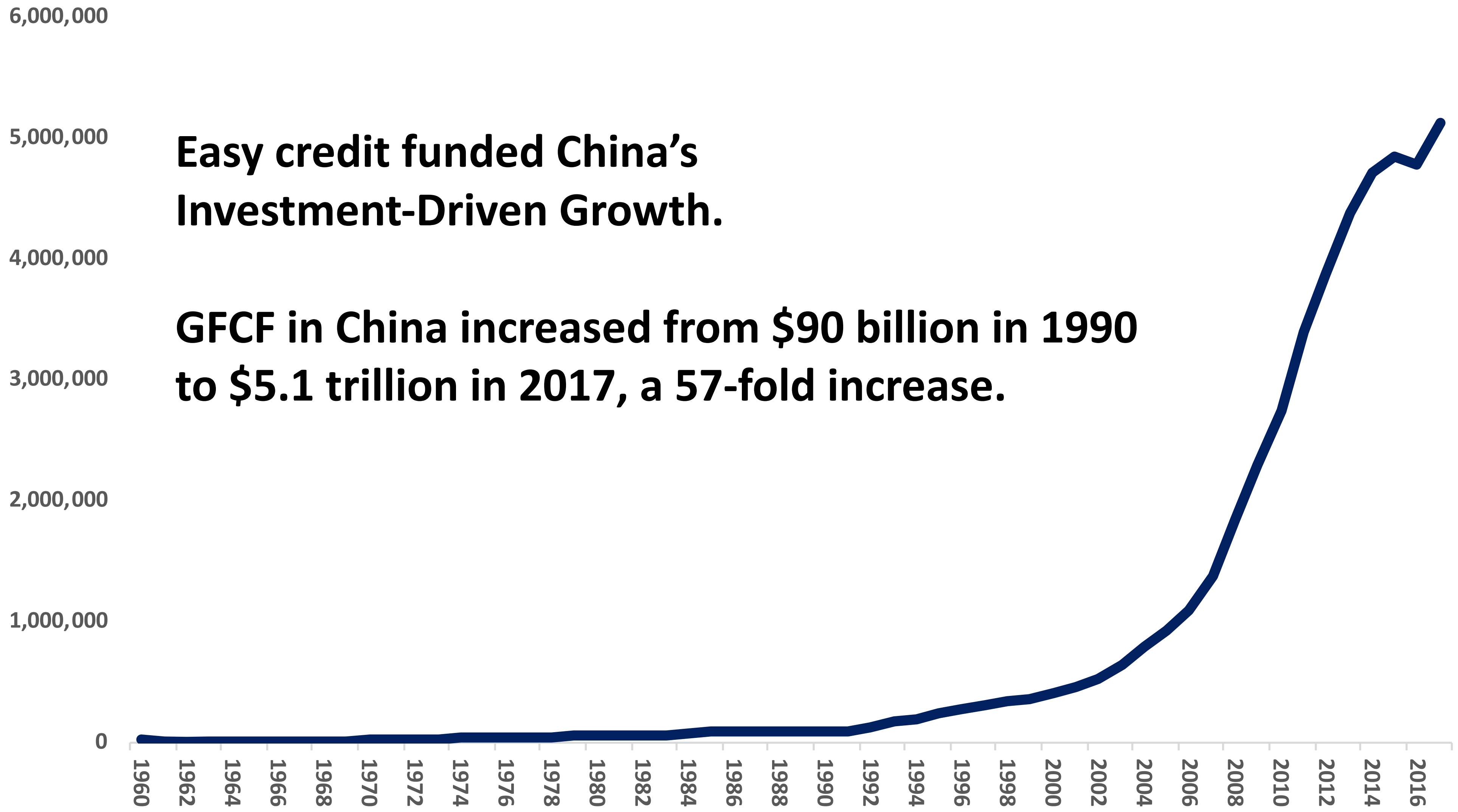
RMB Billions, 1990 to 2017



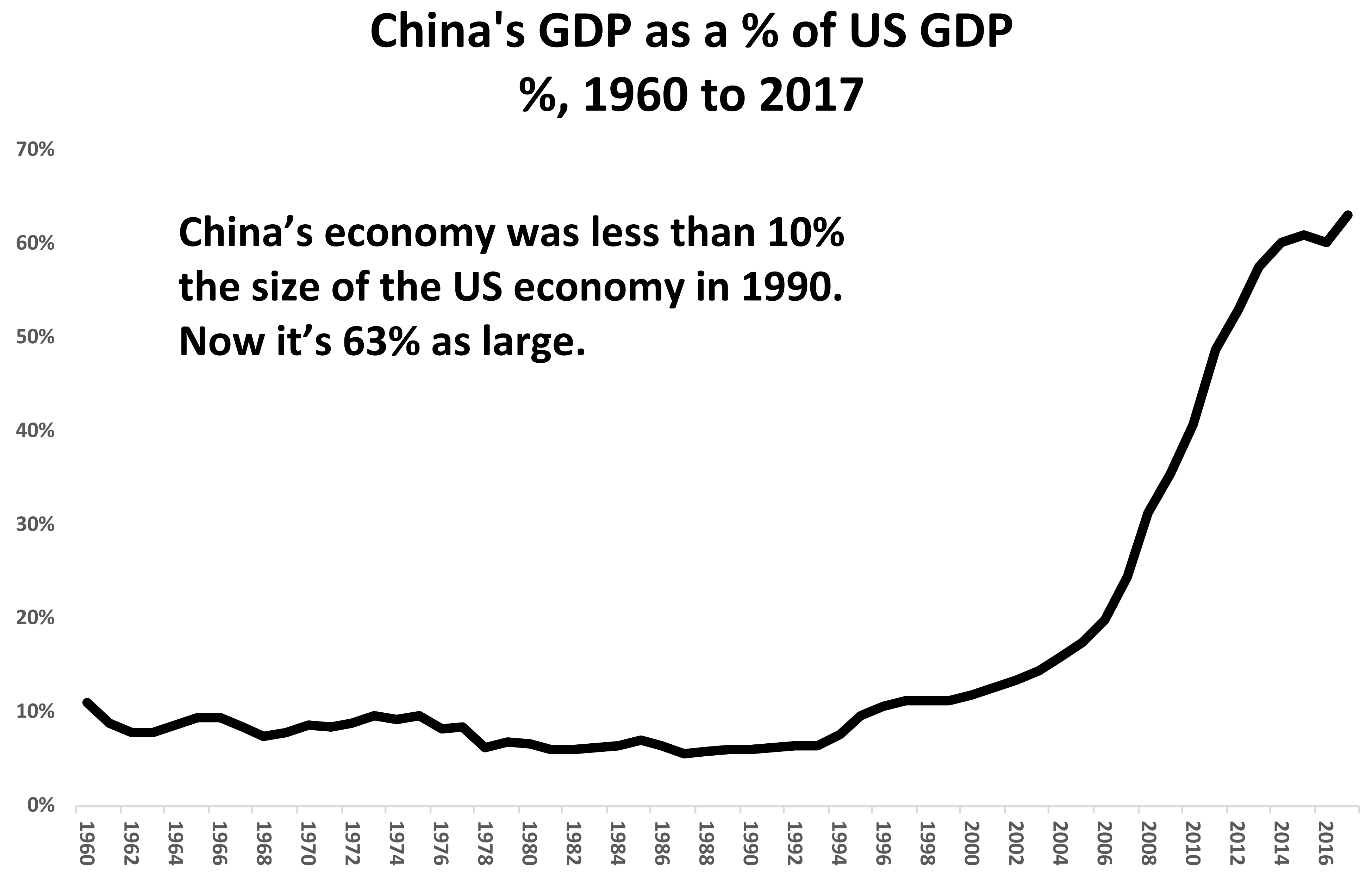
Source: CEIC

Investment (Gross Fixed Capital Formation)

US$ Millions, 1960 to 2017



Source: CEIC



Source: CEIC, World Bank

Impact On The US

- The impact of Chinese Monetary Policy was felt all around the world.
- It affected the US economy in two main ways:

1. By artificially depressing the value of the RMB, the PBOC held down the price of the Chinese-made products entering the United States as imports. The flood of low cost goods into the US drove down the inflation rate and, as inflation fell, interest rates followed inflation lower.
2. Between 1990 and 2014, the PBOC acquired approximately three trillion Dollars in order to hold down the value of the RMB relative to the Dollar. It then invested those Dollars into US Dollar-denominated bonds, pushing up their price and driving down their yields (i.e. interest rates).

Impact On The US

- Low interest rates caused the US property market and the economy to overheat.
- The Fed raised the Federal Funds Rate from 1% in mid-2004 to 5.25% in mid-2006, but longer-term interest rates (like the yield on 10-year government bonds) didn’t rise…
- …because the flood of money being invested in the United States by the PBOC (and other foreign central banks) held the yields down.
- Consequently, the Fed lost control over US interest rates and, therefore, over the US economy.
- An economic bubble formed.
- And in 2008 that bubble imploded, sparking off the economic crisis in the US – and around the world.

Impact On The Rest Of The World

- The creation of RMB 28 trillion by the PBOC not only transformed China, it made China an engine of economic growth for the rest of the world.

China's Imports From The Rest Of The World

(excluding The US)

US$ Millions, 1980 to 2017

Between 1995 and 2017, China imported nearly $20 trillion worth of goods from the Rest Of The World (excluding the US). Without the PBOC's intervention to depress the value of the RMB, China's imports would have only been a small fraction of that amount.

In that case, the economic growth in the ROW would have been much slower.

Source: CEIC

If The PBOC Had Not Intervened

- Had the PBOC not intervened to depress the value of the RMB, then the RMB would have appreciated sharply from the early 1990s as Chinese exporters converted the Dollars they earned in the US into RMB.
- In that case, China's trade surplus with the US would quite likely have come back into balance by 1995.
- That would have stopped China's economic growth in its tracks.
- China's export growth, credit growth, and economic growth would have stalled.
- Consequently, China would not have had the money to buy $20 trillion of goods from the Rest Of The World (excluding the US).
- If Chinese imports from the Rest Of The World (excluding the US) had been only $2 trillion instead of $20 trillion, the global economy would be a great deal smaller today than it is.

Commodities

- Consider the impact on the price and the production of commodities if China's economy had remained small and stagnate.
- The World Economic Forum has estimated that China now accounts for 59% of global demand for cement, 56% for Nickel, 50% for Coal, 50% for Copper, 50% for Steel, 47% for Aluminum, 47% for Pork, 33% for Cotton, 31% for Rice, 27% for Gold, 23% for Corn and 14% for Oil.
- Without the surge in Chinese demand over the past quarter century, commodity prices and production would be very much lower today.

Property Prices

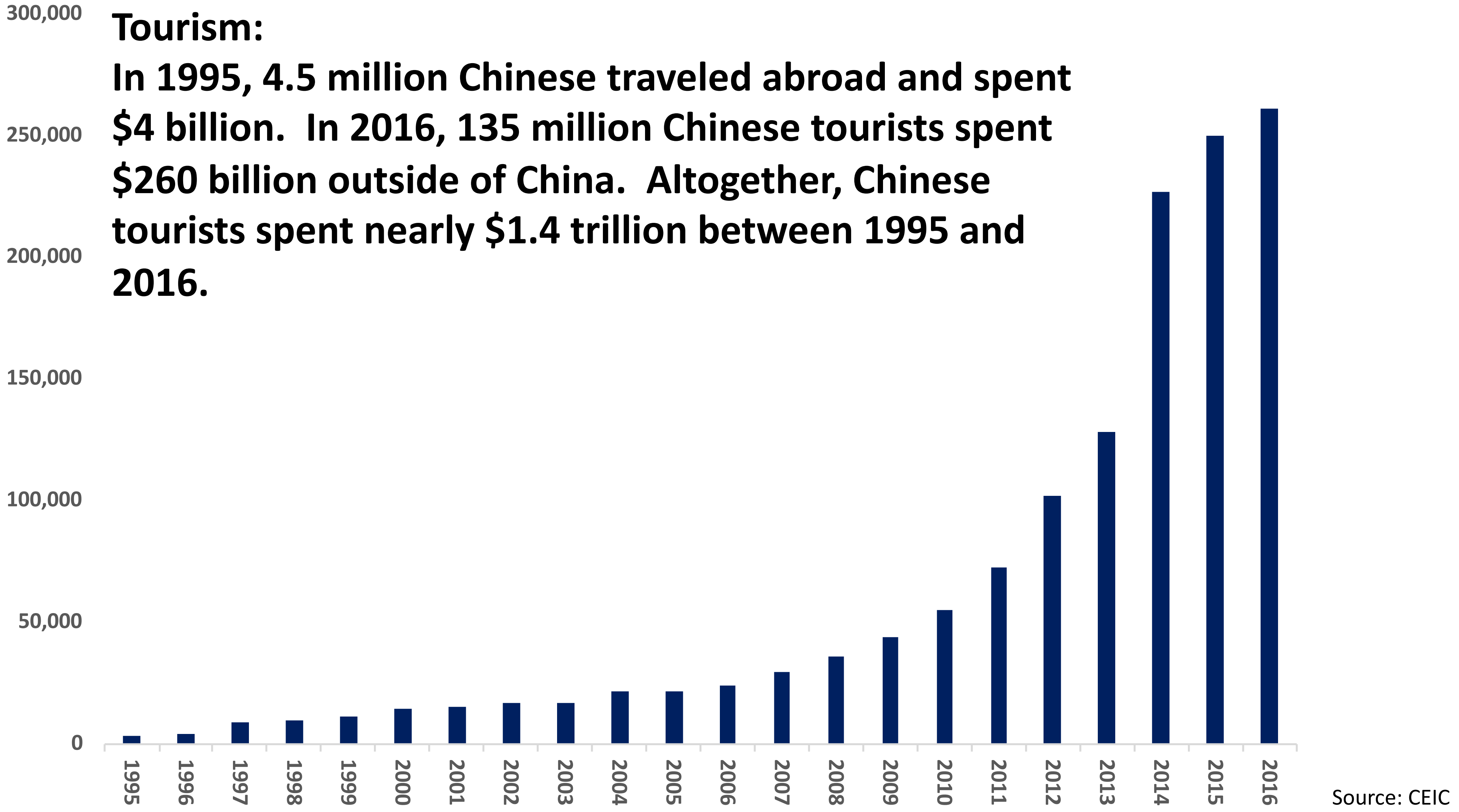
- Next consider China’s impact on global property prices.
- Property prices in Melbourne, Sydney, London, New York, Toronto, Vancouver and, of course, Hong Kong and Singapore have all been driven much higher due to Chinese buying.
- Inflating property prices have produced a wealth effect that has boosted consumption, government tax revenues and economic growth in those and numerous other financial capitals around the world.

Chinese Tourists Expenditure Overseas

US$ Millions, 1995 to 2016

Tourism:

In 1995, 4.5 million Chinese traveled abroad and spent $4 billion. In 2016, 135 million Chinese tourists spent $260 billion outside of China. Altogether, Chinese tourists spent nearly $1.4 trillion between 1995 and 2016.



Belt Road Initiative

- In 2013, China launched its Belt Road Initiative, a plan to invest at least $1 trillion building an infrastructure network of roads, railways, ports and power plants from China to Europe and Africa and beyond.
- To date, major projects have been completed in Pakistan, Sri Lanka, Cambodia, Indonesia, Iran and Hungary.
- Other projects are underway in numerous other countries.
- Nearly 70 countries have signed up to take part in BRI.

Conclusion

- So, in this video, we’ve seen that the PBOC’s policies of aggressive currency manipulation transformed China and transformed the world, beginning from the early 1990s.
- In the next video, we’ll see that the PBOC was forced to radically alter those policies beginning in 2014, when large-scale capital flight out of China threatened to send the Chinese economy into crisis.
- That video will also show that the PBOC was ultimately compelled to alter its policies because China’s economic model of export-led and investment-driven growth is now exhausted.