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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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Currencies Are Global, Monetary Policy Is Local: The US Dollar and the Chinese Yuan

The price of oil fell 56% in the last year. One-year Treasury yields rose to their highest levels since 2010. And today the Chinese central bank oversaw a 2% drop in value of its currency. What do all of these developments have in common? They are byproducts of major central banks' activities in the global financial ecosystem.

First, China's currency move is not completely unprecedented. The forerunner to today's events occurred only six months ago in another currency zone, the euro zone. The Swiss National Bank (SNB) had maintained a peg with the euro, offering to buy euros at an advertised rate in exchange for highly sought after Swiss francs (CHF). Anticipation of the imminent launch of the ECB's QE prompted the SNB to rethink their offer and the CHF was allowed to float.

Flash forward to today and, in a largely unexpected move, the People's Bank of China (PBoC) performed a de facto devaluation of its currency by moving the daily fixing of USD/CNY higher by 1.9% (meaning it takes more CNY to buy each US dollar). Although the magnitude may seem comparable to some of the other one-day currency moves seen in emerging market economies over the course of the past few years, this event is historic for a couple of reasons. It's the largest single day change since the Chinese de-pegged in 2005, and more importantly, the first time the PBoC has devalued its currency since 1994.

Both the SNB and the PBoC responded to shifts in monetary policy elsewhere. The US dollar has been strengthening for much of the past year in large part because of market expectations that the Fed will move rates higher while almost all other developed central banks will stand pat. We can see as much in the front end of the treasury curve, where 1-year US treasury yields have nearly quadrupled in the last year (from 10 basis points to 38 basis points). Higher interest rates make the US dollar more attractive. And, in the words of BIS researcher Hyon Song Shin, "Currencies are global but monetary policy is territorial; or rather, the mandated domain of monetary policy is territorial." Translation: anyone who pegs their currency to the US dollar is, in effect, importing the US Fed's monetary policy.

The appreciation of the dollar has filtered through into the appreciation of the Chinese currency (CNY), which has risen about 20% in trade-weighted terms since early 2014. China has felt the impact via weaker exports and lower producer and consumer prices. Data released on Friday night showed an 8.3% drop in exports in July. Perhaps this was the final straw.

So the People's Bank of China (PBoC) decision to allow the Chinese currency to trade more freely makes perfect sense—at least in hindsight. The SNB-PBoC is not a perfect comparison. But, the bottom line is that currency policies have consequences. Central banks that have tethered their currencies to the dollar, like the PBoC, will be forced to respond.

At Payden, we continue to recognize the nature of the global financial system and the role of major central banks in that ecosystem. The Fed's domestic-focused efforts aimed at slightly tighter monetary policy will send ripples around the globe in currencies and commodities markets. We expect a stronger US dollar to persist along with weaker commodity prices (or at least lower commodity prices and not a rebound as many have foreseen). It's unlikely that the PBoC follows the SNB and allows the CNY to float freely or devalue by 20%, but a more orderly crawl toward a weaker currency make sense.

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