Chinese moves trump Fed’s effect on US bonds
By Diana Choyleva

Efforts to devalue renminbi could push up Treasury yields

All eyes are on the future path of US Federal Reserve policy and what it means for the economy and asset prices. But growth trouble across the Pacific may have a much bigger impact on US yields in 2015 and 2016 than the expected pace of US central bank tightening.

China holds $4tn of foreign exchange reserves, of which $1.3tn was invested in long-dated US government bonds in 2013, according to US Treasury data. For a long time the threat that Beijing might sell US Treasuries rang hollow, but no longer.

An overvalued renminbi has hurt corporate profits and caused growth to slow sharply over the past two years. An expensive currency in a world of weak demand makes it impossible for China to rebalance its economy without a collapse. Beijing knows this and has intervened in the foreign exchange market to lower the renminbi in a bid to discourage currency speculation and support growth.

But nominal depreciation of just over 3 per cent, coupled with producer price deflation of about 2 per cent, is not enough to eliminate the renminbi’s overvaluation, which we estimate at 15-25 per cent. China needs further renminbi weakness; the question is how to achieve it.

More currency intervention risks provoking Washington’s ire. After all, the International Monetary Fund reckons the renminbi is still 5-10 per cent undervalued.

Liberalise capital flows
The best solution would be to liberalise capital flows. Chinese citizens have been denied free access to foreign assets for years. Money has seeped through porous capital controls, but, if Beijing opened the flood gates, asset diversification would cause huge outflows that would swamp inflows.

The good news is that President Xi Jinping’s administration has made more progress on this front in one-and-a-half years than the previous leadership did in a decade. Financial market reform is a daunting task, which Beijing could easily bodge or abandon. For now the omens are positive and implementation swift by Chinese standards.

But if growth were to stall and unemployment to rise, a nervous Beijing might well repeat its 2008-09 stimulus by throwing money at unproductive investment. In such an event, the renminbi would come under pressure. China’s current account surplus, about 2 per cent of gross domestic product, could easily turn into a deficit. Capital outflows would follow as people saw through the futile policy response and headed for the exit.

We modelled the impact of these possible outcomes on the 10-year US Treasury yield. If China continued opening the capital account in the next couple of years, we assume 5-10 per cent of domestic bank deposits would be switched, mostly into other dollar assets through either portfolio or foreign direct investment. The People’s Bank of China would intervene to smooth the renminbi’s decline, running down its dollar reserves and so pushing up the 10-year Treasury yield 18-50 basis points.

Lethal combination
The alternative is a stalling of reforms, with either major intervention to weaken the renminbi or an investment binge. The result is likely to be a re-run, on a greater scale, of the selling of long-dated Treasuries witnessed in 2012. Yields could rise 10bp. These outcomes would slow but not derail the US recovery – yields rose by almost a percentage point in the second half of 2013.

Moreover, these scenarios assume all other things are equal. But they are not. Renminbi devaluation and higher US yields would be a lethal combination for the eurozone. Most European countries have modestly improved their trade positions with China thanks to stronger
German capital exports and soft consumer spending, which has capped imports. But a much weaker renminbi would reverse the trend, thus subtracting from growth.

The eurozone’s peripheral economies would be hurt most because they have a larger export share of lower value-added manufactures and are more likely to compete with China. But Germany’s export-led growth would also suffer if China reduced its excessive reliance on investment.

In addition to the currency effect, a rise in US yields transmitted to the eurozone would represent just the “unintended tightening of monetary conditions” that Mario Draghi, European Central Bank president, has identified as one of three contingencies that would warrant a monetary policy response.

In this context, any major financial market dislocation in Europe or Asia would be likely to trigger a flight to the safety of US Treasuries. If such haven flows were half as great as they were after the euro area debt crisis in 2010-11, our model suggests they would offset the impact on US Treasury yields of a decline in the renminbi.

*Diana Choyleva is head of macroeconomic research at Lombard Street Research*

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