Connolly Insight
Vision beyond the horizon

China and Yellen: Dangerous Dynamics?

Bernard Connolly, December 18, 2015

- The China Beige Book suggests the possibility of dangerous dynamics in the Chinese economy.
- It is hard to see how a substantial yuan depreciation can be avoided.
- It is disturbing that Yellen, unlike the BoE and the ECB (although the views of this last body always contain an element of political calculation), considers global economic risks to have diminished.
- Her selective listing of factors influencing US inflation may have been determined by political considerations.
- It really does seem that the FOMC is repeating the mistakes of 2000 and 2007 and is acting on the basis of what it thinks is best for its "credibility" rather than on an objective risk assessment.

As we noted yesterday, there were several disturbing elements in Yellen's media conference. We concentrated yesterday on what we considered the most important of them. But others also deserve consideration. She claimed that the economic risks from the rest of the world had diminished since the summer. It is hard to see on what she bases that contention. Perhaps she is being unduly influenced by her former head of research at the San Francisco Fed, Williams, who some weeks ago said he had been considerably reassured about China by his visit there and his meetings with officials. Williams presumably knows how little the Fed knows about the US economy, so it is surprising, for more reasons than one, that he should place much weight on what he is told by Chinese officials. Today the latest Chinese Beige Book, based on interviews with more than 2,000 executives, managers and bankers rather than on a few formal meetings with Chinese officials, was released. It described a "disturbing deterioration" and "pervasive weakness" in the economic situation and outlook.

Readers will know from our notes in recent years that we think, on the basis of theoretical reasoning and the experience of other countries such as Ireland which experienced explosive and unbalanced growth, that China inevitably faces an incipient hard landing. China has far more policy tools available to mitigate a potential hard landing than Ireland had. But the authorities have a very hard row to hoe and "pervasive weakness" is likely to persist for quite some time to come. The Beige Book pointed, in particular, to emerging evidence of risks in the labour market and to the possibility of damaging deflation. Given that, the dynamics of "mitigation" are highly uncertain. We think the risks from China and thus, in part, from the emerging-markets world, have increased, not diminished, since the summer. In particular, it is hard to see how China can avoid, despite the apparent political imperative of allowing the "right" members of the elite to get their money out, a substantial yuan depreciation. The massive effective appreciation of the yuan over the past couple of years must be having a very severe impact in China. Just moving from a dollar reference to a trade-weighted basket for the yuan will be nothing like enough.

Yellen's complacency about global risks is rather strangely at odds with the views both of the BoE (which can usually be relied on to express views based on economics rather than politics) and of the ECB (which cannot be so relied on but may occasionally be right) that global risks have intensified. Why? Having to ask that question is itself somewhat disturbing.

We note also that Yellen listed a number of "idiosyncratic" factors which have been (but, she implied, not for much longer) holding down core inflation in the US. But she did not mention the most important factor pushing core inflation *up* – not an absence of economic slack but rents and OER. Perhaps she did not mention it because it would have been politically inconvenient to do so: the reduced affordability of home purchases, as a result of the HPA eagerly induced by the Fed, has contributed to increased rental demand and thence increased rents. That has meant a further increase in economic inequality in the US – something with which Yellen will not want the Fed to be tainted any more than it already is.

In sum, we really do think that the FOMC is repeating the mistakes of 2000 and 2007 and is acting on the basis of what it thinks is best for its "credibility" – or the credibility of its conceptual framework – rather than on an objective risk assessment.