Financial Markets React to Chinese Interventions

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Global output growth slowed to 2.6 percent year over year in the second quarter (Chart 1), but the outlook remains stable and the global economy is expected to grow at a faster pace in the second half of 2015 and 2016. Emerging markets’ growth remained relatively steady at 4.0 percent despite Brazil’s entry into recession in the second quarter. Advanced economies posted 1.3 percent growth, although some countries in the euro area are gaining momentum. Global risks include low inflation, a slowdown in emerging markets and volatility in financial markets.

Prices Remain Low in Advanced Economies

Inflation continues to be low in advanced economies at 0.6 percent year over year in July but is expected to pick up through 2016 (Chart 2). Low oil prices have had a significant depressing effect on headline inflation, but core inflation, which excludes food and energy prices, was low as well at 1.4 percent year over year in July in advanced economies. Producer prices, which primarily measure the prices of tradables, have decreased throughout 2015.

Monetary Policy Diverges at Major Central Banks

With low inflation in advanced economies, many central banks are pursuing quantitative easing programs and loose monetary policy. The European Central Bank (ECB) has purchased 60 billion euros’ worth of government bonds each month since March, with purchases intended to continue through September 2016 and possibly beyond (Chart 3). At its Sept. 3 meeting, the ECB left its interest rates unchanged, but ECB President Mario Draghi expressed that its quantitative easing program could be expanded if inflation does not move toward the ECB’s inflation target near 2 percent. Meanwhile, the Bank of Japan continues to expand its balance sheet by 80 trillion yen per year. While central bank balance sheets in the euro area and Japan continue to grow, balance sheets in the U.S. and U.K. remain stable, highlighting an increasing divergence of monetary policy among the world’s largest central banks.

Emerging Markets Facing Trouble

Growth in emerging markets has been flagging, with Purchasing Managers Indexes (PMIs) in Brazil, Russia, China, South Africa and Turkey in contractionary territory in August. Brazil fell into recession when its gross domestic product (GDP) shrank by 1.9 percent from the first quarter to the second quarter, its largest contraction since March 2009. Standard & Poor’s downgraded Brazil’s credit rating to junk status on Sept. 9, citing political turmoil and growing debt. Brazil’s economy has also suffered from low commodity prices, an ongoing corruption scandal and the slowdown in China, its largest export market.

China’s GDP growth was 7.1 percent year over year in the second quarter and is projected to decline during the second half of the year. Industrial production growth ticked up to 5.9 percent year over year in August but came in below market expectations due to slowing investment in fixed assets and a persistent decline in manufacturing sector growth rates. China’s PMI data shows a slowdown in manufacturing activity in August. Based on both the Caixin/Markit and official August PMI readings, China’s manufacturing sector is performing below its five-year average (Chart 4). While stock of raw materials and suppliers’ delivery times remain close to their five-year averages, all other components of the official PMI are below.
Markets Respond to Renminbi Depreciation

Fears of a slowdown in China were worsened by the People’s Bank of China (PBoC)’s interventions to depreciate the renminbi, cut interest rates and lower reserve requirements during the summer, causing stock market volatility both in China and abroad. The renminbi fell 3 percent in August, its largest depreciation in 20 years (Chart 5). The currency switched from a peg to the U.S. dollar to a 0.5 percent managed float in June 2010. The PBoC widened the trading band to 1 percent in 2012 and, subsequently, to 2 percent in 2014. On Aug. 11, the PBoC announced changes to the way it sets the renminbi’s midpoint, basing it on the previous day’s closing value as opposed to an average of quotes submitted to the PBoC.

The Aug. 11 depreciation amplified volatility in financial markets as investors questioned if it was an attempt to stimulate the Chinese economy and boost exports. Following the sharp movement in the exchange rate, the CSI 300 index of large Chinese companies saw a large drop after the Chinese stock market had already fallen markedly in June. Chinese authorities’ mixed messages in conveying a plan for the future path of the economy further added to the increased volatility in the foreign exchange and stock markets, and other countries’ stock markets experienced higher volatility as well (Chart 6).

Uncertainty Remains a Headwind

Global output growth is expected to increase, although uncertainty surrounding the divergence in monetary policy of the world’s largest central banks and volatility in financial markets reflecting worries over China’s slowdown remain headwinds.

—Valerie Grossman

Note:


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