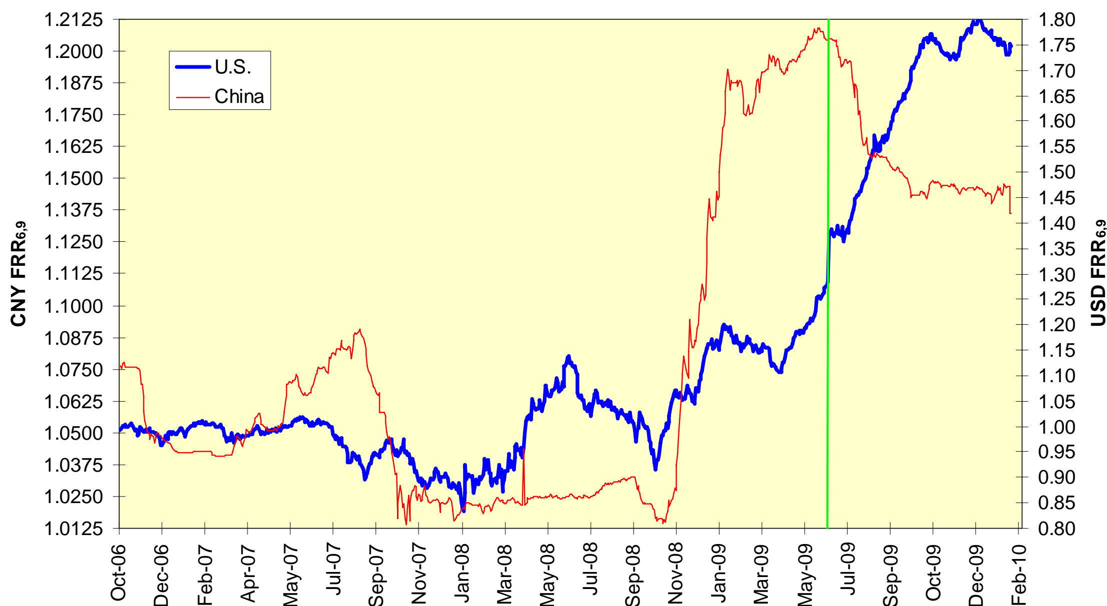
Chinese Monetary Policy And U.S. Fixed-Income

The phrase "looked at me like I had two heads" has a sound foundation in evolutionary design. Somewhere in time, biological development was split into two routes, protostome and deuterostome. In a protostome, the mouth develops before the anus; in the deuterostome, the opposite route is taken. Unsurprising to anyone who follows national politics, human beings are deuterostomes; regardless, we still have one and only one head for good reasons.

What, then, are we to make of the single organism of Chimerica, the "G-2" economic bloc of China and the United States, which share a pegged currency and an economic symbiosis of them lending us the money to buy things we no longer make? By the Law of One Head, we should share a coordinated monetary policy and have money-market yield curves that look very similar to each other.

Wrong. If we compare the money-market yield curves of the U.S. and China as measured by the forward rate ratios between six and nine months ($FRR_{6,9}$), we see they have been heading in opposite directions since May 2009. The $FRR_{6,9}$ is the rate at which we can lock in borrowing for three months starting six months from now divided by the nine-month rate itself. The more the $FRR_{6,9}$ exceeds 1.00, the steeper the yield curve is.

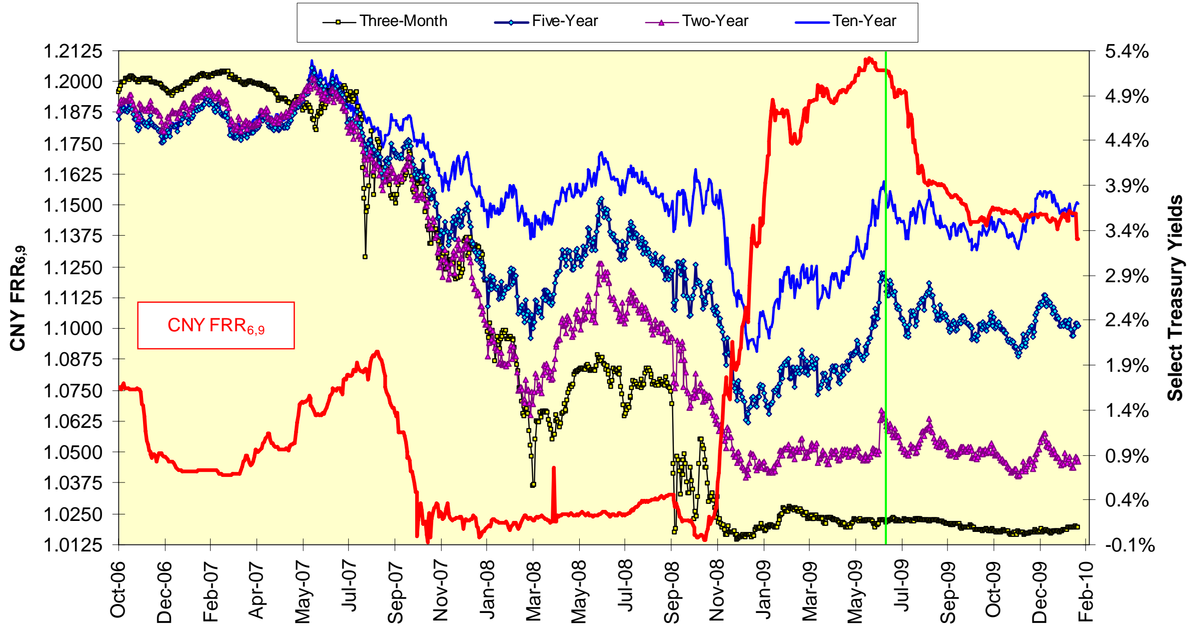
Divergent Money Market Yield Curves



Several developments can be seen in the chart above, including the extremely rapid steepening of China's $FRR_{6,9}$ a year ago, its recent abrupt flattening, and the much higher $FRR_{6,9}$ for the U.S. The green vertical line marks the date when U.S. ten-year Treasury note yields peaked in June 2009.

Of what significance is that? The decline in the Chinese $FRR_{6,9}$ is irrefutable evidence of a tighter monetary policy, yet this is inconsistent with the peg of the yuan. A country normally tightens credit by issuing bonds to soak up excess funds, and these higher interest rates generally put upward pressure on the currency. However, paying interest on those bonds can get expensive. An ingenious way around this mess is to take excess funds out of the Chinese economy by buying ever-greater quantities of U.S. debt, either directly or by being a floating-rate receiver in global interest rate swap markets. This supports the dollar against the yuan and allows the Chinese to receive interest from the U.S. taxpayer rather than paying interest to their citizens. It also had the side benefit of supporting the dollar and yuan against the euro during those months in 2009 when the dollar looked like it was going to crater.

The whole affair makes the U.S. Treasury market a plaything of sorts for policymakers in Beijing. If we map the course of Treasury yields at various maturities against the CNY $FRR_{6,9}$, we see how everything has been frozen in a tight range since last June. If anyone has wondered how the Treasury can keep auctioning hundreds of billions of dollars of new and rolled-over debt at stable interest rates, this is the answer.



Of course, we have China right where we want them, too. The minute they stop financing the U.S. Treasury, American interest rates shoot higher and their most important customer no longer will be able to buy Chinese goods. Nothing scares the Communist Party more than the prospect of tens of millions of unemployed and unattached young males hanging around the cities with idle time on their hands.

How will this credit symbiosis end? Very badly, of course: All one has to do know to understand the history of international finance is to know the exporter keeps financing the importer until the importer becomes absolutely bankrupt. Then the exporter has an economic depression and the importer slinks off into poverty. The only question is when.