Are the latest Chinese tremours a smoke screen?

On 11 August the global markets were shaken by the rather unexpected devaluation by China of its currency, the Yuan. Despite Beijing's various interventions, the Shanghai Stock Market nosedived by 35% in 3 weeks since its mid-June peak, and the Index was gyrated violently by the subsequent 4% devaluation against the dollar in 3 days. The rest of the world was awoken by the realisation that the Chinese economy and Beijing's policy actions really matter.

China's economic slowdown is undeniable, after years of poor investment decisions and executions of wasteful top-down projects. However, the Chinese economy is expected to continue to grow, albeit by lesser extent, and the authority still has room to manouvere. China's economy is in transition from an export-led model to a domestic demand-driven one. The recent events in China are steps it must take to become more mature. The world's main stream media's reactions to the Chinese drama are overdone, particularly those in Japan with ridiculously accusatory tones. We should not be sidetracked by sensational headlines. What is far more important to the whole world is the future of the dollar in the current global monetary and currency system. It is being challenged openly by China and Russia, and increasingly looks like being on its way out.

Thus it is worth reviewing the US policies and their effects of the last few years.

What are ZIRP and QE for?
Soon after the 2008 global financial crisis, the Federal Reserve Bank, the US central bank, introduced Zero Interest Rate Policy ('ZIRP') and Quantitative Easing ('QE'). At the time the Fed said these policies were to stimulate the US economy. Mainly having seen the labour market's gradual improvement (i.e. more part-time job creations), it stopped its QE with its third iteration at the end of October 2014, whereas they have kept ZIRP in place. Did these policies work?

The answer is a resounding no. The recovery of the US economy is fragile at best. And at the same time they have widened the gap between the rich and the poor. Who would argue against this conclusion? These policies were already demonstrated ineffective as the Bank of Japan's earlier experiment had shown empirically. Still, the Fed launched them as if it believed that its QE on a massive scale would make a difference. Now its credibility is being questioned.

ZIRP is for the government as well
ZIRP helped banks to make money by borrowing at zero cost and investing in higher-yield bearing bonds: a fabulous free lunch for the Wall Street banks. It also helped zombie companies stay alive, while it penalised private savers. Many of them gave up on saving and poured money into stocks. It also forced institutional investors like pension funds and insurance companies to increase their exposure to the stock markets to meet their obligations, with implied expectation that stock prices will rise indefinitely. Of course, not!

ZIRP is actually killing the system. People work to save money and deposit it at banks, and banks lend money to sound businesses and contribute to sound economic growth which should lead to stronger capital formation of the nation as a whole. Isn't this the essence of capitalism?

Who needs ZIRP most? It is neither corporations nor households but the government, which is intoxicated with huge debt. Although ZIRP is first and foremost for the Wall Street banks to boost their profits and consequently improve their balance sheets, it has been helping the government alleviate itself from the burden of repaying the debt. How could the Administration present a strong counter argument against ZIRP then?

QE is not a cure but stimulant
QE is more money printing. By increasing money supply (i.e. injecting more money into the markets), the Fed anticipates higher velocity of money. The markets are undoubtedly awash with plenty of easy money. Is QE really improving the economy?

Consider a man who is on a push bike. He feels the load behind him becoming heavier and heavier, the slope he is climbing is getting steeper and steeper, and the headwind is blowing strongly. On top of these, he himself is feeling weaker by the minute. If he slows down, he would lose his balance and risk falling over. So he has to keep on pedaling. He would need a good strong push from behind to keep the bicycle rolling along.

The US economy is like this man, and the Fed's QE is the push from behind: So long as more money injection and higher velocity of money are maintained, the economy will limp along. QE is not, however, making it healthier and stronger but only sustaining it with more debt! QE is a mere stimulant. A first injection of a stimulant may revive the economy to a certain degree but just like any stimulants, further administration will become less and less effective and actually weaken it.

QE is nothing but money destruction

The Fed is supposed to protect the value of the dollar. Keeping the currency's value stable is a main task of a central bank. However, the Fed is actively devaluing or destroying the value of the dollar by printing more out of thin air. Just like any other commodities, the more dollars, the less value. The US currency is not backed up by such real asset as gold or silver but by mere confidence in the central bank. The recent strength of the dollar against other currencies looks increasingly more like a last gasp before it dies. In fact, it is already showing weakness.

Since the Nixon Shock in 1971, all the world's currencies have become fiat. Issuing more and more fiat currencies is an act of destroying their values, deliberate or not. Imagine a company which has no asset and yet continue to issue promissory notes with no payment date printed! As history shows, fiat currencies do not last very long. The Reichsmark in the Weimar Republic is a notable instance.

Wall Street has been partying and dancing with the excessive supply of the dollar devalued by the central bank's successive QE programmes.This will inevitably lead to a short-term gain and long-term loss.

Another QE is impossible and unnecessary

Since the Fed did not rule out more QE at the end of October 2014, a new QE regime may yet commence. However, the launch will be seen as another attempt to devalue the dollar, and will certainly undermine the Fed's credibility. If the Fed should go for another QE, then I suspect there may be some hidden agenda we are not aware of. Besides, no more QE is needed. It appears to me that the Fed has been active in 'stealth QE', using another central bank depository to keep its purchased assets. Belgium, a country suffering from current account deficit, holds the US Treasury notes and bonds worth one-third of its GDP. It is a prime suspect.

The dollar is to retire soon

The dollar has been challenged by China's RMB, as its economy grows. Its GDP is already the largest in the world in terms of the purchasing power parity.

What the Fed has done by ZIRP and QE has brought forward the time when the dollar risks ceasing to be the world's number one reserve currency and the entire global monetary and currency system is re-set. The Fed's officials are aware of this? It would be surprising otherwise! Since Americans can only be happy if they remain as top dog, and the culture of 'The Winner Takes It All' is still very much alive, Washington/Wall Street will act pre-emptively.

The latest RMB devaluation and sharp decline in the Chinese stock market are very conveniently timed headlines, giving the Fed time before laying out a new board game! I suspect the US is not quite ready to do this…yet. Another perfect storm will hit the world in the near future. It will be far more damaging than the last one and present the US a good opportunity to introduce New World Order. Let us be prepared and not be distracted by false flags and side shows!

© by Mack Konishi

Global Strategy Officer
AGEM GROUP