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Monkey Cage

This is why you shouldn't blame China for the havoc in the markets

By Sarah Bauerle Danzman and Kindred Winecoff August 27, 2015

People are freaking out about the markets. On "Black Monday," publicly traded companies posted huge losses, which contained a downward trend that has now destroyed trillions of dollars in global financial wealth over the past month. The Shanghai Composite Index was down 8.5 percent on Monday alone, down another 7.7 percent on Tuesday, and has erased all its gains for the year. The German DAX closed off 5.5 percent on Monday before bouncing back nearly the same amount on Tuesday. French stocks were down 5 percent, the FTSE down 4.7 percent, the Nikkei closed 4.6 percent lower, and stocks in emerging economies such as India suffered similar losses.

Some of these markets have partially rebounded since, but volatility remains high: the VIX, or "fear index," has spiked to levels not seen in seven years. Over the past month the world's major equity exchanges have fallen in value from 7.5 percent (S&P 500) to well over 20 percent (China's Shanghai index). Commodity prices continued their slide with oil dropping below $40 barrel, and U.S. Treasury yields slipped below 2 percent as investors rushed to safety. The euro, pound and yen also appreciated as "flights to safety" pushed capital into the core and put enormous strain on emerging markets. A Financial Times graphic showing the change in countries' stock markets and currencies since Aug. 10 sums up the recent situation succinctly.

The dominant narrative appears to be that the collapsing Chinese stock market has spread contagion across global capital markets. The New York Times ran with the headline "A Plunge in China Rattles Markets Across the Globe." The Washington Post concurred in an article titled "China's 'Black Monday' spreads stock market fears worldwide." The Financial Times, CNN Money, Wall Street Journal, Boston Globe and others were playing the same chords. Some notable U.S. presidential candidates even got in on the act.

But pinning the blame for market volatility on Chinese stocks is not just wrong; it is dangerous. It is wrong because it overlooks how China's market weakness is an indicator of global rather than national economic weakness: many of these trends — currency weakness in emerging markets, growth slowdowns almost everywhere — have been present before this week's stock market implosion. It is dangerous because it deflects blame from the policymakers in the world's economic core, particularly the U.S. Federal Reserve, who have the capacity if not the willingness to arrest market chaos by crafting monetary policies that can encourage growth globally. Instead, the Fed has been signaling for months that it intends to further tighten monetary policy soon, despite the strengthening of the U.S. dollar, slowing domestic inflation and weak wage data.

Weakness in the Chinese and other real economies is much more concerning than wild stock market fluctuations. China's exchanges are some of the most isolated in the world — less than 2 percent of shares are owned by foreigners. In fact, none of the major emerging economies — Brazil, Russia, India, China and South Africa (or BRICS) — are integral to the global financial network. The United States, however, is now more important for global financial stability than before the subprime crisis. Institutional investors are also not as prominent in Chinese markets, and the prevalence of unsophisticated traders means market fluctuations are less likely to communicate fundamentals. Thus, there is no mechanism for contagion to spread from China's financial markets to others; they just aren't well enough connected.

The problem, in short, is not China. The problem is the global economy itself.

Global growth is slowing. Stock markets can fluctuate for multiple reasons, but the distress across a range of markets is concerning. Rapid declines in key commodities such as copper, aluminum and oil reflect weakening global demand. As investors worry increasingly about world growth prospects, safe haven currencies such as the U.S. dollar, the euro, the yen and the Swiss franc continue to appreciate. Emerging economies are trapped in low or negative growth. The Brazilian economy is poised for its worst performance in 25 years, with a negative growth rate forecast around 2 percent and inflation close to 10 percent. Argentina is also in recession. Turkey, South Africa, Russia and Indonesia all also face low growth and high debt levels.

China's numbers cannot be trusted, but keen observers such as Michael Pettis and Christopher Balding believe that its growth has slowed significantly. China's recent currency "devaluation" was only relative to the U.S. dollar, which has appreciated significantly this year; China was just unwilling to keep riding the dollar upward given the country's overall economic weakness. Europe still hasn't recovered from its rolling debt crises — the botched negotiations with Greece were worrying, as is the absence of a signal from the European Central Bank (ECB) or major E.U. governments that any growth-supporting stimulus is coming — and growth in the United States is tepid at best and possibly weakening.

The good news is that we have tools to fix this. The bad news is that we are unlikely to use them.

All signs indicate that the global economy could use more stimulus. Inflationary pressures are slight, and where price level changes are troublesome the growth slowdown remains a bigger concern. (There is no necessary inverse correlation between the inflation and employment anyway, yet the Fed still refers to the so-called "Phillips curve.") Because the U.S. dollar is so important globally, the Federal Reserve could be providing global stimulus, perhaps in concert with the ECB, Bank of England and Bank of Japan. (The Bank of China is already cutting rates.) This would even be in line with the Fed's domestic mandate, since neither inflation nor unemployment have reached their policy targets. Such a move would stem capital flight abroad and meet demand for liquid assets. Instead, the Fed has continued to signal that the stance of policy will become even more contractionary in the near future. If this happens, even more capital will flow into the United States, potentially causing currency or banking crises throughout emerging markets.

The Fed should know better than to tighten its policy now. It raised interest rates throughout 2006 to 2007, before reversing course and cutting them once it became clear that domestic financial markets were in distress. It then paused its cuts in mid-2008 until the entire global financial system went into chaos following Lehman's collapse and the ensuing liquidity crunch.

Similarly, the ECB actually raised rates in mid-2011, exacerbating the burgeoning European sovereign debt crisis. These crises demonstrated that the risk of doing too little is far greater than the risk of doing too much, yet monetary policymakers appear to have missed the lessons of these experiences. Monetary easing could reduce pressures on emerging markets' exchange rates, reduce capital flight, and boost demand in core economies. A pleasant side effect would likely be more stable equity markets.

Finally, the narrative that Chinese volatility is transmitting crises through stock markets is not simply wrong but dangerous. It emphasizes the idea that interconnectivity leaves us only as strong as our weakest link and contributes to a collective sense that we are powerless to stop amorphous market forces. In fact, global market unrest reflects a simultaneous response to shared global conditions rather than contagion across capital markets. Viewing recent events in this way provides policymakers with a path forward. Global economic weakness can be met with coordinated monetary interventions. As demonstrated by extraordinary actions taken during the 2008 global financial crisis, the Fed has the capacity to coordinate across central banks to tame markets and generate conditions conducive to growth when it wishes.

There are reasons to believe that we are not on the cusp of a major financial disruption, as in 2008 or even 1997. Financial leverage is lower now, and emerging markets owe less debt to foreigners and possess greater currency reserves. But this should not make policymakers complacent. Rapid capital flight is still deleterious, global growth slowdowns are a preventable tragedy, and consequences for political stability may yet be significant. Whether it wishes to be or not, the Fed is a global actor and the world's central banker. It should behave like one.

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