Rosebud

Question: **Mr. President, a clarification if I may. The people who were blocking the Ukrainian Army units in Crimea were wearing uniforms that strongly resembled the Russian Army uniform. Were those Russian soldiers, Russian military?**
Putin: **Why don't you take a look at the post-Soviet states. There are many uniforms there that are similar. You can go to a store and buy any kind of uniform.**
Question: **But were they Russian soldiers or not?**
Putin: **Those were local self-defense units.**
– Vladimir Putin press conference, March 4, 2014

Kane: **Read the cable.**
Bernstein: **"Girls delightful in Cuba. Stop. Could send you prose poems about scenery, but don't feel right spending your money. Stop. There is no war in Cuba, signed Wheeler." Any answer?**
Kane: **Yes. "Dear Wheeler: you provide the prose poems. I'll provide the war."**
– Orson Welles, "Citizen Kane"

Indeed, expectations matter so much that a central bank may be able to help make policy more effective by working to shape those expectations. … Communication about policy is likely to remain a central element of the Federal Reserve's efforts to achieve its policy goals.
– Ben Bernanke, "Communication and Monetary Policy", November 19, 2013

There's no one thing that's true. It's all true.
– Ernest Hemingway, "For Whom the Bell Tolls"

Last Friday I wrote an Epsilon Theory email highlighting the media Narrative around China's shift in monetary policy and associated manipulation of the yuan as a prime example of *The Power of Why*…a facile "explanation" designed to satisfy the business model imperative of financial media (and financial advisory services, more broadly) as well as the political interests of powerful institutions, in this case the Chinese state. I wasn't surprised that the epicenter of this Narrative was a newspaper owned by Rupert Murdoch, whose close ties to the Beijing regime are legendary, and I tried to be kind in not calling out the beat writers who I'm sure were provided with precise talking points. But I am surprised by the degree to which mainstream economists and China watchers have uniformly swallowed and promulgated the notion that this sea change in Chinese monetary policy – which is far more impactful on global economics and investing than anything that happens in the Ukraine – is not only entirely benign but part and parcel of China's accession to liberal modernity and the brotherhood of Western nations.

There are two levels to the official Chinese line on their monetary policy shift – one for the hoi polloi and one for the professional economist/analyst community. I'll deal with both, and apologies in advance for the density of the latter, which requires a bit of inside-baseball lingo.

The first argument is that China is seeking to end the "one-way bet" (I only wish I had copyrighted this phrase two weeks ago, like Pat Riley did with "three-peat") on the yuan going up in value. This argument appeals to a Western, liberal-minded opposition to rigged markets and evil "speculators". Unfortunately, it's complete hogwash, the linguistic equivalent of US politicians who clamor for "a level playing field" while voting for the usual assortment of pork barrel goodies. It's wordplay, entirely symbolic in nature, no different than my saying that I'd like to end the one-way bet on gravity. The Chinese government intentionally created this one-way bet, because the alternatives – either a free-floating currency or a fixed currency regime – would have resulted in unacceptable domestic economic damage in the former case or unacceptable international political damage in the latter case. **The yuan has been going up in a highly predictable fashion because that's exactly what the Chinese government wanted and imposed. To say now that they are shocked…shocked!…at the speculation this engenders is a stratagem in the best tradition of Casablanca's Capt. Renault.**

Are there speculators (I call them beautiful parasites) who eat the tiny trading crumbs created by the Chinese government's non-economic dribbling of the yuan higher? Of course. Is the Chinese

government – like governments everywhere – genuinely delighted to crush these lamprey eels if they can? Sure. But are they the *reason* China is shifting its monetary policy? Please.

The inside-baseball argument is more nuanced, but ultimately just as misleading. In version A, China is trying to engender a wider "volatility band" in the yuan so that it will ultimately trade like a market-oriented currency. In the still more nuanced (and thus still more appealing to economists) version B, China is seeking to reduce volatility in domestic interbank lending and associated interest rate spreads, and as a result is "transferring" that volatility to currency exchange rates. Again, all with the goal of making Chinese monetary tools and policy more in-line with Western monetary tools and policy.

The problem I have with this argument – and the reason my risk antennae are quivering – is the orchestrated and intentional linguistic focus on volatility. The word "volatility" means something. It's an important and powerful word. There are assumptions behind the word and its meaning. Those assumptions are not just violated here; they are crushed. **The word "volatility" means nothing in the context of a highly manipulated data series.** Or rather, it means something *entirely different* from what it means in a non-manipulated context. It's ersatz volatility. Potemkin Village volatility. Faux volatility. I could go on. Whatever it is, it doesn't mean what you think it means.

I'll spare you the dissertation on stochastic underpinnings of econometric concepts. Suffice it to say that what's happening here is like someone telling you that he has a random number generator when really he's just spouting off numbers that pop into his head and sound kind of random. Trust me, these are not random numbers. But if you treat them as random numbers, say for some encryption program, you're going to be very sorry. Similarly, if you treat "volatility" in a yuan/dollar time series the same way you treat volatility in the euro/dollar time series, say for some relative value forex trading program…well, good luck with that. You, too, are going to be very sorry.

So why the intentional (and intentionally misleading) focus on volatility as the *WHY* behind a monetary policy shift? What's at stake here and what's really going on?

First, let me be clear on what I'm NOT saying. I am not saying that Chinese government economists and policy apparatchiks are out and out lying when they say that they want to crush currency speculators and diminish interbank lending volatility, particularly that latter part. I think that the

Chinese government – like governments everywhere – is terrified of domestic lending seizures or dislocations and will do pretty much anything to mitigate that risk. I also think that the government functionaries who communicate with Western economists and analysts (and not coincidentally tend to speak really good English) are likely true believers in the ultimate liberalization of the Chinese economy along a more or less Western model.

But it's not the whole truth. It's not even, I believe, the essential truth.

The essential *political* truth in China – the glue that keeps the Party, the Army, and 1.4 billion people cobbled together – is economic growth. Economic growth is the fundamental *WHY* of the modern Chinese State, its raison d'etre. This is why Deng Xiaoping mattered so much, because he gave the Chinese State a coherent and attractive alternative to the ultimately self-destructive Permanent Revolution and Vanguard Party of Mao. But if economic growth fails in China, if the *WHY* of Deng Xiaoping's vision fails…then so does the modern Chinese State. The liberal nations of the West can withstand a Great Recession, even a Great Depression, because there's a *WHY* to small-l liberalism that transcends expediency and the "glory of wealth". Not so China. Or at least not so this China, with this governing philosophy.

What I'm saying is that the Chinese government is demonstrating the primacy of domestic politics over everything else. Just like the US government is demonstrating with QE. Just like the Russian government is demonstrating in its actions against Ukraine.

What I'm also saying is that the Chinese government is communicating its monetary policy with language that tries to misdirect, that tries to mask its true political face. Just as the US government communicates its monetary policy. Just as the Russian government communicates its foreign policy.

China must maintain a certain level of economic growth. What that level is, or how we would measure or know it from the outside, I have no idea. But I have no doubt that the Chinese leadership, who live and breathe the political diktat of economic growth every single day, know it quite well. Or rather, they know it when they see it, and they know it when they don't. Every other consideration – faux "volatility bands" and thumping of currency "speculators" foremost among them – is at best epiphenomenon or side-effect to the core imperative of delivering growth.

Is growth in China falling off a cliff? No way. If it were, we would have seen this sort of policy shift months ago, and a lot more drastic stuff today. **But is growth in China *uncertain*, within a political environment where the governing regime is not only accustomed to certainty but requires a high threshold level of growth for its *survival*?** Yes, I believe it is, and that is more than enough to mobilize the traditional pro-growth tools of monetary policy – easy credit and a weaker currency – into high gear.

In the Chinese context, easy money is not central bank balance sheet expansion or even lowering short rates. It's turning a blind eye to credit expansion in the shadows. It's guaranteeing liquidity to banks so that they don't worry about interbank lending. It's bailing out wealth management products. How long will they do this? Until the uncertainty goes away.

In the Chinese context, a weaker currency is not some free-floating pound that gets devalued by 20% in a day amid a flurry of recrimination and regret. It's a carefully managed yuan that probably looks flat versus the dollar over the next 18 months rather than upward sloping. And if exports get tougher or the yen gets cheaper, maybe it's got a downward bias. But compared to the past 8 years of a steadily increasing yuan, this is a big deal. A really big deal. It will create significant trade tensions with the US, and it will make Japan's devaluation/inflation course that much more difficult to achieve. But you know what? China doesn't care. The last 8 years have been a monetary policy of choice. Today we see a monetary policy of necessity. Maybe the West and its army of China apologists will go for the whole "it's only benign volatility" line, and maybe they won't. No matter. The Middle Kingdom takes care of its own.

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