China - A Country Matures, An Exchange Rate Declines (04/07/18)

After two weeks on the road visiting clients your analyst returns with a better view of the consensus outlook. There is, though, much in the consensus to disagree with. In particular it seems peculiar that the consensus believes the democratically elected government of Italy, with policies entirely contrary to EU membership, will be put through the bureaucratic meat grinder in Rome and Brussels and turned into EU sausage, in a similar process that minced the political representatives of Greece.

While this might well be the case, it is hard to understand that the grinding destruction of this democracy, even if it is only moderate compared to the Greek experience, can be anything but bad for growth and asset prices in the EU. Disciplining these politicians to abandon their manifesto promises and follow the ways of the EU is highly unlikely to be a painless experience, either for Italy or the rest of the EU. Nonetheless, investors are content to believe that a painless disciplining of Italy’s elected representatives is all but inevitable. We shall see.

Perhaps the most prevailing consensus view is that the recent weakness of the RMB represents a Chinese counter-punch in the trade war with the US. Coming when it does, it is easy to see the accelerated decline of the RMB as a tactical and not a strategic move. Comments by the PBOC on July 3rd have probably reassured many investors that the managed exchange rate regime is not at risk and that the RMB will continue to be managed against a basket of currencies. Your analyst does not agree.

Readers of the Q2 2018 report (When Monetary Systems Fail - A Guide For The Cautious) will know why the decline of the RMB exchange rate is part of a larger change in the global monetary system. It is a change that is initially deflationary and accompanied by a likely credit crisis. Of course, such a breakdown has been close three times post-GFC with first the European debt crisis (2011-2012), the taper tantrum (2013) and in the commodity price collapse that ended with the so-called Shanghai Accord in Q1 2016. So it is not surprising that market participants believe that, once again, central bankers stand ready to stick their fingers in the dike that holds back the market forces of deflation associated with the end of the current global monetary system. The recent movements in the RMB show that Jay Powell’s refusal to join the shoring-up party (see Solid Ground Fortnightly Damn the Torpedoes - Jay Powell, May 8th 2018) has prompted a fundamental shift in Chinese monetary policy.

Investors need to prepare for a formal widening of the trading bands for the RMB relative to its basket and the problems such a move will create for all emerging markets. That first move in the RMB is inherently deflationary. This is no counter-punch in a trade war; it is the beginning of the creation of a new global monetary system.

While many investors now concede that an emerging market debt crisis is likely, few are prepared to concede that China will be caught up in it. China is always seen as different and of course, in many ways, it is. It may well manage its exchange rate against a basket of currencies, dominated by the USD, but it has tools to manage this relationship that most countries do not.
Its exchange controls allow it to manufacture a capital account surplus, although those controls are not a perfect dam for capital outflows. By creating a larger capital account surplus than would otherwise occur, China maintains the total external surplus that leads to rising foreign exchange reserves and hence growing domestic commercial bank reserves. It thus extends the period of growth. Also, the state owns the commercial banking system and so can force it to keep lending, thus continuing to create RMB, when the growth in commercial bank reserves would dictate more moderate credit growth in a truly private banking system. While these tools allow China to extend the business expansion within the managed exchange rate regime, they do not permit it to abolish the business cycle. If it were so, everyone would be adopting similar policies.

At least since the time of David Hume (died 1776) and probably since Richard Cantillon (died 1734), we have understood how the downtrend in the business cycle is enforced in an exchange rate management regime. It is inevitable, in such a regime, that the enforced excess creation of money leads to a deterioration of the external accounts, an end to money creation and slower growth, often accompanied by deflation. There are natural forces at work within a managed exchange rate that cannot be resisted. Nobody yet has found a way to obviate that cycle, though many have extended it. China’s ability to use its capital controls and commercial banks’ balance sheets to temporarily override those natural forces has now come to an end.

The ability of China to extend the cycle has come to an end as the current account surplus has all but evaporated - a natural consequence of extending the growth cycle by keeping money too loose when the external account deterioration dictated that it should be kept tight. It has come to an end as the capital account is at best in balance rather than surplus. It has come to an end because the RMB is primarily linked to a strong currency in the form of the USD. It has come to an end because the Fed is both raising interest rates and destroying high-powered money to the tune of USD360bn a year (see Q1 2018 report Crowding Out: Higher US Real Rates and Lower Inflation). It has also come to an end because Jay Powell has warned China, and other emerging markets, that he will not alter the course of US monetary policy to assist with any credit disturbances outside his own jurisdiction.

And if that were not enough, it has come to an end because the US runs small current account deficits, by its own historical standards, and the President of the USA seems determined to make them even smaller. Investors now need to ask a bigger question when considering the future for Chinese, and thus emerging market, monetary policy. Why would anybody want to link their currency to the USD?

As a graduate of the University of Cambridge, your analyst can attest that things often done for the soundest of reasons can continue to be done long after they cease to make any sense. Such behaviour is the social habit we often proudly call tradition, or as Henry Ford put it more eloquently -

"History is more or less bunk. It's tradition"

In the field of monetary policy, following tradition is both dangerous and unsustainable and doing it one way because we have always done it that way is not an option. Investors need to think not about the long tradition of the RMB link to the USD, but whether today such a policy makes sense. Indeed, one thing we can all forecast, with a very high degree of probability of being right, is that one day China will have an independent monetary policy as one of the world’s largest economies.

It is of course a big call to say that the tradition of linking to the USD is ending now and a new independent monetary policy is in the process of being created, but that time has come. Japan, the Eurozone, the UK, Canada and Australia are just some countries that manage their monetary affairs free of any de facto or de jure link to the USD. China is now joining the club, and other emerging markets
will either have to decide to move to a free float or, believing that China is now capable of running major current account deficits, move to linking their currencies to the RMB.

So why is it now that China is maturing into a country with an independent monetary policy? It is a combination of a change in the Chinese economy and also a change in the nature of the US economy, and what the US wants to be to the world economy. The US is a country where the current account deficit relative to GDP has been less than 2.5% since 2012 - compared to a deficit of almost 6.0% of GDP at the peak of the last business cycle. President Trump appears determined to reduce even this moderate deficit.

If the US is not to run ever-bigger deficits, how can those linked to the USD run ever larger surpluses? Such surpluses force a rise in foreign exchange reserves and the creation of domestic base money thus facilitating higher economic growth. This tightening of monetary policy through smaller US current account deficits can be somewhat offset, if US interest rates are declining, with positive impacts for capital flows to those managing their currency relative to the USD. However, as it happens, interest rates are rising and as readers of The Solid Ground Q1 2018 report (Crowding Out: Higher US Real Rates and Lower Inflation) will know, the contraction in the Fed’s balance sheet exacerbates the problem.

To add to the problems for those linking to the USD comes the statement by Jay Powell in Zurich on May 8th that he bears no responsibility for the consequences of his monetary policy on emerging markets. In short, it is a system where the de facto lender of last resort has absolved himself of liability. China and other emerging markets will know why they started their managed link to the USD but they will be hard pressed to work out why they continue with it.

At this stage nobody can really move onto a new monetary system until China moves on. If any form of managed exchange rate is to form part of EM monetary policy, then the most important thing to establish is who will run the world’s largest current account deficit. China has been a mercantilist since the death of Mao, and Japan and Germany/Eurozone are all bent on running current account surpluses. While President Trump’s policies may be contradictory in terms of what they will achieve, his resort to non-market mechanisms in terms of tariffs show it would be too dangerous to believe that he will ultimately fail to generate his desired US current account surplus.

So, who can run the current account deficits necessary to make their currency an attractive anchor for smaller countries seeking to run current account surpluses?

It seems well-nigh impossible to believe, following almost 40 years of mercantilism, that China would opt to become a country running large current account deficits. Such a change in the mindset may seem revolutionary, but it is just another necessary shift in the long game in the attempt to make China the pre- eminent global economy. Already the move to a more consumption orientated economy has all but eradicated the country’s current account surplus.

Yet this is a country still with a long way to go in reducing its reliance on investment as a component of its economy. It is a country with a level of debt to GDP that is growing more rapidly than any other country in the world. It is, in short, a country that needs to further accelerate consumption and generate sufficient growth in broad money to inflate away its excessive debt level. It is very difficult to see how those key goals can be achieved without running a material current account deficit associated with much higher nominal GDP growth. This country needs an independent monetary policy.

That independence can only come from abandoning the exchange rate policy and generating the level of high nominal GDP growth, in a world of low nominal GDP growth, that will produce a major decline in the exchange rate. As argued above, structurally and cyclically it is time for China to move on and to take its full place
with those independent nations that do not rely upon others to ultimately determine the price and quantity of money of their domestic currency.

The initial shift to a more flexible Chinese exchange rate is deflationary and dangerous. The USD selling price of Chinese exports will likely fall, putting pressure on all those who compete with China - EMs but also Japan. The USD will rise, putting pressure on all those, particularly EMs, who have borrowed USD without having USD cash flows to service those debts. With world debt-to-GDP at a record high, such a major deflationary dislocation can easily trigger another credit crisis and *The Solid Ground* has previously focused on where such credit events are likely.

However, following the great dislocation, China will be free to reflate the world, for such will be the potency of the monetary policy of such a large economy relaxed about running a current account deficit. Investors should not bet on this happy outcome. There will be deflationary pressures and a potential credit crisis to navigate first. At any time in this process very unpredictable political feedback could delay or prevent China’s move to its new role. So, prepare for the deflationary consequences of this shift in the global monetary system, and expect as well as hope that it too will end as China helps the world to inflate away its debts.
Important Legal and Regulatory Disclosures & Disclaimers

This research is for the use of named recipients only. If you are not the intended recipient, please notify us immediately; please do not copy or disclose its contents to any person or body as this will be unlawful.

Information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but Orlock Advisors Limited does not accept liability for any loss arising from the use hereof or make any representation as to its accuracy or completeness. Any information to which no source has been attributed should be taken as an estimate by Orlock Advisors Limited. This document is not to be relied upon as such or used in substitution for the exercise of independent judgement.

© 2018 Orlock Advisors Limited

Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220