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Turmoil in China

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We have experienced an increased degree of jitters on the financial markets at the beginning of the new year. The triggers of this situation are based in China. Chinese equities have incurred a slump, and the Chinese currency has depreciated relative to the US dollar. Given that at 17% the share of the Chinese economy of the global GDP on the basis of purchase power parities had already exceeded that of the USA (16%) these developments of course come with global effects.

Transformation of the Chinese economy

The structural reason for the fallen optimism of investors is the risk of a so-called middle-income trap. The policies are geared towards avoiding said trap. Very often, economic growth in emerging countries declines significantly in the wake of impressive boom phases as soon as a certain level of income has been achieved. In order to ensure continued (relatively) high rates of growth, a comprehensive set of reforms have to be implemented. This means a transformation of the growth focus from the manufacturing to the service sector, and from investments to consumption.

Also, the currency is subject to liberalisation and internationalisation, forces of market economy gain strength, and the fight against corruption picks up. In order to prevent a credit and investment bubble, efforts are made to also curtail the still high rate of credit growth. Of course this transformation is bumpy, and the outlook as to whether it will be successful is unclear.

Anti-cyclical economic policies

Given that the risk of a hard landing in China has increased, economic policies are implemented that would go against this trend. The most important instrument is the fiscal policy. It has significant influence on whether China will experience a hard or a bumpy landing. Government spending is already growing at 30% year-on-year, and the key-lending rate has been cut. At 4.35%, there is still room on the downside. However, on a trade-weighted basis, the Chinese currency is very strong because it largely joined the USD upswing. This does not fit the current environment. But it is not clear whether and by how much the currency should be devalued or whether the market forces have caused the currency to depreciate already, and what measure of policies will be taken to intervene.

Opaque signals from Chinese politics

The signals of Chinese politics are less transparent than those of the West. This makes the specific intentions of the economic policies unclear. In addition, the economic data are inconsistent and unreliable. And without reliable measurement no reliable assessment of the status quo is possible. Currently we experience a high degree of uncertainty about the development of the Chinese currency and the currency regime from here on in. Uncertainty is poison for the markets, if the optimism of investors is limited.

Liberalisation of the Renmimbi challences China

The gradual liberalisation of the capital account, which states the capital movement between China and foreign countries, constitutes a new challenge for China's economic policy. If the capital movements are increasingly subject to the market forces, the autonomy of the policies can only be retained in relation to the exchange rate or the monetary regime. There are basically three scenarios:
In the first scenario, the central bank cuts the key-lending rate, and the Chinese currency depreciates further due to the capital outflow. At the same time, interventions are launched in order to slow down the depreciation of the renminbi. In fact, the foreign exchange reserves fell by USD 108bn to USD 3300bn in December 2015. In June 2014, they had still totalled almost USD 4000bn. This scenario is realistic.

In the second scenario, the flow of capital is restricted, the key-lending rate is cut, and the exchange rate remains (more) stable. This is an equally realistic scenario. And we have indeed seen initial restrictions being implemented on the purchase of US dollars on 8 January.

In the third scenario, the flow of capital is not restricted, and the monetary policy takes its cues from the USA. This would keep the exchange rate stable. However, the US central bank is signalling interest rate hikes. This is an unrealistic scenario.

Weak growth of the global economy

The challenging environment in China clashes with four international trends in the global economy: global economic growth has fallen sustainably to lower levels; the firepower of the central banks has declined. Key-lending rates are at zero percent; the instability of the financial markets is elevated. This causes a situation where negative shocks within the financial system are transferred more swiftly and in a more pronounced fashion; and earnings per share are receding.

Conclusion

1. An expansion of the budget deficit in China prevents a hard landing. However, the transformation remains bumpy.
2. The renminbi will depreciate further, and significantly so, in spite of currency interventions and partial capital control. Therefore emerging markets currencies remain under pressure although they have become increasingly cheap.
3. Domestic demand in the developed economies has proven resilient. The weakening in China and the other emerging markets does, however, represent a downside risk; it also keeps inflation pressure and the yields of safe government bonds low and central bank policies highly expansive. It limits the extent of the rate hikes that the Fed can implement, so we will probably see two rather than four increases this year.
4. Lastly, the equity markets remain volatile as long as the situation in China is unclear, or as long as no new growth drivers emerge.

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