

<https://blog.en.erste-am.com/turmoil-in-china/>

## Turmoil in China

Gerhard Winzer



© © iStock.com

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 Renminbi challenges 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.

## Legal disclaimer

This document is an advertisement. Unless indicated otherwise, source: Erste Asset Management GmbH. The language of communication of the sales offices is German and the languages of communication of the Management Company also include English.

The prospectus for UCITS funds (including any amendments) is prepared and published in accordance with the provisions of the InvFG 2011 as amended. Information for Investors pursuant to § 21 AIFMG is prepared for the alternative investment funds (AIF) administered by Erste Asset Management GmbH pursuant to the provisions of the AIFMG in conjunction with the InvFG 2011.

The currently valid versions of the prospectus, the Information for Investors pursuant to § 21 AIFMG, and the key information document can be found on the website [www.erste-am.com](http://www.erste-am.com) under "Mandatory publications" and can be obtained free of charge by interested investors at the offices of the Management Company and at the offices of the depositary bank. The exact date of the most recent publication of the prospectus, the languages in which the key information document is available, and any other locations where the documents can be obtained are indicated on the website [www.erste-am.com](http://www.erste-am.com). A summary of the investor rights is available in German and English on the website [www.erste-am.com/investor-rights](http://www.erste-am.com/investor-rights) and can also be obtained from the Management Company.

The Management Company can decide to suspend the provisions it has taken for the sale of unit certificates in other countries in accordance with the regulatory requirements.

**Note:** You are about to purchase a product that may be difficult to understand. We recommend that you read the indicated fund documents before making an investment decision. In addition to the locations listed above, you can obtain these documents free of charge at the offices of the referring Sparkassen bank and the offices of Erste Bank der oesterreichischen Sparkassen AG. You can also access these documents electronically at [www.erste-am.com](http://www.erste-am.com).

**N.B.:** The performance scenarios listed in the key information document are based on a calculation method that is specified in an EU regulation. The future market development cannot be accurately predicted. The depicted performance scenarios merely present potential earnings, but are based on the earnings in the recent past. The actual earnings may be lower than indicated. Our analyses and conclusions are general in nature and do not take into account the individual characteristics of our investors in terms of earnings, taxation, experience and knowledge, investment objective, financial position, capacity for loss, and risk tolerance.

**Please note:** Past performance is not a reliable indicator of the future performance of a fund. Investments in securities entail risks in addition to the opportunities presented here. The value of units and their earnings can rise and fall. Changes in exchange rates can also have a positive or negative effect on the value of an investment. For this reason, you may receive less than your originally invested amount when you redeem your units. Persons who are interested in purchasing units in investment funds are advised to read the current fund prospectus(es) and the Information for Investors pursuant to § 21 AIFMG, especially the risk notices they contain, before making an investment decision. If the fund currency is different than the investor's home currency, changes in the relevant exchange rate can positively or negatively influence the value of the investment and the amount of the costs associated with the fund in the home currency.

We are not permitted to directly or indirectly offer, sell, transfer, or deliver this financial product to natural or legal persons whose place of residence or domicile is located in a country where this is legally prohibited. In this case, we may not provide any product information, either.

Please consult the corresponding information in the fund prospectus and the Information for Investors pursuant to § 21 AIFMG for restrictions on the sale of the fund to American or Russian citizens.

It is expressly noted that this communication does not provide any investment recommendations, but only expresses our current market assessment. Thus, this communication is not a substitute for investment advice, does not take into account the legal regulations aimed at promoting the independence of financial analyses, and is not subject to a prohibition on trading following the distribution of financial analyses.

This document does not represent a sales activity of the Management Company and therefore may not be construed as an offer for the purchase or sale of financial or investment instruments.

Erste Asset Management GmbH is affiliated with the referring Sparkassen banks and Erste Bank.

Please also read the "Information about us and our securities services" published by your bank.

Subject to misprints and errors.



## Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.