Standard Life Investments

Weekly Economic Briefing
Global Overview

The China Syndrome
12 January 2016

After a difficult 2015, it has been anything but the start to the New Year that investors were looking for. The S&P 500 endured its worst first week of January ever, oil prices fell to new lows and financial volatility has returned with a vengeance. As was the case in August last year, China has been at the epicentre of the latest global financial stress episode. Chinese authorities suspended trading on the stock market twice before imposing draconian longer-term restrictions on selling activity, while the currency has continued to depreciate on strong capital outflow pressures. We see these events as the symptom of poorly implemented and communicated policies against the backdrop of a slowing and rebalancing economy. The authorities are struggling to deal with a range of near impossible-to-reconcile objectives, which means that additional policy mistakes and asset price volatility are almost inevitable.

In a challenging market environment, it is even more important than usual to stand back from the noise and rationally assess the economic fundamentals. And when we do that, we find that little has changed since our last WEB in early December. Although our analysis suggests the Chinese economy is growing closer to 5% than the 6.9% reported by the authorities, growth at least appears to have stabilised in recent months. Both the global manufacturing and services PMI slowed towards the end of 2015, but remain close to their average levels of the past 18 months - consistent with global growth tracking sideways at a modestly below-trend pace, rather than decelerating sharply. The advanced economies are still in better shape than the large emerging markets as the benefits of lower oil prices continue to flow through to consumers in the former and policymakers struggle to overcome a range of imbalances in the latter. The US labour market continues to generate rapid employment gains, vindicating the Fed's decision to begin normalising short-term interest rates in December. And although the recent drops in oil prices will delay the base-effect driven rise in headline inflation, there are few signs that underlying inflation is deteriorating. A sluggish, multi-speed, over-leveraged, low inflationary world may not be great for risk assets - but it is a lot better than a recession.

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Solving the Chinese riddle

Interpreting recent moves in China is becoming a more difficult task these days, as policymakers are confounding the markets with unexpected moves and poor communication. In the first week of 2016, the onshore CNY (yuan) depreciated by about 1.5%, the largest weakening since the August devaluation. In addition, and partly as a reaction to the unexpected CNY depreciation, the Shanghai Composite twice hit the 7% daily circuit breaker and is down 10% to start the year. Policymakers reacted by suspending the recently introduced circuit breakers, introducing new stock selling restrictions, and barring some foreign banks access to onshore RMB markets. **The market moves and policy response has once again cast doubt over Chinese policymaking.**

After the panic and volatility witnessed during the last devaluation in August, it was wrongly assumed that the PBOC would not attempt another large currency devaluation. It appeared the PBOC would take one of two options: a) continued currency stability or b) a moderate and controlled depreciation against the dollar. The move suggests a possible shift in policymaker's strategy or desire for further currency depreciation even against their trade-weighted index (see Chart 10). Alternatively, it also exposes flaws in Chinese economic policymaking, too many ministries are competing over too many objectives; as a result, policy is poorly implemented and not well communicated. **We have long argued that China's economic transition and rapid pace of reform will increase the chance of policy mistakes**. It is quite possibly the case that the PBOC wants a flexible exchange rate and open capital account regardless of the volatility that entails, but the NDRC and State Council are loathe to let go of levers of control such as the exchange rate and capital controls. This is resulting is poor coordination and communication.

Chinese authorities are facing a catch-22. There are clear economic reasons to allow the currency to depreciate against the dollar: growth is weakening, exports are suffering, domestic interest rates need to decline (see Chart 11), and the PBOC wants to stop wasting reserves supporting the currency. Furthermore, as we have described in this column before, **China is in the midst of reconciling the "impossible trinity" of an open capital account, autonomous monetary policy, and a fixed exchange rate. If China wants the first two, it must abandon the latter**. However, amidst the economic arguments for depreciation, there is the issue of potentially destabilising capital outflows. Following China's unpersuasive attempt to convince markets to stop looking at the USD/CNY exchange rate and focus on the currency's trade-weighted value, Chinese residents and foreign investors took it as a sign that the RMB would further depreciate and December outflows hit a recent high mark. Capital outflows can destabilise the financial system by tightening money supply when China needs lower rates. Some outflows are benign, such as local residents switching deposits into a foreign currency, an exporter retaining foreign currency earnings, or Chinese corporates paying external debt. Nevertheless, a substantial portion does represent capital flight. After all, with an uncertain economic outlook, policy signalling a weaker RMB, and a relentless anti-corruption campaign, it seems like a logical choice. China has implicitly guaranteed stability for too long; it needs markets to play a greater role but volatility will result.