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CHINA DEVALUATION STRATEGY: AN UPDATE

Since we originally released our insight/analysis piece on the real reasons for, as well as the size and ambition of, China's plans for the renminbi (republished below), this subject has dominated international market attention and that of policymakers. Here is our update on developments since last week.

1. China, as we said, plans a 15 to 20 percent devaluation in the trade weighted index. We remain convinced this is their real goal. They will have to 'engineer' this mindful of the international reaction (e.g. the G20) and a genuine desire not be seen in the Asian world as aggravating the policy challenges faced by neighbours from the secular uptrend in the dollar and the cost of dollar funding. Minimising outflows from China, which has about \$20tn in savings (and which the latest reserve numbers suggest are potentially poised to accelerate if there is fear of further scaled renminbi depreciation). In short, 'a two steps back and one step forward' strategy is likely. We are presently in the 'one step forward' phase: Chinese policymakers have convinced G20 partners there is no plan for a large-scale devaluation or FX intervention, and fixings have stabilised the market, etc.

2. Meanwhile, the Fed, as we argued, was behind the curve in reading the implications from China and is under increasing pressure to resist a rate hike in September. Our sources at Jackson Hole tell us that market volatility and thinned liquidity are uppermost concerns held by some Fed officials, which, of course, are unlikely to be aired in public. These twin factors, we understand, have begun to push the timing of lift-off in the Fed Funds rate to October. The IMF is, of course, able to voice timing concerns and has done so very well in the past week.

3. Below we present a question-and-answer session on the subject of China and the international implications, which we hope you will find helpful.

Questions and comments would be welcome to ideafirst@ideaglobal.com.

Asia: A Q&A with Global Implications

8th September 2015

The current crisis unfolding in emerging markets has many uncomfortable parallels to those that enveloped Latin America in the early 80's or Asia in the late 1990's. In particular, it appears that once again a resurgent dollar is laying waste to commodity producers' terms of trade and inexorably tightening monetary conditions for the mercantilists of S.E. Asia. It is the last element, together with Japan's beggar-thy-neighbour FX policy, which were arguably the main driving forces behind China's move on the Renminbi peg.

Providing insights into China's currency policy and its profound implications, what follows is an interview with an reliably-informed Asian source, the founder of IDEAglobal and IDEAfirst, Shandi Modi.

Question: Why did China move now? What was the real motivation? Was it related to SDR membership, to play catch-up with the rest of Asia's moves or simply domestic concerns?

Answer: The primary motivation for the timing of China's devaluation of the Renminbi was a recognition among political leaders that the economy is slowing down fast. Growth in China is sub 5%. Power consumption data and other time series data closely correlated to growth show a more reliable real growth picture than GDP, which is inaccurate and can, and is, being distorted.

In particular, in the export sector, there is an increasing pace of factory shut-downs with workers being laid off or not being paid. This recognition is reminiscent of political leaders' perceptions in 2009 and hence as then, they fear a social backlash, with potential for political challenges. The overriding policy objective now is to stabilise growth quickly and effectively. Reforms cannot be achieved when the economy is weak, and are being relegated for the moment.

Question: Would you agree that, as in Singapore, the RMB peg in an environment of a surging dollar was playing havoc with money supply growth? Therefore, structurally, won't the devaluation be positive as it will afford the Chinese more options?

A stronger dollar tightens money supply in countries with pegs or dirty floats



Answer: Exactly. In 2009 the policy response was to let public sector banks lend to public sector institutions. However, this form of stimulus has a well-known characteristic in that it distorts asset prices and the market credit mechanism. Hence, this time, they don't feel the banking lever is an option and especially because it can't address the location of the problem, which is particularly acute in the small and mid-sized corporate sectors. They can use the China development bank and the China agricultural bank, but the scale of these pipes is limited. It's also become increasingly obvious that these particular enterprises are especially sensitive to the currency. They have therefore concluded that the best way to get the economy moving is through the exchange rate, allowing the companies to become profitable quickly.

Question: We are hearing that Chinese authorities will initially limit CNY weakness to 5-7% between now and the end of the year?

Given the weakness of her Asian peers, especially the Yen since Abenomics, the RMB move is so far meaningless



Answer: Much as China would like to show they have a stable and trusted currency and a long term reserve, the scale of the economic/political problem in growth means they have to do something drastic and effective. This year alone the Renminbi went up 7 percent on a trade-weighted basis.

Having achieved a 3 percent move in a few weeks, they would not want to stop here. Their ultimate target is probably a 15 to 20 percent minimum move in the trade weighted index. This has to be placed into context with the JPY's 50% devaluation since 2014 and other competitors like Korea, who are aggressively using the FX lever. We expect them to want to achieve another 6 percent from current levels by year-end, and a further 10 percent in 2016. With the current interest rate differentials between offshore and onshore rates, the market can probably take this size of adjustment.

Engineering a devaluation of this magnitude will not be easy, especially given market chaos. However, the PBOC has the mechanism to influence the daily fix with covert interventions by networked players to achieve a creeping devaluation and maintain the appearance of it being "market-led". If the dollar remains in an uptrend then most of the adjustment will have to come through an adjustment in the dollar.

Question: One of the primary concerns is that China has opened a Pandora's Box. Up until now the relative stability and strength of Asian FX has been a powerful anchor for capital. Not only were overseas investors attracted to strong economies, with high levels of reserves and robust currencies, but domestic capital has had little incentive to take their money abroad. Isn't there a risk that China's move, no matter how gradual, now triggers a wave of capital flight with significant consequences for Asian FX and asset prices?

Asian asset markets have been cocooned from the \$'s strength by stable regional FX. That's now changing



Answer: It is realistic to expect a crisis in Asian foreign exchange and asset markets of some size. This will emerge as the market starts to appreciate the real motivations and scale of ambitions on the Renminbi adjustment. Since the 1997 Asian financial crisis, there has been a significant shift in many Asian countries' economic relationships and dependence on China, as part of its supply chain. The relative economic dependence on the USA has decreased. This should guide economic policymakers.

However, of course the financial exposures to cheap dollar based borrowings in the past 7 years among sovereigns and corporates in Asia is significant, and likely to trigger material hedging with the dollar and especially as credit spreads widen. Capital outflows to the developed market asset classes from Asian asset managers now look to turn positive for the first time since 2008.

The crisis will not be in China as they have the huge resources to manage implications for their state owned enterprises and banks. The crisis will be more telling in other countries although originating in China. Current account deficit countries will probably be de-risked more aggressively. Malaysia, Indonesia, Brazil, Turkey, and India are especially vulnerable.

For example, there is a probable scenario in Malaysia that the current incumbent government is replaced, post-election (outright or coalition led) by a fundamentalist Islamic party. This would be a shock to investors in Malaysian assets.

Question: China makes up 30% of Japan's TWI. The day after they moved, Hamada (one of Abe's advisors) said "the magnitude of China's shock is much larger than that from Greece, but we need not worry because the effect of Chinese devaluation can always be offset." So are they implying further Yen weakness? Could we be on the cusp of a regional currency war?

Answer: Even before adding the China factor, Japanese QE has not create significant GDP. The latest Q2 GDP was negative, thus failing to show sustainable growth. Japan has no choice but to engage in further accelerative QQE, which could come in October 2015 or sometime soon thereafter. With this backdrop and the China factor, USD/JPY could very well go to 150.

Question: For the Fed and BoE doesn't this salvo of Asian deflation throw their assumptions into chaos?

Historically a move in the dollar has always triggered a crisis and the Fed has eased, NOT tightened



Answer: While the latest message from Stan Fischer and Mark Carney at the Jackson Hole symposium is that both USA and UK recognise the potential implications of The Chinese Factor, "at this stage" they don't regard it as having a material bearing on current policy deliberations.

If their view is based on the assumption that China's devaluation is almost done, then they are going to have to reassess their assessment soon. If, however, they understand the true magnitude of the potential move and the core motivations for the policy on the Renminbi, we believe both are significantly underestimating the prospects of a disorderly Asian foreign exchange crisis. In particular, the 'material' implications for developed market asset prices, the deflationary impact, and the possibility for global de-risking as we see a huge increase in volatility.

Whether the Fed does indeed lift off moderately in September is less relevant than the likelihood that it will be followed by an admission that "we made a mistake", i.e. a dead cat bounce in the funds rate. If the Fed delays till December, it is likely to be preceded by events triggered from China and Asia to render a lift-off inappropriate.

For the Bank of England, where the timing of tightening is well into 2016, the change in expectations likely among the MPC is clear. The market already is more sanguine in timing and levels than the Governor seems to be.

Note: The source of the above questions and the charts is MI2 Partners.

1 September 2015

China to devalue another 15%?

China currency policy: motivation, target size, implications for Asian FX, and monetary policy in Japan, the USA, and UK

Based on IDEAFirst's reliable sources, we understand that China is thinking about a renminbi devaluation of 15-20% by the end of next year. We expect this is likely to trigger a crisis in Asian currency and asset markets. In turn, it will add motivations for a QE3 from Japan, and affect the current thinking about monetary policy at the Fed, Bank of England, etc.

Why?

The primary motivation for the timing of China's devaluation of the renminbi is a recognition among political leaders that the Chinese economy is slowing down fast, particularly in the export sector, increasing pace of factory shut-downs, and workers being laid off or not being paid. This recognition is reminiscent of political leaders' perceptions in 2009. As then, they fear a sociological backlash from workers and a multiplier which can raise political challenges.

Much as China would like to show they have a stable, trusted currency and a long-term reserve, the scale of the economic/political problem in growth means they have to do something drastic and effective.

Growth in China is running at sub-5%. Power consumption data and other time series closely correlated to growth show a more reliable real growth picture than the GDP statistics, which are inaccurate and being distorted. This is recognised privately among international organisations.

The overriding policy objective now is to stabilise growth quickly and effectively. Reforms cannot be achieved when the economy is weak, and are being relegated for the moment.

How?

With interest rates low, currency adjustment is the primary macro tool employed in the past few years across the world. China's mid-cap companies and small enterprises, where the problem needs to be addressed, have balance sheets that are highly sensitive to the currency. An adjustment of scale in the renminbi can cause a significant increase in profitability in these sectors.

In 2009 the policy response was to let public sector banks lend to public sector institutions. This form of stimulus has well-known characteristics of distorting asset prices and is too credit- (as opposed to market-) based. This time, the Chinese government doesn't feel they have the banking sector lever to address the location of the problem in the small- and mid-sized sectors. They can use the China

development bank and the China agricultural bank, but the scale of these pipes is limited. They have concluded that the best way to get the economy moving is through the exchange rate, allowing the companies to become profitable quickly.

Size of FX adjustment

Having achieved a 3 percent move in USD/CNY over a few weeks, China would not want to stop here. **They probably have a target of 15 to 20 percent at a minimum in the trade weighted index.** However, with markets in chaos they will have to "engineer" the planned devaluation.

How to bring about FX adjustment in trade-weighted terms?

This year alone, the trade-weighted renminbi went up 7 percent. If the dollar remains in an uptrend (IDEA has explained the fundamentals painting a solid dollar uptrend scenario), then most of the adjustment will have to come through an adjustment in the USD/CNY rate.

The dollar's fundamental uptrend scenario is based on credible historic demand/supply analysis, a decreased supply of dollar reserves, structural change in the US current account deficit because of shale production, US economic fundamentals being well ahead of Japan and Europe over the next two years, benchmark Treasury yields offering 2 percent versus 0.5 percent for Bunds, exposure among EM corporates and sovereigns to dollar-based borrowing at a time Fed is considering a lift-off, as well as other factors.

To engineer a renminbi devaluation will not be easy, but the PBOC has the mechanism to influence the daily fix with covert interventions by networked players (we see this being reported in the market, including in London) to achieve a creeping devaluation and maintain the appearance of it being "market-led".

In total we expect China to want to achieve another 6 percent devaluation from current levels by year-end, followed by a further 10 percent in 2016. With the current interest rate differentials between offshore and onshore markets, the market can probably take this size of adjustment.

The size of 15 to 20 percent in total has, of course a background of about a 50 percent devaluation in the Japanese yen since 2014, and other competitors such as Korea using the FX lever aggressively.

Implications for Asian foreign exchange

Based on these insights, IDEA expects a crisis of some size in Asian foreign exchange and asset markets. This will emerge as the real motivations and scale of ambitions on the renminbi adjustment become appreciated in the market. Since the 1997 Asian financial crisis, there has been a significant shift in many Asian countries' economic relationships and dependence on China as part of its supply chain. The relative economic dependence on the USA has decreased. This should guide economic policymakers. However, of course the financial exposure to cheap dollar-based borrowing in the past 7 years among sovereigns and corporates in Asia is significant, and likely to trigger material hedging with the dollar and especially as credit spreads widen. Capital outflows to the developed market asset classes from Asian asset managers now look to turn positive for the first time since 2008.

Current account deficit countries will probably be de-risked more aggressively. Malaysia, Indonesia, Brazil, Turkey, and India will likely respond or react to FX depreciation.

The crisis will not be in China, which has the huge resources to manage implications for their state-owned enterprises and banks. The crisis will be more telling in other countries, despite originating in China.

For example, there is a probable scenario in which the incumbent government in Malaysia is replaced, post-election (outright or coalition led) by a fundamentalist Islamic party. This would be a shock to investors in Malaysian assets.

Implications for Japan

Even before adding the China factor, Japanese QQE2 had failed to create sustainable growth. The latest Q2 GDP was negative, failing to show sustainable growth. Japan has no choice but to engage in a new round of quantitative/qualitative easing, which can come in October 2015 or later. Under a QQE3, with the China factor, USD/JPY could very well go to 150.

Implications for USA and UK monetary policy

While the latest message from Stan Fischer and Mark Carney at the Jackson Hole symposium is that both the USA and UK recognise the potential implications of 'The Chinese Factor', they don't regard it "at this stage" to have a material bearing on current policy deliberations.

If their view is based on the assumption that China's devaluation is almost done (say 5 to 7 pct in total, creeping in nature), they are likely to have to reassess their assessments soon.

If their view is based on the intelligence we share in this report of a 15 to 20 pct goal, and the core motivations for the policy on the renminbi, we believe both are significantly misreading the prospects of a disorderly Asian foreign exchange crisis, along with justifiable economic changes to cause developed market asset price adjustments (last week's market actions being a "preview"), deflationary influences, a global de-risking environment and a huge increase in volatility.

Under an actual scenario unfolding as envisaged above, whether or not the Fed does indeed lift off moderately in September is less relevant than the increasing likelihood that it could very well be followed by an admission "we made a mistake", i.e. a 'dead cat bounce' in the funds rate.

If the Fed delays the so-called lift off question until December, under the scenarios envisaged above, events triggered from China and Asia could very well render raising rates inappropriate.

For the Bank of England, where the timing of a first rate hike is well into 2016, the likely change in expectations among the MPC is clear. The market already is more sanguine in timing and rate levels than the governor seems to be.

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