

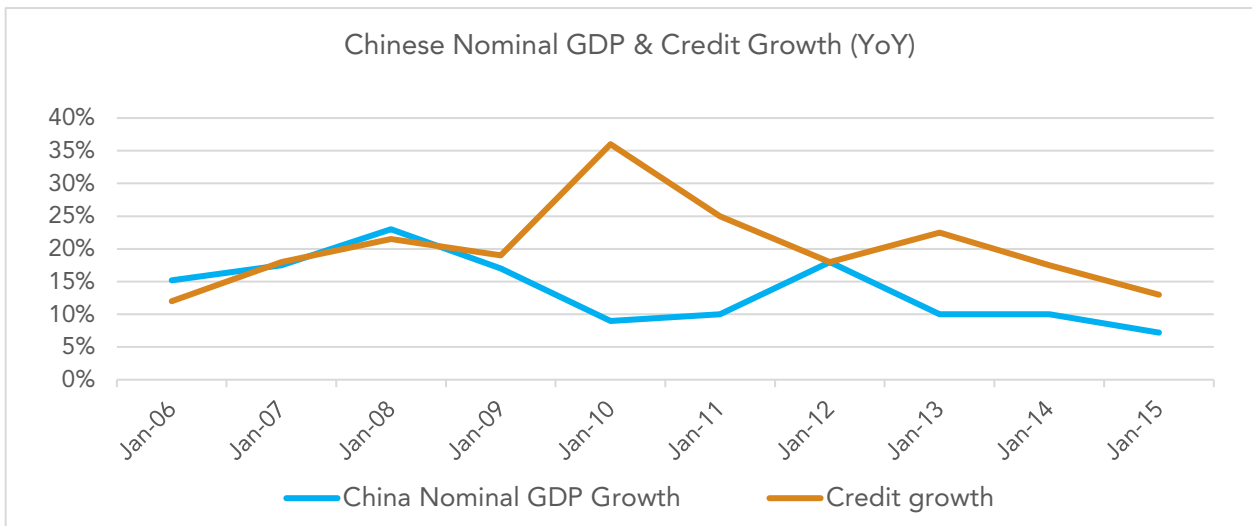
**THE RENMINBI AND CAPITAL DESTRUCTION**



**John-Paul Burke's Market Views**

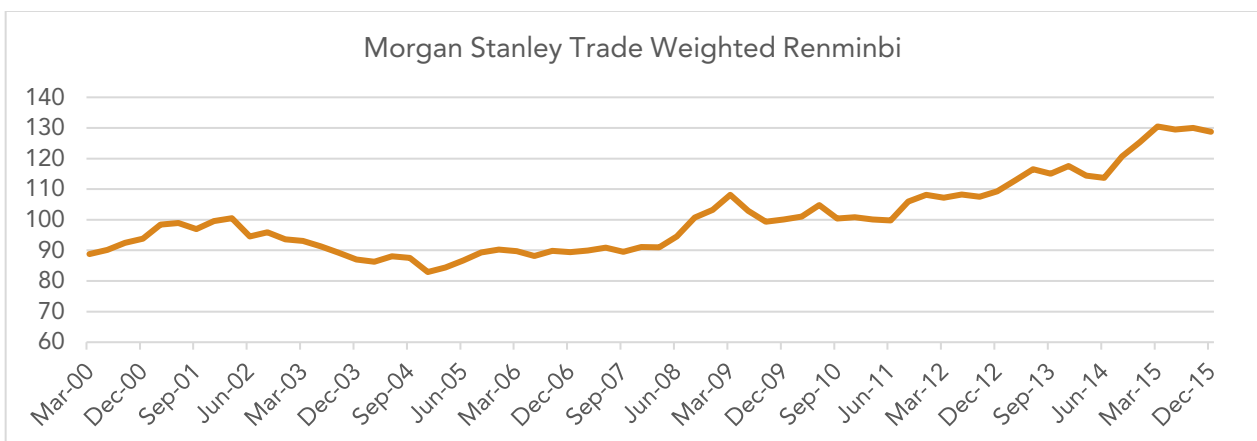
"If authorities eschew devaluation, financial stress will build within the economy, if they embrace it, the fallout is global. Either way, emerging market equities and currencies remain under pressure."

For some time China's growth strategy has involved debt accumulation, so now credit is over twice the size of nominal GDP and growing twice as fast. This is clearly unsustainable.

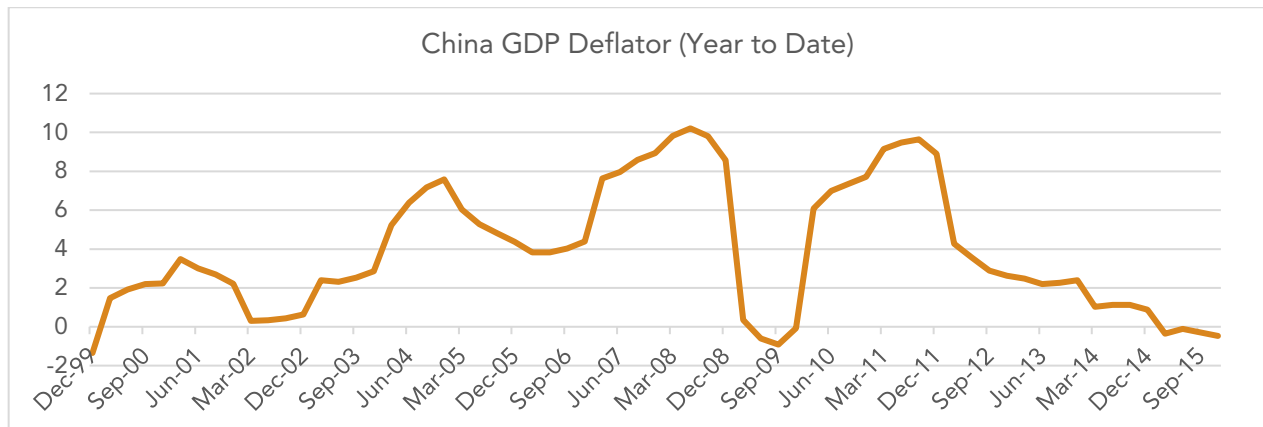


Source: PBOC, CEIC, UBS

Despite the economic slowdown and the credit risks it must imply, China's currency has been on a strengthening path and therefore has been a hindrance to policy stimulus.

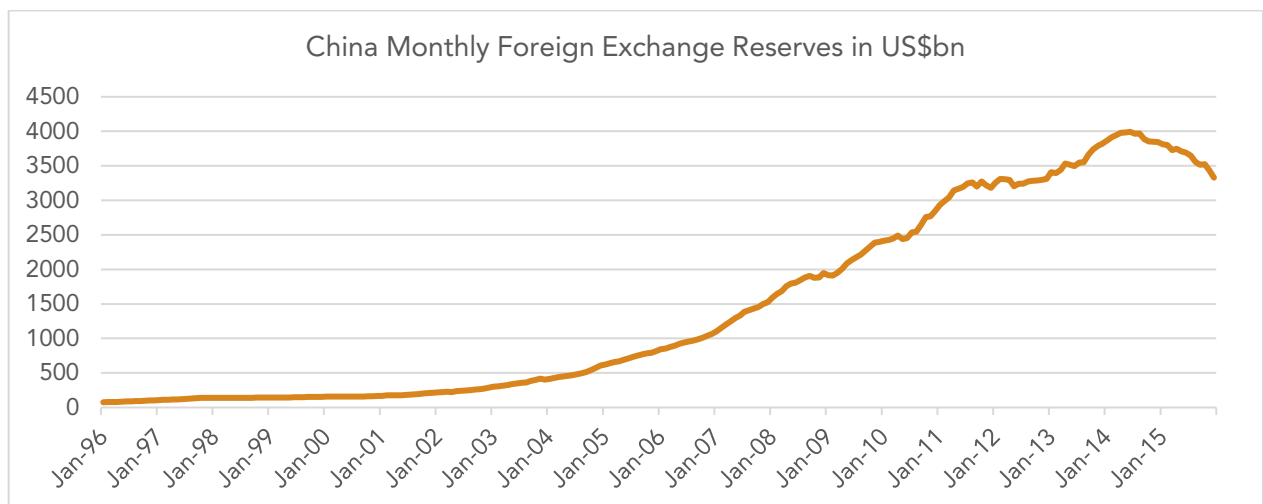


As a consequence, export volume growth has slipped negative, labour market conditions have weakened and the GDP deflator has turned negative.



A strong currency is unhelpful in this environment. Although it has been very poorly conveyed by Chinese authorities, it would appear that since August last year, the currency regime has changed and the renminbi has started to slip.

The decline has clearly been managed, as can be inferred from the fall in China's foreign currency reserves. The authorities sell dollar assets to quell the rate of renminbi decline. Without this intervention the renminbi would have fallen even more rapidly; market pressure is to the downside.



The fall in renminbi value versus other currencies strikes me as sensible and warranted if it helps China deal with the colossal debt pile the economy is burdened by.

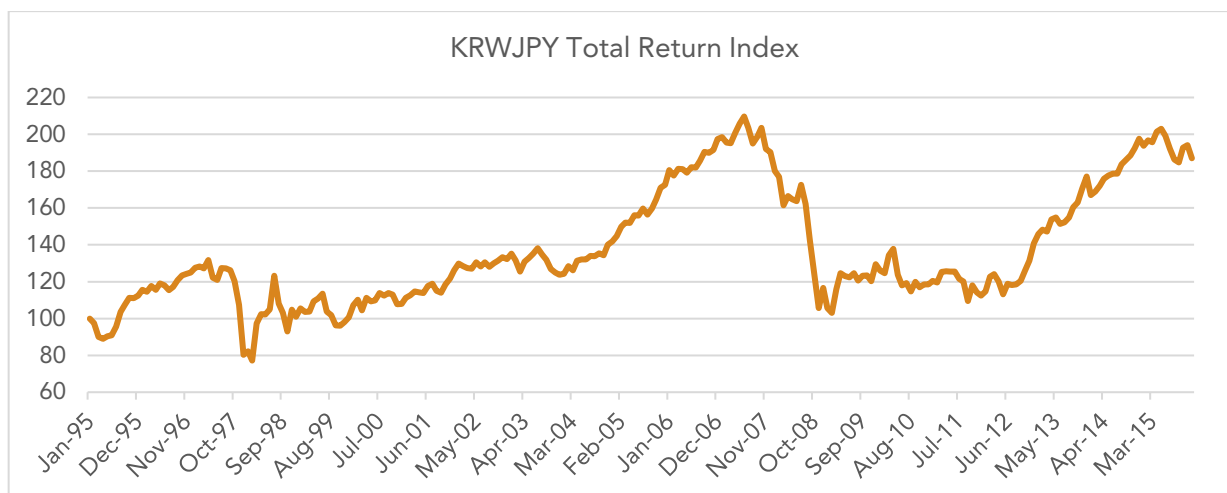
But how far could it fall?

Unfortunately, currency models have poor predictive powers, as fundamental currency values tend only to be reference points through which currencies pass on their journey from being overvalued to undervalued (or vice versa) when the cycle turns.

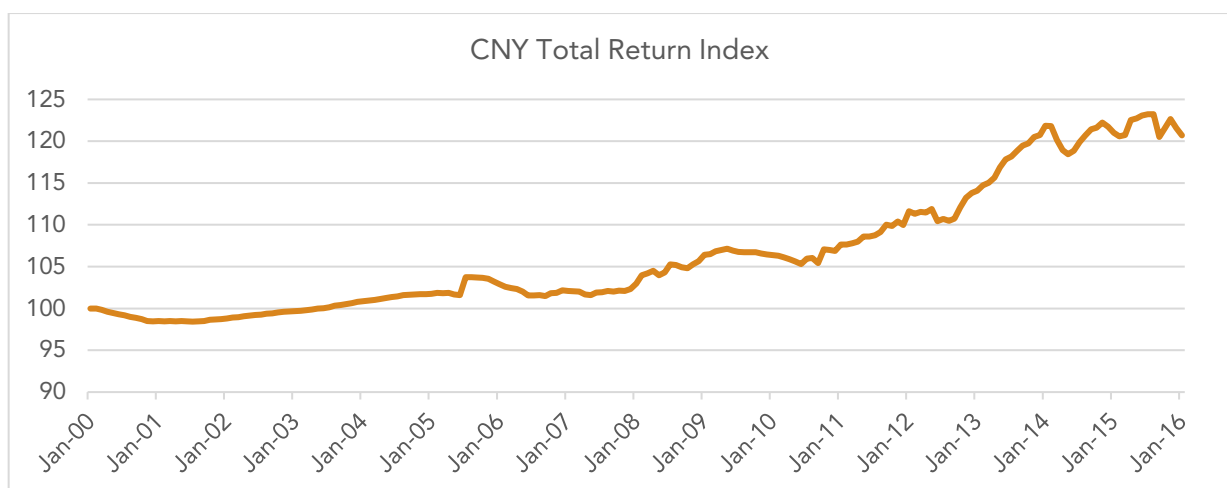
However, a useful guide is to observe where a currency sits in its total return pattern. As I wrote in the Market View, "Carry trade and Capital Destruction", interest rate compensation should be equivalent to capital depreciation over time if the interest rate is a fair payment for the depreciation risk. If this were to be the case, a currency's total return index would never deviate from a value of 100.

However, in the real world, cycles encourage speculation and a currency's total return index deviates markedly from the 'equilibrium', as can be observed by the Korean won / Japanese yen (KRWJPY) total return index.

Two complete cycles can be observed with a third precariously placed.



Applying the same logic to the currency of the country which is the linchpin of the current cycle, China's renminbi, gives an interesting perspective. Since 2000 when China's industrialisation took hold in earnest, the renminbi has returned approximately 20%. The rule of thumb would suggest that this currency appreciation is in excess of that justified by the interest rate, and a capital decline of 20% would recalibrate the index back to equilibrium. This implies a target of approximately CNY 8 against the dollar.



The implications for the rest of the world of a renminbi decline on this scale are frightening due to the deflationary impact, the likely competitive devaluations and probable trade protection retaliations it would provoke from affected countries.

While China continues to slow, burdened by a large stock of rapidly growing credit, it will have to utilise all policy tools at its disposal. In my view this very much includes the renminbi.

If authorities eschew devaluation, financial stress will build within the economy, if they embrace it, the fallout is global. Either way, emerging market equities and currencies remain under pressure.

## INFORMATION

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