

MyConsultant

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Chris's current role at JANA comprises mainly of interest rate and currency manager research within the Fixed Interest team. He is also a specialist economist who undertakes macroeconomic research as an input into JANA's overall asset allocation process.

Prior to starting work at JANA, Chris worked at the RBA for 8 years in the Bank's Economic Analysis, Financial Stability and Domestic Markets Departments. Primarily researching domestic household income and wealth as a direct input into monetary policy deliberations. Previous roles involved research and analysis on a range of issues in macroeconomics and financial markets.

Chris holds a bachelor of Commerce (honours), majoring in Economics from Deakin University.

China's Devaluation and Economic Slowdown

Concerns about the pace of the slowdown in China have intensified following the devaluation of the renminbi in August. The lack of transparency around the announcement of the devaluation gave rise to uncertainty about the motivation of policymakers for the decision, which exacerbated subsequent market volatility as some market participants concluded that the devaluation reflected the Chinese authorities' concern about the growth outlook.

Renminbi devaluation

On 11 August, China devalued the renminbi by 1.9%, the first currency devaluation since 1994. The devaluation was arguably the most important development for China's foreign exchange regime since 2005 when China stopped setting the renminbi at a fixed rate against the US dollar in favour of the currency being able to fluctuate within a narrow band around a 'central parity rate' set by the People's Bank of China (PBoC) each morning. The PBoC also announced a shift to a more market-oriented exchange rate mechanism by taking into account the closing spot rate in the foreign exchange market the previous day when setting the central parity rate (it can move as much as 2% in either direction).

It remains to be seen to what extent the PBoC will allow market forces to influence the setting of the central parity rate. Chart 1 shows the USD/CNY spot rate (the scale is inverted) – following the devaluation, the spot rate declined by around 3% to CNY 6.4, and has subsequently retraced somewhat.

Motivation for the devaluation

The lack of clear communication around the announcement led to widespread confusion in financial markets about the authorities' motivation for devaluing the renminbi.

There are several possible explanations for the devaluation (these are not mutually exclusive):

1. Stimulate the Chinese economy and exports
2. Foreign exchange market liberalisation
3. Promote the inclusion of renminbi in the International Monetary Fund (IMF) Special Drawing Rights (SDR) basket of currencies

1. Stimulate the Chinese economy and exports

The devaluation could be aimed at stimulating China's economy, particularly exports. Growth in China has slowed in recent years, and the transformation from an investment and manufacturing driven economy to a more consumption driven one is proving challenging. A recent run of disappointing economic data increased concerns that China is slowing more quickly than anticipated. Chinese exports have been weak recently, declining by around 4% over the year to September. This partly reflects subdued global demand, but also the strong appreciation of China's effective exchange rate over recent years (shown in Chart 2). China's real effective exchange rate has appreciated by 15% since mid-2014 given it is linked to the US dollar as the currencies of many of China's major trading partners (such as the euro, yen and some emerging market currencies) have depreciated against the US dollar.

Chart 1
Renminbi per US Dollar

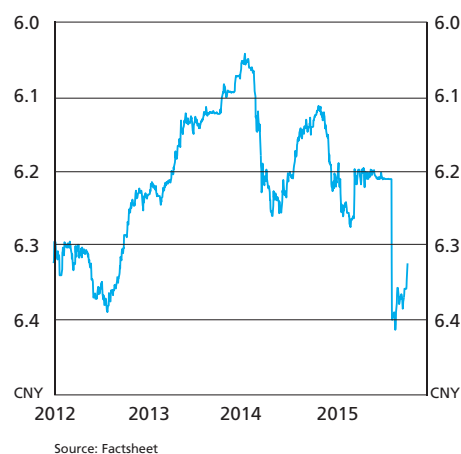
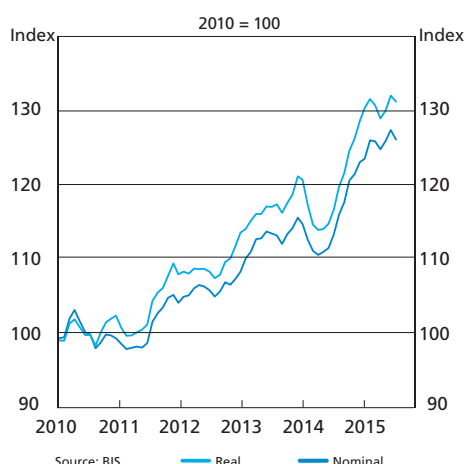


Chart 2
China Effective Exchange Rate



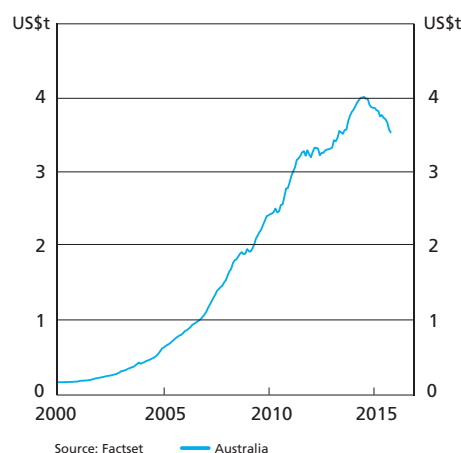
Given the significant appreciation of China's effective exchange rate over the past couple of years, the small recent devaluation by itself is unlikely to be enough to provide a material boost to China's exports. If export stimulus is a key motivation for the devaluation, a much larger adjustment will likely be required to achieve this objective. Subdued global demand for traded goods and services means that the devaluation may not be as effective in stimulating exports as in the past. In addition, many emerging market currencies have depreciated significantly against the US dollar over recent years, meaning that the decline in China's effective exchange rate against the USD has been materially less than that of these currencies.

2. Foreign exchange market liberalisation

As indicated by the PBoC, the devaluation may be a step towards a more market-oriented exchange rate regime to reduce the pressures created by the current regime. Under the current regime, in order to maintain a stable exchange rate, the PBoC must intervene, at times heavily, in the foreign exchange (FX) market to protect the target level of the renminbi. China has experienced sizable capital outflows recently – over the past five quarters, capital outflows (estimated by the change in FX reserves minus the current account balance) have been around US\$520 billion. Although this partly reflects exchange rate movements, capital outflows have been relatively large and persistent compared to recent episodes of capital outflows from China in 2008 and 2012.

With China experiencing substantial capital outflows, there has been significant downward pressure on the renminbi. In order to maintain a relatively stable exchange rate prior to the devaluation, China began to draw down on its large balance of FX reserves accumulated over the past decade (shown in Chart 3). Following the devaluation and subsequent market volatility, China has also used FX reserves to prevent the renminbi from falling too rapidly. In order to support the exchange rate, the PBoC sells assets denominated in foreign currency (mostly US dollars) and buys renminbi-denominated assets. This reduces the supply of renminbi in the financial system, tightening financial conditions in China. To offset the tightening in monetary conditions, the PBoC has undertaken further monetary easing, cutting benchmark interest rates and reducing the amount of reserves that banks are required to hold.

Chart 3
China FX Reserves



The devaluation (and stated move to a more market-oriented regime) may reflect a recognition on the part of Chinese authorities that maintaining a fixed exchange rate (and drawing down FX reserves in order to support the currency in the face of persistent capital outflows) at the expense of an independent monetary policy is unsustainable. This tension will become increasingly difficult to manage over time if China continues to liberalise its capital account, and as some central banks such as the US Federal Reserve look to begin increasing interest rates in the not too distant future.

3. Promote the inclusion of renminbi in the IMF Special Drawing Rights (SDR) basket of currencies

The devaluation could also be aimed at promoting the inclusion of the renminbi in the IMF's SDR basket of currencies. SDRs are an international reserve asset held by central banks, created in 1969 to supplement traditional reserve assets such as gold and the US dollar. SDRs are not a currency or a claim on the IMF, but SDRs can be used to purchase the currencies of IMF member countries. The value of SDRs is currently defined by the exchange rates of a basket of currencies – currently the US dollar, euro, yen, and pound sterling. The IMF will complete a review of SDR in November – a key question for the review will be whether to include the renminbi in the SDR basket. The IMF has noted the need for a market-based CNY/USD exchange rate to value CNY against SDR, and indicated that the PBoC's central parity rate is not adequate for this purpose as it is "not based on actual market trades."

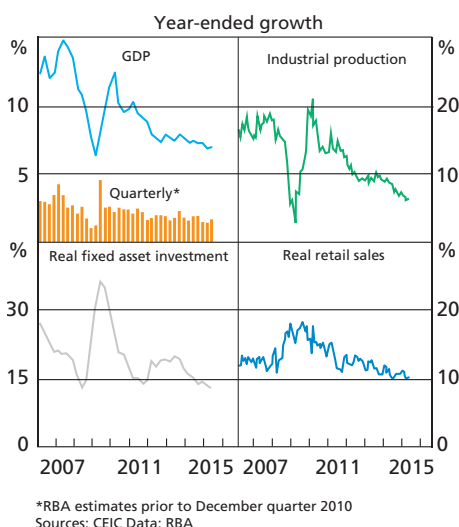
There are a number of reasons why China would like the renminbi included in the SDR basket. Inclusion would confer on the renminbi the status of a reserve currency, and would be a recognition of China's growing political and economic influence. Inclusion in the SDR basket would also help promote the renminbi's use in settling cross-border trade and investment, leaving Chinese exporters and importers less exposed to the impact of movements in foreign exchange markets. The steps towards liberalisation of the capital account (required for the inclusion of renminbi in the SDR basket) will also tend to lower borrowing costs for Chinese firms over time.

Economic Slowdown

As noted above, growth in China is slowing as the economy transitions from investment-driven growth to a more consumption-led growth model. According to official statistics, the Chinese economy grew by 7% over the year to June 2015, in line with the authorities' target (Chart 4). However, there is some uncertainty regarding the reliability of China's official statistics, and whether they fully reflect the extent of the slowdown. Adding to this uncertainty, recent economic data has generally been weaker than expected. Growth in fixed asset investment slowed to a little over 9% in August, reflecting particularly weak growth in manufacturing and real estate investment. Industrial production has also been relatively weak, with growth slowing to around 6%. Both official and private sector surveys suggest that conditions in the manufacturing sector continue to deteriorate.

Although investment and industrial production are slowing more quickly than anticipated, the services sector is growing more strongly, consistent with the broader rebalancing of the economy towards a greater focus on consumption and services rather than capital investment and manufacturing.

Chart 4
China – Activity Indicators



Household consumption and retail sales have also held up well recently. Consumption has been supported by solid labour market conditions, reflecting the relatively strong growth in employment in the more labour intensive services sectors.

Conditions in the real estate market also appear to have improved a little in recent months, with property prices increasing in larger cities and stabilising in smaller cities.

Detracting from recent macroeconomic developments, China faces a number of challenges to its economic outlook. Although credit growth has slowed considerably since the strong growth in the aftermath of the global financial crisis (GFC), China's credit-to-GDP ratio remains high. The increase in credit has been driven by the corporate sector, particularly real estate firms and state-owned enterprises, while household credit remains relatively low. Reflecting the strong increase in real-estate investment in the post GFC period, there is significant oversupply of housing in most Chinese (particularly smaller and medium-sized) cities. Although (as noted above) housing demand appears to be picking up (especially in larger cities), China's housing inventory is expected to remain high, and will likely remain a drag on real estate investment and the rate of economic growth.

Conclusion

China's economy is undergoing a challenging transition away from investment to a more consumption-driven growth model. Reflecting this, growth has slowed significantly. However, the devaluation of the renminbi and recent weaker than expected economic data have led to increasing concern that China is slowing more quickly than anticipated. Given the lack of clarity around economic developments in China, it is difficult to assess either the exact motivations for the devaluation, or the extent of the slowdown in China. While the devaluation may be aimed at boosting exports and economic activity, it may also reflect another step along the road to foreign exchange market liberalisation, and China's desire to achieve reserve currency status for the renminbi. The slowdown may reflect the rebalancing of the economy, and the adjustment from post-GFC stimulus, or may be indicative of a more challenging outlook for China's economy.

China's growth outlook has profound implications for global economic activity and investment markets. A 'hard landing' in China will likely have significant adverse flow-on effects for global growth and asset returns. On the other hand, a relatively smooth transition, possibly supported by further monetary and fiscal stimulus, could provide substantial support for global growth and capital markets.

Australia's economy and investment markets are heavily exposed to China's economic development, particularly through the resources sector. The slowdown in China has been most pronounced in the resource intensive sectors. Commodity prices have declined significantly recently, reflecting concerns about the impact of the slowdown in China on demand for steel and iron ore, as well as the elevated supply of these commodities. Given these developments, resources stocks have suffered sharp falls in recent months.

The slowdown in China also affects the Australian economy more broadly. Lower commodity prices have driven the decline in Australia's terms of trade, which is weighing on income growth. Weak income growth will likely remain a drag on consumption in the period ahead. Given the relatively weak fundamentals for the Australian economy, JANA has for some time been recommending an underweight position in Australian equities and an overweight position in foreign currency exposure.

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