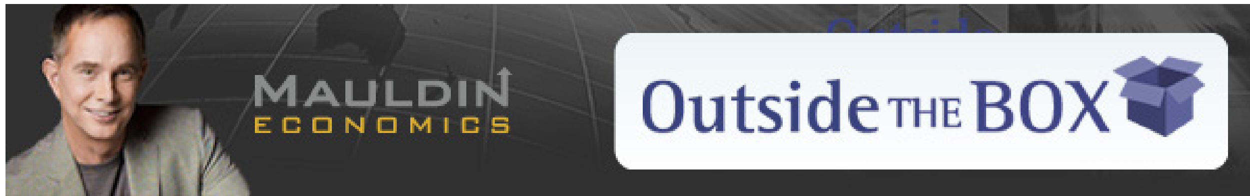


The Debate Over Renminbi Policy

JOHN MAULDIN | January 27, 2016

Longtime readers know how much I respect and rely on the Gavekal group for thought-provoking research. They have a truly unique organization, one in which even junior analysts can question conventional wisdom and ask uncomfortable questions. Moreover, they aren't afraid to let the world (or at least their clients) see their disagreements.

Today I have a recent piece in which Louis Gave jumps into the team's debate over renminbi policy. In true Gavekal style, he openly questions what others in the firm think about China's currency. I won't steal any of his thunder but just encourage you to read this piece carefully. It covers a great deal of very important ground.

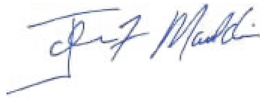
Louis will have much more to say about China when he speaks at my Strategic Investment Conference in Dallas this coming May 24-27. We'll also have Gavekal's other two principals, Charles Gave and Anatole Kaletsky. They rarely all appear in the same place at the same time, so having the three of them together will be a special treat. I'm really looking forward to the good-natured arguments that will no doubt erupt among them. I always learn from their debates.

Speaking of SIC, our early registration period ends this Sunday, Jan. 31, and with it the chance to save $500 off the walkup rate. We'll soon start promoting the conference more widely, so if you want to get in, you should act quickly. I wish I could tell you about some of the additional speakers we are very close to getting, but until the paperwork is finished you can't talk about it. You are really going to want to be at this conference. It will be the event of the year. You can find more information and register at the SIC 2016 website.

I am still at the ETC.com conference in Hollywood, Florida (which is close to Fort Lauderdale). We are staying one more day to have dinner with friends and were thinking that a little beach-time reading would be good. But so much for sunny Florida – this morning saw tornadoes and rain and lots of wind. I could've gone back to Texas for that. In theory, I will get to have dinner with my good friend Suze Orman – if her plane doesn't get stuck on the island where she is because of winds there. I really hope she can hop on over here, because she is just tons of fun to be with.

One of the good things about being at a very large conference like this is that many of the speakers and attendees are friends, so there is a lot of catching up, sharing of notes, and learning opportunities. I fully intend to be in bed by the time you get this issue of OTB, as an early night after the last three really does seem to be the better part of wisdom. You have a great week.

Your finally attacking his inbox analyst,



John Mauldin, Editor
Outside the Box

The Debate Over Renminbi Policy

Louis Gave
January 21, 2016

One of the core tenets of Gavekal's philosophy is that we embrace open debate. Rather than concealing the diversity of our analysis beneath a single suffocating "house view", we strongly believe that conducting our —often animated—discussions about the big topics of the day out in the open adds value for our readers. And few of our recent debates have been as lively as the one over Beijing's renminbi policy. Joyce's view is that the Chinese currency is set to weaken this year as Beijing bumps up against the impossible trinity and accepts depreciation as a price worth paying for interest rate cuts to support growth (see Going Down With The Renminbi). In contrast, Chen Long and Arthur argue that with key financial reforms now in place, the Chinese government is backing away from its policy of renminbi internationalization (see Retreating From An International Renminbi). In true Gavekal style, I would like to take issue with both views.

There are two separate topics here:

1. Whether the renminbi is likely to rise or fall over the coming years. Right now, this is one of the questions which has got global markets in a panic.
2. Whether the renminbi will make the grade as a truly international currency.

Of course, you could say that the two are related: for the renminbi to go up, it needs to become an international currency; and to a large extent, there is no doubt that increasing internationalization would lend the currency a nice tailwind, as more and more people, companies, central banks etc. start to save in renminbi. This argument is one of the reasons I have been bullish on the renminbi for the last decade. In my view, as we move from no one in the world saving in renminbi, to perhaps 2%, then 5%, then one day even 10% of the world's savings (ex-China) being allocated to renminbi assets, the underlying demand for the currency would mean an increasing number of marginal buyers. And more buyers usually mean a higher price.

A Japanese precedent?

But that is not the only path to currency strength. As Arthur has pointed out, during the 1990s and 2000s, the yen was broadly strong, and Japanese government bonds were the best performing bonds in the world, in spite of a fall in global yen usage, weak domestic growth, short term interest rates that had been cut nearly to zero, and repeated bouts of quantitative easing from the Bank of Japan. This yen strength was the result of domestic deflation, large increases in domestic savings, deleveraging by the corporate sector, and of course a large current account surplus.

In other words, conditions that were not that different from those we see in China today. This brings us back to the first question above: Is the renminbi likely to rise, or fall, over the coming years?

Right now, I think it is fair to say that the consensus view is heavily tilted to the bearish side (when was the last time you met a renminbi bull?). To me this bearish bias underlines a simple reality: Everywhere around the world, we are in the middle of a massive US dollar buying panic. I see signs of this panic everywhere I look, from renewed speculation against the Hong Kong dollar peg (a dud trade if ever there was one), to the recent front page article in Canada's National Post newspaper advising people to go out and do their grocery shopping now as prices are sure to soar because of the Loonie's collapse, to the number of people falling over themselves to explain why China—the world's largest exporter and the country now running the largest trade surplus in history (not just in China's history, but in the whole of recorded world history) needs a much weaker currency.

Long in the tooth

Meanwhile, what is interesting about this US dollar buying panic is that most major non-US dollar counters (except for sterling) have actually been holding up reasonably well lately. In the midst of this buying panic, the euro has not made new lows, the yen has rallied strongly (granted, the yen always rallies when things are bad in markets) and gold has been hovering between US$1,050 and US$1,110/oz for a while. In short, it feels as if the US dollar's "strength" may be getting a touch long in the tooth?

Frankly this should not be too surprising. If there is one trade that looks obvious for 2016 it is that the US Federal Reserve will not raise rates the four times it has promised. You can pick your own reason why the Fed will hold back. With the ISM manufacturing PMI below 50, corporate spreads making post-crisis highs, US industrial production in negative territory, headline inflation far below target, US profit margins shrinking, and equities falling, there are more than enough to choose from.

Weak footing

So, given all of the above, why has the renminbi started the year on such a weak footing? Obviously, when a market weakens, it means there must be more sellers than buyers. On the "buyers" side, I tend to think that most potential renminbi buyers are shying away because of the US dollar buying panic mentioned above. But what is probably more interesting is the "sellers" side. From a cursory look at the financial media, you would think that we are at the beginning of a massive exodus of Chinese capital out of China. In short, the bearish argument for the renminbi is simple: the renminbi will go down, and go down a lot, because the Chinese people themselves are losing faith in their own currency.

One can make this argument about any currency. If the British were no longer to trust the pound, then the pound wouldn't be worth very much. If the Swedes were to decide that they are no longer willing to hold krona, then the value of the krona would crash.

But somehow this argument gains far more media traction when it comes to China. The reason, I think, is that (whether we realize it or not) most of us in the Western world tend to regard the Chinese government as illegitimate, since it was not chosen through elections. And given that the government is "illegitimate", surely any smart person will seek to ship his or her savings abroad, because an "illegitimate" government cannot have a credible currency.

On-the-ground evidence

My problem with this line of thinking is that there is little evidence on the ground that this is what is actually taking place. Sure, Chinese people have been taking money out of China. But that is nothing new. Ask anyone in Vancouver, Sydney, Auckland, Hong Kong, or Bordeaux. Chinese money has been coming in for years. Macau was built as one huge conduit to get money out of, and sometimes into, China.

The big question today is whether many more Chinese people are taking their money out, and whether they are doing it on a scale large enough to overwhelm China's US$600bn trade surplus. The recent contraction in China's reserves suggests that this is what is happening, and of course this is what the media are latching onto. But I am troubled by the fact that at the anecdotal level, there are few signs of these massive capital outflows. For example, one easy way for Chinese people to send money abroad is through the Shanghai-Hong Kong Stock Connect scheme (which channels funds indirectly into the Hong Kong dollar); but this has barely been utilized. Meanwhile, real estate transaction volumes in the markets typically favored by Chinese buyers—Vancouver, Hong Kong, Macau, Sydney, Auckland—have fallen recently (although prices have proved more sticky). So if the Chinese are shipping their money out of China, where is that money going? In what asset markets can we see volumes and prices rising?

Exporters now hedging

This brings me to my next point. Maybe the drop in the renminbi is not primarily linked to the Chinese public panicking over the value of their currency and deciding, en masse, to buy US dollars. Perhaps it has more to do with large numbers of Chinese exporters adjusting their currency exposures and hedging their positions as they have been caught up by the general global US dollar buying panic. To me this seems a much more plausible explanation. And it is one for which there is anecdotal evidence. A number of Hong Kong-based friends in the import-export business have recently told me that they are now hedging their foreign exchange exposure for the first time. If this is what is happening on a general scale—and admittedly it is a big "if"—we should probably not read too much into recent market moves, as they will have been the result of short term panic-buying by corporates, rather than the start of wholesale capital flight out of China.

None of this detracts from the views put forward by Arthur and Chen Long. As they point out, the situation has changed, and it is clear that from now on the PBOC will:

1. Manage the renminbi more against a trade-weighted basket of currencies (much like Singapore) than against the US dollar, and

2. Tolerate a greater degree of exchange rate volatility than in the past.

But these are not surprises. They are natural, healthy developments that the PBOC has been telegraphing for years. As I have argued repeatedly over the past year, the days when a simple buy-and-hold strategy could earn you 250bp more in dim sum bonds than in US treasuries, with 2% less volatility, are now clearly over. There was a window of opportunity for quick-footed investors to make easy money with less risk, but it is now closing. From now on, returns in the Chinese bond market will be more volatile. But this volatility will also offer opportunities for sharp investors.

Buy the dip?

This brings me to the next important question. For the past five years, one of the simplest ways to make decent money in Chinese bonds was through a "buy the dip" strategy. Each time the renminbi and dim sum bonds dipped—and they tended to dip together—investors could buy in, confident that the Chinese government would step in to support the market. And why would the government step in? Because of its desire to promote the renminbi as a credible international currency, that could be used for trade financing (to prevent a repeat of the 2009 trade freeze), and one that could be used to denominate central bank reserves around the region and across emerging markets. If as Chen Long and Arthur argue, we are now seeing a change in this policy to establish the renminbi as an international currency, investors will have to ask themselves whether renminbi bonds are still a good buy-the-dip asset, even as the volatility increases and the dips get bigger.

Now to be sure, there is a lot to dislike about what the Chinese government has been doing lately. Indeed, two years ago, at the Communist Party's third plenum, foreign investors were given a glimpse of a China that would embrace supply side reforms, deregulate industry, and embrace restructuring. It was easy to get excited. Since then, Beijing's track record on reform has proved increasingly disappointing. As Arthur has pointed out recently, it feels as if things are going the wrong way fast on the policy front (see China: Still Off Course). The abduction over the holidays of Hong Kong book-publisher Lee Bo, allegedly by mainland security agents, was a deeply shocking development. As Talleyrand said of the Prince de Conde's murder by Napoleon, "It was worse than a crime; it was a mistake". One has to wonder what President Xi Jinping was thinking (assuming that the decision to kidnap a Hong Kong bookseller was taken at the highest level). How could his stance not have been: "I am the president of China. I am above such trivialities"? Worse, like Henry II, did Xi effectively exclaim: "Will no-one rid me of this turbulent priest?" Either way, such developments bear out Arthur's case that all is not well in Chinese policymaking circles.

Still, going back to what China's renminbi policy will be going forward, and whether the buy-the-dip strategy still makes sense, I note that one of the points Arthur makes is that the Chinese leadership is simply too reluctant to let market forces determine either the value of the renminbi or the level of interest rates, for the renminbi to become widely accepted as a credible international currency or bond market.

Paradox

But there is a paradox here. It is precisely this reluctance to let the market dictate the value of the renminbi or the level of Chinese interest rates that has made the renminbi such an interesting alternative to the US dollar, euro and yen for trade financiers and central bank reserve managers. It was this very reluctance that ensured the success of the buy-the-dip strategy.

Put simply, the only reason foreign central banks were prepared to shift capital into the renminbi, or companies consider financing trade in renminbi, was because there was an implied Chinese government guarantee that the volatility of the renminbi against the US dollar would be confined within "acceptable" limits—an implied guarantee which effectively underpinned the high returns of the buy-the-dip strategy.

Currency basket

The Chinese government's new "promise" is that this volatility will now no longer be measured against the US dollar, but against a basket of currencies. There are several ways to see this promise:

1. The first, as Joyce has argued, and as the consensus appears to believe, is that this is a promise that the Chinese government will be unable to keep. In this view, the Chinese government has simply made too many promises for it to keep them all, so some will have to be sacrificed. One of the victims will be its promise for the exchange rate.

2. The second—and the one I am inclined towards—is that this promise is not surprising. It is consistent with the broad pattern that has been unfolding over recent years, and which continues to point towards the renminbi establishing itself, slowly but surely, as an international currency, with all the normal attributes you would expect of a major currency, including greater volatility than the renminbi has shown in the past. Naturally this process is happening in a very Chinese manner: one small step at a time, and very slowly.

Policy options

To understand why, imagine you are sitting in Beijing and planning how to internationalize the renminbi so that over time, more and more of your imports can be denominated in your own currency, rather than in somebody else's (somebody you might not be able to trust 100% in a crisis, and somebody you definitely see as a rival for regional geopolitical hegemony). To achieve your objectives, what would you do today?

1. Your first option is to deregulate interest rates, deregulate the exchange rate, relax capital controls and let prices settle wherever they may. To some extent, I detect in Arthur a sense of frustration that this course of action is not being embraced more openly. Leaving aside the fact that, in terms of Chinese policymaking, such a drastic course of action would be unprecedented, I would question whether, given the current nervous state of markets, such a course of action would be productive. On the contrary, it could easily trigger panic. And if it did end up triggering a panic, would the ultimate goal of moving away from US dollar dependency have been furthered, or undermined? Please don't get me wrong: I am all for market prices rather than government prices. But this approach reminds me of the story of the American tourist who got lost in the Irish countryside. Spotting a farmer, he asked the way to Dublin, only to be told: "Ah! Dublin is it? Well if you want to go to Dublin, you don't want to start from here…".

2. Your second option is to conclude that you are screwed. Growth is collapsing and you have a debt crisis on your hands. In this scenario your best option is to forget about your international plans and focus on domestic problems. Hunker down, probably devalue the renminbi, and probably forget about your dreams of an international currency. To some extent, this is what Joyce has been arguing, and I also get a hint of this line of thinking from Chen Long and Arthur's most recent report. But if Beijing were really going down this path, then why would policymakers have bothered intervening in the foreign exchange market to the extent that they have over the last six months? If Beijing has cooled towards its internationalization strategy, why would it have bothered with funding the Asia Infrastructure Investment Bank and the Silk Road Fund etc? Why would policymakers bother pretending that the renminbi is moving from being managed against the US dollar, to being managed against a basket? An awful lot of money would have been poured down the drain for no good reason.

3. The third option would be to continue gradually internationalizing the renminbi by slowly increasing its exchange rate volatility, turning the currency into something more than just a US dollar proxy. Of course, the process won't be linear, but over time the renminbi will increasingly come to resemble a "normal" currency—one other countries feel comfortable borrowing in (note South Korea's recent issue of panda bonds), and which companies feel comfortable holding as working capital. Personally, I believe Beijing is still following this path, even if recent policy moves have proved disappointing.

As a result, investors have a choice to make. They can conclude that:

a) Beijing is losing or will lose control of its exchange rate in the face of massive capital outflows. To me, this belief is another example of the current US dollar buying panic. While I was very bullish on the US dollar five years ago, it seems to me that in the near future we will get confirmation that the Fed will not be tightening, a policy path which may well shine new light on the growing US twin deficits.

b) Either the Chinese government no longer regards renminbi internationalization as its policy priority, or it is not prepared to pay the price of having a truly international currency. I am not sure I buy into the argument that we have reached the stage at which the Chinese government will have to accept greater market volatility as the price for further internationalization. We may well reach this point one day, but for the time being, as the renminbi continues to build market share, it seems to me that the main concern of investors is whether the buy-the-dip strategy continues to makes sense.

c) The Chinese government still wants to internationalize its currency, if only because Xi is a more nationalist president than his predecessors, and keen to establish China as the unchallenged Asian power as part of his "China Dream". If this is the case, the buy-the-dip strategy will continue to makes sense over the coming years, even if the dips get bigger, and the volatility greater.

Obviously, believers of the third option (and I count myself among them) will note that the recent sell-off is the biggest dip on record, and that it therefore presents an interesting buying opportunity for the renminbi and renminbi bonds.

Under-owned assets

To be fair, this view is driven largely by the belief that renminbi assets remain one of the most under-owned asset classes in the world today and that this "under-ownership" will gradually diminish over the coming years as an ever-growing number of marginal buyers enter the market.

This is the big difference with Japan. In January 1990, Japanese equities were 48% of the MSCI World, and there were seven Japanese financials among the top ten companies in the index. Back then, every equity and every bond manager was long Japanese assets whether he or she liked it or not. This positioning opened the door to two decades in which foreigners sold Japan (and even then, shorting the yen and the JGB market was a poor trade).

Having said that, there is nothing pre-ordained about foreigners buying more Chinese assets. For this to happen, Chinese policymakers need to ensure that the environment is attractive for foreigners to deploy capital. Greater currency volatility would be a deterrent to foreign capital inflows. So would backtracking on supply side reforms, keeping zombie companies alive and kidnapping book publishers. Nevertheless, long term renminbi internationalization remains a powerful tide, and one that I, personally, don't want to try swimming against. The probability remains in place that over the coming years we will continue to see greater use of the renminbi in international trade, regional project finance, world central bank reserves, and global bond issuance.

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