

The Disruptive Discoveries Journal

Weekly analysis of how disruption in commodities, geopolitics, and macroeconomics converge to create opportunities

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China at the Tipping Point

Question: What is China's #1 export?

Answer: Deflation

Though the real answer to the question above is electronic equipment (\$571 billion USD worth according to the CIA Factbook), the PBOC yesterday made a compelling case for replacing electronic equipment with deflation as banking officials in the country moved to devalue the Chinese Renminbi (RMB) by close to 2%.

It is obvious to even the most casual China-watcher that the country has been losing export competitiveness as the RMB trading band essentially rendered the RMB stronger due to its peg to the US Dollar. The USD continues to strengthen and shows no real signs of reversing as the Federal Reserve appears determined to raise short term interest rates later this year. We are left to wonder why the PBOC did this with \$4 trillion in foreign exchange reserves. A stronger RMB is in China's longer-term interest as the economy rebalances.

PBOC's yuan daily fixing rate



Source: Wall Street Journal

Under the current mechanism, the RMB is allowed to fluctuate within a tightly controlled band. Each morning, the PBOC sets a midpoint for the currency and market participants are allowed to trade the currency within a 2% band up or down. The PBOC has kept the trading band in place, but by devaluing the RMB by 1.9%, has given Chinese exporters a (brief?) respite. According to Bloomberg, this is the most significant downward revision in the RMB since 1994.



Source: Bloomberg

We think that the slowdown in the Chinese economy is the reason for this currency intervention and the “last straw” may have been the July Chinese export numbers which fell over 8% from a year earlier. Market expectations were for a 1.5% decline. Though there are indications of the Chinese growth model shifting away from exports, this fall was clearly too much and so the powers that be in Chinese central banking had to intervene. In addition to this, China’s producer price index (PPI) numbers continue to be in free fall, declining 5.4% on a year-over-year basis. What is significant here is that this index has been declining for **41 consecutive months**. If there ever was evidence of China exporting deflation, this is it and it’s about to become more pronounced.

This move to devalue the RMB, coupled with the effective “lockdown” Chinese authorities have on their domestic equity markets, has many wondering how China expects to have the RMB included in the IMF’s Special Drawing Rights (SDRs), a widely viewed basket of reserve currencies. Acceptance into this “club” is one of the country’s main goals and is no secret. The IMF has written a lengthy, but very informative piece on SDR valuation you can see [here](#).

The PBOC has [called this devaluation](#) a “one time” move and is really more about market reform than propping up a collapsing export sector. In addition to the devaluation, the PBOC is pledging to let market forces play a more significant role in setting the RMB level by ensuring market makers take into account the previous session’s USD/RMB closing level as well as overnight developments in the financial markets. There does seem to be some validity here, but it is likely just as much posturing towards the IMF.

Commodities and the bond and currency markets have not reacted well to this news. The US 10 Year government bond dropped to yield 2.12%. Asian currencies including those in New Zealand, Taiwan,

South Korea, and Australia all fell by 1% or so as of this writing. The inference here is that as the RMB weakens, Chinese exports will become “cheaper” relative to those of other countries and so those countries must also push down the value of their currencies to compete. This is a classic “race to the bottom” and beggar-thy-neighbor scenario and it seems clear that China is about to hammer its emerging market cousins in a bid to restore growth.

WTI crude is down 4% to \$43.16 per barrel and copper down 3% to \$2.32 per pound. The gold price seems to have held its own, up .44% to \$1,109 per ounce. With China as the largest producer (and consumer) of a host of metals, a cheaper RMB will only encourage domestic production, further depressing prices and adding to gluts in already oversupplied markets.

While the economic repercussions are clear and visible, the geopolitical repercussions are less certain but likely to be just as profound. As China has manipulated value of the RMB anew, politicians will have an absolute field day with this. In the United States, as we head into the real heart of a Presidential election cycle, we can't wait to hear Donald Trump pontificate on this move.

On a more serious note, Chinese President Xi Jinping is preparing for a state visit to Washington later this year. One can only assume that China's intervention in not just its own financial markets, but global currency markets will be at the top of the list of items to discuss. One can only wonder if a few phone calls from the White House to the IMF haven't been placed discussing “a review” of China's hopes to be included in the SDRs.

What this all unfortunately means is that we've just taken one step closer to a deflationary spiral. Sub-par global growth is a given. In the immediate-term, keeping a close eye on the RMB performance within the trading band is going to be important. Over the longer-term, performance of emerging market currencies and balance of payments data will give a clear signal of just how much deflation China is indeed exporting.

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