Orient Capital Research

August 19, 2015

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The Politics of the Renminbi

Employment is the Bottom Line

Dateline: Chongqing, Sichuan Province

There clearly is a conflict between different groups over the devaluation of the Renminbi. To get to the punchline: ***I see this as a progressive and aggressive move by Zhou Xiaochuan at the PBOC.*** However, I doubt the PBOC was very clear about the impact of the devaluation on the domestic economy or global sentiment. The pushback was much larger than they had anticipated. Still, it was a classic Chinese policy: internationalization as a tool to handle domestic problems. This was true with the WTO entry under Zhu Rongji, which led to reform of the state owned firms. Zhou Xiaochuan is among the most cosmopolitan of senior policy makers (USA PhD) and this is his style.

GDP Decline Caused Timing

Why now and for what reason? Not because of the SDR. The inclusion of the RMB into the SDR was a fig leaf used to convince senior leaders of the need to devalue (or depreciate, depending on your view) the currency. The IMF did note in July "In the event of SDR inclusion, the Fund, in consultation with the Chinese authorities, would need to identify a market-based exchange rate that could be used as a representative rate for the RMB." And the IMF had said a more flexible exchange rate was one of five criteria for entry. However, SDR inclusion is more for domestic bragging rights. It's hard to gather evidence for this view except to note the recent dismal growth statistics (electricity, rail freight, etc.) and the love the State Council has for anything that demonstrates China's international scope.

The timing, though, may have been influenced by expectations of a Fed rate rise later in the year.

It's About Political Stability

The bigger issues for the PBOC and the senior leaders are a) capital flight and b) employment.

Flight to Safety. For capital flight, the PBOC used a one-time shock devaluation to force speculators out of the market. The WSJ reported August 14 that total outstanding funds for foreign exchange held by Chinese financial institutions fell 249.1 billion yuan ($39 billion) in July to 2.89 trillion yuan. This represented the largest monthly decline since 1998 when the data set started.The problem is, with continued pressure on the currency, the PBOC may have to use billions to keep the currency from going into a free fall.

They are capable of doing this and probably will. But they are clearly worried. The director of international payments at the State Administration of Foreign Exchange, Guan Tao, was recently quoted as saying that capital outflows were akin to the situation before the 1997 Asian crisis, when capital flight accelerated. Others have expressed similar concerns. With fewer than 5% of savers controlling up to 50% of bank deposits, the opportunities to move money offshore are significant.

Employment Problems. The employment issue is interesting. There is a regional conflict between the mainly privately owned exporters, heavily concentrated in Guangdong and Fujian provinces, and the state sector in the north and center of China. My visit to Fujian three weeks ago suggests that the private sector over-expanded during the 2009 fiscal stimulus and is now being starved of capital because the banks are concerned about bad loans and tend to lend to the state sector anyway.

The PBOC may have told the State Council that something had to be done to keep employment up among private firms, which are export oriented, or the country may face massive unemployment. But that couldn't be stated publicly. I still think this was the major driver for the policy move. In a 2011 paper the IMF noted that a 10% appreciation/depreciation historically lowers/raises employment ex-agriculture by 0.4 to 1.4 percentage points. (Although many people point out that State firms are net importers while the private sector is a net exporter. Presumably, the State Council would rather protect the state sector — except when massive unemployment would threaten the Party).

More Bad Policy to Come

What does the devaluation mean for domestic policy and global markets?

1) **Confusion.** As China's economy declines there will be a lot of confusion and

fighting among groups that is going to result in a lot of bad -- and some good -- policies. This one was good. The stock market recap was bad.

2) **RMB Floor?** China is going to use the exchange rate instead of administrative tools to stem capital flight. This is also smart as market tools tend to be more effective. But what is the floor? Are the wealthy going to expect further devals and rush money out? There was a report in the Hong Kong press that mainlanders have quickly started buying apartments due to the devaluation.

3) **North-South Divide.**There will be a big fight between the commodity-intensive importers within the state sector and the export-led private sector over the currency. This is almost a North-South fight. But with Guangdong Party Secretary Wang Yang now in the Politburo the exporters have a champion at the top. However, it's going to be ugly, particularly as the princelings get most of their graft from the state sector.

4) **Capital Flight.** The wealthy will be searching for new and more creative ways to export capital. Our interviews in April suggested that false trade invoicing is running into regulatory opposition and service payments has become the new channel. Tools such as overseas bond issuance will become more prevalent. This explains why state security agents were caught in California by the FBI threatening a well-connected Party member. They are more accustomed to administrative measures (in this case, thugs…) than to using markets to alter behavior. I am sure Zhou Xiaochuan is not happy about this style of policy making. It's not clear how large this can become without a crackdown by regulators but we estimate the service deficit could double to $400 billion in 2015.

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