# February Article

## What to expect from the Chinese Turmoil?

Over the past 50 years there has been a global recession once every eight years, on average, and the next one could be arriving soon. In August 2015 the Chinese stock market crashed (which wiped out all of its yearly gains of 60% until then) and the renminbi devalued 2% against the US dollar. From then onwards, it is expected that the next global recession will likely be “made in China”. This is even more worrisome if we take into account that, since the global recession of 2008-09, China has emerged as the largest contributor to global growth (nearly 30%), replacing, the previous leader, the U.S (accounting with 17%). Therefore, the key to global growth rests in Beijing's hands.

The impressive double-digit record (around 10% a year) of China’s growth from 1992 until 2014, mostly relied on the massive increasing debt as it converged with the advanced economies. For all these 22 years but three, China always stayed above the GDP target that the government imposed every year, often by a big margin. However, China inevitably could not keep on growing at this pace forever, as it would be unreasonable to do so with a debt-to-GDP of 250% 2015 Q3. The reasons for this recent downturn fit within the long history of business cycles: rising excess capacity in a growing number of industries, excessive leverage in the private sector and irrational reasoning, at times, in asset markets.

China announced to the world, on January 19th of 2016, that its GDP had only grown by 6.9% (inflation included), which was actually the lowest rate in 25 years. The Chinese economy continues transiting toward a growth driven by services and consumption rather than manufacturing and investment. However, these new drivers have not yet demonstrated their value in relation to the old ones . Earlier in January, China released their latest currency devaluation, which forced the PBoC (People`s Bank of China) to tighten even more the capital controls. This serves the purpose of slowing down the major capital outflows the market has been witnessing (estimated to be USD 110 bn in January). This situation has led Beijing to support its currency stability at the expense of its “rainy day fund”- its USD 3 tn foreign reserves (the largest worldwide), which dropped to its lowest level in almost four years. The overwhelming USD 90 bn that the PBoC spent, prevented the currency from falling too fast in January, which accounted to more than a quarter of what it spent in the whole year of 2014.

There are two opposing views to what might happen in the following months concerning the value of the Chinese currency. Some might argue that the PBoC will have to let the renminbi to devalue against the US dollar, which is coherent to the introduction of the renminbi into the IMF`s basket of reserve currencies by late 2015. For instance, Kyle Bass, who greatly benefited and predicted the 2008 financial crisis, stated that one of the best investment ideas for 2016 was to short the Chinese currency, as he anticipates a yearly renminbi devaluation of 10-15%. Others will argue that the resilience in consumer spending and the solid property market is expected to offset the sharp decline that has been occurring in heavy manufacturing in 2015. Therefore, this view predicts that the renminbi shall not suffer a significant devaluation in the short-term.

Additionally, after the major currency devaluation last August, there have been an increasing number of heavy bets on the renminbi depreciation through the CHN (the offshore version of the currency). These risky investment strategies turned out to be wise, as the exchange rate depreciated from 6.40 to 6.70, from August to February. However, the CNH bears have appeared to pull back, with the offshore exchange rate at 6.60, which coincides with the official exchange rate (Onshore RMB per USD) . Following this line of thought, the “bears” betting now on the sharp renminbi devaluation are likely to end up frustrated.

The end of the stalemate around the renminbi is approaching soon. China’s policymakers do not seem to be ready to give up the fight and the currency bears should beware. In my opinion, rather than tightening up capital controls that sow panic in the general public, China should implement macroeconomic policies that support growth, as well as an expansionary fiscal policy, in order to build confidence among investors regarding the uncertain renminbi.

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