

The year of the Monkey



Hilliard MacBeth

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For the Chinese people it will soon be the Year of the Monkey. The lunisolar Chinese calendar celebrates a New Year, also known as the Spring Festival, starting on Monday, February 8. The characteristics of the New Year contain a hint of what could come on foreign exchange markets.

Are the Chinese preparing to surprise the markets with another sudden devaluation of the Renminbi (also called the yuan) in an attempt to stop the outflow of foreign exchange and promote economic growth?

There are 12 animals in the Chinese zodiac. The Monkey is the 9th in the cycle. People born in the year of the Monkey are supposed to be quick-witted, intelligent, curious, innovative and mischievous. But the Year of the Monkey is also known as one of the most unlucky years in the zodiac.

As the celebration starts the rest of the world is worrying about China's economy and the yuan. See my blog on January 22 for an overview of the implications of the shift in the Chinese economy from investment-driven to consumption. The currency and China's rapidly depleting foreign exchange reserves are two other concerns frightening markets.

Foreign exchange speculators are increasing their bets on a drop in the value of Chinese currency. When China devalued the yuan by 1.9% on August 11, 2015 to 6.32 against the US dollar, financial markets worldwide reeled. Today the ratio is 6.54 to the US dollar, 3% lower than August.

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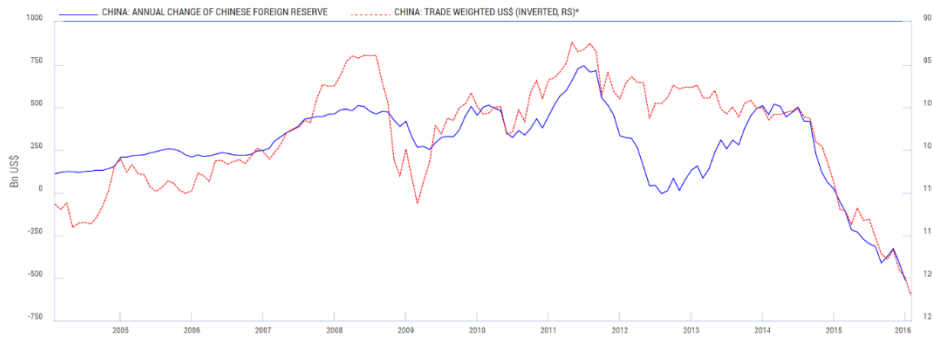
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The Dollar Exchange Rate And The Value Of China's Official Reserves



*SOURCE: J.P. MORGAN CHASE & CO.

Source: BCA Research Inc.

As the government tries to manage the depreciation the risk grows that they might lose control. An increase in the rate of money flowing out of China would cause the Chinese government to spend more foreign reserves (held mostly in US dollars) to slow the fall of the Renminbi. But history shows that often such efforts are futile.

Investor George Soros suggests that a “hard landing” in China is “practically unavoidable.” He is shorting Asian currencies on the market, without specifying if it’s the Hong Kong dollar or the Renminbi or some other currencies. Over the last year China’s currency has lost 5% of its value, a minor change but good for Chinese authorities who are fighting sluggish growth. But Soros is betting on a bigger change and the possibility that China will lose control of the process.

China’s official newspaper the People’s Daily, an arm of the Chinese Communist Party, challenged Soros in a January 27 op-ed article:

"Soros openly declared war on China, asserting that he shorted a large volume of Asian currencies," said the op-ed article, which ran on the front page of the paper's overseas edition Tuesday.

It was written by a researcher at the Chinese Commerce Ministry with the scoffing headline, "Declaring war on China's currency? Ha ha."

"There is no way his challenge to the Chinese renminbi and the Hong Kong dollar will succeed," the article said.

It would be mischievous, like the Monkey, to spring another sudden devaluation. Such a move would help solve China’s problem, at least in the short term. But it would have the negative outcome that Soros and other speculators would be rewarded.

The more that official sources protest, the more traders become interested in shorting the currency. The Xinhuanet on January 23 2016:

As for those who want to bet on the “ultimate failure” of the Chinese economy, they should look back at the past four decades, which witnessed China’s growth from an underdeveloped economy into a global economic powerhouse through continuous reform and opening up.

They should also take into consideration the fact that the Chinese government has been constantly improving the country’s market regulatory system and legal system. As a result, reckless and vicious shorting will face trading costs and possibly severe legal consequences.

This kind of talk is likely to bring more “vicious shorting” of the Chinese currency, making a devaluation probable.

But it’s not just currency speculators that are shorting the yuan. Chinese citizens are selling the local currency and buying US dollars, gold and Vancouver houses. As Credit Suisse said in a January 15 piece “China: the Year of Living Dangerously” — “this genie is very hard to put back in the bottle once it’s released.”

Ultimately investors should expect capital controls and other forms of financial repression.

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