WaveFront Insights

The PBOC vs. Soros; We'll Take the PBOC

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A Sizable Devaluation in the RMB Could Be Devastating for the Global Economy

Recently, there has been a very specific drum beat emanating from the financial press regarding the RMB/Yuan. Certain hedge fund managers (we've all heard the names) have been evangelizing a single message: a major devaluation of the Chinese currency is inevitable. With all due respect to the rather famous personalities involved, we fundamentally disagree with their position, certainly on the scale they are suggesting. The simple fact is, such an event would likely cause a serious global recession, downward pressure on commodity prices, and a sharp rise in unemployment. None of these outcomes favor China or anyone else. Not to mention, it raises the risk of competitive currency devaluations by every other country in the neighborhood!

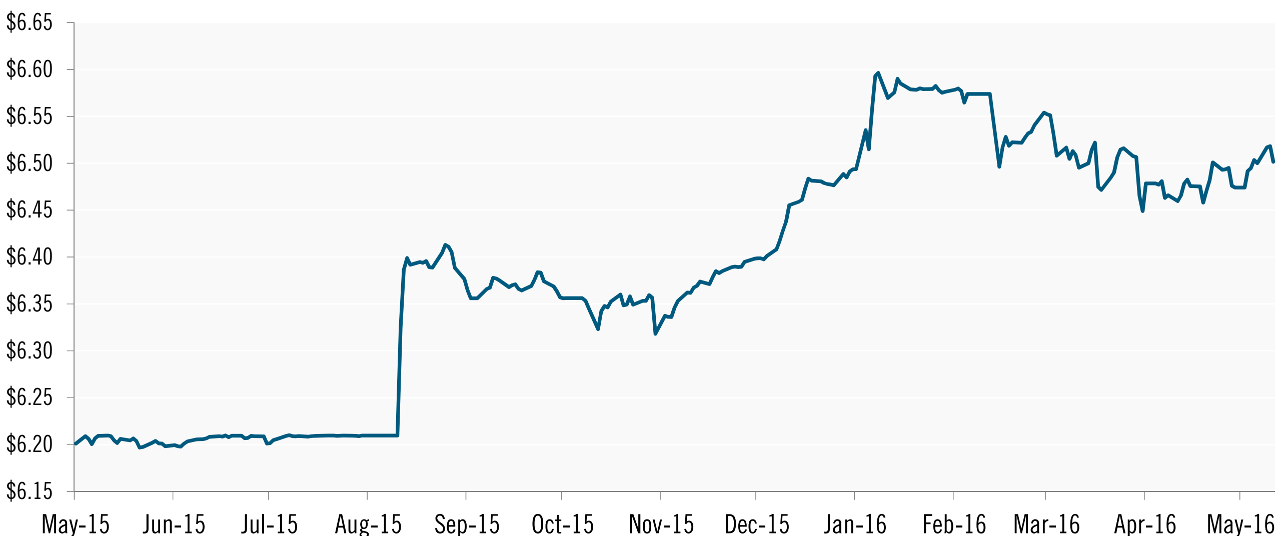
Why All the Nervousness?

Worries about China's currency began in earnest last August 11th, when the dollar exchange rate fell 3.5% without any warning or comment from the People's Bank of China (PBOC). Uncertainty reigned and FX market participants were left to their own devices to explain the sudden change, which is never a good thing. The most common thesis was that it was an initial move by the PBOC to make Chinese exports more competitive, thereby boosting their economic growth rate.

However, PBOC officials eventually pointed out that inclusion in the IMF's Special Drawing Rights (SDR) basket required two criteria: (1) the RMB must be "freely usable" to make payments for international transactions; and (2) it must be widely tradable in principal foreign exchange markets. China argued that the so-called devaluation was initiated to make the RMB's valuation more "market-based". Moreover, the China Foreign Exchange Trade System began publishing a market-based benchmark of the RMB/USD exchange rate five times each day, and the Ministry of Finance committed to issuing three-month treasury bills on a weekly basis and using its rates to calculate the SDR interest rate basket. All positive developments in our humble opinion.

Exhibit 1: FX Value of the RMB/USD

May 1, 2015 through May 6, 2016; Daily Close



Market Confusion

Those insights weren't enough to quell the uncertainty and, as a result, the RMB remained in the spotlight. George Soros and a cadre of other hedge fund managers, sensing an opportunity, have been vigorously stirring the pot, suggesting that a major devaluation (i.e. 10 to 20% or more) is inevitable. As evidence, they point to the $800 billion decline in Chinese dollar reserves over the past 18 or so months, although China's reserves have actually increased over the last two months. While the overall decline is not a positive trend, keep in mind that over $3 trillion still remains, so the PBOC should be able to defend the currency aggressively for some time, if it so chooses.

Many economists also cite the Chinese as facing the classic policy trilemma of international economics: a country cannot simultaneously have more than two of the following three attributes: (1) a fixed exchange rate; (2) independent monetary policy; and (3) free international capital flows. It has become increasingly obvious that Chinese authorities don't subscribe to the same theory. Rather than viewing the problem as something that needs to be tackled head-on, they have been pursuing alternative methods to achieve their goals. Premier Li Keqiang noted in early March, for example, that China's budget deficit target would be increased from 2.3% in 2015 to 3.0% in 2016. This suggests that the government is using fiscal policy to stimulate the economy.

Lastly, Chinese authorities claimed last fall that the RMB's value would be determined by a basket of foreign currencies and not solely the U.S. dollar. This policy was well received by market participants, but authorities have not followed their statements with market actions. The PBOC appears to be using the "basket of foreign currencies" approach when the result suits their overall objective (i.e., when the RMB is stable) and ignoring it when a lower or higher RMB/USD exchange rate is called for. Mixed signals at best.

Many market participants have therefore concluded that the ultimate objective of the PBOC is to avoid any meaningful downward pressure on the currency regardless of market conditions. The RMB/USD exchange rate has, in fact, only declined by a further 1.25% since last August 12th (Exhibit 1). Nevertheless, PBOC and other authorities still claim that no further devaluation is needed, and FX market participants continue to be puzzled by their true policy objectives.

What we Think…..

Bureaucratic communication miscues, from the still-learning government of an emerging market, should not be exaggerated or interpreted to spell doom for the currency. While a few hedge funds stand to make enormous gains if a sizable (10 to 20%) devaluation were to occur, it must be recognized that the consequences would be enormous. It would, in all likelihood, push the global economy into a lengthy period of contraction and set off competitive devaluations by other central banks. Therefore, we believe the odds of a major devaluation are extremely low. In this instance, a few major hedge funds can't bully a currency like they would a domestic stock. China will undoubtedly act in its own best interest, and a major currency devaluation just doesn't seem to fit that bill in the current environment.

More importantly though, we see a Chinese economy that is stabilizing, and is capable of a pace of growth that remains the envy of the world. While we find some of the PBOC actions perplexing, we do think they have the ability to steer the currency on a path that will promote global economic growth and continued prosperity.

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