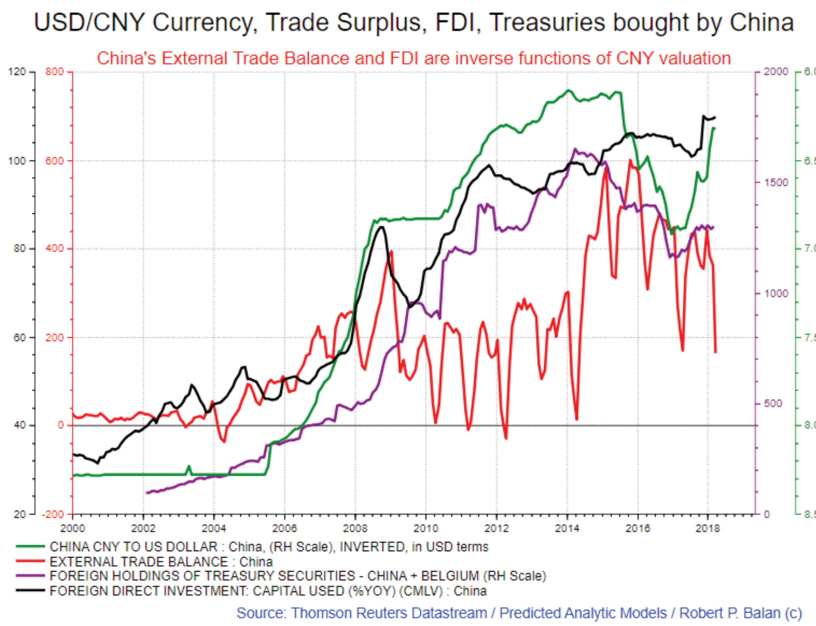
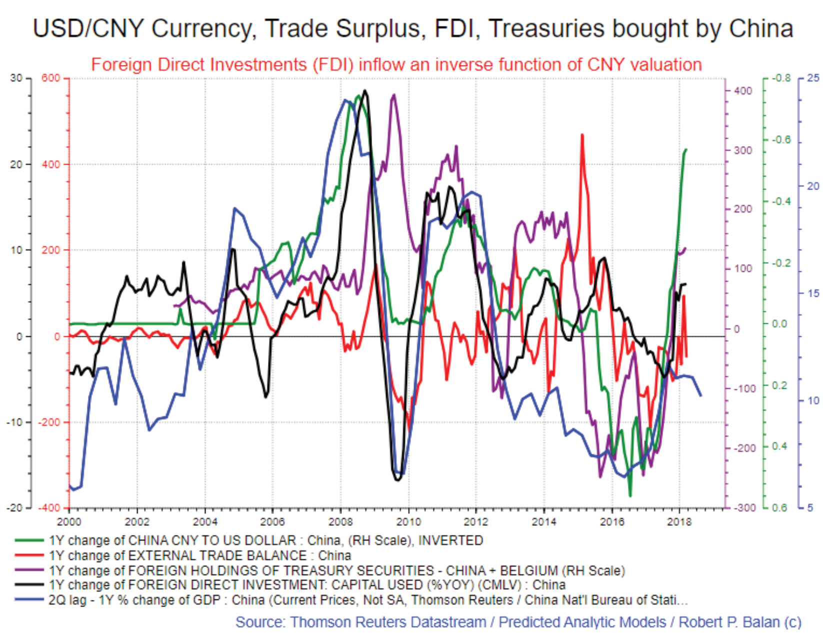
# 44 / Devaluing The CNY: China's Secret Weapon In The "Trade Wars"? Not Really, But An Opportunity Too Juicy To Ignore, Or Waste

It's all over the financial pages of the business media. Business and popular media claim that as part of the trade wars, China may have the ultimate weapon at hand, i.e., inject further liquidity and devalue the Yuan (CNY). The media claims that this squeezes the US Dollar strongly higher, thereby worsening the US competitive situation. On the other hand, it allows China to come through relatively unscathed through the upcoming economic crisis by having a competitive currency. Thereby it can continue to export its products even in the event of a US economic crisis (and subsequently, a global crisis).




The media believes, and marshals the argument, that the recent cut in PBoC bank reserve ratio is revealing of this strategy. Our opinion: yes, it does, but the thrust of that policy action is directed elsewhere. In fact, it confirms our observation about a likely slowdown in Chinese activity. Chinese governments have previously used this tool as another defensive action in forestalling growth declines. We elaborate further in the article.




**For us, we conclude that devaluing the CNY is not a secret weapon in the "trade wars" -- China has to do it to kickstart a flagging economy. It is also an opportunity that is too juicy to ignore or waste.**

We illustrate and help explain the logic of these conclusions with the sequence of graphs presented here after:

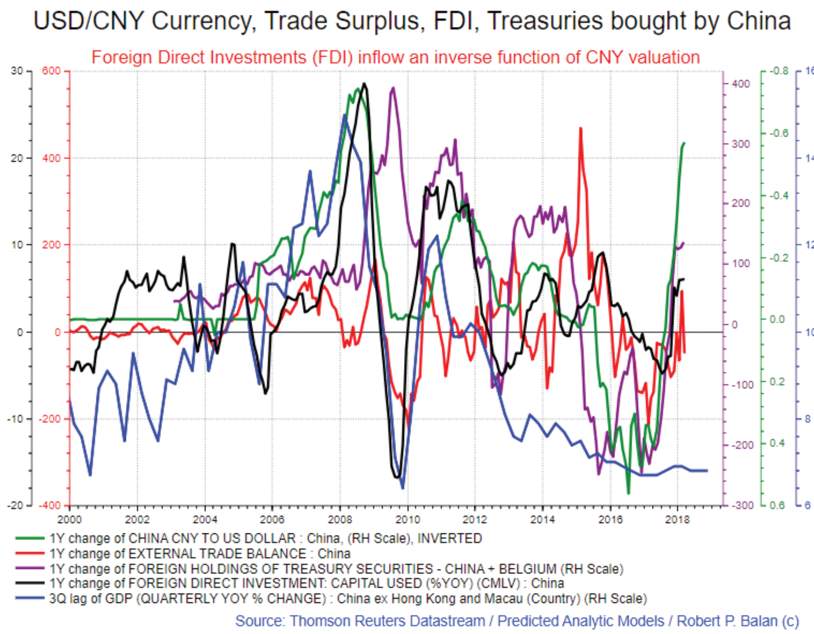
In the 1st graph on this page, we see that China's External Trade Balance (Trade Surplus, in this case) is inversely correlated with the domestic currency (CNY). In fact, the trade surplus is a function of the level of the CNY -- weaker CNY begets a bigger trade surplus, as China's exporters become more competitive.

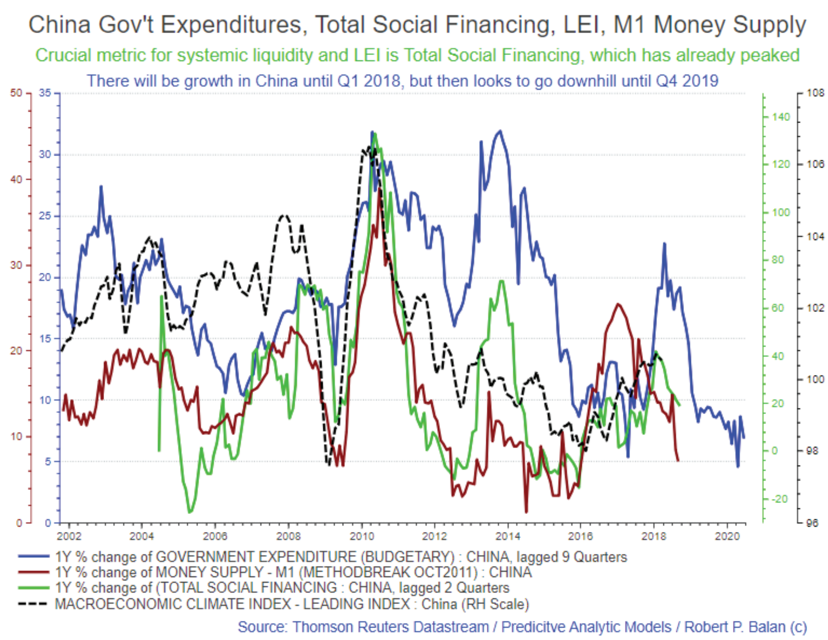
Likewise, China's Foreign Direct Investments (FDI, Capital Actually Used) has an inverse correlation with CNY. A weakening currency tends to attract FDIs, in China's case.

It is the same graph as the one before (*see 2nd graph above*), but this time we converted the data into their year-on-year changes (to make comparisons possible). We also added a year-on-year change of China's GDP (current prices, not seasonally adjusted) to get a sense of how the growth outlook may be influencing the Chinese's viewpoint on these factors.

**We find that growth has been declining for the past four quarters, although the fall has not yet reached critical dimensions, based on current prices. However, based on**

**official, seasonally adjusted data, the GDP medium term outlook remains dismal** *(see 1st graph on the right).*




**It's is not hard to fathom why. Government expenditures in China have virtually collapsed since January 2016. And like everywhere else, if the government does not spend, economic activity slows down in proportionate degree. And the government tightening in China had been severe.** The heady rise of the central government expenditures from January 2015 to January 2016 has been essentially erased over the past two years (*see 2nd graph on the right*).

**These have been the consequence of such a slowdown: (1) Total Social Financing is now collapsing. As a consequence, (2) China's Leading Economic Indicator (LEI) will also decline soon, as soon as the next few months. (3) The fall in M1 Money Supply dropped precipitously from January, this year, and no bottom in sight, so far** (*see 2nd graph on the right*)**.**

**As for the cut in the banks' Reserve Requirement Ratios (RRR), it is nothing more than a realization that domestic growth prospects have deteriorated** *(see graph on next page).* Since the government of President Xi Jinping seems unwilling (it's inconceivable that they are unable) to loosen the government purse strings, every little will help. The Chinese banks will now have more leeway to lend, but that would add further to the debt burden of domestic corporations that are already heavily indebted.

**The cut in domestic banks' Required Reserve Ratio (RRR) merely confirmed our observation about a likely slowdown in Chinese activity. Chinese governments have previously used this tool as another defensive action in forestalling growth declines.**

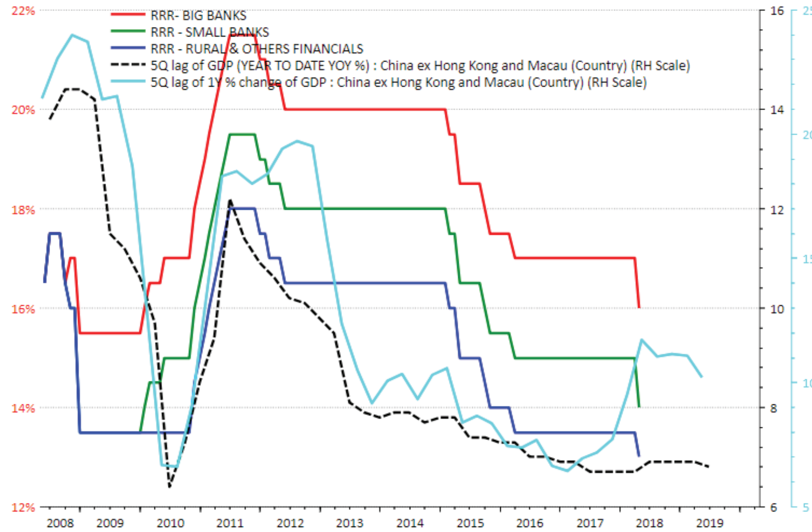
**Note that historically, five quarters after a change in growth outlook, the RRR is altered to help direct the economy towards the desired direction.** That increased lending is again a favoured option of President Xi's government in kickstarting growth shows that China is dipping deep into its policy toolbox, in lieu of fiscal action.

**However, the point is, if the government does not deploy fiscal policy to forestall a slowdown, Chinese growth and activity will decline further.**

**Conclusion:**

**A CNY devaluation, if it happens, will be a decision taken with not the looming "trade war" between China and the US as prime mover. China has to devalue the CNY at some point.** The reference to the trade war is just piggy-backing on something that they really have to do anyway -- either slowly, or in one fell swoop. If they opt for quick devaluation, they can blame the US for pushing them towards that the countermove. **In that aspect, the Chinese are probably hoping The Donald provides them the ammunition for a quick devaluation, and not get blamed. That is an opportunity for a counterpoint that is too juicy to ignore or waste. China might just do it.**

Reserve Requirement Ratios and GDP growth in China



Source: Thomson Reuters Datastream, PBOC / Robert P. Balan (c)