Yuan will enter a 'new era' or 'Minsky moment'

Addressing the recently held 19th congress of the communist party of China, president Xi declared that China had entered a 'New Era'. In political terms, the message is amply clear: more absolute power in his hands for a longer tenure.

The economic prospects are not that certain, though, with the steadily increasing prospects of a turmoil in China's financial markets triggered by a debt crisis and a sharp depreciation in the exchange rate of the yuan.

And, in good measure, the government-owned funds in China, the so-called 'National Team', remained active to curb volatility in the equity market during the congress.

It is commonly agreed that China built trade and current account surpluses over successive decades by keeping the yuan artificially weak, which facilitated its emergence as a global manufacturing powerhouse. Between 2000-2014, Chinese authorities allowed the yuan to appreciate about 27% against the dollar, to encourage domestic consumption and offset persistent criticism of its exchange rate policy.

Since 2014, however, sustained pressure of capital outflows from residents led to a 10% fall in the yuan, despite massive intervention by PBoC, which sold a total of $790 billion in 2015 and 2016. The calm for most part of 2017 so far notwithstanding, there is a danger that yuan can fall further and faster, going forward. This will but be a manifestation of the broad vulnerabilities facing the Chinese economy in transition to its next aspirational epoch. We see four distinct road bumps in China's economic path ahead: current debt built-up, bare adequacy of forex reserves, excessive capital controls and weak spots in US-China trade relation.

Four road bumps

First, the short-term foreign debt by residual maturity was very high at $871 billion in 2016 and debt service to exports ratio rose significantly from 25.1% in 2012 to 39.9% in 2016.

The total non-financial corporate debt which reached a high of 235% of GDP in 2016 is projected to increase to 290% of GDP by 2022. Interestingly, post the global financial crisis, the state owned enterprises (SOEs), whose aggregate assets are now about 200% of China's GDP, have accounted for a significantly large portion of the rise in the overall corporate debt to GDP ratio.

This is particularly worrying as SOEs with questionable governance and business practices have become the focal point of debt vulnerability in overlap with zombie companies and excess capacity firms in ten vital sectors. These are: coal, steel, cement, plated glass, aluminum, chemicals, paper, solar power, shipbuilding and coal-fueled power.

The corresponding picture for public debt is not rosy either. As per IMF calculations, public debt, including the debts of local government funding vehicles (LGFVs) and government-guided funds, was 62% of GDP in 2016 and is projected to reach 92%in 2022. The corresponding fiscal deficit to GDP ratio in 2016 was 12%.

Further, the ratio of household debt to GDP is 44% — well above the emerging market average. Overall, the strategy of debt-fuelled high growth as per the compulsions of the so-called Beijing consensus has probably run its full course.

Second, the IMF metric for Assessment of Reserves Adequacy is based on differential weighting of short-term foreign debt, portfolio liabilities, broad money and exports. For China, it comes to $2,118 billion as the lower bound, with the upper bound higher at 1.5 times the lower bound — $3,177 billion. China’s current forex reserves at $3,109 billion is a tad below the upper bound.

The moot point here is how much of forex reserves is in liquid form to help defend the yuan? Various estimates put it in the range of $1-2 trillion, Given the sharp fall in the ratio of forex reserves to broad money during the last five years (22% in 2012 to 13.3% in 2016), it is doubtful if the liquid forex reserves are sufficient to arrest the yuan's fall, if the residents trigger another bout of capital outflows. Table 1 shows the trend in reserves and Table 2 the value of the yuan between 2000-17. The upshot here is that the risks of rising U.S. rates, trade protectionism and major armed conflicts can test the adequacy of China’s forex reserves, given the underlying external and domestic debt vulnerabilities and likely pressures of capital outflows by residents.

Third, capital controls in China are still extensive and strict, when it comes to the ability of residents to move money abroad. There are rules for outbound investment in sectors which are grouped as banned, restricted and encouraged.

Overseas investments in line with state thinking such as in the belt road initiative are encouraged while real estate and portfolio investmenta are discouraged. However, as is always the case with capital controls anywhere, if the economic incentives are strong enough, residents will find a way to move money cross-border.

In China, the temptation to do so is rising with its deepening debt problem and the current over-valuation of the yuan, which, as per the BIS, is about 20%. There are signs that residents are using creative ways to move money abroad: through tourism, for example.

The overseas tourism outflow rose from 0.9% of GDP in 2012 to 2.2% in 2016. Spending by Chinese tourists abroad in 2016 was $246 billion, a more than threefold rise over 2012. Fourth is the political economy considerations of U.S.-China trade relations. The U.S. Treasury follows a three-point objective criteria for embarking on a detailed review to name a country as a currency manipulator: trade surplus in excess of $20 billion, current account balance greater than 3% of GDP and one-sided forex intervention greater than 2% of GDP in 12 months.

Risk of U.S. sanctions

While China currently meets only one of them, the scale of its persistent trade surplus vis-a-vis the U.S. is a boiling political issue. President Trump has followed a softer stance on trade issues with China since assumption of office than he did in his election campaign, possibly in his bid to obtain China's support in dealing with North Korea. However, if this turns out to be a miscalculation, and President Xi finds a menacing North Korea a better bet than a destabilised one, then imposition of U.S. trade sanctions on China becomes a distinct possibility.

The logic of economics says that the yuan should depreciate in line with China's fundamentals, counterbalanced by the authorities' need for stability. The longer it is delayed, overshooting becomes a distinct possibility and a ‘Minsky Moment’ can happen. Paradoxically, massive forex reserves, meant to assure stability, may themselves lead to instability. If it happens, reverberations will be felt far and wide, including in India.

(Sivakumar Sivaprakasam is MD, Argonaut Global Capital LLC, U.S. Himadri Bhattacharya is senior adviser, Riskontroller Global. Views are personal)

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