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The beginning of the end of the Chinese economy's free lunch

– The lockdown of China's markets will halt the worldwide chain-reaction plunge in stock prices

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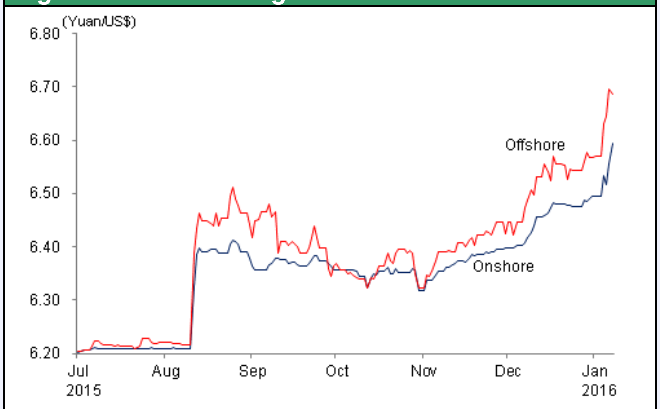
(1) China responds to market turmoil with restrictions and a rejection of the market system

The vicious cycle comes back to life

No end is in sight to the chain-reaction collapse of China's stocks and currency. On January 4, stock markets in Shanghai and Shenzhen established circuit breakers stop trading when prices fall 7%. This limit was reached on January 7 only 30 minutes after trading started. Trading was suspended for the remainder of the day. Falling stock markets in China have caused sharp downturns in stock markets worldwide during the first week of 2016. Worries about the global financial system are increasing quickly. Several geopolitical events are viewed as causes of stock market declines: North Korea's atomic bomb test, the termination of diplomatic relations between Saudi Arabia and Iran, and tension between Russia and Turkey. But China is the primary cause by far.

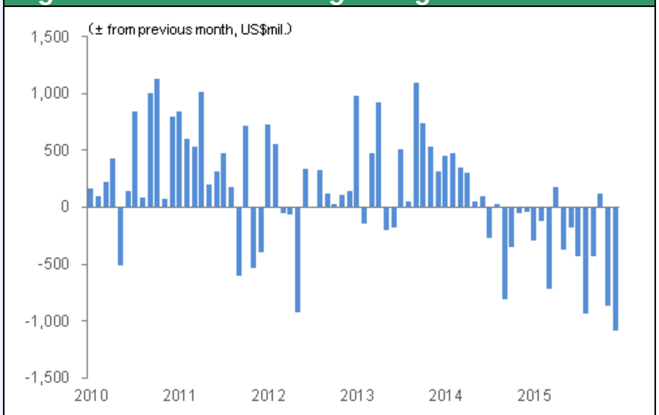
The yuan has been falling in tandem with stocks since the beginning of 2016. First, the yuan moved down in offshore markets. Next, the yuan dropped in onshore markets, which are overseen by the Chinese government. Despite government intervention, expectations for a further decline of the yuan are increasing. Furthermore, China's foreign exchange reserves, which peaked in June 2014, continue to decrease. In fact, the rate of decline is accelerating. These reserves plunged by a monthly all-time high of $107.9 billion dollars in December 2015. Currently, China's average monthly current account surplus is about $20 billion. Consequently, there is an average monthly net outflow of about $130 billion. Several factors may be responsible for this outflow: (1) the growth of China's direct overseas investments, (2) the recovery of investments in China by foreigners, and (3) the shift by Chinese investors of capital to other countries. Factors two and three are probably the most important reasons. In other words, we are seeing the start of a rapid flight of capital from China.

Figure 1: Plummeting CNY onshore/offshore rate



Source: Bloooomberg, Musha Resaerch

Figure 2: Still decreasing foreign reserves



Source: China State Administration of Foreign Exchange, Musha Research

The symptoms of China's slowing economic growth

Falling stock prices (lower asset prices), a weakening currency and outflows of capital are precisely the three events that occurred during the 1997 Asia currency crisis. If nothing is done about the vicious cycle of China's financial instability, we will be increasingly likely to see another crisis like the one in 1997. The conventional response to this situation is to fight the speculators who are attempting to destroy markets. Accomplishing this involves restoring faith in the values of stocks and currencies by boosting economic growth rates. But the Chinese economy is showing no signs at all of renewed growth despite a series of monetary and fiscal initiatives. Many microeconomic indicators are lower than one year ago. Examples include railroad freight volume, crude steel output, electricity consumption, and exports and imports. Moreover, China has been using real estate development and railroad investments to stimulate the economy. But by the end of 2015, these investments were less than one year earlier. If China is unable to stop its economic slowdown, the vicious cycle of falling stock (asset) prices, a weakening currency and capital outflows will inevitably gain momentum.

However, China absolutely cannot allow the bursting of an asset bubble and outbreak of a financial crisis to continue. The reason is that these problems would quickly create a crisis regarding the autocratic rule of China by the Communists.

China has few options for avoiding a crisis

China's only course of action now may be to distort the price determination mechanism, prohibit stock sales and return to a fixed-price market. That means the country has one choice: a rejection of the free market mechanism. The Chinese government is responding to plummeting stock prices by reinforcing its market interventions aimed at propping up prices. For instance, the government has once again prohibited sales of stocks of listed companies by large shareholders, a measure that was enacted for a while in 2015. In addition, the government has decided to stop using the circuit breaker, which is an easy target for speculators. When stocks fell sharply in 2015, the Chinese government responded by suppressing information. One action was rounding up securities company people, investors and journalists who recommended selling stocks for questioning by the police. The government may step up actions to control information.

For foreign exchange, the Chinese government may restore a fixed exchange rate and enact even tighter controls on cross-border transactions involving capital. In September 2015, China effectively prohibited sales of forward exchange contracts. But now this measure has become completely ineffective. Only very strong actions implemented with an iron fist can stop the outflow of capital and the yuan's downturn. Under the leadership of Prime Minister Mahathir, Malaysia used an iron fist during the 1997 currency crisis. Ignoring the urging of the IMF to accept its support, Malaysia instead drastically devalued its currency and established a fixed exchange rate. Malaysia also placed limitations on capital outflows. Foreigners were prohibited from sending proceeds from asset sales outside the country and a tax was imposed on capital leaving Malaysia. These actions largely ended foreign exchange speculation.

Today, China appears to have only one way to deal with this crisis. The government needs to prohibit cross-border capital movements, stabilize the yuan, effectively prohibit stock trading and take other decisive actions. If this is really the country's sole option, we can expect to see positive outcomes. Speculators will no longer be able to sell stocks and the yuan, the chain reaction of global financial market instability will be blocked, and stock prices worldwide will stop falling. In this case, the world can probably avoid another crisis like the Asian currency crisis of 1997. But all of these extreme measures would effectively shut down markets.

For years, China has been attempting to establish a socialist market economy, which is itself a contradiction. China wanted a free lunch by cherry picking only the good parts of a market economy. Rejecting the market component of its economy would bring China back to socialism (a controlled economy). But this goes against the reforms toward the market capitalism desired by the world. We will be pushed to a stage where we will have to give up and conclude that there is no other option.

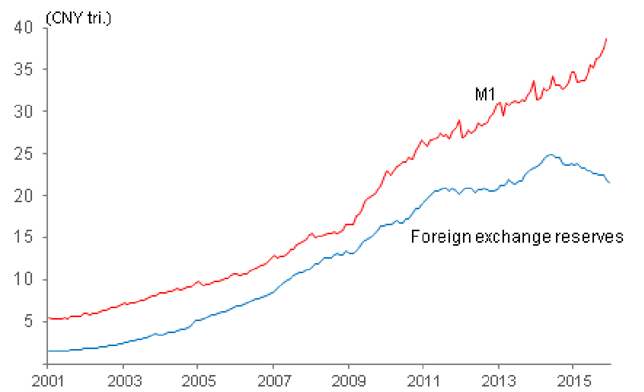
(2) Financial isolation would be a double-edged sword for China

Enormous reliance on foreign capital is China's Achilles' heel

Rejecting markets may be effective at preventing a crisis for the time being. But this stance will create even more serious problems for the Chinese economy. The resulting difficulty using markets to procure funds would almost certainly lead to the collapse of the entire economy. This is because huge inflows of foreign capital have been the single greatest factor underpinning the strength of the Chinese economy. In particular, a free lunch resulting from the catch-up growth of emerging countries (in the past, Japan and Korea also benefited from this free lunch) has been a key element of the growth of the Chinese economy. This free lunch included the ability to receive technologies and gain access to overseas markets. Receiving capital from overseas was an especially valuable part of the free lunch. Idle capital from around the world flowed to China in the form of investments and loans. This explains why China accumulated a massive volume of foreign exchange reserves. But becoming a financially closed country would block all paths to procuring funds from global financial markets.

Huge investments that fueled the remarkable growth of the Chinese economy originated from equally huge foreign currency inflows and loans. Rising foreign external debt caused foreign exchange reserves to skyrocket. These foreign funds backed money supply growth in China that made possible investments on an unprecedented scale. For proof, we need only note that foreign currency assets account for more than 80% of the assets of the PBOC, the country's central bank. Foreign exchange reserves are the symbols of a country's international financial power. But in China, more than half of these reserves rely on the funds of other countries. We must therefore conclude that China's international financial power is very low.

Figure 3: Foreign exchange reserves and M1



Note: Conversion to CNY of foreign currency reserves by Musha Reseaerch
Source: State Administration of Foreign Exchange, Musha Research

China's debt-reliant reserves create foreign currency problems

As I have discussed in previous reports, the nature of foreign exchange reserves in Japan and China is completely different. Government agencies hold foreign currency-denominated assets for the purposes of making payments to other countries and stabilizing foreign exchange rates. Japan defines foreign exchange reserves as foreign currencies held by the Bank of Japan and the Ministry of Finance. Most of Japan's reserves were acquired during foreign exchange market interventions. Japan's current account surplus is the source of all of these reserves. At the end of November 2015, Japan's foreign exchange reserves totaled $1.23 trillion. Of this figure, 1.07 trillion (87%) was foreign government securities, chiefly U.S. Treasuries.

In China, foreign exchange reserves originate from the current account surpluses of prior years and, to a much greater extent, loans from overseas. China has strict rules for the foreign currency holdings of private-sector and foreign-owned companies. As a result, the PBOC holds the majority of the foreign currency received in the form of payments for exports, loans from overseas and other sources. Apparently, China counts these central bank deposits as part of its foreign exchange reserves. Consequently, foreign exchange reserves represent only 16% of Japan's foreign assets but are an unusually high 61% of China's foreign assets.

In Japan, foreign exchange reserves have no strings attached. But in China, more than half of these reserves are funds linked to a huge volume of debt. Since this money belongs to other countries, it cannot be used for foreign exchange market interventions. Therefore, if overseas Chinese investors start to pull out their enormous volume of investments and loans in China, the country may discover that its foreign exchange reserves, which are considerably overstated, are insufficient. The data on China's foreign assets and liabilities in Figure 4 provide an additional perspective concerning this potential foreign exchange crisis.

Figure 4: China's International Investment Position (quarterly)

Unit: in 100 million of US dollars

Item	31-Mar-11	30-Jun-11	30-Sep-11	End of 2011	31-Mar-12	30-Jun-12	30-Sep-12	End of 2012	31-Mar-13	30-Jun-13	30-Sep-13	End of 2013	31-Mar-14	30-Jun-14	30-Sep-14	End of 2014	31-Mar-15	30-Jun-15	30-Sep-15	
Net International Investment Position	17595	17888	16577	16884	17435	17006	17999	18665	18855	18571	19103	19960	19915	19921	17962	17764	14038	14640	15399	(a−b)
Assets	43440	45607	45944	47345	49309	49677	50755	52132	53827	54644	56960	59861	61290	63084	62880	64087	63808	64337	62810	(a)
1 Direct investment	3234	3347	3506	4248	4402	4541	4685	5319	5532	5711	5880	6605	6215	6402	6648	7443	9858	10129	10383	
1.1 Equity and investment fund shares	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	8058	8309	9492	
1.2 Debt instruments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1800	1820	1891	
2 Portfolio investment	2269	2224	1934	2044	2397	2405	2518	2406	2438	2411	2491	2585	2665	2612	2593	2625	2487	2760	2575	
2.1 Equity and investment fund shares	960	935	670	864	971	1006	1035	1298	1312	1246	1431	1530	1626	1650	1613	1613	1591	1777	1591	
2.2 Debt securities	1309	1289	1264	1180	1427	1398	1483	1108	1125	1165	1060	1055	1039	961	980	1012	896	983	984	
3 Financial derivatives (other than reserves) and employee stock options	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	175	39	56	
4 Other investment	6781	7330	7726	8495	8678	9583	9898	10527	10689	10951	11329	11867	12314	13512	14179	15026	13439	13695	13894	
4.1 Other equity	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1	1	1	
4.2 Currency and deposits	2122	2567	2484	2942	3026	3363	3345	3906	3419	3410	3503	3751	4290	4909	5160	5541	3324	3125	3575	
4.3 Loans	1508	1492	1687	2232	2428	2671	2852	2778	2970	3055	3037	3089	3277	3672	3715	3747	4319	4658	4945	
4.4 Insurance, pension, and standardized guarantee schemes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	170	200	178	
4.5 Trade credit and advances	2135	2314	2716	2769	2765	3101	3232	3387	3322	3476	3762	3990	3708	3884	4232	4677	4501	4547	4947	
4.6 Other accounts receivable	1015	958	839	552	459	448	470	457	988	1011	1027	1038	1039	1046	1072	1061	1124	1165	248	
5 Reserve assets	31156	32706	32779	32558	33831	33148	33653	33879	35157	35570	37260	38804	40096	40558	39459	38993	37848	37713	35903	
5.1 Monetary gold	485	508	550	530	565	542	600	567	541	418	450	408	435	450	410	401	401	624	612	
5.2 Special drawing rights	126	125	120	119	122	118	115	114	111	110	112	112	113	112	107	105	100	105	105	
5.3 Reserve position in the IMF	99	97	91	98	95	88	87	82	79	75	72	71	67	65	65	57	47	46	47	
5.4 Foreign currency reserves	30447	31975	32017	31811	33050	32400	32851	33116	34426	34967	36627	38213	39481	39932	38877	38430	37300	36938	35141	
5.5 Other reserve assets	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	0	-2	
Liabilities	25845	27720	29368	30461	31874	32672	32756	33467	34971	36072	37857	39901	41374	43163	44918	46323	49769	49697	47411	(b)
1 Direct investment	16439	17142	17694	19069	19389	19732	20077	20680	21418	21972	22866	23312	24154	24748	25454	26779	27515	28274	28521	
1.1 Equity and investment fund shares	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	25388	26027	26335	
1.2 Debt instruments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2127	2247	2186	
2 Portfolio investment	2289	2424	2487	2485	2892	3008	3129	3361	3323	3330	3486	3865	4050	4223	4597	5143	9679	8997	7875	
2.1 Equity and investment fund shares	2063	2140	2148	2114	2447	2466	2516	2619	2682	2655	2756	2977	2970	3054	3251	3693	7396	6727	5541	
2.2 Debt securities	226	284	339	371	445	542	613	742	641	675	730	889	1080	1169	1345	1449	2283	2270	2334	
3 Financial derivatives (other than reserves) and employee stock options	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	150	108	119	
4 Other investment	7117	8154	9187	8907	9592	9932	9550	9426	10231	10770	11705	12724	13170	14192	14968	14402	12424	12318	10896	
4.1 Other equity	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	0	0	0	
4.2 Currency and deposits	2039	2350	2780	2477	2548	2580	2500	2446	2766	2576	3061	3466	3290	3861	4983	5030	4365	4611	3831	
4.3 Loans	2647	3138	3570	3724	4086	4110	3886	3880	4076	4832	5107	5642	6411	6775	6274	5720	4581	4341	3867	
4.4 Insurance, pension, and standardized guarantee schemes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	90	85	90	
4.5 Trade credit and advances	2191	2397	2566	2492	2711	2901	2995	2915	3036	3095	3268	3365	3190	3282	3335	3344	3123	2987	2847	
4.6 Other accounts payable	129	158	163	106	139	235	261	278	248	162	162	144	170	165	172	207	179	195	168	
4.7 Special drawing rights	111	112	108	107	108	106	108	107	105	105	107	108	108	108	104	101	96	98	98	

Current account

term	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1		
100mil dollar	15	437	424	484	286	590	762	516	410	427	326	320	70	734	722	670	756	730	603
annually				1,361				2,154				1,482				2,197			

Foreign exchange reserves

15/Jul	15/Aug	15/Sep	15/Oct	15/Nov	15/Dec
36513	35574	35141	35255	34383	33300