The Slow-Motion Reverse Asian Crisis

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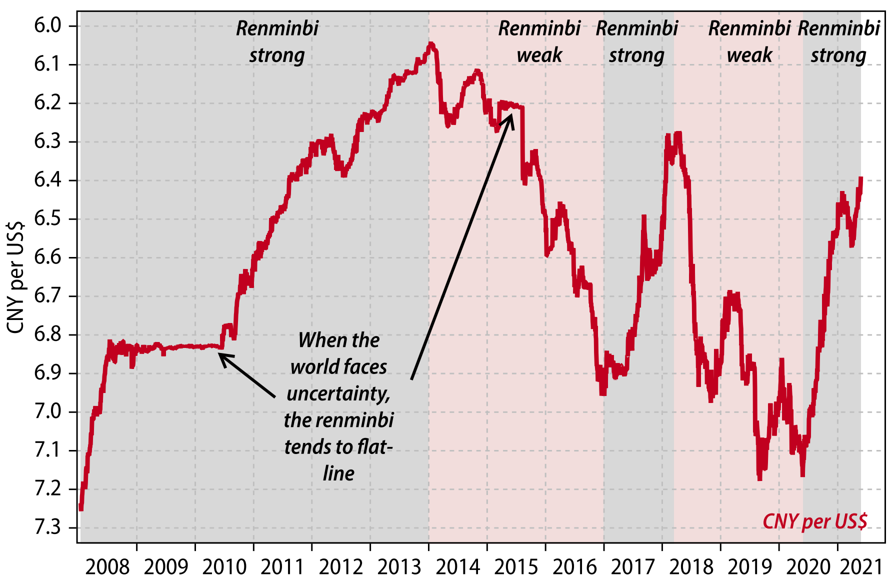
A perhaps over-used Gavekal trope is that people tend to worry excessively about "scary" events. Ask any sophisticated investor what was the key event of 2001 and the answer is likely to be either the September 11 attacks, or the TMT bust. Yet, with the benefit of hindsight, we know that it was China's entry into the World Trade Organization that cast the longest shadow on both the global economy and markets. The same is true of 2007-08: most of us working in financial markets were captivated by every twist and turn in the US mortgage bust, yet the more significant event was probably the launch of the smartphone, giving birth to a whole new tech ecosystem.

Will the pandemic really prove to be the key financial event of 2020-21?

I reiterate the above because of the Covid-19 pandemic. After all, with the global media continuing to hammer the point that most countries are one mutant strain away from Armageddon, Covid fears are hard to shake. Yet, in a decade's time, when we look back at 2020-21 (hopefully not through full-face masks!), will Covid have shaped the decade's financial returns? Let me suggest that amid the pandemic panic, investors may have missed the more important event of 2020, namely, the renminbi's rebound.

Periods of renminbi strength and weakness since the financial crisis



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I reviewed the above chart in [The Importance Of The Renminbi] but return to it now as it sends investors a vital message: during previous periods of global macro uncertainty, Chinese policymakers have either frozen the value of the renminbi (2008-2010 and 2015 during China's equity market boom-and-bust cycle), or let it slide. Yet despite a collapse in global trade and Chinese growth going negative in 2020-21, the authorities allowed/encouraged the renminbi to deliver its biggest ever 12-month gain against the US dollar.

Despite a tough backdrop in 2020-21, the renminbi delivered its best 12-month gain against the US dollar

In the following pages, I propose to review possible reasons for this important change in policy and the investment implications that flow from it.

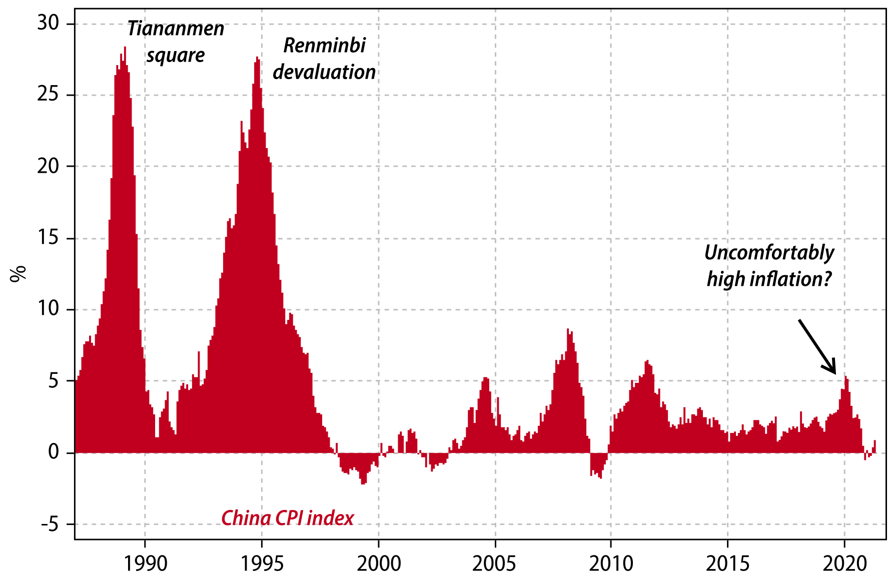
Part 1: Why would China revalue the renminbi in the face of massive global uncertainty?

Regular readers will know that over the past year, we at Gavekal have addressed this question from a variety of angles and found a range of explanations, none of which are mutually exclusive. In short, just as success has many fathers, there are probably several drivers to the renminbi's strength.

The Chinese Communist Party is committed to the notion that inflation sparks revolutions

Explanation #1. The People's Bank of China being the only hawkish major central bank: Xi Jinping and the rest of the Chinese Communist Party leadership may not look—or even sound—very communist, yet all Chinese leaders were raised in the Marxist church. And the first tenet of this faith is that historical events are shaped by economic forces (rather than individuals or ideas), with inflation being among the most powerful. For Karl Marx, Louis XVI would have kept his head and his throne, had it not been for rapid food price inflation in the years before France's revolution in 1789. And for a Chinese technocrat, the Tiananmen uprising of 1989 only happened because, at the time, inflation was running above 20%.

A Marxist fear of inflation and its consequences



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Tiananmen was a deeply traumatic event for China's elites as their own kids were at university in Beijing

Tiananmen was traumatic for China's leadership as no one likes to shoot down young people. Moreover, in 1989, few Chinese citizens were able to attend university. The students were thus an "elite", whose parents were often communist cadres, or even party leaders. Thus, when the CCP sent in the tanks, it was literally mowing down its own children. To put things in perspective, for the CCP to gun down the students of Beida and Tsinghua universities would be similar to Emmanuel Macron gunning down the students of l'Ecole Polytechnique, l'ENA and Sciences-Po. Or for Boris Johnson to send the military against undergraduates at Oxford and Cambridge universities.

So what of today's Chinese leadership? In 1989, President Xi Jinping would have been 36 years old, while Premier Li Keqiang would have been 33. It is hard to imagine that they would not have known some of the students, either directly or indirectly; or that the shock of the massacre would not have left a deep impression on them. And so, just like post-war Germans—traumatized by the collapse of the Weimar Republic, the rise of Nazism and defeat in World War II—vowed to never go down the path of inflation again, the current generation of Chinese rulers likely made similar vows.

After all, if the ideology on which the Chinese regime rests teaches its leaders that inflation leads to revolts, revolutions and social instability, and early in their careers they faced just such an event, it makes sense that this same leadership will strain every sinew to prevent another inflation surge. If only because the CCP's leadership derives legitimacy not from the ballot box, but through its ability to deliver social stability and ensure national unity.

The PBOC looks like the new Bundesbank

With that in mind, it is perhaps not surprising that China is already tightening policy, even as the Western world continues to pump the stimulus pedal. As Charles and I have argued, the PBOC looks like the new Bundesbank.

Explanation #2. China needs to de-dollarize Asian trade: a key theme of the book Charles and I published in 2019 (see ***Clash of Empires***)is that US-China tensions are forcing Beijing to reduce its dependency on the US dollar. This is not easy. After all, the dollar benefits from the key attributes of a reserve currency: deep, liquid and trusted capital markets, the world's dominant military and control of the SWIFT payments system, to name a few. Yet as tall as that mountain may be, China has little choice but to climb it.

So how can China transform the renminbi into a currency capable of competing with the US dollar?

China's leadership is not willing to release capital controls, yet it wants a currency that can compete with the US dollar

The general view among Western investors is that little trade will be done in renminbi until China loosens its capital controls and, in essence, forgos the capacity to control its value. However, such a view is anathema to most of the CCP's leadership, for whom maintaining some control of both exchange rates and capital flows is important. This divergence in views brings me to the "core" set of beliefs of the current Chinese leaders.

Xi Jinping, premier Li Keqiang and all other members of the standing committee are part of a generation that would have spent their formative years swept up in the dark days of the Cultural Revolution. These men would have had to carry Mao's Little Red Book everywhere they went and undergo endless sessions learning Mao Zedong thought. Meanwhile, most of the Little Red Book has to do with guerilla warfare (most of it written while Mao and his troops fought the Kuomintang, then the Japanese). In other words, China's current leadership grew up being fed guerrilla warfare strategy for breakfast, lunch and dinner, and will have memorized famous passages like:

> *"Fight no battle unprepared, fight no battle you are not sure of winning; make every effort to be well prepared for each battle, make every effort to ensure victory in the given set of conditions as between the enemy and ourselves".*

Hence, it seems unlikely that China would try to unsettle the US by tackling the dollar's primacy head on, for this would not even be a David and Goliath match-up. Thus, if China wants to de-dollarize its trade, it has two options:

- Build a parallel system with gold as an anchor, or half-way house (see **A Smoking Gun** or **Toward A Renminbi-Gold Standard**).
- Develop a completely new parallel system built around fintech and a digital renminbi (see **Questions On The Digital Renminbi**).

Needless to say, the above paths are not mutually exclusive. But in any event, there may be no time like the present to challenge the US dollar's dominance. For when, in the recent past, have we seen in the US the combination of runaway budget deficits, negative real interest rates, huge central bank balance sheet expansion, political uncertainty and a lack of national unity? With Chinese bonds offering real yields of around 1%, and Western equivalents offering -2% or below, China can argue to Asian central banks and companies that the renminbi is a better option for managing their working capital. And having a structurally strong currency is, needless to say, essential to making this case.

China is making the case to regional central banks that their reserves will be protected if invested in renminbi

Explanation #3. China's business model is evolving for demographic reasons: when, in 2008, global trade collapsed due to fallout from US mortgage crisis, some 35mn Chinese manufacturing workers were laid off. This created a dilemma for policymakers whose key goal was, and remains, the need to preserve social stability. Confronting this rise in unemployment, China embarked on an unprecedented infrastructure spending binge (high-speed trains, motorways, canals). Back then, China was still undergoing a demographic transition that was seeing roughly 20mn young people move from the countryside into cities every year.

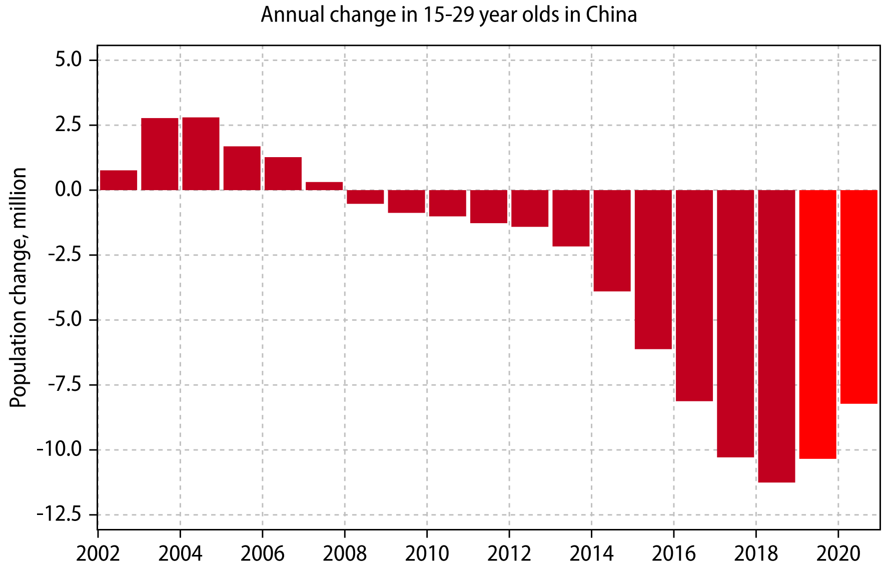
Fast forward to 2020-21, however, and the effect of China's "one-child" policy means the country's demographic picture has now changed markedly. Rather than expanding by a few million every year, the 15-29-year-old age group (the cohort most likely to feel disenfranchised and throw stones at the police) is shrinking by roughly 7mn to 10mn a year (see chart overleaf).

This demographic shift means there is no longer a need to create manufacturing jobs almost at any cost (see **Q&A On The Inflation/Deflation Debate**). Simultaneously, an aging Chinese population will likely favor a rising currency (more purchasing power, less inflation). So perhaps the stronger renminbi is testament to the CCP's desire to deliver what the vast majority of the Chinese population now want. In 2008, it was manufacturing jobs. In 2021, it is purchasing power.

China no longer needs to create new jobs at all cost, and that changes the equation of setting broad macro policy

Explanation #4. The slow, unfolding launch of the digital renminbi: in recent years, I have drawn a parallel between reserve currencies and computer operating systems. In this regard, the US dollar is the Microsoft of the currency world: everyone uses the US dollar because everyone else uses the US dollar. For any currency to replace it (or Microsoft), the new currency (or operating system) would have to be not just a bit better, but many times better. Today, nothing comes close. Consequently, the US dollar remains the cornerstone on which the global financial architecture is built.

In China, the rebellious part of the population is shrinking



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The younger cohort of China's population is already shrinking sharply

Of course, over the last couple of decades Apple and Google have chipped away at Microsoft's dominance in the world of operating systems. Apple did so initially by focusing on niche markets. Visit an architect's studio or a web design firm and all the personal computers are likely to be Apple. As Apple focused on capturing such niche markets, it pretty much abandoned the big corporate IT system spend to Microsoft. But it completely blindsided Microsoft in another field—which brings me to what probably, in retrospect, was the most important event of 2007: the launch of the iPhone.

At a stroke, Apple established iOS as a parallel operating system, whose users were not the big corporates that until then had dominated global IT spending. Instead, users of this new, parallel operating system were middle- to high-end Western consumers (and in time emerging market consumers too). With the iOS launch, Apple showed that to displace a behemoth, you do not have to take it on at its own game. Instead, you should challenge it on a different field of play. Apple left the big corporate IT spend to Microsoft, and instead created a new, parallel operating system. In the process, it created a new consumer market that turned out to be at least as big, if not bigger.

Is China playing Apple to the US Microsoft?

China looks to be trying to create a new currency operating system, just as Apple did with the launch of iOS

If the US dollar is the Microsoft of the global currency system, there is little doubt that in recent years China has tried to position the renminbi as the Apple equivalent. First, China tried to capture "niche" markets that were at best peripheral to the incumbent currency behemoth: financing intra-Asian trade, funding commodity imports into China and financing infrastructure projects in places like Myanmar, Sri Lanka and Pakistan where, historically, infrastructure projects have struggled to attract funding. But owning niche markets only gets you so far. If they are all you own, at best you will end up stuck somewhere between an "also ran" and a "never was".

This means that, if Xi really wants to reduce China's dependency on the US dollar, the CCP doesn't have much of a choice: it must follow Apple's example and build a parallel operating system that doesn't try to compete with the US dollar on its own turf.

Cue the launch of the digital renminbi (see Questions On The Digital Renminbi) with the eventual promise of a future in which consumers and companies across emerging markets will no longer need to use the US dollar, nor even the SWIFT system, to trade with each other.

Ironically, highly-controlled China could become the vanguard of decentralized payments focused on consumers

The irony of this is that if China is successful in its digital renminbi launch, and if the digital renminbi becomes the bedrock on which Alipay, WePay and other fintech companies build the bridges between Chinese producers and global consumers, a curious situation may develop: the democratic and federal United States would control the highly-centralized part of the global payments system (focused on big transfers for large corporates), while an authoritarian and centralized China control a more diffuse and decentralized part of the global payment system focused on small payments and consumer needs. It would be like Apple versus Microsoft all over again.

Part 2: The implications of the renminbi revaluation

Implication #1. The current post-crisis investment environment is already very different from the post-2008 environment: the 2008 crisis was first and foremost a banking crisis and bust banks are typically a deflationary burden for any economy. But the global economy's deflationary trends were amplified by China not letting the renminbi appreciate (despite running big trade surpluses) and Western governments quickly embracing fiscal austerity to counter-balance the 2008-09 stimulus (in the UK, David Cameron made a virtue of being parsimonious, the Tea Party's rise in 2010 helped freeze US government spending for six years, while in Europe, the eurozone crisis forced the region's "olive belt" into unprecedented fiscal tightening).

The macro situation today is the complete opposite of that after the 2008 crisis

Fast forward to today and the situation could not be more different. Instead of bust banks calling in loans, banks today are only too happy to shower money on whoever asks. Instead of a flat renminbi, China's currency is strengthening. Instead of fiscal tightening, Western governments are busy sending checks so workers can stay at home. So will a different setup lead us to the same outcome? Or should investors position their portfolios differently?

Global macro environment, then and now

Post-2008	Post-2020
Bust banks	Thriving banks
Tighter fiscal policies (US Tea Party, UK austerity, EMU crisis)	Easiest fiscal policies on record
Accelerating globalization	Increasing regionalization
Flat renminbi	Strong renminbi
Excess supply	Supply chain dislocations

It seems that either the US or China is making a major policy mistake, but which is it?

Implication #2. Growing policy uncertainty: in a number of recent papers (see [1994 All Over Again] and [The Ant And The Grasshoppers]), Charles and I have reviewed a quandary that investors must confront. Simply put, never before have we seen the world's largest economy step on the fiscal and monetary gas to such a degree, while simultaneously the second largest economy hits the brakes. This policy divergence raises the question of whether US and Chinese policymakers can both be right. Or, whether one side is making a major policy mistake. This leaves us with two options:

1) China is tightening too early. In such a scenario, commodities will likely sink and OECD government bond yields will slump to new lows.
2) The US is over-stimulating. In this scenario, treasury yields will continue to rise and/or the US dollar will fall precipitously.

Against such a binary decision tree, investors should in the short term seek a "tails I win, heads I don't lose" strategy. Alas, few asset classes qualify. If China is making a mistake, then growth stocks should thrive. But if the US is overstimulating, why overpay for growth stocks when attractively valued commodity and financial stocks should rip higher? The same goes for bonds: if China is making a mistake, OECD government bonds will rally; if the US is overstimulating, such instruments will likely get crushed.

Local currency Asian bonds look like an asset that should do decently well in either of the two scenarios that I posit

Among the asset classes that seem to offer a "win, don't lose" proposition are local-currency Asian government bonds: if the US is overstimulating, Asian exchange rates will likely soar, while if China is making a mistake, yields should collapse. Precious metals could also play this role as a Chinese error may trigger capital flight from the country (usually good for gold), while an overstimulating US could boost gold (to the extent that the dollar tanks).

One pandemic, two reactions

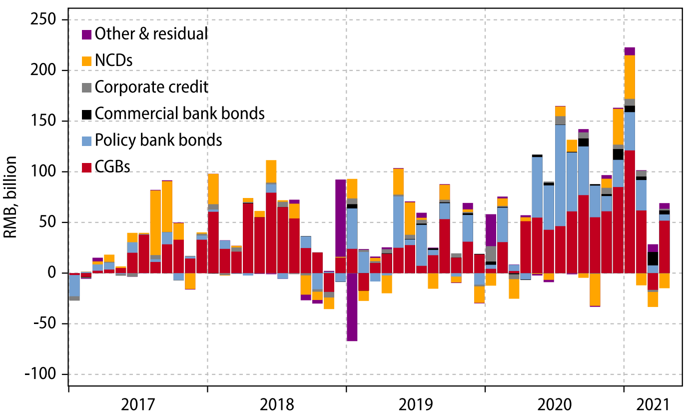
Western world	China
Easy monetary policy	Mild tightening of monetary policy
Easy fiscal policy	Tighter fiscal & regulatory policies
Steeper yield curves	Flatter yield curves
Weak currencies	Strong currency
Accelerating inflation	Inflation in check (thanks to strong forex)

Implication #3. Capital is flowing East and will likely continue doing so: just as water flows downhill, capital tends to go where it is best treated, and rewarded. Today, for fixed income investors, the choice is thus between lending money to Western governments (whose central banks are openly calling for the "euthanasia of the rentier") or China, where the central bank is already acting to prevent inflation from accelerating.

It's not much of a choice, really. And thus, despite some worrying headlines associated with entities like Huarong Asset Management, foreigners continue to deploy capital into China's bond market. And as they do, the Chinese government bond market continues to outperform, staking its claim as the new anti-fragile asset of choice (see charts overleaf).

Foreigners are discovering Chinese bonds

Monthly change in foreign bond holdings, by bond type



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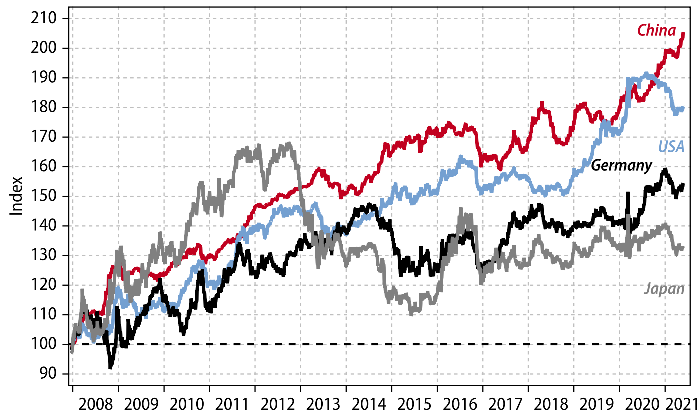
Chinese government bonds have outperformed

Government bond (7-10 Year) total return in US$



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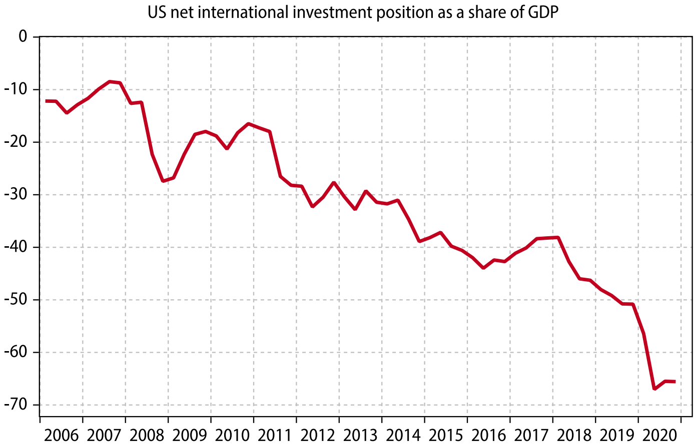
The footprint of the US dollar has been shrinking every year

Implication #4: Could the world de-dollarize faster than most expect? In fact, the world has now been gradually "de-dollarizing" for more than a decade. From China buying oil from Iran in renminbi, to Europe proposing to pay for Russian natural gas in euros, to Russia moving most of its central bank reserves out of dollars, the footprint of the US currency has grown a little less deep every year. Still, the question is whether the US dollar's global role will move in the way of an Ernest Hemingway-imagined bankruptcy (very slowly at first, then suddenly). Today, with the US running twin deficits that exceed 20% of GDP and a negative net international investment position of roughly two-thirds of GDP, the possibility can no longer be brushed aside.

The left-hand chart below is worrying as it shows the difference between the current situation and that before 2008. Back then, the US's net international investment position was roughly flat. Thus, if the US dollar fell in value and foreign investors cashed out due to unfavorable US policy settings, there was likely to be a countervailing sale of foreign assets by those Americans keen to repatriate capital at an advantageous exchange rate. In contrast, Japan can be seen to have steadily increased its net international investment surplus.

The US has a huge net-negative international investment position

US net international investment position as a share of GDP



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Japan, in contrast, has a large net surplus

Japan net international investment position as a share of GDP

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In periods when the Bank of Japan's quantitative easing was "too aggressive", the yen would start to weaken. But then, because Japanese savers own lots of foreign assets, those savers would react to yen weakening by repatriating capital, thereby placing a floor under the yen. In this way, the BOJ effectively monetized public debt without crushing the value of its currency. Japan's large net foreign investment position explains why the "widow-maker" trade shorting Japanese government bonds never worked out.

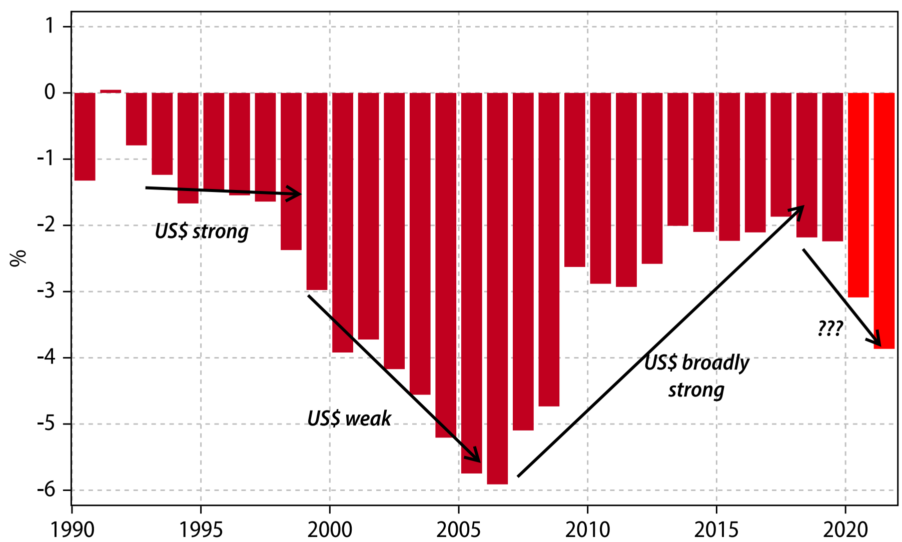
If the US dollar falls markedly, US investors lack the volume of foreign assets to sell in order to be able to buy back their own currency cheaply

The same can not be said of the US. Should those foreigners presently loaded up with US assets decide to lighten their exposure—either because they do not like US policy settings (excessive money printing, high government spending, increased taxes on capital and more regulations) or simply because returns are more attractive elsewhere (positive real rates, Europe's re-opening and booming commodity prices)—American savers will have few foreign assets to sell to counterbalance the falling US dollar.

And let us not forget that in 2021 the US current account deficit will likely be US$600bn-700bn. Thus, for the US dollar to end the year where it started, foreigners on the other side of this current account deficit will have to be convinced to keep their "earned dollars" in US assets (whether US dollar bank deposits, US bonds, US real estate or US equities). At a time of record twin deficits, this might be a tall order.

The US current account deficit is set to again widen

US current account deficit as a share of GDP



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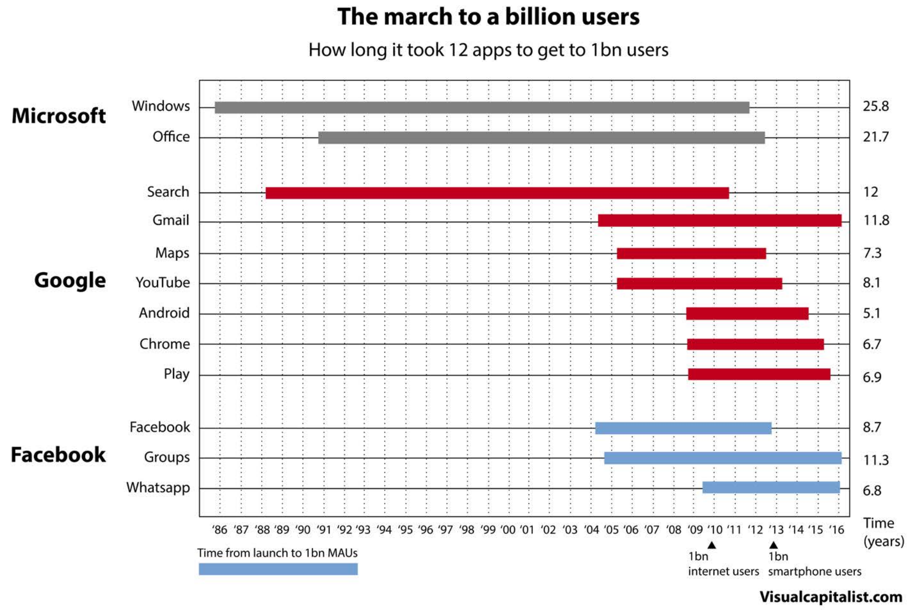
Crypto-currencies still lack the basic functionality of money, which is an interesting backdrop for launching the digital renminbi

Implication #5. The crypto-currency quandary. The past year's parabolic rise in crypto-currencies has been a head-scratcher yet behind the enthusiasm for bitcoin, ethereum or dogecoin is a healthy disdain for the US dollar. The challenge for crypto-currencies is that they are inefficient as standards of value or means of exchange (see **Financial Manias: The Crypto Craze**), and remain, for most investors, too volatile to be genuine stores of value. And this is where the launch of the digital renminbi—Digital Currency Electronic Payment, or DCEP—gets interesting.

First, once the Chinese government puts its whole regulatory and financial weight behind the digital renminbi, it seems likely that this new currency will capture 1bn users in a fairly short amount of time. In that regard, the DCEP could break the records established by Facebook (8.7 years to its first billion users), Whatsapp (6.8 years) or Android (5.8 years).

Could the growth of DCEP usage eclipse that achieved by Microsoft, Google and Facebook?



Second, if the DCEP rapidly acquires 1bn or more users, who can then use it to buy goods on Alibaba, services on Meituan or Didi and entertainment on Tencent or Netease, what will happen to the other digital currencies? Will bitcoin become MySpace to DCEP's Facebook? After all, one of the key lessons of the past couple of decades is that, in our platform-driven world, there are few silver medals and even fewer bronzes. What is the point of being second to Facebook, Google or Amazon?

Against that are the privacy concerns. The beauty of bitcoin is its decentralized, and anonymous, nature. In contrast, a DCEP that is controlled, monitored and regulated by the CCP is hardly the same proposition as today's crypto-currency offering. In fact, apart from the renminbi also being an "anti-US dollar" play, the DCEP in its very conception could not be further away from both the spirit, and nature, of today's other crypto-currencies.

It is not clear that privacy concerns will dissuade users across the world from using DCEP

But then again, if the past 10 years of tech-world evolution have taught us anything, it is that almost all consumers, everywhere in the world, will gladly trade privacy for convenience; every day of the week and twice on Sundays! How else can we explain the popularity of the Google Chrome browser, Netflix suggestions, or even the fact that people put Alexa in their living rooms and sometimes even in their bedrooms?

The combination of a stronger renminbi and the wider roll-out of the digital renminbi (which should happen around the time of next February's Beijing Winter Olympics) could thus be an event that destabilizes both the US dollar and the crypto-currency market.

Conclusion

We are all the fruits of our own experiences. For me, the Asian Crisis was a key formative experience. I had only recently started working for Banque Paribas which, with perfect timing, had closed the purchase of a pan-Asian broker (Asia Equity) on June 1, 1997: a month before the Thai baht devaluation set off a chain of events that would see most Asian currencies fall by at least half against the US dollar, and most Asian equity markets and real estate markets, fall by at least as much. It was a bloodbath that scarred a generation.

Asian policymakers learnt austere lessons from the 1997-98 Asian crisis that have shaped the region ever since

This bad experience led most Asian policymakers to conclude they should never again depend on the willingness of strangers to fund their deficits. From then onwards, Asian countries, by and large, aimed to keep undervalued exchange rates so as to run big current account surpluses, which could then be captured by central banks whose reserves kept swelling.

Needless to say, such policies were deflationary for the world. Not only did Asia's undervalued exchange rates allow Western consumers to buy Asian labor at low cost, but the recycling of the resulting trade surpluses usually meant that money was taken from the private sector (Asian exporters earning US dollars through trade) and returned to the public sector (usually the US Treasury). For more than two decades, Asian producers subsidized Western consumers (a lifetime ago, we called this "The Circle of Manipulation". Curious sleuths will find pieces in the Gavekal archive on this topic dating back to 2001-05).

However, China's decision to allow the renminbi to revalue in the face of the past year's uncertainty could be a sign that this "arrangement" is now rapidly going into reverse.

This shift in policy may be driven by geopolitical reasons. It may also be the result of a demographic shift. Or it may simply be in the natural order of things. Specifically, as Asia becomes richer, Asians will start to consume more of what used to be produced for the benefit of Western consumers.

However, the compact of Asian consumers working hard and spending little is set to break down, big time

Whatever the reason, over the next decade Asia's growth will slow and wages will rise, as will currencies. Asia will move from producing to consuming and surpluses will disappear. And this transition risks being highly inflationary. All of a sudden, Western consumers will have to compete, on price, with Asian consumers intent on having their share of the "consuming life".

The coming rise in Asian currencies will be an Asian crisis in reverse. Capital will flow from the West to the East (since the East will provide the stronger currencies), as will purchasing power.

The likes of Japan, Switzerland, Scandinavia, Canada, Australia and Germany (if it leaves the euro) may be able to cushion Asia's inflationary shock through higher currencies. Others, such as the US and the eurozone, will not. Such countries will then become sources of capital rather than a destination for capital. Just as Asia was through the late 1990s.