pressat

Capital Way Review: If the Yuan Decline Continues, China Might Find Itself In A Bigger Pit Than The U.S.

Wednesday 14 August, 2019

The recent trade war between the two most powerful economic countries, the US and China, is causing the financial markets to shake. The cause of this war started when President Trump began to realise the thousands of dollars of tax imbalance on products imported from China as opposed to the tax that China charges on imports from the US.

The impact of US taxation on products from China has, therefore, become significant since the beginning of the year. China's economy has grown at its slowest pace since 1992, according to published growth figures. In fact, the economy grew at a quarterly rate of only 6.2% in the second quarter (April-June) compared to 6.4% in the first quarter. Economists are expecting an approximate 6.3% growth for the third quarter. Along with the war, China has experienced a huge tumble in its currency. So what is the significance of the weakening Chinese currency? Capital Way experts have analysed the circumstances of this complex situation.

Trump's recent announcement of taxing more $300 billion on Chinese products has led the Chinese government to stop supporting the local currency entirely. As a result, the Chinese yuan has weakened to its lowest level in 10 years, standing at ¥7.05 (yuan) to the dollar. The price of 7 yuan to the dollar has been a technical-psychological barrier for the past three years. When the yuan reached this price level, it resisted. Staying above this barrier in the coming months could be an indication of further weakening of the currency. Investors and speculators will end up most likely selling the yuan against the dollar.

Why don't the Chinese fight devaluation?

China is an export-oriented country. It exports goods, products, and services worth $2.41 trillion a year and imports $1.54 trillion. When a country is export-oriented, its domestic currency is of high importance. A lower currency value will make it easier for exporters to sell the products at a cheaper price, while still profiting of course, while continuing to purchase more and more products.

The funds that come from exports allow the Chinese economy to continue to grow. With high export, more companies will be hiring, eliminating numbers from the unemployed and continuing the exportation of products to world countries, bringing in more money to the country and increasing the economy levels. "In fact, at current prices, the Chinese government has no interest in stopping depreciation in the local currency, as long as it's maintained at a reasonable limit", says Peter Wilson from Capital Way.

According to the International Institute of Finance, the last time the yuan experienced such a harsh drop it sparked the biggest capital loss in Chinese History. China's foreign exchange reserves fell by $1 trillion, and the People's Bank of China tried to stop the flow of money abroad. Traders and investors also tend to rally around symbolic prices of the yuan to protect themselves. Currency options and futures are mostly traded during such times, assuming the price of ¥7 to the dollar is maintained. Therefore, if or when this price is breached, the fluctuations will most likely be more extreme as a result of options and futures re-pricing.

In addition, the Chinese foreign currency debt accrues with the illusion of currency stability. This can be seen quite clearly as a result of highly leveraged construction contractors that have become the driving force in the Asian high-yielding bond market. China borrowed record amounts of dollars this year, with the expectation of a rise in US interest rates. The FTSE Asia Pacific Government Bond Index has already risen by 50% this year.

According to Moody's, Chinese contractors have issued $33.8 billion in China bonds and $19.3 billion in foreign countries. These bonds are either facing redemption or have become a target for Put option - an option for investors to sell assets at an agreed price before a particular date, which in this case, would be next year.

"Several hundred smaller players in the debt market have already gone bankrupt this year. Such business crashes can have a devastating effect on a fragile financial system, parts of which are already begging for dollars", say Capital Way's analysts. Last month, the Chinese government restricted the ability of construction contractors in order to raise capital in the bond markets outside China, for any purpose other than refinancing the dollar debt to maturity. Perhaps all in anticipation of the yuan depreciation.

Media:

Related Sectors:

Business & Finance :: Opinion Article :: Personal Finance ::

Related Keywords:

Capital Way :: Yuan :: Dollar :: Depreciation :: Capital Market :: People's Bank Of China :: Devaluation ::

Scan Me:

"If seven yuan to the dollar is no longer the 'magic number' of the People's Bank of China, policymakers should begin to talk about another target which will prevent a significant fall of the yuan. A short, sharp devaluation will benefit Chinese representatives in trade negotiations with the US, but if the yuan decline intensifies, Beijing will feel much more pain than Washington", say Capital Way experts.

What do investors do during such a period?

From the beginning of 2018, the yuan exchange rate is seen more as a depreciation. This is a downward trend, breaking the area of 7 yuan to the dollar in more recent days. The working assumption is that as long as its price remains above 7 yuan per dollar in the coming months, the weakening trend will continue. Of course, it should be taken into account that this is a currency with a central bank that 'unfairly' regulates its currency as it wishes and not a currency that is freely traded across countries.

Most investors and capital market traders do not want to enter an investment where such a large body can be 'played' against them, and usually look for other investment channels. However, for those already invested, with the trend expecting a weakening in Chinese currency could remain in position. Anyone holding a yuan should make "hedges" and even sell the deal in the event of the yuan's continued weakening in the coming days.

*** This Capital Way review does not constitute a recommendation for investment and does not replace financial advice.**

Company Contact:

_

Capital Way

T. +44 (0) 203 318 4938
E. support@capitalway.com
W. https://capitalway.com/

View Online

Additional Assets:

Newsroom: Visit our Newsroom for all the latest stories:
https://www.capitalway.pressat.co.uk