http://www.forbes.com/sites/johnmauldin/2016/02/02/heres-whats-happening-with-the-chinese-economy/3/#1868801c7d6b

That last point deserves some comment. China experts everywhere tell us the country is transitioning from manufacturing for export to supplying consumer-driven services. So if both manufacturing and service activity are slowing, is that transition still happening?

The answer might be “yes” if manufacturing were decelerating faster than services. For this purpose, relative growth is what counts. Unfortunately, manufacturing is slowing while service activity is not picking up all the slack. That’s not the combination we want to see.

Something else China Beige Book noticed last quarter: both business and consumer loan volume did not grow in response to lower interest rates. That’s an important change, and probably not a good one. It means monetary stimulus from Beijing can’t save the day this time. Leland thinks fiscal stimulus isn’t likely to help, either. Like other governments and their central banks, China is running out of economic ammunition.

One quarter doesn’t constitute a trend. Possibly some transitory factors depressed the Chinese economy the last few months, and it will soon resume its “stable deceleration” course. It is hard to imagine what those factors might have been, though. The data is so uniformly negative that it sure looks like something big must have changed.

What does this economic weakness say for Chinese stocks? Probably nothing. It should be clear to all that the Chinese stock market is completely unrelated to the Chinese economy. They don’t move together, nor do they move opposite each other. They have no consistent connection at all – or at least not one we can use to invest confidently.

I went to Macau when I was in Hong Kong a few weeks ago, just to observe the fabled fervor with which the Chinese gamble. The place did indeed have a different “feel” than Las Vegas does. I’m not the only one to think that the Chinese stock market is just an outpost of Macau, but one in which leverage and monetary stimulus can overload the system.

Let me say that there are real companies with real value in China. But the rules on the ground, not to mention the accounting, make it a particularly treacherous market to invest more than your own “gambling money.”

China’s currency is another story – and a much deeper one.

**Yuan Flew Over the Cuckoo’s Nest**

Recent Chinese stock market volatility has had more to do with China’s currency than its stocks. Donald Trump and other politicians (yes, he is one) often assail Beijing for devaluing its currency and acquiring an unfair advantage.

First, the Chinese have actually been manipulating their currency upwards. While countries in the rest of the world have been letting their currencies devalue against the dollar, China has maintained an effective dollar peg until very recently.

And then the “move” that seems to have everybody in a dither was only about 4%. To be fair, what really had the markets worried was that this move might presage an effective devaluation. And considering that China has watched the euro, the yen, and nearly every emerging-market currency drop anywhere from 30 to 50% against the yuan – a rather painful experience for its export sector – the Chinese have been quite patient.

I find it fascinating that we can be singularly focused on China and its currency, which has moved only slightly, and not pick on those countries that are openly and aggressively manipulating their currencies down. Seriously, if you want to have an intellectually consistent argument, why not talk about what those evil people in Europe are doing to lower their currencies against the dollar? Or Mexico? Or almost any other country in the world?

If you are truly against the strong dollar, then why not just say so and promote a policy of further massive quantitative easing and competitive currency devaluation? That is the only logical conclusion to the Chinese currency-bashing polemics. I guess all the loose talk is just another misguided attempt to Make America Great Again™.

In a normal world, nations with trade deficits naturally see their currencies weaken. No one needs to intervene or manipulate markets. When you bring stuff in, you send cash out. When you send stuff out, you bring cash in. It’s as effortless as breathing. **And if your cash is useful only for buying things in your local country, when too much of your money is offshore, your currency is going to weaken.**

Then why has the dollar gotten stronger even as we continue to run massive trade deficits? Because the dollar, being the world’s reserve currency as well as the currency for international trade, is in demand.

In fact, it is in such demand that if we closed the trade-deficit gap (as we have been starting to do), the dollar would get even stronger, because the world needs dollars to facilitate global trade. We do indeed enjoy a special privilege. Which is why I want to think at my conference about the consequences of the world’s leading trading currency going to negative interest rates.

It is true that politicians everywhere try to pervert the trade process and gain short-term advantages by cheapening their currencies. Most are smart enough not to equate their currency valuations with national pride. I wonder if Trump, et al., have thought through the consequences of their seeming desire to see the dollar weaken. Hopefully someone will enlighten them soon.

Back to our story: does Beijing think it can boost exports by manipulating its currency lower? I don’t think so. Remember how their business model works. Unlike, say, Saudi Arabia, China doesn’t simply extract resources from the ground and export them. China imports raw materials, transforms them into finished goods in its factories, and then exports those goods. Their gain lies in the value added in the manufacturing process.

That means that China can’t grow exports without also growing imports. Pushing the yuan lower helps, but it’s a relatively inefficient tool for reducing the trade surplus.

Cheapening the currency has another consequence China doesn’t want. It makes imported products more expensive for Chinese consumers. The country’s abilities are growing fast, but it still depends on outside sources for many important goods. Making them cost more doesn’t help build the consumer-driven economy Beijing says it wants.

For those reasons and more, China Beige Book has a contrarian view on the Chinese currency. They believe Beijing wants the yuan to rise, not fall. So what is happening with all these interventions the Chinese authorities are making in the currency market?

The first point to remember is that the adjustments have all been quite small – far smaller than the hoopla suggests. For all the clamor that erupted last year, the yuan fell just over 4.5% against the dollar. That’s quite a lot if you are leveraged 10x, as currency traders often are, but for most merchants and consumers the change was hardly noticeable.

Recall all that happened in 2015. Aside from the stock market fireworks, China won acceptance of the yuan into the IMF’s reserve currency basket. It also watched the Federal Reserve finally make a first, tentative move toward higher rates and a correspondingly stronger dollar. If all that couldn’t crush the yuan, it’s not clear to me that anything will.

Nevertheless, periodic adjustments make headlines because they happen so unpredictably. I think the surprises are intentional. The People’s Bank of China wants to keep markets guessing about its intentions. This tactic allows them to gradually nudge their currency in the desired direction. And by gradually, I mean over years or even decades.

Let’s go back to the two Chinese sages I quoted at the beginning of the letter. You have to know the Chinese leadership is steeped in such philosophies:

“Be extremely subtle, even to the point of formlessness. Be extremely mysterious, even to the point of soundlessness. Thereby you can be the director of the opponent’s fate.”

— Sun Tzu

The second point is critical: China controls its currency by both central bank action and subtler tools. They have immense power to nudge the currency up or down. Tightening and loosening the controls is like turning a volume knob. They can crank the yuan up or turn it down.

Presently they are clamping down harder than usual in order to deter speculation. Much of this is happening under the radar, one business and industry at a time. Nevertheless, people are starting to feel the consequences.

[China Law Blog](http://www.chinalawblog.com/2016/01/getting-money-out-of-china-what-the-heck-is-happening.html) (what, it’s not on your regular reading list?) is a great resource from Harris & Moure, a Seattle law firm that helps companies navigate the Chinese import-export maze. I like it because they write in language that can be understood by anyone. They said this on Jan. 14:

So what has been going on lately?

Well if there is a common theme, it is that China banks seem to be doing whatever they can to avoid paying anyone in dollars.

I heard similar rumblings when I was in Hong Kong earlier this month. China is making it very, very difficult to move capital outside the country. They do this in many different ways, as you’ll see if you read the article above. Banks and bureaucrats all over China are clearly responding to some kind of central edict.

We don’t know exactly why Beijing is doing this. If, hypothetically, they wanted to make it difficult for foreigners to take short positions against the yuan, what they are doing would help. And we know they are restricting access and bringing regulatory oversight to bear on those who want to short the yuan.

Leland Miller is very confident – and I concur – that China will not impose any major overnight devaluations, as so many people fear they will. Doing so wouldn’t move them toward their goals and would send them backwards in some respects. I have talked with other veteran Chinese watchers who also agree. The Chinese will continue to do whatever they do in very deliberate, often confusing, and sometimes downright mysterious ways.

If we do see a huge devaluation, it will mean something is very, very wrong in China. It will be an indication that the wheels are coming off. The Xi Jinping government will do all it can to avoid getting stuck in that position.

Leland reminded me that China is scheduled to host this year’s G-20 summit meeting in September. The last thing the Chinese will want is negative economic headlines while the leaders of the world’s top economies gather in Hangzhou.

On the other hand, the Chinese can’t control the headlines or the rumor mill on the trading floors. This limitation might explain their vigorous resistance to speculators who want to provoke a devaluation. Beijing wants to squelch that trade before it attracts more attention. It is very easy to believe that their concern is as much about maintaining the appearance of control as it is about the actual currency valuation.

Understanding all this is hard because we want there to be a binary choice: i.e., the yuan must go up or must go down. Beijing doesn’t see it that way. They have very long-term goals and don’t mind taking a circuitous path toward achieving them. What they can’t countenance is anything that makes the Chinese public lose faith in the government.

In other words, the exchange rate can do whatever it will so long as the public believes Beijing is either in charge or at least neutral. The authorities intervene when necessary to preserve that perception. Otherwise, they seemingly take a hands-off approach.

The macro traders who think they can provoke Beijing into a major one-off devaluation aren’t likely to get one, in my view. To paraphrase Keynes, Beijing can stay stubborn longer than traders can stay solvent.

### ****The Other Side of the Coin****

As I noted above in reference to Donald Trump, FX rates have two sides. If one side goes up, the other must go down. If you believe the yuan will weaken, you also believe the dollar will strengthen, which in fact it has done in recent years.

Bearish yuan sentiment is also bullish dollar sentiment. A month or so ago, when the Federal Reserve told us it foresaw four interest-rate hikes in 2016, many thought this trajectory would be positive for the greenback. They might have been right, too, but now it appears unlikely that we will ever find out.

No one expects a Fed move next week, and the odds are getting slimmer that we will see any more rate hikes through the end of 2016. Maybe just another token move this summer? And maybe the data trends can turn around – that is something we all would like to see. But the markets are not expecting more than one or maybe two interest-rate bumps this year.

So something curious has happened. People turned bearish on the yuan because they were bullish on the dollar. Now the prime factor behind the expected dollar strength has changed, but the bearish yuan sentiment is still with us.

And dear gods, what will happen when the world goes into another recession and the Federal Reserve starts another round of easing? That scenario would be dollar bearish. Will US politicians stand up and accuse the Federal Reserve of participating in a currency war? Just asking.

Is there some new, different reason to think the RMB is headed down? Maybe. The faulty circuit-breaker scheme behind this month’s Shanghai stock selloff didn’t inspire confidence in Beijing. Whatever Chinese citizens think, it sure looked like a bone-headed move from the outside.

Yet remember what happened. When Shanghai couldn’t stay open for even an hour without tripping the breaker, the powers that be recognized their mistake and backtracked quickly. By their standards, that response was equivalent to jumping into hyperspace. Chinese authorities rarely move so fast.

You can call their reaction panic if you want, but it also shows something else: flexibility. A supposedly hidebound, dogmatic regime turned on a dime when it had to. Would the same have happened in the US? I don’t think so. We would have watched markets crash, convened a blue-ribbon panel to investigate, and then made some tweaks a year or three later.

Admitting mistakes is hard, even for communist governments. That Beijing can do it when necessary suggests that they will not be easily bullied.

I began this issue by comparing Chinese markets to the Monkees. If you never saw their 1960s TV show, it was a shameless attempt to exploit Beatlemania. As a band, the Monkees were strictly made-for-TV.

Yet something unexpected happened. The four young actors turned themselves into musicians. Some of their music was forgettable, but some of it was pretty good, too.

China’s attempts to build modern markets and join the international financial elite can be funny to watch – but won’t always be so. Like the Monkees, China has a chance to actually become what it once only pretended to be.

The Chinese are in the middle of that process right now. Beijing has many Daydream Believers. Bet against them at your peril.