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Growing pessimism about world economy

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Oil price fell below US$ 30 a barrel. Indeed, the lowest price in 12 years!

So too the Standard & Poor's 500 also fell, below 1,900 points. This fall was for the first time since September 2015. The US Dow Jones industrial average and the Nasdaq composite index dropped by 2.2%, and 3.4%, marking the New York stock exchange's worst start in the New Year.

Last week, China's stock market was in turmoil.

Excess supply of oil by major producers and low demand for commodities all over the world since the Chinese economic downturn with its August devaluation crisis are the reasons for the recessionary trend for some time. However, during the last few months, upbeat stories of the US recovery, rise in jobs despite low inflation, and the much hyped about normalization of interest rate and finally a symbolic rise in interest rate by America's central bank, gave hopes to the rest of the world.

However, the expectations have been short lived ones.

The first working week of the New Year 2016 ended on a sour note in China. The barometer of economic optimism is the stock price in an economy, where savers flock to stock market for making quick bucks.

As pessimism ruled on Jan 6 and 7, the stock market reflected the mood. Prices were crashing. Regulators resorted to exercising their newly acquired powers to stem the bearish tendencies. They suspended the Shanghai and Shenzhen stock exchanges. These powers are known "stock market circuit-breaker mechanisms - designed to stop free-falling prices. Regulators can close the stock markets if stocks fall 7%.

The circuit breaker was applied twice on Jan 7 and Jan 8. On Thursday, the stock market was closed within half an hour of trading.

Did it help?

No, it created more jitters.

Initial panic

Initial panic was due to the pessimistic perception entertained by investors that China would be devaluing the currency again. This perception was given rise to by the requirement ever since August last year, when China announced that it would float the currency, as a requirement for fulfilling the role of a reserve currency, an honour bestowed by IMF on the country.

While China’s offshore value of renminbi is subject to market forces, its onshore value is regulated by the authorities. The central bank of China fixes the onshore midpoint rate for the renminbi every day guided by the previous day’s offshore rate. For eight days since the New Year began, the offshore rate was falling. Accordingly, the previous day offshore rate determines the day’s fresh onshore rate.

As the offshore value of renminbi is decreasing, its mainland value has to be brought down. That has created the market perception that China would be resorting to the age-old remedy once again, that was done in August: devaluation.

Outflow of capital

China has been allowing outflow of funds. Investors are seeking better markets. Since August last year, the trend has begun.

China’s foreign exchange reserves shrank by US$108 billion in December. This is the biggest monthly drop. In 2015, they decreased by US$513 billion. In fact, China would welcome the trend, as it would bring down the value, indirectly making its exports cheaper.

In fact, the depreciation of the offshore value of the renminbi last Thursday was to its lowest level since 2011. Floating the currency is the latest tactic, which has proved beneficial.

How about stock market reaction?

Authorities do not like it, as it reflects poor investment environment. So they face the dilemma.

A knee-jerk decision was announced. China imposed a ban on sales of stocks for three months which calmed the markets.

No more sales and no more free-falling prices!

While Chinese stock prices are frozen, the world stock prices were falling.

Growth estimates

World Bank says global growth would grow only at 2.9%, revised down from 3.3% and growth rates for major economies are being revised downward. Global investors are pulling funds out of Asia. The Korean won and the Singapore dollar were down 5% and Taiwan dollar and Indian rupee lost 7% per cent against U.S. dollar.

There is no dearth of pessimists. The latest to join them among investment bankers is Andrew Roberts, the Royal Bank of Scotland credit chief. He has joined the gang of predictors of a stock market rout in 2016. Roberts warns of a possible 20% fall in stock markets. He advises global investors “to sell everything except high quality bonds”.

The latest news is Chinese exports rose in December by 2.3% from a year ago.

Has the weakening of the currency helped?

That will open up a round of currency war in Asia!