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Currency War: What Is it Good For?

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If there was any doubt about China's importance to the global economy, the frenzied reaction to a 3% depreciation in the renminbi should make it clear: When China sneezes, world markets catch a cold. So should we be worried about a currency war? Will countries race to devalue their currencies in order to match China or gain a competitive advantage?

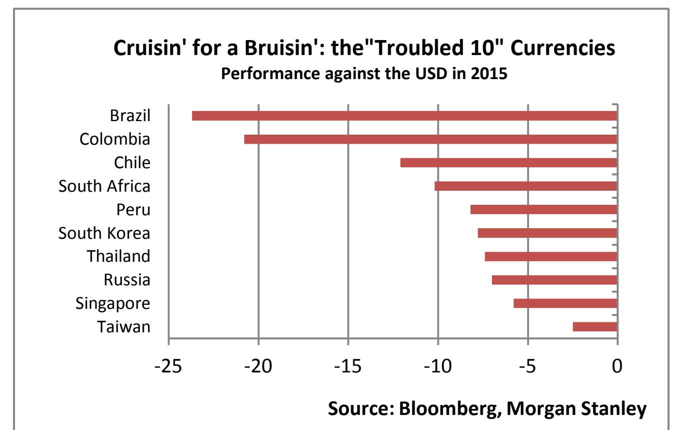
Let's remember that China's currency has been pegged to the U.S. dollar for decades, which led to complaints that China's government kept the exchange rate artificially low in order to help exports. But in fact, since 2013, China's central bank has been propping up the value of the renminbi. Last week, when China allowed it to trade more freely, markets pushed it down by 2.8%. So what caused the sell-off?

Firstly, being pegged to the world's strongest currency has not been much fun for Chinese exporters. With a strong U.S. economy and the Fed about to raise interest rates, the U.S. dollar has soared and pulled the RMB along, gaining 13% against the euro and 20% against the yen. China is no longer the world's low-cost producer as manufacturing wages have risen by an average of 12% per year since 2001. In July, Chinese exports were down 8% compared to last year.

The second big factor is that money is leaving China at the fastest pace on record, an estimated $300 billion in capital flight just in the past six months. Chinese investors are on the move, following a steep decline in property values, a meltdown in the stock market and rising debt levels. Since 2007, China's total debt has nearly quadrupled to $28 trillion. This represents 282% of GDP, more than the United States before the crisis. China certainly has enough resources to bailout the banks, but the warning lights are flashing red.

So with a softening domestic economy and rising risks in the financial sector, it makes sense for China's central bank to let the currency weaken to support exports. But immediately, Vietnam and Kazakhstan followed suit by devaluing their own pegged currencies, which prompted fears about currency wars.

The trouble is that even if countries don't deliberately join the war, investors are exiting emerging markets all at the same time and driving down currencies. Morgan Stanley has a list of the "Troubled 10" that are most vulnerable to this type of currency depreciation.



For businesses in Canada, this will make Canadian exports more costly in emerging markets while capital flight and slower growth will reduce demand. This is doubly bad for commodity prices as China alone consumes between one-third to one-half of traded metals, oil and minerals. Our models now show oil prices struggling to regain $48 by year-end and $62 by end-2016, while the loonie will end the year at 74 cents before climbing back to 78 cents in 2016. Canada's manufactured exports and services have performed remarkably well, but with continued weakness from commodities, 2015 will be a rough year.

For more information, please contact:
Hendrik Brakel
Senior Director, Economic, Financial & Tax Policy
613.238.4000 (284) | hbrakel@chamber.ca