Economic Commentary

QNB Economics
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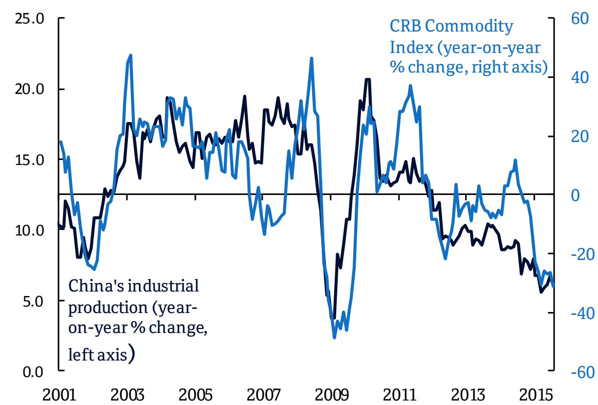
# The global implications of China's devaluation

A few months ago, we argued that the global economy in 2015 is likely to be dominated by two factors. These are the sharp decline in commodity prices—especially oil—and the large movements in the exchange rates market (see our commentary, Oil, currencies and diverging monetary policies: the global economy in 2015). Lower commodity prices shift income from commodity-exporting countries to commodity-importing ones. Exchange rates movements tend to shift growth from countries with appreciating currencies to those with depreciating currencies. The two forces, therefore, have important distributional implications, and they create winners and losers in the global economy. This lens to view the world economy is useful in analysing China's recent decision to devalue its currency and the global implications of the devaluation.

Due to its soft peg to the US dollar, the renminbi appreciated against most global currencies. The appreciation has hurt Chinese exports, making China one of the losers from the large global exchange rate movements. This provided one motivation for the Chinese authorities to delink the renminbi from the US dollar (see our commentary, China kills three birds with "yuan" stone). The impact of the decision is unlikely to be confined to China but would probably spillover to the global economy, particularly through commodity prices and the movement of currencies.

Commodity prices fell in the aftermath of China's devaluation. Oil prices have fallen by nearly 6% since 11 August, while copper have fallen by 5% over the same period. The Thomson Reuters/Core Commodity CRB Index (a broad measure incorporating agricultural, precious metal, industrial metal and energy commodities) has fallen by almost 4% since the devaluation. Investors interpreted the devaluation decision as a signal of weakness in the Chinese economy. And given that commodity prices have been driven by Chinese activity in recent years (see chart), the fall is not surprising. However, if the devaluation succeeds in stimulating Chinese exports and therefore growth, then commodities might get a boost from the move. So the decline in commodity prices induced by China's devaluation may turn out to be short-lived.

**Global commodity prices are driven by Chinese industrial activity**




Sources: Bloomberg, China National Bureau of Statistics and QNB Economics analysis

Commodity prices might fall of course. In fact we argued recently that oil prices are likely to remain low through 2016 (see our commentary, Oil prices lower for longer). But this would happen for reasons unrelated to China's devaluation.

China's devaluation has also resulted in depreciations of a host of currencies. These include currencies in commodity-rich countries such as Australia, Indonesia, South Africa and Latin American nations. These also include neighbouring Asian countries with large trade exposure to China like Taiwan, Thailand and South Korea. The latter set of countries might even respond with measures to weaken their own currencies further and maintain their export competitiveness. Indeed, Vietnam already widened its currency's trading band and followed that with a 1.0% devaluation a week later. Other Asian countries, especially those with low and falling inflation and stuttering growth such as the Philippines and Taiwan, may cut interest rates which is likely to lead to the depreciation of their currencies.

As a result, China's devaluation means that not only has it now joined the global currency race to the bottom, but it is also inducing other countries to follow suit. This implies that, with the possible exception of the UK pound, the US dollar is virtually the only major currency that is currently appreciating. A stronger US dollar could hurt US exports and hence GDP growth as it so painfully did in the first quarter of this year (see our commentary, Eight reasons why the US economy has slowed down in Q1). Coupled with the decline in commodity prices which is expected to continue into 2016, a stronger US dollar can also reduce US inflation from its already low levels. Market participants still expect at least one rate hike from the Fed this year. But lower growth and slowing inflation driven by a stronger US dollar could prompt the Fed to rethink its position.

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