Economist Insights

Silk road-block

What are the implications for China's trading partners of the recent devaluation of China's currency? An ongoing devaluation could create problems for the Eurozone, and to a lesser extent the US. But falling commodity prices triggered by a slowing China could offset a lot of the damage.

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The silk road was the name for the trading routes that wound their way from ancient China through India and the Middle East and eventually to Europe and its centre, Rome. Two thousand or so years later the centre of Europe may be somewhat further north, but the trade links with Asia are once again very important. And whenever trade links are important, there are links through the currency to the pace and timing of monetary policy.

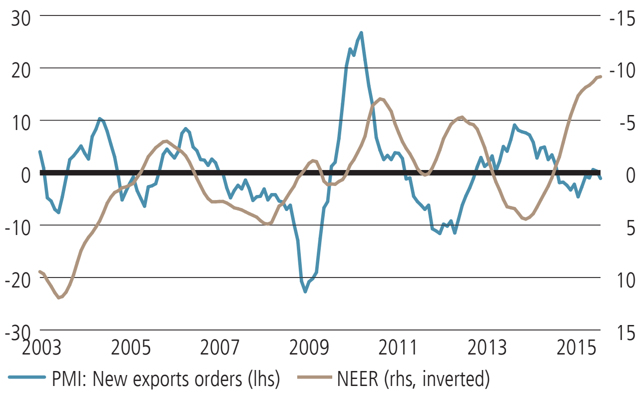
Timing is particularly important. From the misguided early rate hike in mid-2011 to the far too late move into quantitative easing earlier this year, the European Central Bank (ECB) always seems to be relatively unfortunate in its timing. No doubt the difficulty in establishing a consensus is part of the cause of delays, so an external stimulus is often needed to focus minds. One such external stimulus this year was that the currency was too strong relative to the state of the economy (see *Economist Insights,* 8 June 2015).

So having finally embarked on the necessary QE, the EUR immediately started to plummet. This raised hopes that the currency would no longer be too strong for the economy, and exporters looked forward to improving orders. But now that growth in Emerging markets (EM) has started to slow, not only have those currencies weakened but demand for imports has also fallen. With the recent move in China's exchange rate, European exporters have even more reason to turn gloomy.

In short, despite the sharpest depreciation of the EUR on record over the last year, the Eurozone did not experience the expected benefits to growth from the export channel. Export orders in the purchasing manager index for the Eurozone have remained very weak (chart 1). The link between currency movements and export orders is not that robust, and other factors can have an impact on orders. But nonetheless the degree of divergence between the two this year has surprised market participants and the ECB alike.

Chart 1: Price insensitive

Eurozone new exports order PMI (YoY change) and nominal effective exchange rate (%, inverted, 12 months centered moving average, YoY)



Source: Markit, ECB, UBS Global AM

The most likely explanation is that the negative effect of slowing demand in EM (especially China) dominated the benefits of a cheaper EUR. Eurozone export orders may have been even worse if the EUR had not fallen. But all this was before the Chinese authorities decided to allow their currency to devalue. If the currency starts to edge lower day by day it will likely not take long for the currency slide to become substantial. While this may be good for Chinese exports and hence Chinese growth, that comes at the expense of their trading partners.

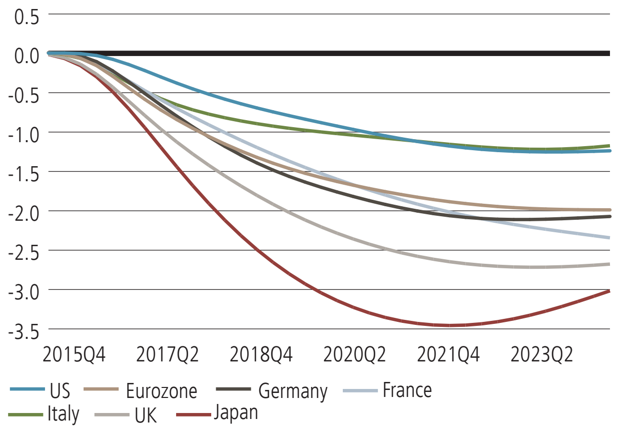
China is the second most important trading partner for the US and the most important external trading partner for most of the Eurozone countries outside the currency union. Within the Eurozone Germany is the most exposed to China; just think of all those German cars being exported to the newly wealthy residents of Shanghai and Beijing.

This makes all of these countries exposed to a further depreciation of the CNY. How big could this effect be? Suppose that the CNY starts to slide, moving a little each day, and eventually gets back to its old fixed exchange rate level from 2004. That would amount to a 30% depreciation, quite substantial by any terms. Of course, given how much the USD has appreciated of late, dragging the CNY with it, this would really just bring the CNY back towards its old trade-weighted level (see last week's *Economist Insights*).

In economics 'what ifs' are always hard to prove precisely, but by using a macroeconomic model it is possible to get an idea of the order of magnitude of the impact of a shock. The impact of a fairly steady depreciation of the CNY is substantial for the Eurozone, coming at around two percent at the peak.

Chart 2: Beggared neighbours

Impact on GDP compared to model baseline of a depreciation of the CNY by about 30% over 9 months, %



Source: NiGEM, UBS Global Asset Management

But the Eurozone is not the most at risk. Japan is one of China's closest competitors, and would likely suffer the most from a sustained Chinese depreciation. Surprisingly enough the UK also seems to suffer more, but that is likely driven by increased imports rather than export competition. In most people's minds the US is usually most closely linked to China when it comes to trade, but the fact is that the US still remains a relatively closed economy compared to many others. Hence the trade impact is relatively short-lived for the US, and it bounces back the fastest.

Anyone looking at these impacts could be forgiven for thinking that a Chinese devaluation would do significant damage to other economies. But the global economy is never that simple, and there are often offsetting impacts. For example, suppose that the reason the CNY is devaluing in this scenario is because China is slowing down drastically. If China is slowing down, then it is likely that commodity prices could fall further, including oil. Lower oil and commodity prices could significantly offsets of the negative impact in our simulation especially in the short term, with the US, Japan and Germany being the biggest beneficiaries. This is because movements in the exchange have a much slower pass-through to the economy relative to changes in the oil price.

The silk road was always seen as a trade route, but as any study of the balance of payments will reveal, a trade route will always be a financial route as well. Someone has to pay for the goods that trade. Back in the ancient world China also had a trade surplus with Europe. In return for Chinese silks and other goods the Romans paid in silver from their mines in Spain. As the silver predominantly flowed in just one direction, Rome eventually ran into a financial crisis because their money supply was contracting. The Roman response was to debase the currency. So the link between Chinese trade and European monetary policy is a lot older than one might suspect.