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How Will Revaluing China's Yuan Affect World Economies?



More important, what effect will a free-floating *Yuan* have on the economy of British Columbia and individual investors?

To understand the implications, we need to look at the possible impacts on the US economy as well as the Canadian economy.

Background

The International Monetary Fund, the US government, the Canadian Government, and the G8 countries have all been putting pressure on China to allow the Chinese currency to appreciate and eventually float freely against the US dollar. Why? It is argued that the *Yuan* is “undervalued,” giving Chinese exporters an unfair advantage over domestic manufacturers. The strongest pressure is coming from domestic manufacturers in the United States, especially in the textiles industries.

Since 1994, China has fixed the exchange rate between the *Yuan* and the US dollar at around 8.28 *Yuan* to the US dollar. For China, it has helped stabilize their rapidly growing economy. Over the same time period, China's GDP has averaged almost 10 percent a year.

For Canadians, our dollar has actually appreciated by around 25 percent in the last three years over both the *Yuan* and the US dollar, making imports from China

even less expensive. Conversely, exports to China have become 25 percent more expensive over the same time period. Yet we don't have the same appetite for goods from China that our neighbours to the south have.

Last year the United States imported \$196.7 billion in goods from China while exporting only \$34.7 billion in goods to China, a trade imbalance of \$162 billion dollars. The imports from China amounted to over 13 percent of all goods imported into the United States. The value of imports from China has more than doubled since 2001.

Will the appreciation of the *Yuan* by 10 percent or even 20 percent stop the trend and give US and Canadian manufacturers a level playing field?

In Canada we imported \$24 billion in goods from China last year while exporting only \$6 billion to China. The imports from China amounted to only 6.7 percent of all imports into Canada. As with the United States, the imports from China to Canada have more than doubled since 2001. Even with the appreciation of the Canadian dollar, exports to China increased by over 50 percent between 2003 and 2004.

What are the possible effects of changing the exchange rate?

Chinese growth and the United States' consumption are the current driving forces behind the world economy. Any rapid change in the exchange rate could have enormous impacts on both countries. The consensus is that any changes should be made gradually, so the effects can be absorbed into the market.

Will the appreciation of the *Yuan* by 10 percent or even 20 percent stop the trend and give US and Canadian manufacturers a level playing field? Probably not. Manufacturing will continue to move into countries with lower-cost labour.

American consumers have become addicted to inexpensive goods imported from China. Increase the price of those goods by 10 percent and Americans will keep buying them. The problem is that those goods account for 13 percent of all imports. So the main effect will be inflationary pressures. Essentially, US consumers will pay more for the same goods.

Over the past several years, lower-cost goods from China have helped control both US and Canadian inflation rates. With rising inflation, the US Federal Reserve will probably react by raising short-term interest rates. The effect in Canada should be more muted because we import far less from China on a relative basis.

The effect on exports would be that Chinese consumers and manufacturers will

be able to import goods at lower prices, especially commodities. China currently consumes around 20 percent of all metals and just under 9 percent of the global oil supply and the rate of consumption is growing. The change in the exchange rate should help to support commodity prices by effectively making it cheaper for the Chinese to import them.

The effect of a higher *Yuan* on British Columbia

As long as the inflationary pressures don't have too large an impact on interest rates and the North American economy, the overall effects of a free-floating exchange rate should be positive. Canada's exports to China should continue to rise and most of those exports will go through BC ports. The long-term support of commodity prices will also benefit the oil and gas industry and the mining industry. The growth rate of imports from China may slow down in the short term, as importers react to higher prices.

Overall for BC business, an increase in the *Yuan* against the US dollar should have a positive effect. The inflationary pressure on Canadians should be modest as long as the changes happen in a slow and orderly fashion. The biggest question is how will the US markets react to the inflationary pressures? After all, the United States is still our largest trading partner and the world's largest consumer market, for the time being
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