FX Forecasts
Desjardins Economic Studies
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Has China just joined in the currency wars?

HIGHLIGHTS

- When they announced the devaluation of August 11, the Chinese authorities stated that they would change the manner in which the reference exchange rate was set. It is commendable that China wishes to further liberalize its currency, but true liberalization will require reforming controls over capital flows and access to foreign exchange markets. In the meantime, any further devaluation of the yuan could give the impression that China has joined in the currency wars.
- The Canadian dollar is clearly lacking support. It could depreciate below US$0.75 in the months to come if the Canadian economy continues to struggle, and if the U.S. dollar appreciates.
- Even though the euro already appears to be relatively weak, it could well depreciate further once the beginning of monetary firming in the United States is confirmed. The lows of last March could thus be tested in the months ahead.
- The last-minute agreement which averted the possibility of Greece exiting the euro zone reduced the appeal of the Swiss franc for speculators who were banking on another financial crisis. The Swiss National Bank still feels that the franc is highly overvalued, and it will remain vigilant to prevent further appreciation.

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Editorial

The Chinese monetary authorities generated a shock wave on August 11 by devaluing the yuan, and then did so again the very next day. This action may be interpreted in many ways. Some will see it as a panicked attempt to stimulate the Chinese economy, or as the beginning of China's participation in the currency wars. Others might see it as one more step towards liberalizing the yuan in the foreign exchange market, which is the message that China tried to convey.

A FAIRLY LIMITED DEVALUATION, IN THE END

First and foremost, it is important to point out that the recent devaluation of the yuan is quite limited. In fact, it consists of a cumulative adjustment of 4.6%, in the space of three days, to the reference exchange rate that is set by the People's Bank of China. Over the same period, the official exchange rate has fluctuated by around 3.0%.

The more limited movement of the official exchange rate is due to the fact that it already stood above the reference exchange rate before the devaluation. A tolerance range of ±2% was introduced in March 2014, allowing a more significant spread to develop between the two exchange rates (graph 1 on page 2).

When they announced the devaluation of August 11, the Chinese authorities stated that they would change the manner in which the reference exchange rate was set. From now on, they will take greater account of currency supply and demand pressures, which should be captured by the movements in the official exchange rate, among other things. Since for many months the official exchange rate had been higher than the reference exchange rate, the People's Bank of China wanted to fix that by raising its reference rate. Currently, the reference rate and the official rate both stand at close to 6.40 yuan/US$, implying that some degree of balance has been reached.

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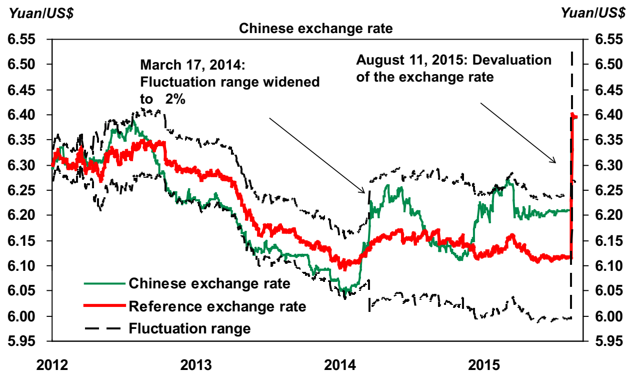
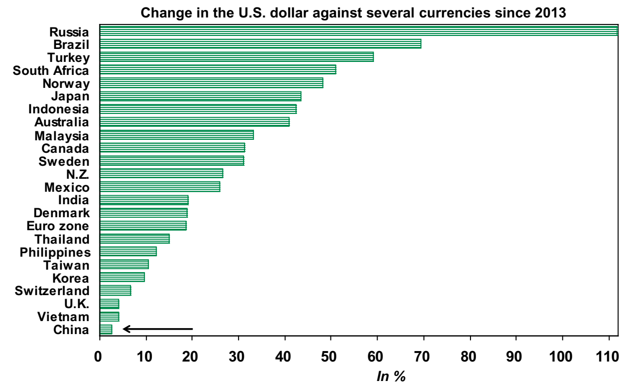
Graph 1 – The official exchange rate was already higher than the reference exchange rate



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – The yuan had not moved much against the U.S. dollar in recent years



Sources: Datastream and Desjardins, Economic Studies

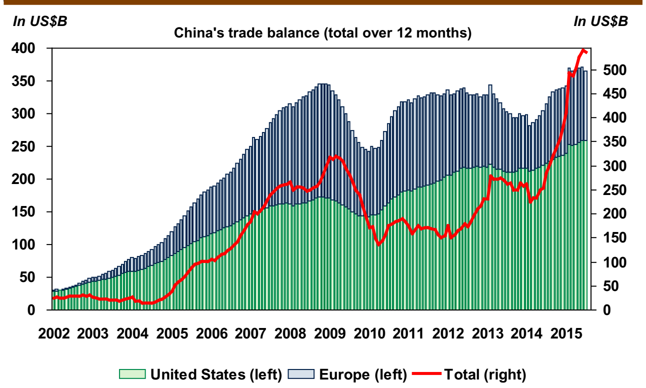
Obviously, if the adjustment to the exchange rate remains so small, the effects on world trade will be limited, and it would be astonishing if other countries were to answer by adjusting their currencies or their monetary policies. But there is a high risk that the Chinese monetary authorities may devalue their currency again in the months to come. In fact, the central bank could now react more quickly to movements in the official exchange rate, which could increase if Chinese economic data were to deteriorate further, or if the U.S. dollar were to appreciate as probable monetary firming in the United States approaches.

WEAK POTENTIAL FOR DEVALUATIONN

The trends in the major currencies in recent years suggest that China has been one of the biggest losers in terms of exchange rate competitiveness (graph 2). Since 2013, the U.S. dollar has gained more than 20% against many currencies, but has remained fairly stable against the yuan; this means that the yuan too has appreciated strongly against other currencies. But we must not forget that the yuan has long been considered an undervalued currency. The exchange rate trends of recent years have certainly helped reduce that undervaluation, but they have probably not been enough to lead to an overvaluation of the yuan. We should also point out that many Asian countries that compete with China have experienced weaker-than-average depreciations of their currencies; for example, Vietnam, South Korea and Thailand.

From a more fundamental point of view, it is interesting to note that China's trade surplus with the United States and Europe has kept expanding in recent years (graph 3). These surpluses contribute to global macroeconomic imbalances, requiring the United States in particular to continually build up debt loads to finance its trade deficit. It would therefore be very difficult for China to justify a substantial devaluation of its currency.

Graph 3 – China's trade surplus with the United States and Europe is still very high



Sources: Datastream and Desjardins, Economic Studies

It is commendable that China wishes to further liberalize its currency, but true liberalization will require reforming controls over capital flows and access to foreign exchange markets. In the meantime, any further devaluation of the yuan could give the impression that China has joined in the currency wars in hopes of gaining a profit. We are predicting that China will restrict itself to cosmetic adjustments to its currency in the months ahead.

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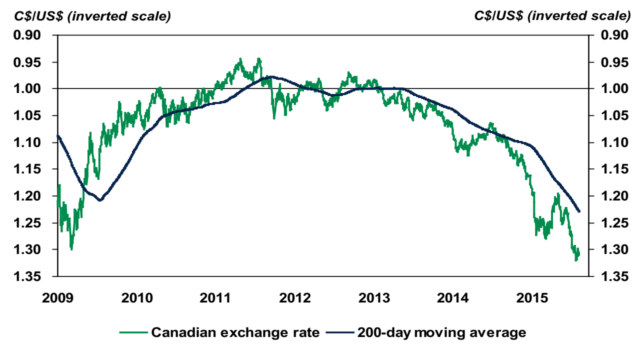
CANADIAN DOLLAR (CAD)

An 11-year low has been reached

- Since the end of June, the Canadian dollar has plummeted. In fact, an 11-year low of US$0.7568 (CAN$1.3214/US$) was reached at the beginning of August. Several factors were working against the currency, including another drop in oil prices, the release of disappointing economic data and the Bank of Canada's decision to lower its key interest rates once again.
- From a technical point of view, the loonie's recent slump is reinforcing the depreciation trend that has been observed since 2013. The momentum has fallen close to the lows that were seen at the beginning of the year, and the net speculative positions have also plunged, indicating that larger numbers of investors are calling for a weakening of the currency.
- Looking at the fundamentals, we still find that the Canadian exchange rate is very closely tied to oil prices. This most recent decline in oil prices is mainly due to expanding production in the OPEC countries, aggravating the surplus conditions that had already been observed. The recent agreement on the Iranian nuclear program will increase that surplus, as the sanctions that are currently limiting Iran's oil exports are likely to be lifted. China's economic tribulations are also weighing down oil prices to a significant degree, casting a shadow over the global crude demand outlook. Many other commodity prices are also affected by the situation in China.
- Since the oil and mining sectors occupy a significant share of the Canadian economy, this has negative repercussions on many of the country's economic indicators. Real GDP has been in decline for the past five months, moving us closer to a technical recession. The depreciation of the loonie appears warranted, as the economy needs more support from the export sector. After several months of disappointment, the trade balance improved considerably in June; we can only hope that this trend will continue. The Bank of Canada opted for a prudent approach in July and announced another interest rate cut. To some degree, the market is anticipating another 25 basis point reduction, in contrast with expectations of monetary firming in the United States.

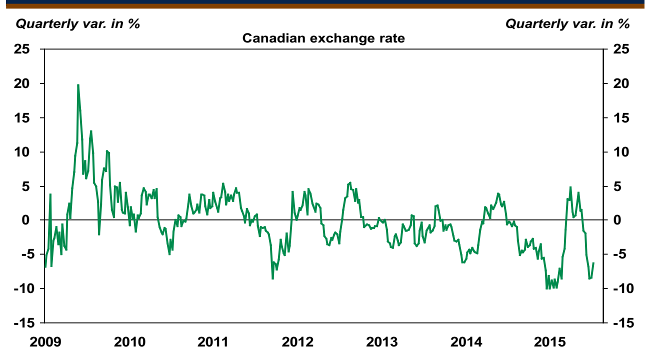
Forecasts: The Canadian dollar is clearly lacking support. It could depreciate further in the months to come if the Canadian economy continues to struggle, and if the U.S. dollar appreciates due to a strong probability of monetary firming in the United States.

Canadian dollar and trend



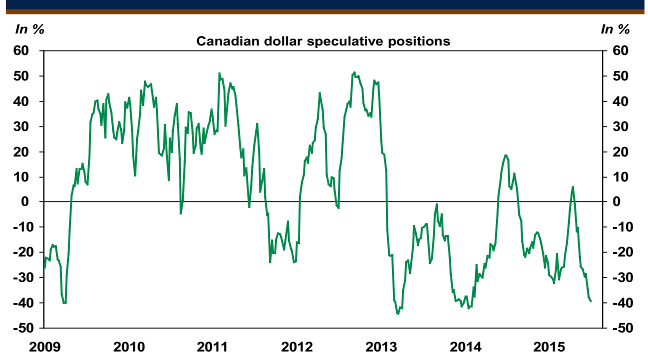
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

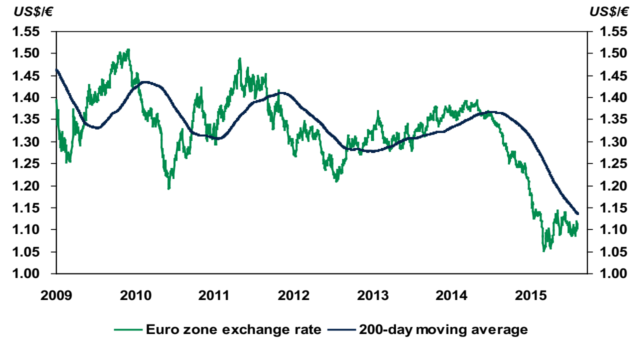
EURO (EUR)

Diverging monetary policies could do more damage to the euro

- The events of recent months have had little impact on the euro, which has been fluctuating within a range between US$1.08 and US$1.12 since the end of June. Surging risk of Greece leaving the monetary union did not affect the euro much in early July, after a referendum in which Greek voters clearly rejected the austerity measures that the European governments were asking for. This clearly shows how unfazed international investors seem to be about this recurring crisis. The drastic reversal that followed, when the Greek government yielded to the European demands and took steps to secure a third aid package, also had little effect on the common currency.
- The recent fluctuations of the euro mainly reflected the trends in the U.S. dollar and expectations of future action by the Federal Reserve (Fed). Some disappointing U.S. data supported the euro in the middle of July, but improved statistics and some comments by Fed leaders, opening the door to an interest rate hike at the September meeting, pushed the euro back below US$1.09 at the beginning of August. More recently, the devaluation of the yuan has favoured the euro by reviving doubts about the advisability of monetary firming in the United States.
- While the risks of a Greek crisis have greatly abated, the issue is far from resolved, since the new aid plan could put the country in an unbearable position, both economically and politically. Putting Greece aside, the euro zone still finds itself in a worrisome situation. Economic growth slowed to an annualized rate of 1.3% in the second quarter, with stagnation in France and continuing modest growth in Germany and Italy. Given that inflation is still very weak and that downside risks for the economy predominate, the European Central Bank (ECB) insisted, in the minutes of its last meeting, on the importance of continuing the monetary easing measures that had already been announced, including its asset purchases, and of being prepared to expand those purchases should the situation require it. Thus the divergence between U.S. and euro zone monetary policies is likely to keep justifying a weak euro.

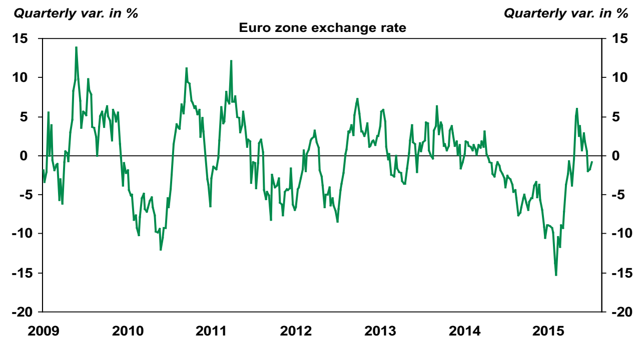
Forecasts: Even though the euro already appears to be relatively weak, it could well depreciate further once the beginning of monetary firming in the United States is confirmed. The lows of last March could thus be tested in the months ahead. The euro could gain back some ground next year, however, when the markets start preparing for the end of the ECB's asset purchases, probably in the fall of 2016.

Euro and trend



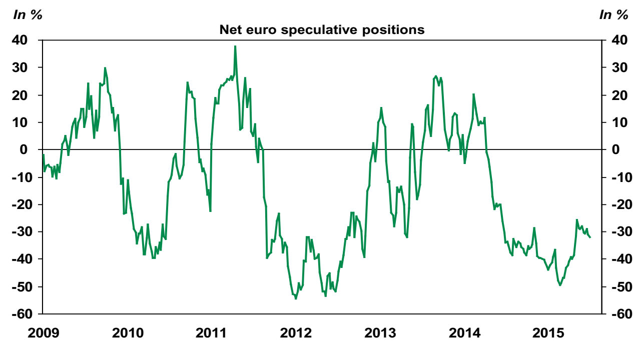
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions

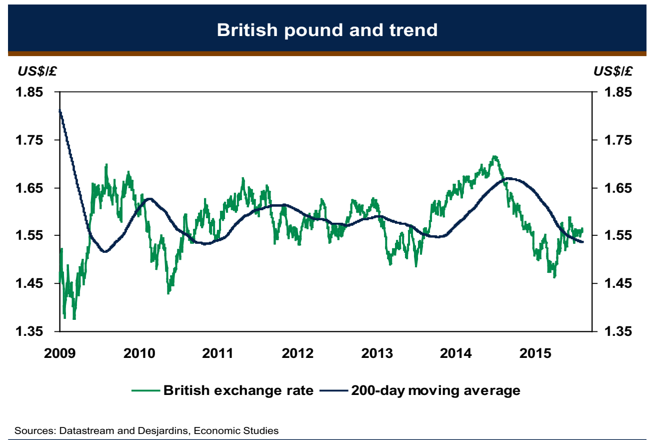


Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The Bank of England will not rush to raise its interest rates

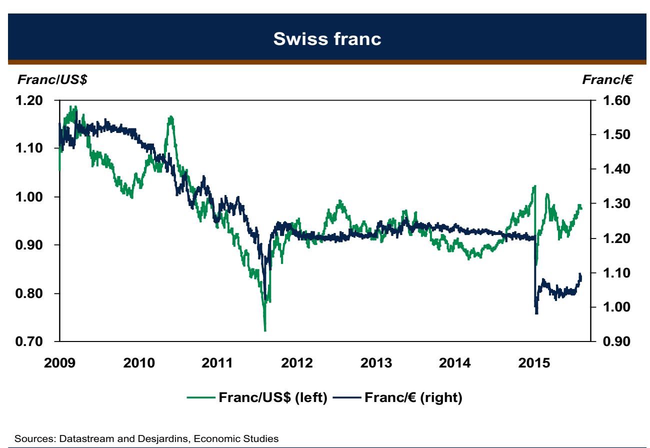
- The pound sterling has been relatively stable against the U.S. dollar recently, fluctuating around US$1.56. In fact, it is one of the few currencies to have posted a gain against the greenback since the beginning of 2015. As for the EUR/GBP pair, it dropped below £0.70 in the middle of July, its lowest level since 2007. The pound's strength was supported by economic data confirming that the British economy had resumed a healthy pace of growth in the second quarter. That, combined with marked wage acceleration, whose annual change climbed from less than 2% at the beginning of the year to 3.2% in May, prompted some investors to position themselves for a hike in the British key interest rates before the end of this year. However, the August 6 meeting of the Bank of England (BoE) dampened expectations of monetary firming, since just one of the nine committee members voted for a rate hike, and the BoE seemed to be concerned about the effects of a strong pound on the inflation outlook. Later, slower wage growth in June confirmed that the BoE could afford to be patient. **The pound is likely to follow the euro's lead and lose ground against the U.S. dollar in the months to come.**



SWISS FRANC (CHF)

The agreement with Greece reduces upward pressures on the franc

- The Swiss National Bank (SNB) was certainly relieved to see the last-minute agreement, which averted the possibility of Greece exiting the euro zone. This reduced the appeal of the Swiss franc for speculators who were banking on another financial crisis. Signs that the SNB was continuing to intervene in the market to weaken the franc also contributed to the emergence of negative sentiment towards that currency. Consequently, the franc has depreciated significantly against the U.S. dollar and the euro in recent weeks. The EUR/CHF pair even reached 1.09 francs recently, its highest point since the SNB abandoned its exchange rate floor at the beginning of the year. With annual inflation dropping to -1.3% in July and fairly mixed economic data in Switzerland, the SNB still feels that the franc is highly overvalued, and it will remain vigilant to prevent further appreciation. **The franc could stabilize against the euro in the short term, and then continue depreciating next year.**

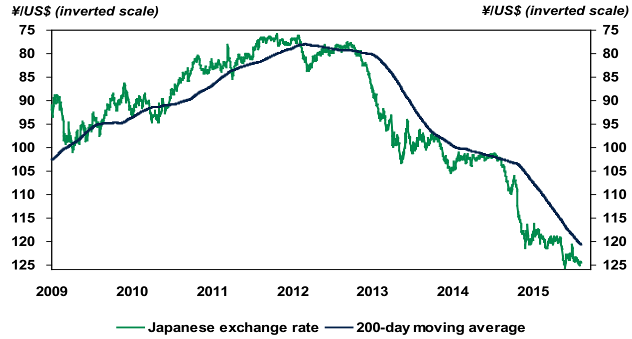


YEN (JPY)

The potential for depreciation is declining

- The Japanese exchange rate has basically held steady between 123 and 125 ¥/US$ since the beginning of the summer. Among other reasons, this is due to the absence of any announcement of new measures by the Bank of Japan (BoJ), and to the absence of further generalized gains by the U.S. dollar against the other major currencies.
- The expected appreciation of the U.S. dollar in the months ahead could potentially weaken the yen but, on the other hand, the yen could benefit from increased market volatility caused by the uncertainties in China and other parts of the world. The potential for depreciation would be more significant if further intervention by the Bank of Japan were to become more likely. However, improvement in several economic variables in Japan seems to be reassuring the monetary authorities despite the decline in the inflation rate that occurred in the spring. BoJ leaders are still predicting that inflation will return to the 2% target in the first half of the 2016 fiscal year. The BoJ's tone could change in the months to come, however, especially since China has changed its exchange rate policy. **Nevertheless, we are still cautious about the potential for depreciation in the yen between now and year-end, with a target of 125 ¥/US$.**

Yen and trend



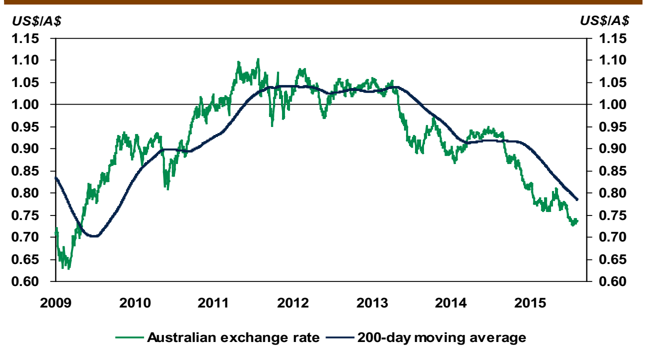
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The Reserve Bank of Australia moderates its stance about its currency

- The Australian dollar recently reached a six-year low at US$0.7215. This currency is not very sensitive to oil price fluctuations, but it is sensitive to prices of other commodities and to the economic outlook for China, which is Australia's main export market. The Australian economy has been showing some pockets of weakness in recent quarters, including reduced investments in the natural resources sector and deterioration in its trade balance and terms of trade.
- The Reserve Bank of Australia appears to be satisfied with the depreciation observed in the Australian dollar. In August, it removed its comment encouraging sharper depreciation of the currency from its monetary policy press release. It is nevertheless leaving the door open to another interest rate cut, which is keeping some downward pressure on the exchange rate. **Barring any sudden improvement in China's economic situation or in commodity prices, the Australian dollar should remain below US$0.75 for several months to come.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

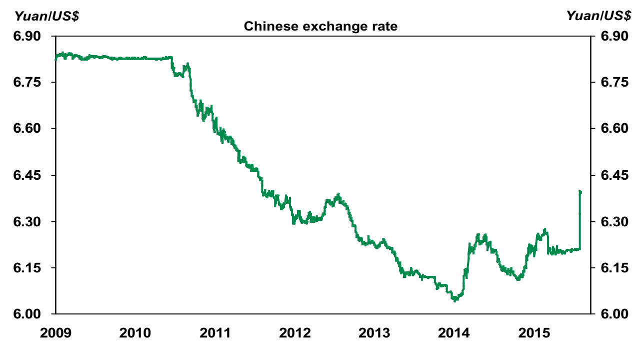
EMERGING CURRENCIES

The Chinese currency takes its turn at depreciating

CHINESE YUAN (CNY)

- Changes have recently been made to allow the yuan to fluctuate further. Essentially, the monetary authorities will take market movements into account to a greater extent when setting the daily reference exchange rate around which a fluctuation range of plus or minus 2% is tolerated. But these changes come at a time when concerns about China's economic growth are growing, giving the impression that this action is mainly designed to support exports. The yuan's devaluation has been fairly limited so far, around 3% since August 11. Most of the other emerging currencies have depreciated far more in recent years. That said, the yuan has long had the reputation of being undervalued, thereby limiting its downward potential. **The Chinese exchange rate could end the year at around 6.50 yuan/US$.**

Chinese yuan and trend



Sources: Datastream and Desjardins, Economic Studies

MEXICAN PESO (MXN)

- The peso has continued to depreciate drastically since mid-July. The USD/MXN pair recently climbed above 16.40 pesos to reach a new, historic high. Besides being affected by negative sentiment towards the emerging countries, the peso also suffers from the recent slump in oil prices. Even though inflation and economic growth are still moderate, the Bank of Mexico (BoM) seems to be increasingly concerned about the destabilizing effect of the peso's decline. At the end of July, the BoM announced a significant increase in its exchange rate interventions, but it was not enough to halt the peso's calamitous descent. **The BoM could soon announce a hike in its key interest rates if the peso keeps depreciating; therefore, it would be unwise to count on further depreciation of this currency.**

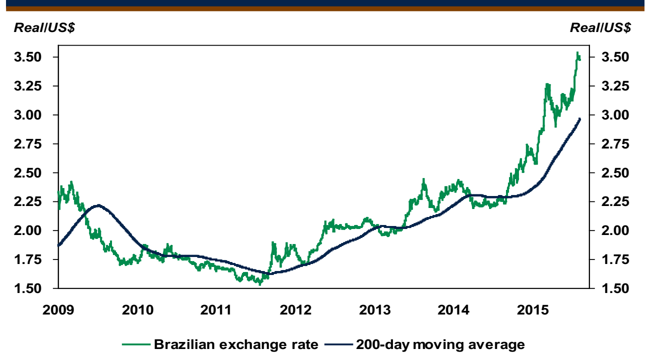
Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

BRAZILIAN REAL (BRL)

- The Brazilian exchange rate recently reached its highest point since 2003: 3.5701 reales/US$. The real's depreciation is founded on the deterioration in commodity prices and on Brazil's precarious economic situation. Despite weak economic growth, inflation is still very high—close to 10%—due to insufficient production capacity in many sectors for one thing, and also to the currency's depreciation. This is forcing the central bank to pursue monetary firming to the detriment of economic growth. We estimate that **the exchange rate could stay above 3.50 reales/US$ for several more months.** The 2016 Olympic Games, to be held in Brazil, could eventually support the currency.

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	*Spot price* August 18	*Percentage return since* 1 month	3 months	6 months	1 year	*Last 52 weeks* Higher	Average	Lower
Americas								
Argentina – peso	9.2442	1.0765	3.3125	6.3774	11.7083	9.2485	8.7375	8.2753
Brazil – real	3.4694	8.6039	14.9267	22.2183	53.4160	3.5389	2.8303	2.2340
Canada – dollar	1.3075	0.7591	7.7728	5.1764	20.1249	1.3167	1.2010	1.0842
Canada – (CAD/USD)	0.7648	-0.7533	-7.2122	-4.9216	-16.7533	0.9224	0.8326	0.7595
Mexico – peso	16.4298	3.3984	8.6031	9.9936	25.9274	16.4717	14.7085	13.0445
Asia and South Pacific								
Australia – (AUD/USD)	0.7340	-0.4331	-8.1254	-6.0371	-21.2419	0.9378	0.8069	0.7271
China – yuan renminbi	6.3938	2.9680	3.0552	2.2174	4.0827	6.3989	6.1947	6.1112
Hong Kong – dollar	7.7549	0.0568	0.0535	-0.0438	0.0555	7.7708	7.7540	7.7500
India – rupee	65.4537	3.0902	2.7397	5.4739	7.6895	65.4537	62.4912	60.2750
Japan – yen	124.4050	0.2660	3.6795	4.7268	21.2879	125.6250	117.5745	102.5700
New Zeland – (NZD/USD)	0.6601	1.3532	-10.6740	-12.3771	-22.1533	0.8480	0.7481	0.6511
South Korea – won	1,185	3.2810	9.1600	7.5503	16.4538	1,190	1,095	1,013
Europe								
Denmark – krona	6.7723	-1.6940	2.7055	3.6741	21.3848	7.1086	6.3982	5.5792
Euro zone – (EUR/USD)	1.1035	1.6678	-2.8994	-2.8781	-17.4280	1.3363	1.1703	1.0522
Norway – kroner	8.2870	1.3471	11.8943	10.0919	34.6071	8.3125	7.4145	6.1474
Russia – ruble	65.7950	15.2479	34.1653	7.3153	82.2854	72.4500	53.1330	36.0945
Sweden – krona	8.5545	-1.1549	3.9233	2.3015	24.8105	8.8229	8.0035	6.8540
Switzerland – swiss franc	0.9776	1.8175	6.0307	3.6034	7.8795	1.0194	0.9515	0.8533
United Kingdom – (GBP/USD)	1.5656	0.1343	-0.1817	1.3334	-6.3890	1.6724	1.5572	1.4642

* In comparison with the U.S. dollar, unless otherwise indicated.
Note: Currency table base on previous day closure.

Table 2
Currency market: history and forecasts

End of period		*2014* Q3	Q4	*2015* Q1	Q2	Q3f	Q4f	*2016* Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	1.1199	1.1621	1.2688	1.2493	1.3333	1.3514	1.3333	1.3158	1.2987	1.2821
Euro	(EUR/USD)	1.2632	1.2101	1.0740	1.1142	1.0800	1.0600	1.0800	1.1000	1.1100	1.1400
British pound	(GBP/USD)	1.6212	1.5593	1.4845	1.5727	1.5500	1.5300	1.5500	1.5700	1.5800	1.6000
Swiss franc	(USD/CHF)	0.9534	0.9894	0.9744	0.9314	1.0000	1.0100	1.0000	0.9900	0.9900	0.9600
Yen	(USD/JPY)	109.66	119.70	120.14	122.50	124.00	125.00	126.00	127.00	128.00	127.00
Australian dollar	(AUD/USD)	0.8746	0.8170	0.7607	0.7709	0.7300	0.7400	0.7400	0.7600	0.7700	0.7800
Chinese yuan	(USD/CNY)	6.1385	6.2061	6.1995	6.2010	6.5000	6.5000	6.4500	6.4000	6.3000	6.2000
Mexican peso	(USD/MXN)	13.43	14.75	15.26	15.74	16.50	16.30	15.75	15.40	15.20	15.00
Brazilian real	(USD/BRL)	2.4507	2.6559	3.2077	3.1022	3.6000	3.5000	3.3000	3.2000	3.2000	3.1000
Effective dollar*	(1973 = 100)	81.30	85.13	92.06	89.94	93.60	94.90	93.80	92.70	92.10	90.40
Canadian dollar											
American dollar	(CAD/USD)	0.8929	0.8605	0.7882	0.8004	0.7500	0.7400	0.7500	0.7600	0.7700	0.7800
Euro	(EUR/CAD)	1.4147	1.4061	1.3626	1.3920	1.4400	1.4324	1.4400	1.4474	1.4416	1.4615
British pound	(GBP/CAD)	1.8155	1.8119	1.8835	1.9648	2.0667	2.0676	2.0667	2.0658	2.0519	2.0513
Swiss franc	(CAD/CHF)	0.8513	0.8514	0.7680	0.7455	0.7500	0.7474	0.7500	0.7524	0.7623	0.7488
Yen	(CAD/JPY)	97.91	103.00	94.69	98.05	93.00	92.50	94.50	96.52	98.56	99.06
Australian dollar	(AUD/CAD)	0.9795	0.9494	0.9651	0.9630	0.9733	1.0000	0.9867	1.0000	1.0000	1.0000
Chinese yuan	(CAD/CNY)	5.4813	5.3406	4.8863	4.9636	4.8750	4.8100	4.8375	4.8640	4.8510	4.8360
Mexican peso	(CAD/MXN)	11.99	12.69	12.03	12.60	12.38	12.06	11.81	11.70	11.70	11.70
Brazilian real	(CAD/BRL)	2.1883	2.2855	2.5282	2.4832	2.7000	2.5900	2.4750	2.4320	2.4640	2.4180

f: forecasts; * Trade-weighted against major U.S. partners.
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies