What Would Happen if China Decided to Float its Currency?

Each year brings new mutterings that China is interested in methodically dismantling currency controls that keep the yuan pegged to the dollar with the eventual goal of making the yuan a (more) freely convertible currency.

It's a wonderful thought, but to be fair we're probably still a long way off from that ever happening. China initiated a currency peg to the U.S. dollar back in 1994, in an effort to secure their spot as the world's leading exporter. With a weak yuan, China's exports have remained competitive on a global level ever since and developed countries like the U.S. have exported hundreds of thousands (perhaps millions) of low-skilled manufacturing jobs there as a result.

What's lost in domestic manufacturing for developed countries, like the U.S., is gained in cheaper imports of goods and the cheaper manufacture of higher-end goods (since some parts are sourced and built in Chinese plants then brought back to the U.S. for final assembly). It's not a perfect model, and politically it's a sticky issue (since jobs are lost), but all things considered there's a net economic benefit — the U.S. (and global) consumer gets lower prices and the Chinese economy has seen blistering growth over the last 30 years. Taken together, this has provided an overall boost to the global economy and lifted a lot of other ships with it like Emerging Markets economies and stock prices.

Some of you might be thinking, sure, but isn't this still just plain and simple unfair trade? China manipulated its currency to keep its goods hyper-cheap relative to the world and essentially created a monopoly on manufacturing in the process. A lot of people here are out of work as a result.

This is true, and it's why the U.S. has put political pressure on China over the last decade to allow its currency to appreciate — something I believe China should absolutely do. But at this stage, we have to also be very careful about "biting the hand that feeds us," so to speak. A rapid appreciation of the yuan could mean goods made in China become more expensive, a cost that will likely get passed to consumers (you). Additionally, a stronger yuan would mean a slowdown of Chinese manufacturing, which makes up over 25% of its economy. If China weakens
substantially, the global economy will feel it and it could hurt global growth and stock prices.

If it sounds like a Catch-22, it's because it is. But it's only a Catch-22 if the yuan rapidly and sharply appreciates against the dollar. What I would rather see is a gradual move toward greater flexibility, much like China started back in 2010. By some estimates, the yuan could be undervalued by 25%, so moving the trading band by a few percentages each year could be a smart solution to leveling the playing field, and to making removal of the peg easier when that day finally comes.

Currency hardliners would like to think that the solution is as simple as, "let the currency float and the free market will handle the rest." But it's not that simple - considering these pros and cons below will underscore why.

**Pros to Letting the Yuan Float**

**Helps U.S. Exports** – and European exports, for that matter. If the playing field is leveled and all of a sudden China may not be the best solution for cheap goods and production, the attractiveness of U.S. and European goods inherently rises. That could even lead to some manufacturing jobs returning to the U.S.

**Promotes New Types of Investment in China** – if China and multinationals lose their "subsidy" for expanding the manufacturing sector, it could free up capital for investment in other areas like expanding the service economy and promoting domestic consumption.

**Empowers the Chinese Consumer** – speaking of domestic consumption, the middle class in China is one of the fastest growing demographics in the world. If their currency goes a longer way towards purchasing goods in the global economy, everybody wins.

**Creates New Wealth for Emerging Industrial Countries** – if the cost of manufacturing in China rises with a rising yuan it could open new doors for other industrial nations with cheap labor, like Mexico and Vietnam. If there's one thing you can be fairly certain of, it's that multinationals will find a place with cheaper cost of production and move there. Doing so could help an emerging economy really gain steam and create new wealth.

**Cons to a Rapidly Appreciating Yuan**

**Chinese Exports Hurt** – If the manufacturing boom slows or even contracts, it could affect China's overall growth rate. As the second largest economy in the world, China is a hugely meaningful component to global GDP. Softening global GDP could threaten stock prices.

**Softens China's Demand for U.S. Treasuries** - China sells yuan and buys dollars to control the currency, but they recycle those dollars to buy U.S. Treasuries. Doing so helps the US finance our budget deficits. If the yuan floats, Chinese demand could sap.
Higher Production Costs for Some U.S. Multinationals – as production costs rise, those could get passed along to the consumer. Over time, those multinationals will likely seek cheaper production and move operations (a positive), but in the short term it could affect prices.

The Bottom Line for Investors

Having the yuan float is a tricky issue – both economically and politically – and I’m not sure there’s a perfect solution. Regardless, the bottom line is that any change will happen only gradually, which should give the market plenty of time to digest the economic effect one way or the other. If the announcement comes that China is ready to move the trading band for the currency again, or even ready to let it float, I think there will be some clear winners and losers to emerge and investment implications would likely apply. Until then, it’s a wait-and-see.

Regardless of whether China decides to float its currency (or not), its power comes from exports to America. But, what is the outlook for U.S. markets and our domestic demand? What are Zacks' predictions concerning Exports, Imports and Net Exports?

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It includes the first forecast prepared entirely with our new macroeconomic model, MA/US 2015 and contains some surprising twists. There are opportunities, but also some ringing alarm bells regarding growth, the upside of the S&P 500, and, yes, China. I strongly encourage you to read it.

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