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Yuan Devaluation Shaking World Economy and Oil Market

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On August 13, the benchmark West Texas Intermediate crude oil futures price (the daily closing price for the front-month contract) fell by $1.07 per barrel from the previous day to this year's new low of $42.33/bbl, slipping below the year's previous low of $43.46/bbl posted on March 17 after a plunge since late last year. The intraday low for August 13 stood at $41.91/bbl, close to the psychologically important barrier of $40/bbl.

The WTI price bottomed out after the low in March and stayed in a $50-60/bbl range in April and a $50-70/bbl range in May and June. Its high for this year was $61.43/bbl on June 10. From the high, the August 13 level represented a sharp fall of some $19/bbl or 31%. The WTI price gradually declined from July and hit this year's new low on August 13, indicating a double dip situation. Future developments are difficult to predict.

As noted in my previous special bulletin on “A Japanese Perspective on the International Energy Landscape,” multiple factors have been behind the crude oil downslide since July. The first factor is a basic oversupply. The second is a downside risk fear for Greek, Chinese and other economies. Coming third is a high oil production level maintained by the Organization of the Petroleum Exporting Countries. The fourth factor is the presence of shale oil production indicating a strong resistance to low oil prices. The fifth is Iranian crude oil's expected comeback to the international oil market after Western countries' future termination of sanctions on Iran. Among other factors may be financial ones like the dollar's strength and an expected U.S. interest rate hike, as well as a risk-off situation emerging from the destabilization of the Shanghai stock market.

But there is a new factor among those behind the latest fall to this year's new low. That is China's decision to devalue the yuan, which surprised market participants.

Among Chinese factors, the economic growth deceleration and the plunge and destabilization on the Shanghai stock market had played a role in pushing down oil prices earlier, as explained above. The economic growth and Shanghai stock market factors had already been discounted into the market in the absence of no major changes regarding these factors. But the People's Bank of China announced a decision on August 11 to lower the target value of the yuan against the U.S. dollar by 2% from the previous day, astonishing market players throughout the world.

The yuan devaluation continued for three days until August 13, bringing the total devaluation to 4.5%. (On August 14, the Chinese central bank raised the target value by 0.05% from the previous day, indicating an end to the yuan devaluation for the immediate future.)

The Chinese authorities described the yuan devaluation as the first phase of a foreign exchange market reform to make even the controlled yuan value close to the market's prevailing level by raising or lowering the target closer to the previous day's closing market rate. On August 14, the Chinese central bank raised the target by 0.05% to end the yuan devaluation campaign for the immediate future, allowing the market to take a breather. The lingering key problem is how the Chinese authorities would move the target value for the yuan in response to future market developments.

A key reason the yuan devaluation campaign shocked the market is that many market players interpreted the campaign as being designed to stimulate China's exports and its economy and grew confident that Chinese economic conditions have deteriorated to such an extent. Direct market intervention to devalue a currency can eventually lead to an international currency-devaluing race to shake the world economy. For China that is the second largest economy in the world, such a measure is a risky one that could expose the country to severe denunciation by its major trading partners. Market players speculate that if the authorities implemented the measure while acknowledging such result, it may indicate that economic conditions have worsened to the extent where some action must be taken.

As noted above, the Chinese authorities have explained the yuan devaluation as part of a market reform rather than as a measure to stimulate exports. But many market players do not seem to be convinced by the explanation. The successive yuan devaluation has led to a global stock market decline to destabilize the world economy. The currency devaluation has prompted some people to anticipate a capital flight from China. Given the international criticism and serious adverse effects, some market players suspect a pause in the yuan devaluation campaign.

But the problem is the great significance of the Chinese economy for the world. If China's real economic conditions are worse than conceived at present, it may have great impacts on countries for which China is a key economic, trading partner. The United States, Europe (including Germany), Japan and other major Asian countries cannot brush off the problem, which also has great impacts on resource-rich countries that depend heavily on China's demand and import expansion.

The Greek debt problem and the Shanghai stock market plunge since July had already made market players in the world nervous before the yuan devaluation problem emerged as a new major destabilizing factor. As a matter of course, the yuan devaluation, if not substantial, may contribute to stimulating the Chinese economy to the advantage of the world economy. In this sense, the situation is not simple. We may have to carefully watch Chinese economic conditions, market and policy trends and their impacts in the future.

The yuan devaluation has emerged as a new component of the so-called China risk, shaking the world economy and affecting crude oil prices. For the double-dip oil market, Chinese economic developments may remain the largest uncertain factor.

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