Everything is Connected

Marc-Antoine Collard
Chief Economist
Industry Experience: 12 yrs.
Joined Rothschild in 2013.

The headwinds and tailwinds facing individual economies often differ substantially. Moreover, what might provide a tailwind for a net-importer—such as falling energy prices—might be a headwind for a commodity-exporting nation. While each economy faces its own unique circumstances, global participants have become increasingly interconnected. To discuss this theme further, we recently sat down with Marc-Antoine Collard, Chief Economist at Rothschild.

Q: Let's talk about connectivity. One area you have discussed before is how we are truly a global economy. Past events, such as the Asia Crisis of the late 1990s, had a significant local impact but were less impactful for developed countries. Now that emerging markets are becoming larger economies, not only with respect to trade but also financial linkages, does this global connectivity perhaps have a dark side?

Collard: Yes, this is a potential concern. During the Asian Crisis, the situation was very different. At that time, I'd say the main thread of connectivity was through trade. So that's why when you had the Asian Crisis the impact on the advanced economies was much limited.

Now, not only do we have more connected trade around the world, but we also have financial linkages that are much stronger today than they were back then.

For example, today you have corporates in Brazil that have loans from European banks denominated in U.S. dollars. It means that, if there is a slowdown in Brazil, and the Real depreciates, not only are these corporates hurt because the economy is in recession, but also because they have to repay the loans in U.S. dollars. So when their local currency depreciates, it becomes more expensive to service that debt; if on top of that you have an increasing interest rate in the U.S., it becomes very problematic for these corporates. Even though the direct link in this example is with European banks, European banks are also linked with the U.S., and so indirectly, you have this link between Brazil and U.S. So it gives you an example of how everything is much more inter-connected than before.

“Financial linkages are much stronger today.”

Q: There’s been some discussion that China could just simply devalue its currency to avoid a hard landing. What do you think the knock-on effects would be, not just for the U.S. market but for some of the commodity-producing economies worldwide?

Collard: Well, I think when you look at the dynamics behind the devaluation, on one hand, you might get through time a volume effect on your exports; but on your import side, you have a price effect, which means that when you devalue your currency, everything you import is suddenly much more expensive. So the import effects are immediate, whereas the potential positive volume effect on exports is realized over time. So when you devaluate, usually you have a deterioration in your current account balance because the trade balance worsens.

So for China, it would mean that countries that are trading with China will suffer from that because China will consume less, including less commodities. For commodity producers, that will also present a significant negative effect. So overall, Chinese trading partners might gain through time but the immediate impact would be negative, especially for commodity producers. When you consider the impact on these countries, it’s very relevant for any global outlook. So I’m not sure if Chinese devaluation will be a necessarily good thing for the world economy, not to mention the uncertainty that it will bring to the financial sector. We’ve seen this in 2015: when you have a devaluation of the yuan, you get a big reaction in the market.

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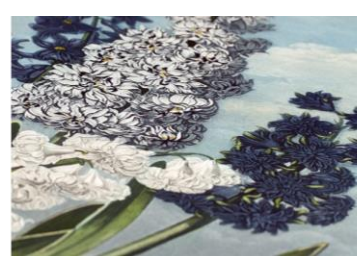
Benjamin Poor, Head of North America Marketing
at benjamin.poor@rothschild.com



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