Let’s hear from the experts - USA & China Trade War and its Impact to our Foreign Reserve

Op-Ed by Natasha Eddie, Ali Homelo, Charlie Kuper

The past two Sunday’s we looked at what Foreign Reserves is, its importance and some technical aspects to it. I had an opportunity to discuss with Mr Ali Homelo, Chief Manager Financial Market and Exchange Control Department of CBSI, the USA & China Trade War saga. And get contributions from Charlie Kuper, a Senior Investment Analyst for Financial Market and Exchange Control Department. I was keen to get their views on the global trade war and its likely impact to our Foreign Reserves. In this article the views and opinions expressed are of the contributors and do not necessarily reflect the policies and standing of CBSI.

To begin, this escalating trade tensions between the USA and China have been all over the news for the last several months and you may be wondering how this trade war could affect our country, especially on our foreign reserves. It is apparent that the US-China trade disputes have affected global trade. The world is experiencing a global economic slowdown, fuelled by the USA protectionism policy and many other geopolitical tensions including the Brexit issue. These geopolitical tensions have caused much fear and uncertainty for many countries, including the Pacific region in terms of the economic outlook and global trade prospects. For Solomon Islands, the impact may seem vague but the implications are significant not to ignore. The obvious global implication so far arising from the USA-CHINA trade tensions are on the following macroeconomic market indicators

1. Interest Rates Market
2. Exchange Rates Movement
3. Possible Inflationary pressure

Recently we have seen the major global Central Banks responded by taking proactive monetary policy stance in light of the concerns of global economic slowdown. Such policy decisions are intended to manage and insulate their economies, not only from the impact of the global trade tensions but also as a response to subdued inflation growth, which have remained low for some time. Indeed, many central banks have undertaken quantitative easing monetary policy measures, which basically means cutting the policy rate. By cutting the policy rate, it effectively lowers the cost of borrowing and free up money for productive investments in the economy. The overall objective is to maintain, stimulate and drive growth in their local economy, a responsive measure to boost confidence and manage growth amidst the global growth uncertainty. Consequently, lowering the policy rates have resulted in the decline of global financial market interest rates. We have seen the US Federal Reserve cutting its policy rate for the first time since 2008 from 2.5 percent to 2.25 percent in July and then again another 25 basis points cut in September to 2.0 percent. As a result, the Reserve Bank of Australia followed suit, cutting its policy rate three times this year from 1.5 percent to 1.25 percent and then 1.0 percent. Its most recent rate cut on 1st of October 2019 moved the policy rate to 0.75 percent. The lowest policy rate recorded for Australia. The Reserve Bank of New Zealand, India and other emerging economies have also taken the similar measures by cutting their policy rates.

What effects would the fall in Global interest rates have on our Foreign Reserves?

While the global market interest rates fall, indirectly it leads to minimal investment opportunities for our foreign reserves because of very low interest rate offers in the market. In terms of yield, this means lower returns on conventional investment asset classes. However, the tactical investment options in such a scenario would be for us to look at safe haven or low risk investments like government securities and gold market. Government fixed securities (bonds and notes) often are considered safe. Central banks have a duty to ensure the safety of foreign reserves from inherent risks including interest rate risks, hence, do not engage in speculative investments.

How it will affect our Exchange Rate Market

On the one hand, this situation has had an obvious impact on the exchange rate market. One interesting phenomenon is that, the USD has not weakened inspite of the US Federal Reserve cutting its policy rate. The USD continued to strengthen against most global trading currencies. On a bilateral basis, we have seen our Solomon Islands Dollar weakened against the basket index, which was driven largely by stronger USD. On the other hand, the SBD strengthened against the Australian Dollar. Gold price also increased, following high uncertainty in the global financial market, as investors looked to hedge in gold as a safe haven, the high demand for gold has driven its price above the USD1, 500 per ounce mark. So, in context, the weaker the Solomon Dollar against the basket index or the US Dollar, the better it will be for our export industry and remittances, which in turn contribute to our foreign reserves growth. However, on the flip side, our importers might be worse off with a weaker SBD as it will be too expensive to buy imported items in US Dollar. Conversely, our SBD experienced relative strength against the Australian dollar, so it might perhaps be cheaper to import in AUD than in US Dollar. On the potential inflation: The weakening of our Solomon dollar against US dollar in the above context, also points to a potential inflationary pressure, particularly on imported inflation. However, the prospects for such a scenario may be minimal in the medium term given (amongst many other factors) lower commodity prices.

The US - China trade tension, although is a threat to global growth and trade, in a sense, does seem to have both a positive and negative window of opportunity for Solomon Islands. For instance, if we are exporting our products to US or China, we might benefit from the competitive prices in both markets due to the exchange rate differentials. The US and China are imposing rounds of tariffs on selected products, ramping up the domestic retail prices. This scenario means that both countries will tend to seek alternative import substitutes from other countries where comparative products will be cheaper.

Some developing and emerging economies have taken advantage of the opportunity to gain positively from the US – China trade spat. For Solomon Islands, we too, stand to benefit from the trade war in terms of our forestry, agricultural and marine exports, which feeds the Chinese import appetite for primary products. However, given that China has responded to US Tariffs by manipulating its currency against the USD, it might have unintended consequences to the price of our raw material exports to China.

With the status of our foreign reserves, sitting on a comfortable adequacy level, it is safe to say that the escalating global trade tensions may have minimal or no direct impact on our foreign reserves for now, but may pose indirect instability in our financial market and domestic growth of our local economy.

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