



Sinology

by Andy Rothman

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- * I believe President Trump still wants to sign a trade deal with Xi, because Trump recognizes that a deal is better than no deal for his re-election prospects. A 2H19 deal is possible.
- * No trade deal would mean continued taxes on Chinese goods, paid for by American families.

CHINA'S CURRENCY MANIPULATION— A SIGN OF PANIC OR A CUNNING PLAN?

Over the past several months, there has been hype about the prospect of the Chinese renminbi (RMB) weakening past 7 per U.S. dollar, despite no evidence that 7 is a magical number. China's central bank, People's Bank of China (PBOC), had denied that it was focused on defending 7, and the IMF said it wasn't significant. So when the RMB finally broke 7, the media treated it as a dramatic event, but I believe, this will soon pass.

It is likely that the timing of the move was deliberate, following President Trump's latest round of tariffs last week.

A sign of panic?

In a Monday morning tweet, President Trump responded to a depreciating Chinese renminbi by stating, "It's called 'currency manipulation.' "

The decision to tag China as a currency manipulator was either a sign of panic, or a cunning plan. Or a bit of both.

My interpretation of yesterday's tweet is that the president still wants to sign a trade deal with Chinese President Xi, because Trump recognizes that a deal is better than no deal for his re-election prospects.

No deal would mean continued taxes on Chinese goods, paid for by American families. (And the next round of tariffs would fall largely on consumer goods, which had previously been spared because of the direct impact on voters.) No deal would mean a continued Chinese boycott of American soybeans, which is contributing to harsh conditions for farmers in politically important states. No deal would mean continued economic uncertainty, which is leading to weaker corporate capex and worries about a recession. Moreover, the prospect of no deal, and an escalation of the tariff dispute into a full-blown trade war, has had a clear, negative impact on investor sentiment.

I believe Trump wants a deal, but is struggling to find a way to close the deal.

Given that the currency manipulator label carries no concrete consequences, Xi is unlikely to feel more pressure to sign a deal that he believes is disadvantageous. He may see the accusation as a sign of panic. I believe the timing of latest currency move was a short-term political signal by Xi.

Xi is unlikely to resort to a significant devaluation to respond to Trump, in my view. The tariffs are having little direct impact on China's economy (net exports were less than 1% of China's GDP last year, and only 20% of total exports went to the U.S.), and Xi has far better tools to deal with the more significant indirect impact: weak confidence by manufacturers, who have slowed output and deferred investment. Further, China's consumer story—the largest part of its economy—remains pretty healthy, as does employment and wage growth, so there is no reason for Xi to panic.

A cunning plan?

In the past, Treasury Secretary Steven Mnuchin ignored the president's calls to

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tag China as a currency manipulator. And when the law required a formal ruling on the question, Mnuchin—following in the footsteps of many Democratic and Republican predecessors—declared that China was not a manipulator.

His last finding was just a few months ago, on May 28, when Mnuchin informed Congress that China did not meet the criteria for being designated as a currency manipulator under either the 1988 or 2015 legislation.

Yesterday, however, just several hours after Trump's tweet, Mnuchin issued a press release designating China as a currency manipulator under the 1988 legislation. "In recent days, China has taken concrete steps to devalue its currency...to gain an unfair competitive advantage in international trade," according to the press statement.

What changed between May 28 and Monday that led Mnuchin to reverse course?

During that period, the RMB depreciated by all of 0.4% against the dollar. Was that enough to justify a change in policy? Was that sufficient to provide, as the Treasury press release claimed, "an unfair competitive advantage in international trade."

The timing of Xi's decision to relax his central bank's interventions that had for many months prevented market forces from pushing the RMB below 7 was clearly politically motivated, in response to Trump's August 1 announcement of additional taxes on Chinese goods. But this market pressure itself was the result of uncertainty created by the Trump tariffs, and Xi's action was modest: The PBOC lowered its target rate for the currency by only 0.3%, although market forces pushed it down further.

Here's another way to look at it: between Trump's August 1 announcement of additional taxes and Monday's currency manipulation decision, the RMB depreciated 0.3% against the dollar.

Yet another perspective: over the course of 2019, the RMB is behaving as it has in recent years, with its direction vs. the dollar determined by the strength or weakness of the dollar. Year to date, the RMB is down 1.5% vs. the dollar, while the U.S. Dollar Index (DXY) is up 1.5%.

(China has in fact been manipulating its currency to stop market forces from weakening it even more. The Trump administration wants them to stop? And on Tuesday, China's central bank guided the exchange rate a bit higher, consistent with its statement that they are "not carrying out competitive devaluation.")

It is fair to conclude that little has changed since the Treasury's May 28 decision that China did not meet the legislative criteria for currency manipulation.

So, did Mnuchin change course yesterday simply due to pressure from his boss?

Or, was it part of a cunning plan?

Yesterday's press release says, "As a result of this determination, Secretary Mnuchin will engage with the International Monetary Fund to eliminate the unfair competitive advantage created by China's latest actions." Well, we know that the IMF believes the RMB is roughly fairly valued, so this is unlikely to worry Xi.

Did Mnuchin decide that designating China as a manipulator might calm the president without blowing up the trade talks, because there are no consequences to the designation? Mnuchin may have decided that this course of action would lead Trump to give U.S. Trade Representative Robert Lighthizer and him more time to negotiate with their Chinese counterparts, in an effort to reach the deal that Trump knows he needs, but doesn't know how to achieve.

If they are given room to negotiate, I think a deal can be reached by the end

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of the year, as I believe that Xi continues to want to reach a deal. While tariffs are not a huge problem, as China is no longer an export-led economy, failure to conclude a deal would open up the risk that a full-blown trade war leads to restrictions on China's access to American tech, everything from semiconductors to research collaboration. That would be a setback to China's economic growth, which Xi wants to avoid.

Regards,

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Sources: Matthews Asia, CEIC