CHINA Insights

Trade war 2.0 and its impact on RMB

Monday, May 13, 2019

Highlights:

- **The sudden unexpected collapse is a surprise. However, it does not mean the end of US-China trade talk.**
- **There are four core discrepancies yet to be agreed.**
- **Impact on the economy remains uncertain.**
- **China is unlikely to engineer RMB deprecation to counter the tariff.**
- **The near term RMB depreciation pressure may depend on three factors including the size of China's retaliation package, US's plan to impose tariff on the remaining US$325 billion products and market's assessment on whether the setback is temporary or not.**

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No miracle. The USTR raised the additional tariff on US$200 billion Chinese products to 25% from 10% on Friday as planned, marking the escalation of the trade war. However, this does not mean the end of US-China trade talk though the talk was shadowed by the rise of tariff. Both sides are still trying to narrow the differences but failed to reach any conclusion last Friday. The negotiation has met the obstacles as China has stepped up its defence of its basic principles.

Since last December, the relationship between US and China has improved steadily albeit gradually, the sudden unexpected collapse ahead of the final step to ink a 150-page long trade deal caught market by surprise.

What has happened?

With more information being unveiled by both sides, it is getting clearer that there are possible four core discrepancies yet to be agreed.

The whole drama started from 3rd May according to the US side after the US received the modified version of trade deal from its Chinese counterparty omitting the part of change of laws as demanded by the US side. This was read by Lighthizer as backtracking of previous agreements, which led to Trump's twitter on 5 May.

The initial hope that Trump's twitter may be part of his negotiating strategy proved to be wrong as it was mainly the reflection of the anger from the US side on the slow progress of trade talk. In the hindsight, market has underestimated the discrepancies between both sides. Based on the current clues from the both sides, we think there are four core concerns for the upcoming negotiations.

Four core discrepancies

First, the US wants to secure China's regulatory commitment via the change of law endorsed by National People's Congress rather than via the guidance from the State Council or respective ministries. This may touch China's red line. As mentioned by Vice Premier Liu He last week, China wants a balanced text of the deal to ensure the dignity of both nations. The different understanding about the dignity may be one of the key hurdles for the negotiation.

Second, China wants to remove the entire existing additional tariff should a deal be reached. However, it seems that Trump administration is unwilling to compromise. Trump has repeatedly shows his satisfactory about the increasing tax receivable via the tariff. He even argues that US may use the money from tariff to purchase agriculture products from US farmers who were affected the trade war.

Third, the aggressive enforcement mechanism, which may allow the US to re-impose tariff unilaterally should China fail to comply with the trade deal, may also be unacceptable to Chinese government.

Fourth, the possible increase of targets for Chinese purchase may also contribute to the stall of trade talk. China's Vice Premier Liu He said that the amount of purchase should be in line with reality.

Impact on economy remains uncertain

With the new tariff being imposed, the marginal impact of tariff on Chinese economy is likely to be significant as not may Chinese exporters are able to handle 25% tariff as compared to 10% tariff due to their thin margin. However, the impact on the economy remains uncertain as it depends on which side will eventually be responsible for those tariffs. It is not necessary that the tariff will be paid by Chinese manufacturers.

China is unlikely to engineer RMB deprecation

The impact on market is more straight-forward. RMB weakened as expected with the USDCNY moved from 6.70 range to 6.80 range. RMB weakened by about 10% against the US dollar in 2018, partially helping counter the impact of tariff. However, we think China is unlikely to engineer 25% depreciation to counter the impact of tariff as the cost of capital outflows amid the shrinking current account surplus may outweigh the benefit of supporting export. **The pressure on RMB depreciation may depend on three near-term factors.**

First, China has mentioned clearly it will retaliate. We think there is good chance that China will follow up with the retaliation measures this week. However, it is not clear whether those retaliations will be measured or tit-for-tat. Should China's retaliation is controlled; the pressure on RMB depreciation may be lesser.

Second, it may also depend on how soon Trump administration will target the remaining US$325 billion Chinese products, which are still not subject to additional tariff. It was reported that Lighthizer will release details of plans on Monday. Trump also threatened in his twitter over the weekend that China would get far worse deal in his second term unless China acts now. The pressure on RMB will probably also depend on market's assessment on whether the trade war will eventually become a full-blown war.

Third, it will also depend on market's hope whether the recent setback is temporary. Clearly the negotiation will continue as mentioned by both sides. Meanwhile, Trump's economic advisor Kudlow also said that President Trump and President Xi may meet at G20 meeting. The door is still open though the uncertainty remains high. As such, market may trade on headlines and expectations whether both sides are ready to move ahead. Should expectation on total break-up dominate, RMB index may first slip back to 2018 low of 92. This may suggest that the USDCNY may test 6.98 based on current cross currency data. Nevertheless, should the expectation that the recent setback is temporary dominate, the USDCNY may be able to consolidate in the 6.80-6.90 range.

Co.Reg.no.:193200032W