

A vicious cycle

Tommy Xie Dongming
Economist
+65 6530 7256
xied@ocbc.com

- The off the cycle announcement by US Treasury to name China as the currency manipulator shows that the US China tension has been officially escalated from trade war to financial/currency war.
- It will be a long process as the US President will take punitive actions only after the negotiation to correct undervalued currency fails in one-year time.
- The hope for a quick turnaround of trade war wanes given China's character of never giving in to pressure and aggressive push.
- Two possible scenarios for RMB in the near term.
- In the medium term, we cannot rule out the risk for Trump Administration to increase the tariff further.

The US Treasury named China as the currency manipulator for the first time in 25 years although China does not meet the criteria for currency manipulator set by the US Treasury. The off the cycle announcement by US Treasury shows that the US China tension has been officially escalated from trade war to financial/currency war.

What's next?

Theoretically the US Treasury will hold special talks with the country to correct an undervalued currency for one year. According to the <Trade facilitation of trade enforcement act of 2015>, should the Treasury Secretary determine that the country has failed to adopt appropriate policies to correct the undervaluation and surpluses, the US President shall take the punitive actions after one year as below.

The US President shall take one or more of the following actions:	
1)	Prohibit the Overseas Private Investment Corporation from approving any new financing (including any insurance, reinsurance, or guarantee) with respect to a project located in that country
2)	Prohibit the Federal government from procuring or entering into any contract for the procurement of goods or services from that country.
3)	Instruct the US Executive Director of IMF to call for additional rigorous surveillance of the macroeconomic and exchange rate policies of that country and as appropriate formal consultations on findings of currency manipulation.
4)	Instruct the US Trade Representative to take into account in consultation with the Secretary in assessing whether to enter into a bilateral or regional trade agreement with that country or to initiate or participate in negotiations with respect to a bilateral or regional trade agreement.

Source: <Trade facilitation of trade enforcement act of 2015>

As such, it is usually a long process for both countries to negotiate.

In addition, in the past, tariff has usually been used as the threat by the US to force the currency manipulator to correct the undervalued currency. That's probably not the case for this time as the US administration has already imposed the hefty tariff on Chinese imports. The name of currency manipulator was more like justifying US's decision to impose additional tariff.

Implications

The immediate impact of the currency manipulator on RMB is limited in our view. We see two possible near term impacts. First, the escalation of trade war will probably reinforce expectation on the September rate cut by the Fed. Second, the hope for a quick turnaround of trade war wanes given China's character of never giving in to pressure and aggressive push.

Impact on RMB

There are two possible scenarios in the near term: First, the fixing for the next few days will be important. The RMB fixing was set at 6.9683 on 6 August, stronger than market expectation. Together with the news that PBoC will issue CNY30 billion PBoC bills in Hong Kong on 14 August, it shows that RMB depreciation is not a one-way bet. Should the fixing be fixed below 7 for a few consecutive days, market may calm down. And the USDCNY may be traded around 7 in the spot market.

Second, should China allow the market to set the daily fixing, the USDCNY may drift higher with the next equilibrium level could be around 7.2 (5% above pre-trade war level of 6.87 to reflect the impact of trade war).

In the medium term, the currency of a "currency manipulator" country tends to appreciate. Will RMB appreciate in the medium term? It probably depends on the progress of US-China trade. Nevertheless, we cannot rule out the risk that the Trump Administration may increase the tariff further on Chinese imports to 40%, which may further weigh down on RMB.

Treasury Research & Strategy

Macro Research

Selena Ling

Head of Strategy & Research
LingSSSelena@ocbc.com

Emmanuel Ng

Senior FX Strategist
NqCYEmmanuel@ocbc.com

Tommy Xie Dongming

Head of Greater China Research
XieD@ocbc.com

Terence Wu

FX Strategist
TerenceWu@ocbc.com

Howie Lee

Thailand, Korea & Commodities
HowieLee@ocbc.com

Alan Lau

Malaysia & Indonesia
AlanLau@ocbc.com

Carie Li

Hong Kong & Macau
carierli@ocbcwh.com

Dick Yu

Hong Kong & Macau
dicksnyu@ocbc.local

Credit Research

Andrew Wong

Credit Research Analyst
WongVKAM@ocbc.com

Ezien Hoo

Credit Research Analyst
EzienHoo@ocbc.com

Wong Hong Wei

Credit Research Analyst
WongHongWei@ocbc.com

Seow Zhi Qi

Credit Research Analyst
ZhiQiSeow@ocbc.com

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