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ECONOTE No. 75 Weaponising forex rates in the tariff war: The case of the CNY 28/8/2018

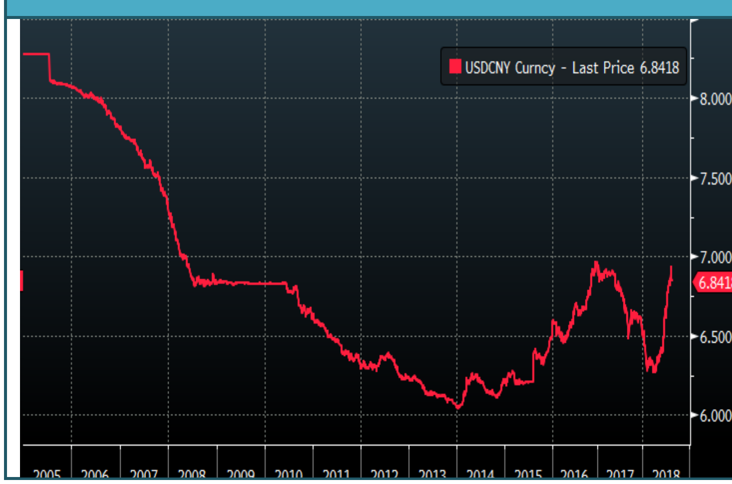
Summary	Investment Conclusions
The USD/CNY forex rate is a managed rate, but by no means fixed. The fixing of the rate is supported by capital controls, meaning that the CNY is not freely convertible for capital account purposes although it trades relatively freely for the trade account balance. Capital controls in China have been continuously varied or slowly removed. However, Chinese residents and foreigners cannot still dispose freely of their CNY balances for USD. The recent weakening of the USD/CNY has been the result of a number of confluent developments but cannot be considered as establishing a permanent trend in response to the US tariff war on China.	The 12M outlook of USD/CNY, is likely to be characterized by a flattening out of the depreciation of the CNY followed by stability, but, unlikely to strengthen again to pre-June 2018 levels. The Chinese authorities will not want to appear that they countered the US tariffs by forex depreciation, but equally, given their past performances, they will move cautiously and selectively. Hence the recent depreciation by 9.5 % can be considered consistent with current macro and political developments and likely to define the maximum range of movements in the next 12 months

A brief history of recent CNY policy

Fig.1 shows nearly 19 years of USD/CNY movements and policy stages.Whatever else can be said for the CNY it can not be called “peggd to the USD” or inflexible.One of the main accusations of the US against China has been that it had kept its exchange rate, on purpose, undervalued in order to support its exports.Although the issue of measuring undervaluation is highly controvertial,it is clear that the CNY over the 2005-2013 period appreciated by about 30.0%, or an average of 3.3% pa.Since 2014 the policy has been far more selective including periods of depreciation (2014-2016), appreciation(2017) and deprection again. Since 2015 the PBOC set a daily dollar reference rate from which the CNY was allowed to move by 2% in either direction during onshore trading. The PBOC set the reference rate in line with the currency’s previous day’s close against the dollar as well as dollar movements in overnight trading in global markets. An attempt at market reform in August 2015 caused forex volatility, as well as capital flight in the second half of 2015 and early 2016, forcing the government to introduce tighter capital controls.

Why the recent depreciation ? (1) Signs of the economy weakening.All this is relative as GDP grew during 2Q.18 at a respectable 6.7 % yoy. (2) Negative sentiment, also driven by the poor performance of the stock market.(3)The tariff war.For now, the amount of exports to the US subject to tariffs is too small to make any significant impact to China’s GDP growth, which, in any case, is not and has not been, export driven despite widespread belief to the contrary.

Fig 1. USD/CNY 2005-2018



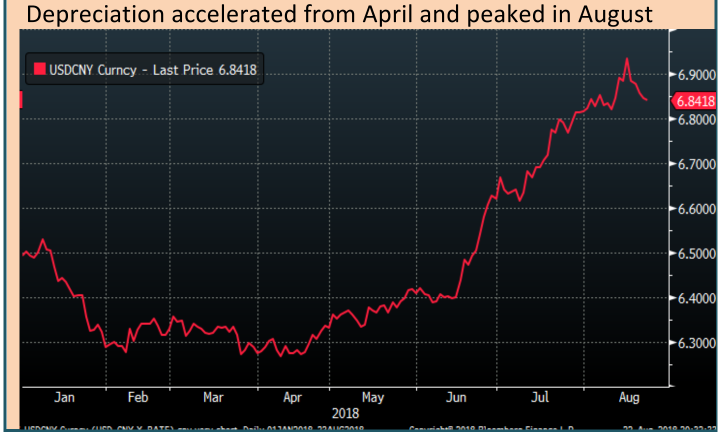
Source: Bloomberg

What happens next ?

Assuming that China had depreciated its currency in order to counteract the US tariffs, its competitive edge should not be judged solely on absolute terms, 9.5 % depreciation versus the USD, as all other major currencies such as the EU, GBP, JPY have also weakened versus the USD. In Fig.2 we show the USD index DXY which consists of a weighted set of forex rates versus the USD (but not for the CNY) including those of EUR,GBP and JPY. The yellow line, DXY has risen sharply since March 2018 indicating the strengthening of the USD versus all other major currencies.The depreciation of the CNY has not quite matched that of the rise of the DXY and, hence, in relative terms it might have even appreciated versus other major currencies ! This can be used as one more argument against the notion that the CNY forex rate has been weaponised versus the USD and US tariffs.

Fact Box: USD/CNY Day by Day during 2018

Depreciation accelerated from April and peaked in August



Source: Bloomberg

During August 2018, the PBOC introduced a measure broadly termed as" countercyclical factor" which is basically a form of intervention designed to slow down and even reverse the recent depreciation. There was also the added consideration that the markets would have considered a USD/CNY of 7.0 as a psychological barrier, which may have added pressure to the forex reserves of the PBOC.

Fig.2: USD/CNY and Dollar Index 2017-1018 (2017=100)

Source: Bloomberg

Conclusions

The notion that exchange rates can be used to counter the US tariff increases is an attractive one but suffers from two main defects.Assuming an average tariff hike of 25.0% it is easy to think in terms of a 25.0% depreciation.This assumes that the tariff hike is passed on fully to the customers and ,hence , it needs a 25.0% forex adjustment.There is also the consideration and that the currency depreciation will increase the cost of imported inputs to China thus countering any beneficial impact the depreciation might have to final prices of Chinese imports to the US. This is of particular relevance to China whose main exports, electronic goods, contain a great deal of imported components and especially from the US.

We have offered here a number of reasons as well as evidence as to why the depreciation of the CNY is not part of the tariff war but is the result of a mixture of cyclical as well as of political considerations.The depreciation is unlikely to continue and, hence, the movements of the USD/CNY in the next 12 months may be contained within what has happened to the forex rate since roughly April 2018, that is a depreciation of 9.5%, which has now topped and even midldy reversed.

Andrew Freris (writing completed 28 August 2018)