Economics & Strategy

DBS Flash

Xi-Trump: Be realistic, not optimistic

Strategy/FX

Group Research

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- *Realistically, a trade deal is not expected at the Xi-Trump meeting during the Osaka G20 Summit on June 28.*
- *Having been "once bitten, twice shy", China is not keen on another trade truce like the one struck at Bueno Aires G20 last December.*
- *Any upside surprises will lead to a relief rally in the Chinese yuan; the US still needs to remove tariffs for an appreciation past 6.70*
- *The Chinese yuan has been stable in a 6.70-6.90 range after the first US tariffs hit last July. China believed that cooperation was the correct choice to resolve its trade differences with the US.*
- *This position may shift if China is convinced that Trump will not back down on using tariffs to force American demands in trade negotiations.*
- *If Trump decides, after his meeting with Xi, to impose a 25% tariff on the remaining USD325bn of Chinese goods, it will re-escalate the trade war and open the door for the yuan to depreciate well past 7.*

Don't expect too much out of the Xi-Trump meeting

The world will be longing for China and US to ease trade tensions at the 2019 G20 Summit in Osaka, Japan on June 28-29. No one truly believes either America or China will win the trade war. A lose-lose outcome for the global economy is, however, assured if the leaders of the world's two largest economies stop talking altogether.

Global financial markets cheered after US President Donald Trump tweeted, on June 18, about an "extended meeting" with Chinese President Xi Jinping at the summit. Trade negotiators from both countries are scheduled to meet in Osaka as early as June 25 to put together a plan before their leaders meet. This, however, does not imply that Xi-Trump will ink a trade deal. **Based on their positions, the bar is high for both sides to even resume trade talks.**

China is not keen on another trade truce like the one struck at last December's G20 Summit in Bueno Aires, Argentina. China does not want to go through multiple rounds of trade negotiations only to be accused by the US government of backtracking. In the end, the truce and talks merely pushed out, from January 1 to May 10, Trump's decision to increase US tariffs to 25% from 10% on USD200bn of Chinese goods. **China is unconvinced that more talks would avert Trump's threat to impose a 25% tariff on the remainder USD325bn of Chinese imports.**

According to its White Paper published on June 2, China has not only rejected the US government's accusation of its backtracking but put the blame solely on America for the severe setback to the China-US economic and trade consultations. **China would never compromise on major interests concerning its core interests.**

First, one of China's prerequisite for a trade deal is that the US should remove all tariffs on Chinese exports to its shores.

Second, China's purchases of US goods should be realistic. China complained that the more the US was offered, the more it wanted.

Third, China wants to achieve a proper balance in the text of the agreement to serve the common interests of both sides. For example, mutual respect means that any agreement should not force China to sacrifice its right to development or undermine its sovereignty. China would also require the US to exhibit good faith as the foundation of consultation.

Don't expect the US to give up on tariffs

Trump believes that tariffs work in forcing countries to stop migrant flows or accepting America's trade demands. Trump has not rescinded his threat to decide, after meeting Xi at the G20, whether to hit USD325bn of Chinese goods with a 25% tariff. **Trump has formally announced**, on June 18, **his 2020 re-election bid**. During his 2016 campaign, one key theme was to label China a currency manipulator and hit a 45% tariff on its goods into America.

The US wants a monitoring system to enforce the final trade agreement on China, and as a penalty for non-compliance, the right to impose more tariffs without retaliation. **The US Trade Representative's Office wants to include currency manipulation clauses into free trade agreements** like the one for the US-Mexico-Canada (USMCA) trade agreement that replaced NAFTA. **The US Commerce Department has proposed**, in a Federal Register notice on May 24, **a rule change to levy tariffs on products of countries found to have manipulated their currencies for trade advantages**. The Commerce Department will defer to the US Treasury Department (USTD) in identifying currency manipulators.

The USTD has, in its semi-annual Currency Report issued on May 28, **stepped up efforts to monitor more countries for unfair currency practices**. The USTD is no longer be limiting its examination to America's 12 largest partners. Under the new threshold, a wider net has been cast over 21 countries whose bilateral goods trade (exports plus imports) exceeded USD40bn in 2018. Collectively, these countries accounted for more than 80% of US goods trade last year. Every trading partner here had a bilateral trade surplus of more than USD20bn with the US.

New US Treasury Threshold Under the 2015 Act

Benchmark	Previous threshold	New Threshold
Currency Manipulator Criteria		
1) Bilateral trade surplus with US	USD20bn	USD20bn
2) Material current account surplus	3% of GDP	**2% of GDP**
3) Net FX purchases	2% of GDP for 8 of 12 month	2% of GDP for **6 of 12 months**
Major Trading Partner Coverage		
Total bilateral goods trade	12 largest trading partners	**USD40bn**

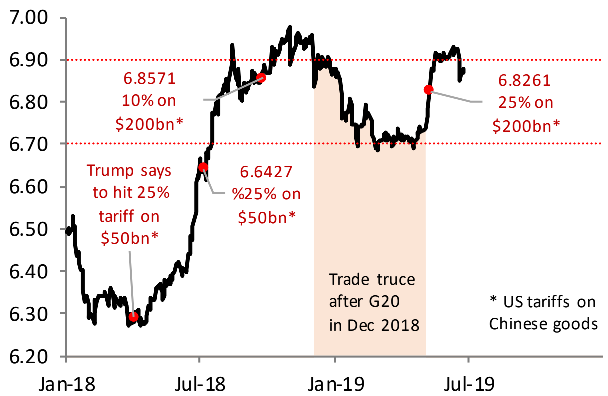
Source: Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the US, US Dept of the Treasury Office of International Affairs, May 2019

More importantly, **the USTD has tightened two out of the three criteria that will rule a country a currency manipulator** (see table). A country will be named a manipulator when it meets all three criteria. Meeting two out of the three criteria will earn it a place on the monitoring list. Based on the new criteria, the list has expanded from six to nine countries, six from Asia (China, Japan, South Korea, Singapore, Malaysia and Vietnam) and three from Europe (Germany, Italy and Ireland). The newbies (Singapore, Malaysia, Vietnam, Italy and Ireland) will need to stay on the list for at least two more reports.

Chinese yuan basically stable with a bearish tilt

The odds for a market positive outcome at the Xi-Trump meeting are lower than those for a disappointment. Both sides are far apart for a trade deal. Seeking a truce would require moving some red lines. Any upside surprises would be limited to a relief rally in the Chinese yuan. The US would need to roll back tariffs for the yuan to appreciate past 6.70 vs the USD.

USDCNY in a 6.70-6.90 "tariff war" range



Sources: DBS Research, Bloomberg data

The worst-case scenario is a re-escalation of trade war that opens the door for the Chinese yuan to depreciate past 7 vs the USD. Under this scenario, Trump would make good his threat to impose, after his meeting with Xi, to hit a 25% tariff on the remaining USD325bn of Chinese imports. The amount is more than the existing 25% tariff on the USD250bn that drove the yuan weaker from 6.30 to 6.90 during last year's tit-for-tat tariff war.

The People's Bank of China (PBOC) has pledged its readiness to ease monetary policy and sees room for fiscal policy to support the economy. The central bank has taken the view that yuan depreciation from trade tensions had been driven by market forces. The PBOC considers the level 7 as no more important than any other number. In fact, yuan flexibility will be desirable to act as a stabilizer for the balance of payments as well as to help ensure stability in the financial system.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).