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- *What has been the impact of trade wars on CNY so far? What would further tariffs mean for the currency?*
- *We do some back-of-the-envelope calculations to estimate effective tariff rates and their likely impact on the CNY*
- *If trade talks fail by end-February next year, we will expect USDCNY to cross 7 readily*
- *If trade wars escalate to the point of all Chinese goods being subject to 25% tariff, the currency will likely cross 8 against the USD*

China-US trade talks resume

Chinese President Xi Jinping and US President Donald Trump agreed, at the G20 Summit on December 1, to a 90-day ceasefire on their tit-for-tat trade tariff war. To facilitate trade negotiations, both countries will refrain from increasing tariffs on each other's goods until March 1, 2019. The US has effectively suspended its original plan to lift the US tariff rate on USD200bn of Chinese goods to 25% from 10% from 1 January 2019. Trump has also toned down his threat to impose tariffs on the remainder USD267bn worth of China's goods.

In the spirit of stress testing the impact of tariffs, already implemented or in the realms of possibility, we have devised a simple model.

Back-of-the-envelope calculation on the impact of US import tariffs on the CNY

Let's start with the three tranches of Chinese goods (USD50bn, USD200bn and USD267bn) that Trump has allocated for his import tariffs. The weighted tariff of each tranche is the product of its share of all goods and its respective tariff rate, which together, produce an effective tariff rate for all tranches. The base rate used to calculate the exchange rate needed to offset the impact from the effective tariff rate is 6.51, the end-2017 level for USD/CNY.

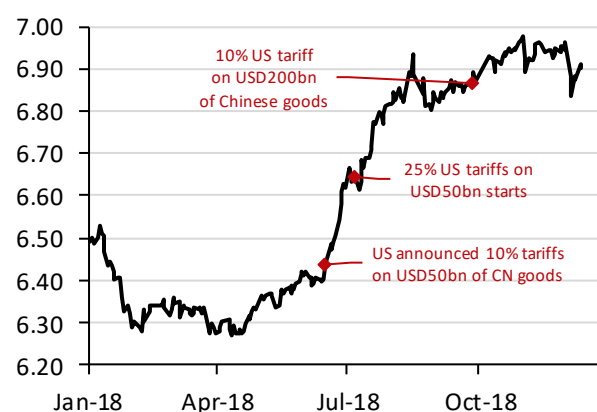
US tariff on Chinese goods – Phase 1

Imposed on China's goods		US tariff rate	
USD bn	% of total	Actual	Weighted
(a)	(b)	(c)	(d) = (b) x (c)
50	10%	25%	2%
200	39%	0%	0%
267	52%	0%	0%
517	100%	Effective rate	2.4%
Implied USD/CNY rate*			6.66

*calculated from 6.51, the end-2017 USD/CNY rate

During Phase 1, Trump hit USD50bn of Chinese goods with a 25% tariff rate. According to the above table, this would translate into an effective tariff rate 2.4%. To hypothetically offset the impact of the tariff, USD/CNY would need to rise to 6.66. Coincidentally, USD/CNY was around 6.64 on 6 July, the day the tariff took effect on the first USD34bn of goods.

USD/CNY has risen with US tariffs on Chinese goods



Sources: DBS Research, Bloomberg data

Similar results emerged when we back-tested Phase 2. USD/CNY averaged 6.92 after Trump hit an additional USD200bn worth of Chinese goods with a 10% tariff rate from 25 September. Uncannily, the implied USD/CNY rate was also 6.92 from the effective tariff rate of 6.3% for cumulative USD250bn of goods.

US tariffs on Chinese goods – Phase 2

Imposed on China's goods		US tariff rate	
USD bn (a)	% of total (b)	Actual (c)	Weighted (d) = (b) x (c)
50	10%	25%	2%
200	39%	10%	4%
267	52%	0%	0%
517	100%	Effective rate	6.3%
		Implied USD/CNY rate*	6.92

* calculated from 6.51, the end-2017 USD/CNY rate

USD/CNY to surpass 7 when trade talks fail

If the China-US trade talks fail to produce a deal after 90 days of negotiations, US President Trump will make good his pledge to become “Tariff Man” again.

US tariff on Chinese goods – Trade talks fail

Imposed on China's goods		US tariff rate	
USD bn (a)	% of total (b)	Actual (c)	Weighted (d) = (b) x (c)
50	10%	25%	2%
200	39%	25%	10%
267	52%	0%	0%
517	100%	Effective rate	12%
		Implied USD/CNY rate*	7.29

* calculated from 6.51, the end-2017 USD/CNY rate

The first step would be to reinstate the original decision to lift the tariff rate on USD200bn of Chinese goods to 25% from 10% from 1 March 2019. This would double the effective tariff rate to 12% for the cumulative USD250bn of goods and imply a USD/CNY rate near 7.30.

Hence, we have maintained our forecast for USD/CNY to hit 7.20 in mid-2019. At this juncture, it is prudent to be more cautious than optimistic about the trade talks between the world's two largest economies. Our forecast is also based on our expectation for three cuts in the reserve requirement ratio totaling 150-300 bps.

Worst-case scenario sees USD/CNY above 8

Trump has not rescinded his threat to impose tariffs on the remainder USD265bn of Chinese goods. Assuming no desire for future trade talks with China, the risk for Trump to the final tranche with a 25% tariff cannot be discounted.

US tariff on Chinese goods – Full-blown trade war

Imposed on China's goods		US tariff rate	
USD bn (a)	% of total (b)	Actual (c)	Weighted (d) = (b) x (c)
50	10%	25%	2%
200	39%	25%	10%
267	52%	25%	13%
517	100%	Effective rate	25%
		Implied USD/CNY rate*	8.13

* calculated from 6.51, the end-2017 USD/CNY rate

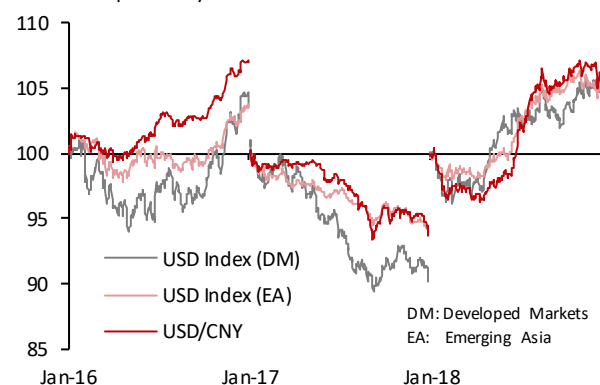
To offset the 25% tariff on all USD517bn headed to America, USD/CNY would hypothetically need to rise to 8.13. If this worst-case scenario materializes, the outlook for the yuan and other Asian currencies would need to be downgraded. Imposing tariffs on all of China's goods is expected to accelerate the slowdown in its economy.

Currency manipulation?

The above simulations do not imply that China is a currency manipulator. The yuan's one-off devaluation in August 2015 helped to realign it to the USD's resurgence.

USD/CNY is increasingly aligned with global USD trends

Indexed to previous year-end levels



Sources: DBS Research, Bloomberg data

Since then, USD/CNY has been tightening its relationship with the major USD indices in DM and Emerging Asia (EA), both in direction and magnitude. The yuan's correlation with the EA currencies has been particularly high at 94% in 2017 and 99% this year. That said, the correlation with DM currencies has also been meaningful at 87% in the past two years. This was easily explained by China's position as the top trading partner in most Asian countries and many DM countries.

Hence, the weaker yuan from failed trade talks would spill-over negatively into EA/DM currencies. Conversely, if the trade talks surprise on the upside (and remove tariffs), USD/CNY could find its way back to the 6.50 base level and bring the USD lower against EA/DM currencies.

Growth, Inflation, Policy Rates & FX forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018f	2019f	2020f	2017	2018f	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	7.1	6.7	7.1	7.4	4.5	3.6	4.0	4.2
Indonesia	5.1	5.1	5.2	5.1	3.8	3.2	3.8	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.1	2.5	1.6
Philippines**	6.7	6.3	6.5	6.4	2.9	5.3	4.7	3.8
Singapore	3.6	3.4	3.0	2.8	0.6	0.7	1.8	1.5
South Korea	3.1	2.7	2.6	2.4	1.9	1.6	1.7	1.6
Taiwan	3.1	2.7	2.2	1.8	0.6	1.5	1.0	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.4	1.5
Vietnam	6.8	6.9	6.6	6.3	3.5	3.6	3.8	3.4
Eurozone	2.5	1.9	1.8	1.8	1.5	1.8	1.4	1.4
Japan	1.9	1.0	1.0	0.5	0.5	1.0	1.1	1.6
United States***	2.3	3.0	2.5	1.5	2.1	2.6	2.5	2.5

* refers to year ending March ** new CPI series *** eop for CPI inflation

	Policy interest rates, eop							
	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.50	6.75	6.75	7.00	7.00	7.00	7.00	7.00
Indonesia	6.25	6.50	6.50	6.50	6.50	6.50	6.50	6.50
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.00	3.00
Philippines	5.00	5.25	5.25	5.25	5.25	5.25	5.25	5.25
Singapore**	2.10	2.30	2.55	2.70	2.70	2.70	2.70	2.70
South Korea	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.25	0.25	0.50	0.50
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00
United States	2.75	3.00	3.25	3.50	3.50	3.50	3.50	3.50

* 1-yr lending rate; ** 3M SOR; *** prime rate

	Exchange rates, eop							
	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
China	7.10	7.20	7.15	7.10	7.05	7.00	6.95	6.90
Hong Kong	7.85	7.85	7.84	7.83	7.82	7.81	7.80	7.79
India	74.0	75.0	76.0	77.0	76.5	76.0	75.5	75.0
Indonesia	15000	15200	15400	15600	15500	15400	15300	15200
Malaysia	4.25	4.30	4.28	4.25	4.23	4.20	4.18	4.15
Philippines	53.5	54.0	54.5	55.0	54.8	54.5	54.3	54.0
Singapore	1.42	1.44	1.43	1.42	1.41	1.40	1.39	1.38
South Korea	1180	1200	1190	1180	1170	1160	1150	1140
Thailand	33.5	34.0	33.8	33.5	33.3	33.0	32.8	32.5
Vietnam	23500	23600	23550	23500	23470	23440	23410	23380
Australia	0.68	0.66	0.67	0.68	0.69	0.70	0.71	0.72
Eurozone	1.10	1.08	1.09	1.10	1.11	1.12	1.13	1.14
Japan	116	118	117	116	115	114	113	112
United Kingdom	1.26	1.24	1.23	1.22	1.23	1.24	1.25	1.26

Australia, Eurozone and United Kingdom are direct quotes

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

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