China holds 'moral high ground'

Renminbi likely to stabilise further before June G20 summit

by Iris Pang in Hong Kong

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Beijing's response to Washington's tariff increase has, to date, been relatively mild. It raised retaliatory tariffs to 25% on a package of $60bn of imports from the US. This is considerably less than the US tariff rise to 25% on $200bn of imports from China last Friday.

The retaliatory measures will take effect from 1 June, corresponding roughly to the date from which the first US tariffs of last Friday's increase become effective. The US applied tariffs on products shipped from China from last Friday, and mostly affects goods shipped by sea. This means the first goods to be affected by the tariffs will arrive in around three weeks, given average shipping time to the US.

In the light of this gentle response and recent meetings in Washington, it seems that China aims to keep the door open for further negotiations on a trade deal and contain further escalation. But the US has threatened to raise additional tariffs if China were to retaliate, meaning the risk of circumstances being aggravated is far from elapsed.

If the US were to expand its tariff measures, Beijing is expected to continue to retaliate in a similar mild fashion. This is because it is difficult for China to respond with equal measures, since the country imports a great deal less from the US than the US does from China. But this is not the only reason. With its mild response, China maintains the moral high ground in the conflict.

If the US retaliates by imposing 25% tariffs on all remaining Chinese goods ($339.5bn, using 2018 data of US imports from China) China might react more aggressively. As a first step, China could stop businesses from investing in the US. The hot topic of whether China will stop buying US Treasuries depends on whether the US escalates the trade war, but China would probably prefer this be the last option.

As mentioned by Chinese Premier Li Keqiang on 10 May, the government is prepared to cut taxes and fees to further support the economy. These fiscal measures will be combined with more targeted monetary easing. The increase in liquidity will put downward pressure on interbank interest rates.

Renminbi depreciation is not the answer to boost exports. If export orders fall as a result of tariffs, a small depreciation of the currency will not help. In fact, if the renminbi depreciates further in a short period of time, it will fuel concerns of capital flight. The central bank wants to prevent this from happening, mainly through stabilising the daily fixing of the exchange rate. This ought to signal to both onshore and offshore markets that the renminbi is stable.

The renminbi is likely to have stabilised further by the time Presidents Xi Jinping and Donald Trump meet at the G20 summit in June. We maintain our 6.75 renminbi-to-dollar forecast for the end of the second quarter, though there may still be instances of increased volatility in the pair in the run up to the G20 meeting next month.

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