CLIFF TAN

East Asian Head of Global Markets Research
Global Markets Division for Asia
T: +852 2862 7005
E: cliff_tan@hk.mufg.jp

MUFG Bank
A member of MUFG, a global financial group

USD/CNY/Asia – Manipulation is in the Eye of the Beholder

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Key Points:

- **We believe US Treasury will expand the number of monitored countries in its next currency report from 13 to 20**
- **And this time, we believe the Trump Administration will designate China as a currency manipulator for the first time since 1994**
- **The latter may be interpreted as a first shot in trade war escalation**
- **We expect knee-jerk reaction could aim for higher USD/CNY, only to be frustrated by official resistance**
- **Consequences for other currencies added is unclear, except maybe greater volatility**
- **Currency manipulation may be the last Trump campaign promise to be fulfilled**
- **It's likely the US Administration will jettison its 2015 criteria for manipulation and use earlier legislation from, yes, the 1980s**
- **Some countries to be added to Trump's list include Asian nations running large bilateral trade surpluses against the US**
- **The US has revealed how it thinks global currencies should be managed; China is very unlikely to agree**

The Lede

The next Treasury currency report will expand the list of monitored countries

It's come to our attention, via a reliable Asian government source, that the next US Treasury report (due out next week) will be a notable departure from recent, previous reports, in that **the United States intends to expand the number of major trading partners against whom it is monitoring currency management practices for signs of manipulation to 20 from 13.** On the expansion from 13 to 20, it's our understanding US Treasury officials have already traveled to Asia a number of times this year to meet with counterparts and communicate this more aggressive tack. As with much of the rest of the US government over the past two years, it's our understanding Treasury bureaucrats have pursued US President Trump's new line with diligence and fealty, even should such a new designation fall outside the past rules of engagement they had previously used for currencies. (As might be described for much of US government since 2016, it's Trump's way or no way.)

And will name China a currency manipulator, a first step toward trade war escalation

We also, in this note, make a call on the sexier question in market minds, which is whether the US will designate China a currency manipulator in this report. **Our answer is yes it will, for the first time since 1994;** not so much for objective (and defensible) reasons than that such a designation fits in better with the Trump Narrative and how we think the Administration will further escalate its trade war with China. As such, you might call currency manipulation the first shot of further escalation.

Manipulation is Apparently Unidirectional

Manipulation is unidirectional

To give you an idea of what this means, Neal Kimberly (once an MUFG colleague) wrote in the *South China Morning Post*:

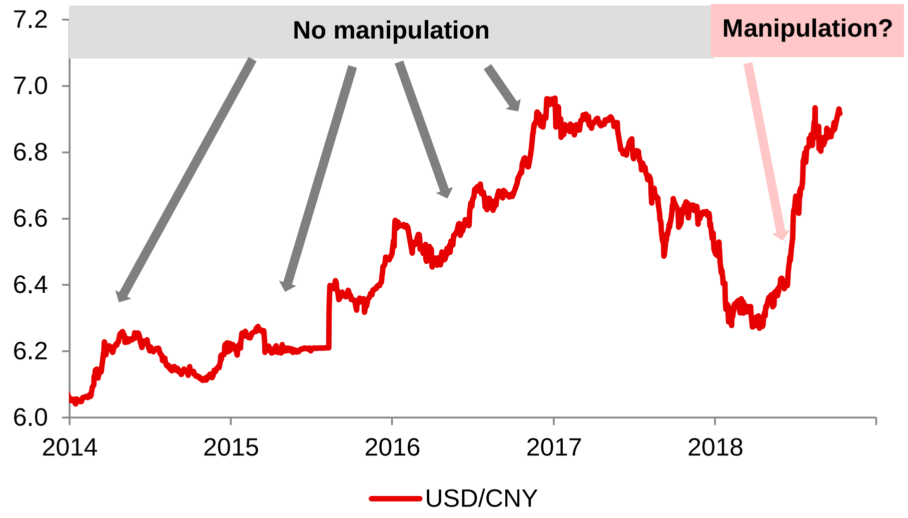
… Mnuchin, speaking to CNBC on August 28, said that China's currency "is more of a controlled currency than other markets that are free access. But if they go in and support their currency, that is not currency manipulation." He added that if China lets its currency weakens, "either for structural reasons or for actual manipulation, that is

something that is manipulation".

Weaker RMB = manipulation

So to be clear: Stronger RMB = no manipulation; weaker RMB = manipulation. Makes us wonder why write a report at all when you can just look at a chart?

USD/CNY: DEAL OR NO DEAL



Source: Bloomberg, MUFG Bank

Anticipated Market Reactions

A desire for higher USD/CNY while volatility for others

Naming China a currency manipulator doesn't actually lead to a lot of immediate difference on the policy front. US law says the US must initiate a year-long negotiation with a named manipulator to address unfair manipulation. But nonetheless our judgments in markets is there still may be market reactions, with some possibly perverse. Ie, though this (and past) US Administrations clearly want bilateral surplus countries to strengthen their currencies, we suspect if China is named a manipulator initial market response might be to push USD/CNY *higher* (ie, renminbi weaker still), which onshore authorities will very likely resist given the stance of recent policy. But while USD/CNY may remain within the ranges of our forecasts, the same may not be true in other Asian currencies added to the list. A higher USD/CNY would pressure USD/Asia higher too for competitiveness reasons (we discussed this in the July 2018 *MUFG Foreign Exchange Outlook*). But how markets ultimately digest new rhetoric from the American bully pulpit for smaller Asian nations remains to be seen. At the very least our guts expect more volatility.

The Last Campaign Promise

The manipulation tag is political

The previous chart made it clear that designating China as a currency manipulator is, at its heart, a political decision. Recall that candidate Trump had called China "a manipulator, grand master level," and promised, "I am going to instruct my Treasury secretary to label China a currency manipulator." (He also campaigned on a longstanding promise to impose 45% tariffs on China.)

Trump has been methodical in carrying out campaign promises

Since taking office, Trump has methodically sought to implement campaign promises one by one (Michael Woolf's book *Fire and Fury* reported a master list of such promises on a whiteboard in Trump strategist Steve Bannon's White House office), with perhaps one glaring exception in the currency manipulation tag. Leaks from inside the White House since Trump took office said past aides, such as former National Economic Advisor Cohn, helped talk Trump out of taking this action. But Trump himself said he delayed "because I wanted to get as much as they [China] could give us with respect to North Korea." He added, "But there came a time when I couldn't delay it [tariffs plus the currency manipulation tag] any more. It's too much money that they drain out of our country."

With manipulation one of the last dominoes to fall

Tariffs, of course, are in. And President Trump seems to think he is doing well with North Korea. So there seems little in his way of taking on currency manipulation as the next step in the US pressure campaign on China. Going into the midterm elections, *Bloomberg Businessweek* asserted Trump thought bashing China would help Republicans win votes.

Moving the Chains[1]

Trump is "looking very strong" at the manipulation formula

In the past 2½ years, the US Treasury had been employing criteria laid out in the Trade Facilitation and Trade Enforce Act of 2015 (operationalized in the April 2016 edition of the report) to determine who is a currency manipulator. As we argued above, if your currency is depreciating against the US, you could be a currency manipulator (you could also be a redneck). But Trump claimed to be "looking very strong at the formula" in a 30 August interview with Bloomberg.

Which was mandated by a 2015 law

The operationalized criteria had been:

1. A trade surplus with the US of at least USD20bn;
2. An overall current account surplus of greater than 3%; and,
3. Repeated intervention in currency markets implied by the accumulation of foreign reserves in excess of 2% of GDP.

(Of course, if your currency is strengthening against the US, presumably none of this matters in practice.)

But which prevents him from acting as he wishes

Criteria above would *not* have allowed Trump to name China as a currency manipulator to date (because its current account surplus is < 3% and because it's losing foreign reserves). But Trump, who publicly contradicted the last April 2018 Treasury report three days after publication, is reportedly putting pressure on Treasury Secretary Mnuchin to change the call and label China the currency manipulator ("the" because we expect China to be the only one), Bloomberg reported Mnuchin getting increasingly involved in the details of the upcoming report. It also separately reported that the President (and Mnuchin) could either vary the threshold levels of the 2015 law or go back to the original 1988 law that mandated twice-yearly reports, to find legal justification for naming China (and presumably the other 19 countries as well).

Which means the law has to go

For an Administration that decided Chevys and BMWs from long-time US allies like Canada and Germany could be national security concerns, we've been impressed at how this Administration under US Trade Representative Lighthizer has made use of existing legislation in the way the old joke said drunks used a lamppost: less for illumination than support.

[1] Apologies for an Americanism. This refers to moving the 10-yard long chain that referees use in American football to judge whether a team had advanced far enough to gain a first down.

MAKING THE FINAL CUT: THE GANG OF 20

Potential List in October's Report	April's Report	Goods: Total Trade (USD Bn, 12-month rolling)	Bilateral Trade: Goods Balance		Current Account Balance (CAB)	
			Latest (USD Bn, 12-month rolling)	2017 (USD bn)	CAB (% of GDP)	3-year Change in CAB (% of GDP)
China	China	664.7	-397.0	-375.6	1.2	-1.5
Canada	Canada	613.1	-19.0	-17.1	-3.2	0.4
Euro Area	*	602.4	-149.3	-132.6	3.2	0.0
Mexico	Mexico	596.0	-76.1	-71.0	-1.9	0.6
Japan	Japan	212.8	-68.7	-68.9	3.8	0.7
Germany	Germany	182.7	-68.0	-63.7	8.2	-0.7
South Korea	South Korea	124.5	-19.9	-23.1	5.5	-2.2
France	France	88.4	-16.8	-15.3	-1.3	-0.9
India	India	83.1	-22.8	-22.9	-2.3	-1.3
Italy	Italy	76.1	-32.6	-31.5	2.6	1.0
Taiwan	Taiwan	72.5	-15.8	-16.7	13.6	-0.7
Brazil	Brazil	70.3	8.9	7.8	-1.6	1.7
Ireland		65.8	-43.4	-38.1	9.8	-1.1
Switzerland	Switzerland	61.5	-16.7	-14.3	9.7	-1.2
Singapore	Singapore	57.5	7.3	10.4	18.9	0.3
Vietnam		56.9	-38.7	-38.4	3.0	3.1
Malaysia		52.0	-26.7	-24.4	2.4	-0.7
Thailand		44.1	-19.9	-20.2	9.3	1.3
Indonesia		28.5	-12.9	-13.3	-1.9	0.1
Russia		26.7	-12.4	-10.0	4.5	-0.6
Austria		16.1	-9.4	-7.5	2.5	0.6

Source: MacroBond, Bloomberg, MUFG Bank (Euro area is an economic Bloc, but not an individual state.)*

Eight more countries in the cross-hairs

Our expectation when the new Treasury report is unveiled is the US will name one currency manipulator – China. Other countries previously on the US watchlist (ie, in the doghouse) will stay the same, *viz.* Japan, South Korea, Taiwan, India and Germany. The expanded list of countries to be monitored will be not only the largest trading partners of the United States, which had been the selection criterion up till now, but also a few countries selected because the US is running a large bilateral trade deficit against them (remember our explanation of how Trump the Mercantilist thinks this is supremely important – *Asia Cross Current: Trump May Become a Dollar Wimp*, 18 January 2017). Our characterization of Trump as a Mercantilist now seems amply supported by anecdotal evidence in his first two years in office; eg, Trump's trade views and convictions presented in Bob Woodward's recent book, *Fear.* We also show the three old criteria from the Trade Facilitation and Trade Enforcement Act of 2015. Our expanded Gang of 20, compared with the old Gang of 13, primarily highlights the role large bilateral trade surpluses with the US is playing in this Administration and the naming and shaming of other nations' currency practices.

How the United States Wants to Manage Global Currencies

The US style of currency management is in the USMCA

A more broad attack on other currencies by the United States is intriguing right now because recently we've seen the US signal how it thinks it should be allowed to manage other currencies. We see this in Chapter 33 of the just concluded US-Mexico-Canada Agreement (NAFTA II) and in similar language contained in a side agreement of the original but now abrogated Trans-Pacific Partnership. Secretary Mnuchin has indicated if the US and China are to come to any future trade agreements as a result of Trump Trade Tariffs, China must agree to include currency in the agreement, just as Mexico and Canada has.

Which includes reporting FX interventions

In Chapter 33, all three countries agreed not to manipulate currencies in the sense that's been discussed throughout this note. They seem to agree to publicly disclose intervention in FX markets and otherwise meet IMF SDDS reporting. South Korea, one of the countries on the Treasury watchlist and which successfully negotiated with Trump over KORUS (though renegotiation has yet to be approved by the Korean National Assembly), is reportedly close to publicly reporting its FX interventions in the future. Some countries do privately report their FX interventions to the IMF, but not China. Any failures at transparency and reporting commitments can be taken up by the USMCA dispute resolution mechanism. In addition, there is some sort of macro committee of all three countries that is supposed to meet at least once a year to review compliance on Chapter 33 commitments. Bilateral consultations can ensue with the IMF acting as a referee.

But the US itself refuses to be bound by such rules

One of the dirty little secrets in all this transparency, however, is that the US itself has limited the scope of this agreement so it itself will not be bound in the future. The Chapter 33 agreement is explicitly restricted so that it "does not apply with respect to the regulatory or supervisory activities or monetary and related credit policy and related conduct of an exchange rate or fiscal or monetary authority of a Party." That means if some central bank decides to undertake QE, eg (or QQE), that cannot be construed as having some meaning for exchange rate policy.

China is nowhere near to agreement

By now, one of our market rules of thumb is it's difficult to make intervention work (even in the short run) unless it's coordinated intervention. As such, the US making unilateral assertions (not intervention) about how global currencies should trade strikes us as possibly even more quixotic. Especially when it itself doesn't seem to be willing to be bound by the same rules. The idea China will want to report its FX interventions anytime soon also strikes us as a little fairy-tale like. For one thing, to do this seriously would require PBOC to disclose the role the overall banking system plays in quasi-intervention.

1980s currency management led to major misalignments

What these measures do remind us, however, is (you guessed it) the 1980s, when major countries seemed to believe they could dictate the destiny and course of global currency markets. Our main memory is of how this led to major, major currency misalignments.

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