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USD/CNY – Oh, Never Mind

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Key Points:

- **From joint "communique" to maybe we need a "different structure" took only five days**
- **Round 2 of the US-China Section 301 trade negotiations – if it had been a Broadway play – would have closed, judging by reviews**
- **Numbers matter to Trump; and there were *no* numbers nor dates in the "communique"**
- **Instead of the Chinese buying $200 billion more from Americans, we think they'll be lucky to stretch that to $20 billion, with unintended trade diversionary effects for third countries**
- **The *raison d'etre* for the entire Section 301 investigation was IPR protection, that seems completely glossed over. If Trump fails here, US companies have a right to be outraged**
- **Though vague, the "communique" suggests Chinese and Americans are talking in three broad areas: Technology; Finance; and Big Agriculture**
- **China and North Korea may have tried going 2-on-1 on Trump; now that he's cancelled the Summit, will he become more belligerent on trade?**
- **This US President seems to prefer a strategy of melding all issues together into one giant hairball, out of which he hopes to extract victory; this raises risks considerably**

Market reactions

Despite the Trump Trade Truce Chinese assets are down

While last weekend's US-China trade talks outcome was broadly in line with our expectations (Big Ag for ZTE, which we put in our *FX Weekly* USD/CNY ranges) and while initially equities globally and in China seemed to treat the event as risk-on (which we expected), USD/CNY did not fall as expected with the Big Dollar Bull Run continuing to flatten all contrary trends in front of it. At week's end Chinese equities had more than given up all gains and continuing buying flows in USD/CNY meant some parties onshore needed USD.

Are developments more negative for China than realized?

The most interesting comment from the trading floor was a question whether, despite the Trump Truce on the Trump Trade Offensive and sometime Trump Trade Tantrums (the word for today is … alliteration), what occurred last week might not somehow be bad for China in the long run, to explain asset market reactions? Intriguing, but we didn't have a final answer. Hopefully the below sheds some light.

A lot can happen in five days

From a grand "communique" to maybe we need a "different structure"

From Saturday, when former CNBC commentator Larry Kudlow – now US President Trump's chief economic advisor – walked back earlier trumpeting of China having agreed to buy an extra USD200bn of American goods a year (China later said it did no such thing, which sort of reminded us of North Korea promising denuclearization) and attempted to paint a joint US-China statement on trade (cf. Appendix) as a "communique" coming from two great nations; to Wednesday, 4:55am,presumably in Trump's White House quarters, when the President tweeted:

Our Trade Deal with China is moving along nicely, but in the end we will probably have to use ***a different structure*** *in that this will be too hard to get done and to verify results after completion.* HT @realDonaldTrump

Reviews are in

After Round 2, the American reviews of Trump Trade were nearly uniformly negative; Trump got rolled

All this followed a rough week of reviews of what the US did *not* achieve in round 2 of its bilateral trade talks with China. If last weekend's act was a Broadway play, we might have shut down by now, after reviews like *"China is winning Trump's trade war"* (the *Washington Post*), *"Trump's China Deal is the Worst Ever"* (the *Nikkei Asian Review*) and our favorite (for now) *"An Artless Negotiation from the President Who Penned 'The Art of the Deal'"* (*The New York Times*).[1]

Others, including heretofore strong Trump supporters, also reacted negatively to the communique:

... even among people who are usually Trump allies. Dan DiMicco, a former steel CEO who has been a big supporter of Trump's steel and aluminum tariffs, tweeted shortly after the statement came out, "Not good enough. ***Time to take the gloves off."*** *He followed that up with: "Did [the] president just blink? China and friends appear to be carrying the day." Fox Business host Lou Dobbs summed up the situation this way: "Chinese say 'no deal.' " Sen. Marco Rubio (R-Fla.) tweeted, "Why do U.S. officials always fall for China trickery?" Wall Street Journal trade reporter Bob Davis tweeted that the big takeaway is:* ***"Trump administration gets rolled by the Chinese."***

No numbers, no dates and far from what Americans originally wanted (which pleased the Chinese)

No #s, no dates; and maybe why the Chinese seemed pleased

There's an old forecasting joke which goes like this: Give 'em a #, or give 'em a date; but *never* give them both. In this case the "communique" goes one better – there are *neither* numbers nor dates here (cf. Appendix). We did find it weird that initially it was difficult to locate the document on the White House Press Secretary's website. It was a breeze, however, to find on CGTN, which is China's official global television enterprise (a bit like RT); a US diplomat subsequently told us the Chinese side seem to regard the "communique" as "a Thing."

$200 billion? Try $20 billion

The Americans appeared to hear what they wanted to hear

Below is the USD200bn claim Kudlow tried to walk back:

Larry Kudlow, director of the National Economic Council, said Friday that China had agreed to buy "at least $200 billion" more from the United States each year. On Sunday, Kudlow appeared to back away from that claim, saying on ABC News's "This Week" that "there's no agreement for a deal. We never anticipated one. There's a communique between the two great countries. That's all."

Mnuchin's semi-promised trade #s

Okay, if it's not USD200bn then how much is it? [By the way, so we don't get kicked off the economist guild, we focus on bilateral trade #s because Trump focuses on bilateral trade #s.]

The treasury secretary would not comment on reports that China had balked at a U.S. request for $200 billion in increased annual purchases, a figure that many economists regard as impossible to execute. Instead, he said the two sides had agreed on specific targets for individual sectors, such as agriculture and energy. "We expect to see a very big increase, 35 to 45 percent increases in agriculture this year alone," Mnuchin said. "In energy, doubling the energy purchases. I think you could

[1] In what follows, we will use liberally sources including the *Washington Post;* CNBC; the *South China Morning Post; The Wall Street Journal; The New York Times;* but we *won't* insert the specific URLs

see $50 [billion] to $60 billion a year of energy purchases over the next three to five years."

Based on Mnuchin, we think at most an extra USD18-28bn of Chinese purchases a year from the US

Based on the above, a 40% increase this year in Chinese agricultural imports from the US would be roughly USD8bn. We interpret Mnuchin's statement above as suggesting USD10-20bn a year of extra Chinese purchases of US energy in the next 3-5 years (2021 to 2023). **Add the two up = USD18-28bn** more Chinese imports from the US a year. Presumably this includes (from the *South China Morning Post*):

Prospects for US energy exports to China got a boost in November, when China National Petroleum Corporation and US natural gas producer Cheniere Energy reached an agreement on shipments of liquefied natural gas (LNG). That deal was the biggest development among those announced during Trump's trip to Beijing in November, which he said had a combined value of US$250 billion. [So why does he need US$200 billion?] China National Petroleum Corporation and US natural gas producer Cheniere Energy reached an agreement in November on shipments of liquefied natural gas. Cheniere will supply CNPC with about 1.2 million tonnes of LNG annually starting this year and continuing through to 2043, according to an announcement by the US company, which did not put a value on the shipments. The volume of LNG contracted is worth more than ***US$200 million [NB millions, not billions] per year,*** *according to the average LNG export price posted by the US Energy Information Administration, and not taking into account discounts for long-term supplies or other factors specific to the deal.*

But in reality, it's probably less

Our general view for these sorts of proffered managed trade solutions is probably even more pessimistic than the above. While trade bureaucrats can stretch their imaginations, at most we expect these sorts of ideas (5,000 more Teslas, 20,000 more Escalades, etc.) to add up to what may be a USD10-20bn poultice on a USD375bn pox (to Trump). [We will next publish a more substantive note explaining the macroeconomics behind this thinking.]

Managed trade diversion

With almost certain diversionary impacts in third markets, a reason they need to retaliate

The Big Ag portion of the Trump Truce led this week to market concerns if China was to buy more agriculture from the US (as much as can be produced, Trump tweeted), it would do so at the expense of Australia (the unlucky country). Initially the thinking went if China was going to slap tariffs on US soybeans, Brazilian growers were going to benefit (also due to the Argentinian drought). But after the truce, easy come, easy go. And now diverted Chinese purchases may hurt both Brazil and Australia. *We cannot rule this scenario out.* For one thing, the US and China seem led now by men for whom manage trade seem to fit their styles better. Second, in the era of Trump Trade Tantrums these sorts of unintended side effects seem par for the course. The US, by dint of having a pretty big paddle, can divert at a whim large flows of global commerce anytime and anywhere it decides to stick the paddle in. The rest of the world should be forewarned (and forearmed; see our discussion on retaliation in *Asia Cross Current: USD/Asia – How Bad Can a Trade War Get? (Pretty Bad)*, 10 May 2018).

Tariffs on hold; ditto investment restrictions

Tariffs on hold

Treasury Secretary Steven Mnuchin confirmed that the tariffs are now "on hold" when he appeared on "Fox News Sunday."

But it appears it wasn't only tariffs which were put on hold.

But so are investment restrictions

Monday [was] the deadline for Mnuchin to "report progress" on the investment barriers. Now it looks as if those limitations are on hold, too, according to a lobbyist familiar with the deliberations who isn't authorized to speak publicly about the

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administration's decision-making and spoke on the condition of anonymity. Derek Scissors, a China expert at the right-leaning American Enterprise Institute who advised the Trump administration on China trade last year, also thinks Mnuchin won't push this week for any further blocks on Chinese investment in the United States. ***Mnuchin never had any intention of recommending anything serious that I know,"*** *Scissors said.*

The markets, though, don't think the truce is permanent

Since in our view future US investment restrictions on China could have been far more damaging for "Made in China 2025" than tariffs, this delay might have been seen as **a major victory for China** (eg, see demand #4 in the China list of the Appendix); **but we don't think it's permanent.** (Maybe that's partly why Chinese asset values have declined despite the truce.)

IPR seems papered over

IPR was supposed to be at the core of the Section 301 game

Intellectual property protection was originally the *raison d'etre* for Trump's entire Section 301 effort directed against China and seems papered over in the communique:

The real battle against the Chinese was supposed to be over intellectual property theft ... On this front, the statement was brief and lackluster, saying that both sides agreed to "strengthen cooperation" ***(diplomatic speak for not doing much)*** *and that* ***China would "advance relevant amendments" to its patent law.*** *It remains to be seen whether that happens (and whether China enforces any new laws).*

China's own domestic IPR protection scheme is, at this stage and to put it kindly, nascent. As in almost everything in China, what's less important is not what's written into law but its implementation.

It was mentioned once in the "communique"

We were especially struck by some complaints by industry groups that originally supported the Trump Administration's efforts:

"It's a huge disappointment, *given the expectations," said Scott Paul, president of the Alliance for American Manufacturing, a partnership between steelworkers and their employers. "It plays right into Beijing's hands . . . and* ***is more of the same old failed policies we saw under the Bush and Obama administrations."***

Should Trump's IPR efforts through Section 301 fizzle out, in some ways that may represent the ***worst*** outcome for American businesses that wanted this White House to fight for them on IPR. It's too early to call this as the final outcome, but if it turned out that way US businesses would have a right to be outraged.

Tech, Finance and Big Ag

Broadly, the Chinese and Americans appear to be negotiating over Tech, Finance and Big Ag

Mnuchin has also declared the US and China is negotiating a framework around which more specific commitments can be subsumed. Commerce Secretary Ross is scheduled for another lightning 2-4 June visit to Beijing to flesh out details. (If the scheduling of the trip includes travel time, it seems Ross has at most two days to meet the Chinese in the capital, including a Sunday.) We can initially divide the "communique" into three areas: Technology (what Section 301 was originally intended to address); finance; and agriculture. In tech the Chinese are asking for items which the US Pentagon appears to be resisting fiercely, including in dual-use export controls that America has never been willing to dismantle till possibly now, as well as 1989-era sanctions tied to Tiananmen. Perhaps because of such opposition, it appears the Chinese are trying to make more headway in finance (hoping Wall Streeters will speak up on its behalf in hopes of opening up, as in the past) and making agricultural trade (and the voters it supports) more important in the Trump-China calculus. Should technology make *no* headway, as discussed above, we do not expect US businesses to be very pleased.

NAFTA is now a 2019 issue

NAFTA is a 2019 issue

Mnuchin also suggested that Trump was prepared to wait until 2019 to wrap up negotiations aimed at a new North American trade deal. He confirmed that the United States, Mexico and Canada remain "far apart" after nine months of talks, having missed a deadline set by House Speaker Paul D. Ryan (R-Wis.) last week to reach a deal on which lawmakers could vote this year.

But has been dragged into the US-China discussion nonetheless => US-China is now a 2019 issue?

Since these remarks were made, Trump this week has further ordered his Commerce Secretary to begin another Section 232 investigation (the same kind that rationalized the steel/aluminium tariffs) into whether he should impose higher tariffs on imported automobiles, reportedly to put pressure on Mexico to agree to NAFTA revisions the US wants and thereby linking NAFTA directly to US-China tensions.

North Korea, China may have been jointly playing Trump

Finally we have North Korea.

The prospects of a Trump-Kim Summit might have softened Trump's trade stance

Dennis Wilder, a former China analyst for the Central Intelligence Agency, said the president's softer line was linked to his desire for a successful June 12 summit with North Korean leader Kim Jong Un, a Chinese ally. The recent visit to Beijing of a North Korean delegation of municipal and provincial officials — the first such visit in eight years — suggested that Beijing might have been preparing to relax its sanctions on Pyongyang, perhaps in retaliation for Trump's tariff threats, Wilder said. "The administration has been a little rattled by how quickly the China-North Korea rapprochement occurred," he said. "He probably believes that China is using the North Korea card in the trade negotiations."

But, then, the Chinese and North Koreans may have been playing 2-on-1 and the Summit is cancelled

So the idea was that China dangled the success of a North Korea Summit to back down Trump trade threats (including punishments against ZTE); while North Korea uses prospects of China relaxing sanctions to extract more concessions from the US ahead of the Summit. Trump himself tweeted a suggestion the Chinese were the reason Kim Jong Un turned tougher in public, and repeated the hint. A number of analysts also suggested Trump's desire (vainglory) for a Nobel Peace Prize (which his despised predecessor Obama had won) led him to fold on China trade.

That was, of course, before he cancelled the Summit last night.

One giant hairball

Trump likes "lots of balls in the air;" we call it a giant hairball

Longtime readers will know we were and remain a Never Trumper (so we need to check our biases). Events had seemed to be rolling up to a crucial test of Trump and his Administration. By virtue of his position and the power he holds, there wasn't ever going to be an outcome in Trump's first two years that wasn't going to involve some dead-serious test of US intelligence, long-term strategy, short-term street smarts and the ability to produce good "America First" outcomes. We're not trying to cram US-China trade, North Korea, NAFTA and probably European steel/aluminum tariffs together into one Mega Issue; it's Trump who has decided on this mode. To quote him from *The Art of the Deal:*

"I never get too attached to one deal or one approach. I keep a lot of balls in the air, because most deals fall out, no matter how promising they seem at first."

Trying to extract victories from the hairball means no deadline is sacrosanct

For a media-sensitive President, this seems to us like an attempt to meld a number of issues together in hopes of extracting a "victory" in at least one of them, so as to proclaim achievement and progress ahead of midterm elections which Trump himself has painted as an impeachment threat against himself. Such an approach helps us to understand why Trump deadlines hardly seem like deadlines at all. In the search to extract victories from the hairball, the gambler lets it ride if there is still hope of victory. If Trump still thinks he can get a better deal from the Europeans, he will let the 1 June deadline on the steel/aluminium tariffs slide as well.

A US President, however, cannot bat .300 and be judged a success

But a single victory for a US President is not enough. In baseball terms, a President can't bat .300 and be judged a success; not if the other 70% of the issues turn out to be a mess. Not when there are dead-serious consequences. Eg, when we wrote our preview of the now-cancelled Trump-Kim Summit (*Asia Cross Current: USD/NKRW – Why Do Kim Jong Un, Trump Want to Talk?* 22 March 2018) we talked about running out of diplomatic runway, which is the thought that if Trump toughness is what got us to the summit in the first place, if it fails what is the only alternative? And now that the Summit seems dead, does that mean Trump will become more belligerent on US-China trade?

APPENDIX

The Joint Communique

It seems useful to start with the language of the communique the US and China jointly issued on Saturday 19 May 2018 after round 2 of two days of trade talks:

THE WHITE HOUSE – Office of the Press Secretary
FOR IMMEDIATE RELEASE – May 19, 2018
Joint Statement of the United States and China Regarding Trade Consultations

At the direction of President Donald J. Trump and President Xi Jinping, on May 17 and 18, 2018, the United States and China engaged in constructive consultations regarding trade in Washington, D.C. The United States delegation included Secretary of the Treasury Steven T. Mnuchin, Secretary of Commerce Wilbur L. Ross, and United States Trade Representative Robert E. Lighthizer. The Chinese delegation was led by State Council Vice Premier Liu He, Special Envoy of President Xi.

There was a consensus on taking effective measures to substantially reduce the United States trade deficit in goods with China. To meet the growing consumption needs of the Chinese people and the need for high-quality economic development, China will significantly increase purchases of United States goods and services. This will help support growth and employment in the United States.

Both sides agreed on meaningful increases in United States agriculture and energy exports. The United States will send a team to China to work out the details.

The delegations also discussed expanding trade in manufactured goods and services. There was consensus on the need to create favorable conditions to increase trade in these areas.

Both sides attach paramount importance to intellectual property protections, and agreed to strengthen cooperation. China will advance relevant amendments to its laws and regulations in this area, including the Patent Law.

Both sides agreed to encourage two-way investment and to strive to create a fair, level playing field for competition.

Both sides agreed to continue to engage at high levels on these issues and to seek to resolve their economic and trade concerns in a proactive manner.

What the Americans wanted

It then seems useful to contrast the above with reporting on the original demands of both sides that were presented in Beijing at the 4-5 May 2018 first round of US-China trade talks, beginning with the American side [according to *The New York Times*]:

1. China will reduce its bilateral trade surplus with the US by USD100bn between June 2018 - May 2019, and by another USD100bn between June 2019 - May 2020.
2. Stop all subsidies made to advanced manufacturing under Made in China 2025.
3. Allow the US to restrict imports from Made in China 2025.
4. Take “immediate, verifiable steps” to halt commercial cyberespionage into the US.
5. Strengthen intellectual property protections.
6. Accept US restrictions on Chinese investments into sensitive technologies without retaliating.
7. Cut average Chinese tariffs (10%) to the same average as of the US (3-5% for “noncritical sectors”).
8. Open up services and agriculture to full American competition.
9. Meet every quarter to review progress.

What the Chinese wanted

China on its side demanded [according to the *Washington Post*]:

1. The United States commits to eliminating sanctions imposed after China's crackdown on protesters in Tiananmen Square in 1989.
2. The United States relaxes export restrictions on technology such as integrated circuits.
3. The United States allows U.S. government agencies to purchase and use Chinese information technology products and services.
4. The United States agrees to treat Chinese investment and investors equally to those from other countries and place no restrictions on Chinese investment.
5. [The United States commits to] appropriately handling the ZTE case to secure global supply chain.
6. The United States agrees to ensure Chinese businesses can participate in U.S. infrastructure projects.
7. The United States agrees to strengthen protection of Chinese intellectual property.
8. The United States agrees to drop its anti-dumping cases against China at the World Trade Organization.
9. The United States agrees to terminate its investigations into Chinese intellectual property theft and not impose any of the sanctions Trump already announced.

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