Daily Note

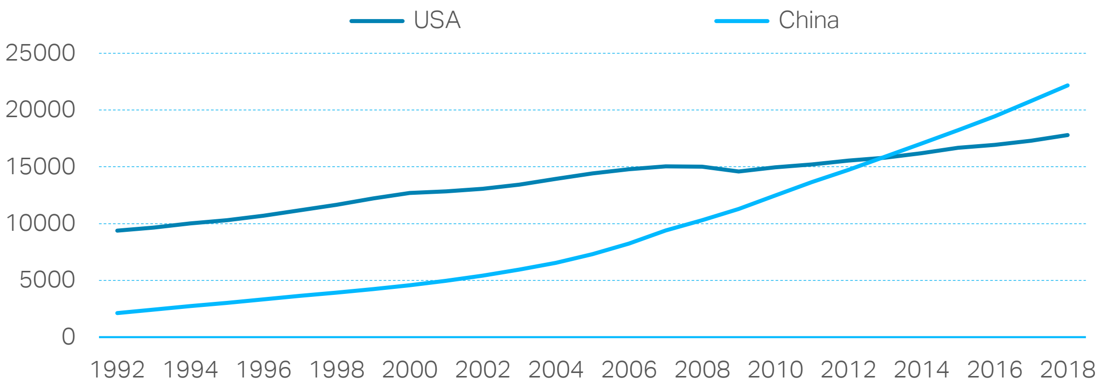
CHINA READY FOR GRIM TRADE FIGHT

Charles Dumas

- **Current US-China tensions are not comparable to 1980s trade tensions**
- **China believes its economic system is under attack, and will fight back**
- **Major further yuan devaluation is likely if recent US threats are for real**
- **Damage to Japan, Korea and numerous EMs could hurt all risk assets**

The impression we get from US commentary to date on the 'trade war' is that Americans see it as a hard-ball negotiating strategy by President Trump that should be resolved quite quickly in some form of settlement. China is in a weak position, in his view. But this may overstate the strength of the US position, and misunderstand the historical context.

Real GDP, Purchasing Power Parity, const. 2010 $bn



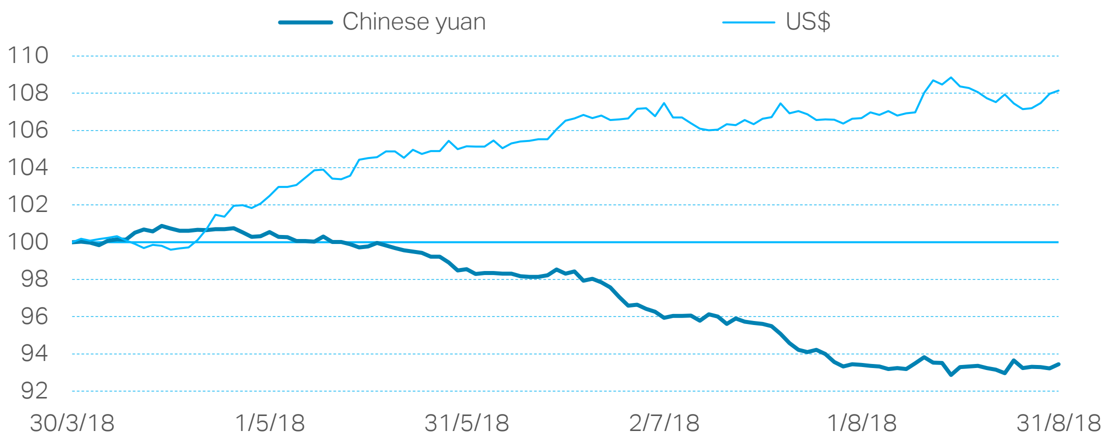
Source: OECD, TS Lombard

Back in the 1980s, not only was the US dealing with trade threats from countries formerly defeated in WW2 – and very much beholden to the US-based international geopolitical system – but also countries whose economies were a fairly small fraction of America's. Though China in the 1990s depended on the US, it does so today mostly in hi-tech, a dependency it wishes to shed by hi-tech development. Its economy is now a quarter larger in real terms, at comparable prices, though US under-measurement of real output growth might modify that ratio a little. China is also growing faster, however, so the disparity indicated by the chart above could soon yawn. For the trade hawks in Washington, this is a fundamental challenge to the US position as 'No 1'.

Trump's cancellation of Treasury Secretary Mnuchin's May deal with China over trade has convinced China that it is involved in a fundamental challenge to its growth strategy. My colleague, Jonathan Fenby, has detailed the way in which Xi Jinping has come back from holiday determined to preserve at all costs the state-directed development process that is in marked contrast with the US free-market system. (While the ultimate merits of this are open to challenge, it is unlikely to encounter existential, systemic problems within the foreseeable future. The simple 'catch-up' potential of China is huge, given output per head still less than 30% of the US level.) As the US challenge over trade has been linked to a broader challenge to China's economic system, both sides seem now to be in entrenched positions from which compromise is unlikely, at least in the near term.

Trump is correct that in a pure tariff war, the US will prove much stronger than China. China's retaliation so far to the limited US tariffs implemented earlier this year has nearly exhausted the range of items that could be penalised. But China has another option that we think is likely to be pursued quite soon, if the US ramps up the trade fight later this week, as is expected.

Real FX rates, PPI-based, Mar-15 = 100



Source: Datastream, TS Lombard

My colleagues, Bo Zhuang and Rory Green, recently outlined how 25% tariffs (which have been threatened) on the bulk of US imports from China would damage China's trade enough to provoke over the next six months or so a further 15% depreciation, on top of the near-8% already seen since May. China's current-account surplus is already now minimal. While depreciation would be expected in any case as a result of financial market action, the Chinese authorities may well wish to precipitate and accelerate the depreciation. Such a shift in rates would create major problems for Japan and Korea, and for the emerging-market world in general that has already seen a number of rivets popping (Turkey, Argentina, soon Brazil perhaps). Even the euro would probably be pulled down in sympathy, partly as a typical 'risk-off' reaction, partly by impaired export competitiveness.

With the S&P Composite attaining new all-time highs in recent days, there is little sign of these threats being reflected in risk-asset prices. It is one thing for the exchange rate to take the chief burden of adjustment in specific situations, like Brexit or Poland back in 2009, but quite another to imagine that stock prices would be impervious to the kind of dollar upswing likely in a full-scale trade war.