China’s economy is in a tough spot, facing multiple headwinds including escalating trade frictions, tightening global financial conditions led by the U.S. rate hikes, and deleveraging efforts curbing domestic demand.

The latest shots fired in the trade war include the Trump administration threatening to hike tariffs to 25% on $200 billion worth of Chinese exports. China retaliated by announcing a list of approximately $60 billion worth of U.S. imports that would be subjected to differentiated tariff rates ranging from 5% to 25%, effective immediately once the U.S. tariffs on the $200 billion of imports take effect. The recently announced $60 billion of tariffs, combined with the earlier $50 billion announced, cover almost all of China’s U.S. imports (around -$130 billion according to 2017 data).
Is China Slowing Down?

China’s credit-to-GDP shows signs of improvement on the deleveraging mandate.

Coupled with stricter financial regulations, as well as tight monetary and fiscal policy, the partial slow-down in China's domestic demand for 2018 was expected, and not particularly worrying. After all, external demand was still strong and synchronized global growth provided the necessary cushion for China’s growth. However, trade frictions intensified, global financial conditions began to tighten due to the U.S. rate hikes, and China found itself having to adjust its policy approach to address any fallout to its domestic economy.

Worries of an economic slowdown are indeed justified with recent data and future estimates. Current forecasts show that annual growth peaked at 6.9% y/y in 2017 and is forecasted to average 6.3% during 2018–2020. Consumer confidence has started to weaken as households spend less, evidenced by retail sales at 15-year lows. The investment side looks particularly weak. Due to deleveraging efforts and lower-than-expected fiscal spending over the course of the last 18 months, real estate and infrastructure investment has suffered. On the external demand side, the trade outlook is increasingly worrisome and uncertain due to the spat with the U.S. Recent trade data (July) came in better than expected, though it is still early to judge considering the fact that the first U.S. tariffs just kicked in on July 6th. Due to these intensifying internal and external headwinds, since Q2, policy makers have been implementing easy monetary policy, through lowering required reserve ratios and providing liquidity rewards to encourage banks to lend more to SMEs and private enterprises.

China Q2 2018 GDP slowed down to 6.7% y/y from Q1’s 6.8%. Forecasts indicate China’s yearly GDP to average 6.3% during 2018–2020.
As interest rate differentials between China and the U.S. narrowed, and the trade dispute heated up, from end of Q1 2018 through end-August, the yuan lost 8.0% of its value against the USD. This sharp depreciation in the yuan led to the U.S. increasing the planned tariff rates on Chinese imports to 25% as the weakening yuan has largely offset the initially proposed 10% tariffs on $200 billion worth of Chinese imports.

The yuan’s fast depreciation since end-Q1 2018 brought the currency back to mid-last-year levels, but ignited fears of a currency war and capital flight.

This rapid weakening of the yuan since the end of Q1 2018, along with the escalation of trade frictions with the U.S., led many to question whether China is purposefully devaluing its currency. Since China will run out of ammunition in the form of equivalent value of tariffs to be imposed on the U.S., many question whether Chinese authorities have started to engage in asymmetric retaliation to the U.S.’s tariffs by devaluing their currency to alleviate the impact of U.S. tariffs on its exports.

In a trade war environment, the yuan’s continued depreciation indeed runs the risk of being perceived as a beggar-thy-neighbor policy — particularly since the yuan is, essentially, a “managed” currency. In our view, the substantial weakening of the yuan between late-April to mid-August was due to the PBoC’s restraint in interfering in the yuan’s downward move, instead setting the currency in line with the market prices. Illustrative of this is that there has been no major change to the PBoC’s daily fixing mechanism where they fix the exchange rate based on the market closes of the previous day during this period.
What Are the Risks Facing Markets in the Trade War?

One of the biggest risks facing markets in a trade war environment would be a policy mistake from the PBoC, one that would resemble the PBoC’s August 2015 surprise devaluation that ultimately led to intense capital outflows and turmoil in global markets. In other words, any continuous sharp depreciation of the yuan may lead to an environment that is reminiscent of 2015–2016. China appears to understand this risk and has been taking concrete steps lately to anchor market expectations which led to more stability of the exchange rate.

Although there have been some restrictions on capital outflows since 2016, policy makers are aware that if the yuan depreciates to such an extent that it disrupts market expectations and awakens the fears of a repeat of 2015–2016, capital flight pressures may reappear, amplifying the USD’s safe-haven position and leading to a self-fulfilling downward spiral of the yuan. It would also mean a substantial escalation in the trade war between the U.S. and China. This would surely lead to an increase in investors’ risk aversion; global equities and other risk assets could face increased volatility. Emerging market countries and other commodity exporters would suffer, pressuring their currencies, leading to a rise in global inflation. In a worst-case scenario, Asia’s export-driven countries could pull down their currencies in order not to lose the market share of exports to China. Global growth would take a hit, and financial conditions would tighten.

While we do not think that this scenario is likely to happen, investors should be aware that particularly in a trade war environment, there is no room for policy mistakes, ample room for misunderstandings, and a very fine line between adjusting the exchange rate to meet domestic economy needs and resumption of capital flight/unsettling of financial markets.

Is China Engaging in Beggar-Thy-Neighbor Policies?

In fact, in August, as the yuan approached the psychological 7-threshold against the USD, the PBoC found it necessary to moderate the pace of the currency’s depreciation. First, on August 6, 2018, China reinstated a 20% reserve requirement on banks’ foreign exchange forward shorts to prevent a repeat of the capital outflows of 2015–2016, a tool they utilized during the August 2015 devaluation scare but later removed in 2017. Additionally, on August 24, 2018, the PBoC reintroduced a counter-cyclical factor in the daily fixing mechanism of the yuan to further halt the bias toward depreciation and exchange rate volatility.

Our view is that, in light of the recent developments and a macro perspective, China is not pursuing a purposeful devaluation of their currency. In retrospect, the recent weakening of the yuan brought the currency back to its mid-2017 level, i.e., right before its strong appreciation trend that lasted until the recent down-cycle. This is not to say that depreciation in their currency does not benefit China’s suffering export demand. However, China’s main concern is utilizing easy monetary and fiscal policy to stabilize their slowing economy in the face of domestic and external headwinds. In addition, more recently, China is clearly worried about the reemergence of capital flight pressures and therefore started focusing on stabilizing the pace of the yuan’s depreciation.

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Going forward, we expect the Chinese policy stance to stay easy but the dilemma facing China is clear: in an environment of rising U.S. rates as well as looming tariffs, balancing easier policy without triggering speculative capital flows will be a delicate task. As Beijing loosens liquidity conditions to stimulate the slowing economy, interest rates in China will likely be put under further downward pressure. In turn, the gap between borrowing costs in China and the U.S. may continue to narrow, and the yuan will be under increased pressure. If Beijing lets its exchange rate take the entire hit from the trade war, it risks triggering capital flows and repeating the volatility of 2015–2016.

**What Is Next for China?**

Chinese rates will likely remain low on easy monetary policy.

Any revival of capital outflows will hit China’s foreign exchange reserves which are already down from their peak of $4.0 trillion in June 2014 to $3.1 trillion in July 2018.

Under the IMF’s reserve adequacy (ARA) measures, according to some estimates, China will need to have at least (approximately) $2.6 trillion of Fx reserves to fight increased capital outflow pressures. Latest data available as of July 31, 2018. Source: BNY Mellon Global Investment Strategy using data from Bloomberg.
What Is Next for China?

Continued downward trend in China’s current account, exacerbated recently by the trade war, puts further pressure on the yuan.

At the same time, easing monetary and fiscal policy to stabilize domestic demand while continuing to pursue the deleveraging mandate (along with keeping regulations tight and housing markets cool) may prove to be a tough job. Indeed, if the trade spat with the U.S. worsens, and the domestic growth slowdown continues, Chinese policy makers may end up halting the deleveraging mandate and start to loosen some of the regulations they had started to implement, which would increase financial stability risks and hurt investor sentiment.

Investors are aware of this tension facing policy makers in China. Year-to-date, Chinese equities, along with other emerging markets have decoupled from developed markets. This underperformance reflects intensifying domestic and external headwinds. In our view, China equities will be under continued pressure until the yuan stabilizes, trade tensions with the U.S. are resolved, and easy policy succeeds in stimulating growth. Interest rates will continue to remain low on easy policy. The yuan will likely continue its overall downward trend (along with it, many Asian currencies) particularly if trade tensions linger and divergence of monetary policies in the U.S. and China continue; but it is clear that after the PBoC’s August exchange rate moves, Beijing does not want a one-way down move for the yuan. Instead, this will be a long-term “managed” depreciation and the exchange rate volatility will be subdued.

Year-to-date, MSCI China has underperformed MSCI EM and MSCI World.
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