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LOL-A-PLAZA!

Why no US-China currency concert is likely

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Summary

- The US is reportedly weighing a bilateral currency accord with China as part of a trade agreement
- Our trade scepticism also holds if we focus just on the purported currency accord
- The US will insist on China committing to a stable or stronger CNY
- This is unworkable against the current US-China dynamic and economic fundamentals
- China also knows the lesson of the Plaza Accord very well and is very unlikely to repeat it
- And how would this even be enforced?

Bilateral currency accord?

Alongside the current round of US-China trade talks there has been a report that **the US is now weighing a bilateral currency accord as part of the potential agreement**.

Bloomberg news reports the proposed currency accord, which it says the US claims China had agreed to earlier this year before trade talks broke down, would be part of a "first-phase agreement" that could potentially also see a further delay in planned tariff hikes on USD250bn of Chinese exports from 25% to 30% currently scheduled for 15 October. This first-phase would then supposedly be followed by more negotiations on problematic core issues like intellectual property and forced technology transfers.

We have written at length about US-China trade talks before from a number of angles, and **we remain sceptical that any real deal can be done**. (See here and here and here for examples.) Indeed, with tensions rising between the US and China on a number of fronts, from trade to technology to sport, the likelihood of a trade deal is now openly perceived by markets to be declining. However, that does not rule out the possibility of a short-term can-kicking exercise until the next US election – though that is far from a given too.

Notably, **our scepticism also holds if we focus just on the purported currency accord now being floated**.

Or discord?

Recall that back in August, the Trump administration formally declared China a currency manipulator for the first time, a major psychological step if not immediately opening the door to any US action. Moreover, Trump has repeatedly made public in Tweets his view that China's currency is too weak (and, conversely, that the USD is too strong.)

As such, it should be obvious that **what the US will be insisting on in any currency accord is China committing to keeping the CNY stable, or even perhaps to strengthening it**. Indeed, Bloomberg reports that "according to people familiar with the currency language", the proposed pact largely resembles what the US has already agreed to in The United States-Mexico-Canada Agreement (USMCA), which has not yet been ratified by Congress.

The USMCA includes provisions forbidding member states from participating in currency manipulation. Article 33.4 of Chapter 33 states each Party should:

(a) *achieve and maintain a market-determined exchange rate regime*;

(b) *refrain from competitive devaluation, including through intervention in the foreign exchange market*; and

(c) *strengthen underlying economic fundamentals, which reinforces the conditions for macroeconomic and exchange rate stability*.

The ABC of weak CNY

From all three perspectives, this is likely to prove unworkable in terms of the US-China currency dynamic. Let's show why:

Achieve and maintain a market-determined exchange rate regime.

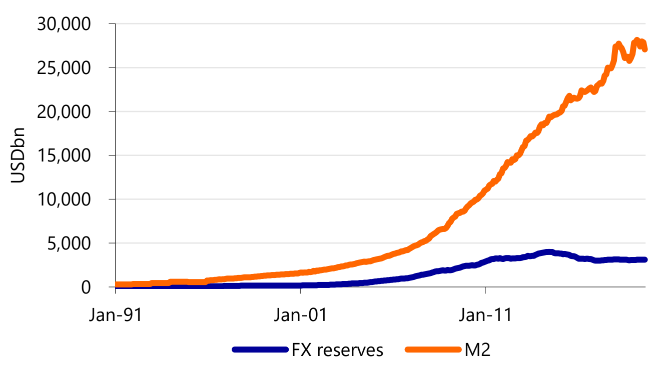
It is widely-known that China does not yet have a market-determined exchange rate. Every day markets have to wait for the PBOC fix to be announced at 9:15am, and trading is only allowed within a +/-2% band on either side of that fix. Moreover, a "counter-cyclical factor" allows the PBOC to set the fix where it sees fit, rather than following the daily market close; and, daily trading rarely comes anywhere close to those limits given there is always a Chinese counterparty involved. China's closed capital account also allows it huge influence over the currency.

Crucially, *if China were to now switch to a genuinely market-determined exchange rate regime, CNY would collapse*. That is one of the key reasons why it does NOT have a market-determined exchange rate regime!

That much should be obvious given three simple factors.

1) CNY has been trending lower for years now;
2) Far more local funds would wish to diversify into other currencies than foreign funds would wish to hold CNY; underlined by the next point that
3) The constant expansion in CNY liquidity relative to holdings of USD (see Figure 1 below).

Figure 1: More and more CNY; same amount of USD



Source: Macrobond

Note that the chart above actually flatters the growth in CNY money-supply because it is translated into USD, against which CNY has been depreciating. Without that, the divergence would be even more extreme. Which leads us to the next point

Refrain from competitive devaluation, including through intervention in the foreign exchange market.

If China stepped back from its structural intervention, it would see CNY weaken very significantly. We believe something in the order of 25% would be entirely possible. Indeed, our medium-term (two-year) CNY forecast is that this will transpire for various reasons.

However, the US is not likely to recognise that Chinese currency weakness is a reflection of its own poor policy choices: in the current political environment, it will instead no doubt cry "competitive devaluation!"

Strengthen underlying economic fundamentals, which reinforces the conditions for macroeconomic and exchange rate stability.

The only forms of economic reforms that could strengthen China's fundamentals such that the currency would remain stable or strengthen would be those that would prompt a huge increase in foreign capital inflows.

While China has long maintained that this is exactly what it wants to see, there has been no sign at all of a genuine deregulation and opening up of the Chinese markets to attract that kind of business capital. Rather, the de facto role of the state appears to be increasing steadily rather than decreasing.

Indeed, where China is perhaps opening up there is a major caveat: its move to a new Social Credit System from 2020 onwards--which will also apply to foreign corporate entities--is seen as an attempt to guide their behaviour. That issue is suddenly even more controversial following the escalating political spat between Beijing and the US National Basketball Association.

Notably, the White House has openly cheer-led the sharp move in supply chains out of China alongside the US-China trade war: yet **this does not support a stable or stronger CNY**.

Of course, China is eager to see an inflow of US financial capital into its bond and equity markets – and this had appeared to offer a bullish case for CNY. However, the Trump administration is apparently pushing ahead with steps to limit that inflow happening too.

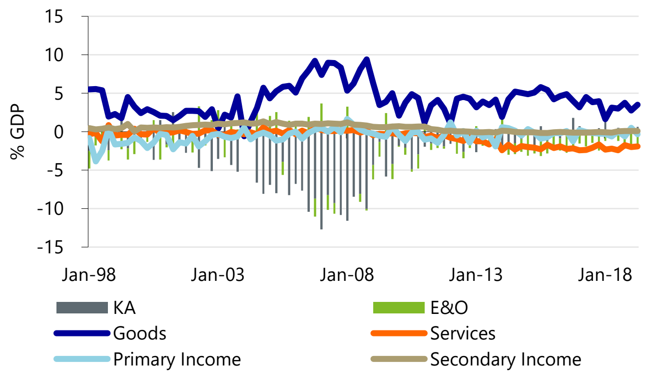
While there are arguably compelling geostrategic reasons for the White House to limit pension flows to China, **that also does not support a stable or stronger CNY.**

In short, the ABC of CNY is that it will weaken ahead regardless of any currency accord.

Capital letters

You will notice that the previous analysis focused only on the capital account and not on the current and trade account. That is for good reason.

Figure 2: The imbalance of China's balance of payments



Source: Macrobond

A look at China's balance of payments in Figure 2 above shows that **the capital account (KA) and Errors and Omissions (E&O) are both in deficit** – and the latter arguably represents capital flight that speaks to the points we just made about Chinese desires for FX diversification, and hence a weaker CNY.

China's primary and secondary income balance is basically zero (no big remittance inflows, or debt repayments, etc.) However, **China runs a large services deficit**. While this is officially tourism, one can again argue that part of it is also capital flight. Even if it isn't, it seems hard to imagine the net flow of tourists in and out of China rapidly changing. (Although it IS possible to imagine the tourist outflow stopping, either for political reasons, or to conserve FX if needed!)

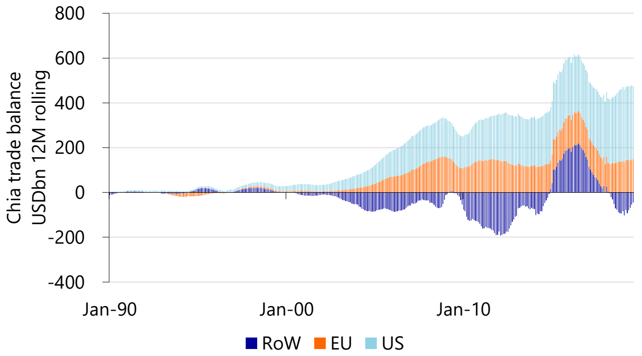
Most importantly, **the one item keeping China's balance of payments in surplus overall, and thus keeping CNY stable, is the trade account**. (Though again, we suspect over-reporting of imports and under-reporting of exports is taking place regularly, and still to facilitate capital flight.)

So far so good for China: **trade is healthy despite the trade war!**

Yet if one looks behind the aggregate figure at the breakdown of exactly who provides that net USD trade surplus (see Figure 3), one sees very clearly that problems lie ahead. Specifically, China runs a trade deficit with the rest of the world (ROW) and surpluses with the EU and--above all--the US, which provided 75% of China's 12-month rolling USD trade surplus as of August.

Isn't the goal of any US-China trade deal meant to be the US narrowing its huge trade deficit with China? If so, then absent China swamping the EU with goods to replace the 'lost' US market, which the sluggish EU economy makes unlikely, then **a US-China trade deal means a weaker CNY regardless of the currency-accord wrapper**.

Figure 3: Who keep's China's Greenbacks out of the red?



Source: Macrobond

That's logically even more the case if the US expects China to keep a strong CNY and hence try to take some of the strain as the global consumer of last resort, as the US has for so long.

As we have hopefully already shown, China simply is not set up that way. **China's economic model is, at root, to pump in massive local liquidity aided by financial repression, all behind a protective capital account firewall, consequently over-invest and under-consume, and then export its excess output to the world**. Moving away from that paradigm without serious pain is almost impossible to achieve.

If China's trade balance were to swing into deficit at the same time as every other area is in deficit, and if the US won't allow FDI and capital inflows to mirror that dollar outflow, or if foreign firms don't want to go into China of their own accord, then China will face a balance of payments crisis...and **a much weaker CNY to counter-balance**.

Yes, China might be willing to sign up to the US' proposed currency accord; and it might really want a stable or stronger currency; but against this backdrop, it isn't going to be possible. Even if there is the will, there is no way.

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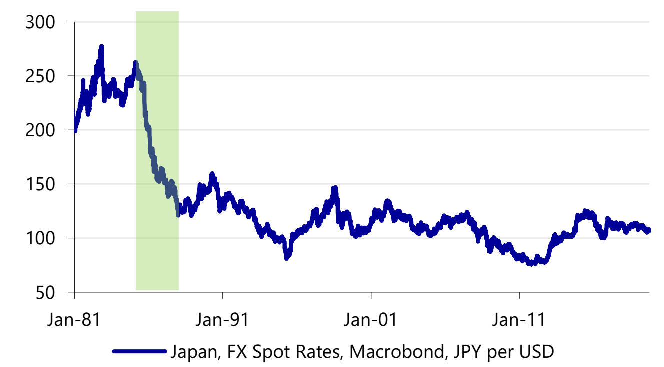
Moreover, is there really the Chinese will?

Those with longer market memories might recall that **in 1985 the US, which was even then running a large trade deficit, forced Japan into the Plaza Accord**, whereby the JPY was revalued significantly higher vs. USD (see Figure 4). USD/JPY moved from over 250 to around 120 in a very short space of time.

Japan, which both relied on the US market and the US defence umbrella, had no choice but to agree. However, the outcome of that decision was hugely negative for it.

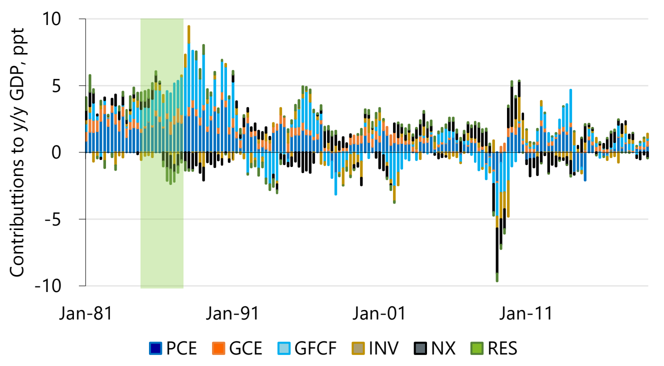
Figure 4: Can you spot the political structural break?



Source: Macrobond

In order to deal with the sudden shift away from an investment- and export-led economy, Japan decided to embrace a property bubble (see Figure 5). As such, it continued to over-invest (GFCF below) even as it no longer exported (NX) so much. GDP growth continued to be rapid for a while, and at the end of 1980s there were as many financial market articles talking about the 'inevitable' Japanese dominance of the US and global economy as there are about China today.

Figure 5: Spot the other structural break



Source: Macrobond

Then the bubble burst – and the Japanese economy has never recovered its dynamism in any area, including private and government consumption expenditures (PCE and GCE, respectively).

Notably, **China knows the lessons of the Plaza Accord very well** and is very unlikely to repeat them. That being said, there is a strong argument to make that is has actually repeated exactly the same error already in the form of the property bubble it has blown to try to maintain growth in the economy since 2008!

Regardless, it seems extremely unlikely that Beijing would want to see CNY move higher, like JPY did; and especially not to please the US and allow it to export more to it, relatively.

Crucially, one also has to ask: even if a deal were struck, **how would this be enforced?** Is China really going to allow the US to monitor its economy and markets, and to act on tariffs based on its own interpretation of what China is or isn't doing on the FX front? Would any economy, let alone China(!), sign up for that kind of erosion of sovereignty?

In short, **we think the idea of a new Plaza Accord in this global environment is laughable: LOL-A-PLAZA! ☺ Indeed, there is most unlikely to be any harmony ahead on the currency front, nor any US-China concert.**

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