DNB

FX Comment
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US naming China a currency manipulator raises the bar for monetary policy easing

The trade war has escalated as FX policy has been made a part of the toolkit. While the risk of US interventions has risen, we expect the administration to refrain as effects are uncertain. However, the threat of tariffs will make policymakers elsewhere more reluctant to ease monetary policy

Direct implications of labelling China a currency manipulator are mostly symbolic. Late Monday, the US Treasury officially named China a currency manipulator, the first time the Treasury has identified a currency manipulator in 25 years. The next step will be to approach the IMF to start negotiations. However, negotiations between the US and China have been underway for a while, leaving yesterday's step a symbolic one. Additionally, the US will not find much sympathy at the IMF, as the IMF's latest External Report from last month saw the yuan to be "broadly in line with fundamentals".

Threat of tariffs may change policymakers' reaction functions. The US President has repeatedly accused several countries of manipulating their currencies and this is obviously high on Trump's agenda. When trade deals with Mexico and Canada were renegotiated, they included paragraphs regarding punitive tariffs if currencies were manipulated. More important, the threat of tariffs will now matter for policymakers. The Swiss National Bank will have to weigh the probability of tariffs against the costs of a stronger CHF. Another punch by the Japanese at something similar to Abenomics will likely be met by countermeasures by the US. The European auto sector is currently risking tariffs, and any further easing by the ECB will run the risk of making these tariffs a little more likely. The same goes for several Asian economies: the bar for monetary policy easing has been raised.

White House brings new tools into the trade war. While the US administration has so far preferred tariffs, their punitive effect has been watered down by changes to FX (e.g. the weakening of the CNY and the MXN). Naming China a currency manipulator has therefore in some way been a long time coming. Yet, it is another attempt by the administration to affect financial market variables to their own liking. By circumventing the most recent legislation, the US Treasury Secretary this week made use of his delegated rights from 1988, which in essence leaves the decision to name someone a currency manipulator up to the Secretary himself rather than the Treasury staff. As such, while the risk of unilateral US FX interventions is small; it has been rising recently. Bear in mind, the decision to intervene remains in the hands of the US President and the Treasury Secretary and the capacity to intervene is significantly greater than the US Treasury's Exchange Stability Fund, as these ~USD95bn can be upped by leverage, bill issuance, or Fed coordination. Still, although not straightforward, a more likely next step would be to apply tariffs under the proposed changes to the current anti-dumping/countervailing duty procedure, changes that would include currency manipulation into the definition of an illegal subsidy. While not yet deemed acceptable by the WTO, the statues passed by Congress allow for tariffs from 15% to 50% if an undervalued currency is deemed an unfair subsidy.

Yet US interventions may backfire. Previous episodes of USD-related interventions have shown these actions to be successful at dampening FX volatility, while the impact on spot is more ambiguous. Just as important, the FX market has changed in recent years, with volumes rising significantly and the liquidity divided among a myriad of marketplaces. Given the current growth and yield advantage facing the USD, we expect any intervention effect on the USD to be short-lived. The irony would be that any USD weakness after US unilateral interventions would increase financial markets' uncertainty and add further fuel to the current slowdown of global growth, both arguments for a stronger USD. Further, any such weakness could be met by further monetary policy easing among trading partners.

Chinese authorities to stay course and not weaponize FX fixings, interventions nor US Treasury holdings. We have been expecting a further escalation of the trade war, as we see the conflict between the US and China as virtually unsolvable. The recent days have supported this view. Despite ongoing negotiations, US authorities have again upped the ante, to the obvious dislike of Chinese authorities. Thus, we continue to expect a further build-up in both tariffs and non-tariffs. Chinese authorities have been less willing to counter slower growth now than they have used to, partly reflecting their determination to reduce risks to financial stability which remain a top priority. While we expect to see FX policies (interventions and fixings) being used to reduce volatility and dampen the speed of any depreciation of the yuan, we do not expect neither FX policies nor the large part of the FX reserves held in US Treasuries being used as tools in the trade war (see this comment by Ingvild for more on the latter). However, as the effects of the trade war continue to dampen the economic outlook, we see it as natural that the Chinese would allow the CNY to drift lower against the dollar.

Magne Østnor, DNB Markets

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DNB Markets Macro Analysis

Kjersti Haugland
Chief Economist, Norway, euro zone
+47 24 16 90 01 / +47 917 23 756
kjersti.haugland@dnb.no

Jeanette Strøm Fjære
Economist, Norway and Sweden
+47 24 16 90 03 / +47 920 37 011
jeanette.strom.fjare@dnb.no

Ingvild Borgen Gjerde
FI/FX Analyst
+47 24 16 90 08 / +47 48 11 52 00
ingvild.borgen.gjerde@dnb.no

Ole A. Kjennerud
Economist, China and Japan
+47 24 16 90 07 / +47 477 57 482
ole.kjennerud@dnb.no

Knut A. Magnussen
Senior Economist, USA and UK
+47 24 16 90 04 / +47 476 04 046
knut.magnussen@dnb.no

Magne Østnor
FX Strategist
24 16 90 06 / 907 47 902
magne.ostnor@dnb.no

Kyrre Aamdal
Senior Economist, Norway, Sweden, Fixed Income
+47 24 16 90 02 /+47 906 61 112
kyrre.aamdal@dnb.no

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