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US-China tit-for-tat will continue until new Plaza Accord 2.0

By: Lars Henriksson, Senior Research Fellow; Co-Head, Frontier Asia Consulting
With Sebastian Spio-Garbrah, Chief Frontier Markets Analyst & Global Managing Director

Following the decision by Chinese authorities to let the RMB drop below the important $7:$1, and an order to stop purchases of all US agricultural products, the US retaliated by designating China as a "currency manipulator." The official statement explained the move as follows: "The Omnibus and Competitiveness Act of 1988 requires the Secretary of the Treasury to analyze the exchange rate policies of other countries. Under Section 3004 of the Act, the Secretary must "consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade."

Despite the posturing, the two sides will ultimately reach a new Plaza Accord, but neither side has felt enough pain to back off yet. More negative events are in store, before an ultimate agreement is reached.

The Chinese move to let the RMB to drop to the lowest level since the great financial crisis of 2008 was prompted by President Trump's decision to slap a new 10% tariff on $300bn worth Chinese imports, including previously spared consumer goods, effective Sep 1. In essence, the China-US trade war has reached a new potentially more dangerous phase where the paramount question is what to expect next?

Negotiations, the short answer. But won't start yet until both sides suffer even more and a Paretto Efficient position is established in the negotiations.

In the past the Treasury has labelled three countries currency manipulator: Japan in 1988, Taiwan in 1988 and 1992 and China from 1992 to 1994.

According to a report by the US Government Accountability Office, the three countries initiated "substantial reforms to their foreign exchange regimes" following negotiations and were subsequently from the list after their "currencies appreciated and external trade balances declined significantly." However on the last point China proved a glaring exception since trade balances continued to widen and ballooned to the $419bn trade deficit in 2018.

The Treasury seems to want to follow the same route this time as its statement it promised to work with the International Monetary Fund (IMF) "to eliminate the unfair competitive advantage created by China's latest actions." However China is no Japan!

It is likely that such negotiations could turn into a Plaza Accord 2.0, but not until the major issues around the US-China strategic trade issues are resolved in a 'Big Deal.'

In 1985 the first Plaza Accord was a joint agreement between G5 nations (France, West Germany, Japan, the UK and the US) to use FX market intervention and complementary national monetary and fiscal policies to weaken the US dollar relative to the Japanese Yen and the German Deutsche Mark and subsequently reduce the trade surplus of Japan and Germany against the US. As a result, the US dollar dropped by 54% against the Yen and the D-mark 49% against the Franc and 44% against the pound. In truth, the Plaza Accord was so successful it prompted the Louvre Accord in 1987, an agreement which was established to halt the US dollar's slide.

However the world today is different from the 1980s in three major ways: the US is the only country officially calling China a FX manipulator; the Federal Reserve and other major central banks are grappling low inflation rather than high inflation; and, perhaps most important China FX-manipulator label is closely linked to geopolitical and long-term competitiveness concerns, particularly in technology, which will not be resolved even if a Plaza Accord 2.0 can be struck.

Contact: Research@DaMinaAdvisors.Com

Phone +1 647 808 9671/+44 7779 656 878