SNAPSHOT - ECONOMICS

Has Trump misjudged China?

With the yuan's latest depreciation, China is upping the ante in its trade war with the US. This has significant market and economic implications.

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The Chinese yuan (CNY) has fallen below 7.0 versus the US dollar for the first time in a decade, a level which has been widely seen as a line in the sand for the currency.

Why is the yuan falling?

The move follows President Trump's decision to impose 10% tariffs on $300 billion of Chinese imports last Friday. This is not a coincidence. Rather than backing down in response to the US, China is upping the ante.

The exchange rate had been on the agenda at the trade talks, with China refraining from allowing the currency to weaken whilst negotiations seemed to be making progress.

Along with the move in the CNY, China has asked its state-owned enterprises (SOEs) to suspend purchases of agricultural imports from the US.

How are markets reacting?

As in the last period of concern over the CNY in 2015, markets have reacted adversely. Risk assets have sold off and safe havens such as government bonds and the Japanese yen are rallying.

Back in 2015, uncertainty over the direction of China's currency was significant as the authorities had not communicated their change of strategy to the markets. Today there is a clearer framework in place, and there are other differences. For example, in 2015 firms' currency exposures were unhedged and unprepared for any currency weakness.

Many borrowed in external currency simply to take advantage of the carry trade. The shock of 2015 and the greater two-way volatility since then, reinforced by messaging from the People's Bank of China, means that there is less of a mismatch on corporate balance sheets.

Messaging around the weakness is also clearer today than in 2015, when the reason for the devaluation was not obvious and so was interpreted as a sign of underlying economic weakness. In short, we would not expect a repeat today.

China had wanted tariffs to be removed as part of any deal, so by doing the opposite Trump was effectively delivering a rebuke. The problem now is that both sides could get into a position where they cannot back down without losing face. Consequently, the prospect of a deal has diminished and the risks of escalation have risen.

What does this mean for the global outlook?

Increased trade tensions will put further downward pressure on global activity, with investment plans likely to be delayed or cancelled and trade suffering. China and the Asian supply chain will be most affected, but US growth will also suffer.

Alongside a stronger US dollar, such an environment may well lead the US Federal Reserve to cut rates faster and further. Such a move may please the president and yet, whilst he could reverse his decision on tariffs with a tweet, it is difficult to avoid the conclusion that he has misjudged China's reaction.