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Trade Wars Jeopardize the Chance of an RMB Adjustment

In a surprise move, China retaliated against US and EU import quotas by removing export taxes on 81 textile products, in addition to canceling recently introduced export taxes on 74 apparel items.

It would appear that Beijing simply lost patience. After all, Beijing had cut fiscal incentives to export manufacturers in order to ease trade tension and renminbi (RMB) pressure, but the US and EU had not accepted these efforts to trim export expansion.

Though the US stance on China's trade and exchange rate policy may only get tougher, we sense a rise of nationalism and a shift of ideology toward the left in China, under current leadership. Vice-Premier Wu Yi abruptly cancelled her meeting with Japanese Prime Minister Koizumi in Tokyo, in which she intended show China's opposition to his insistence on visiting the controversial Yasukuni Shrine. Given this behavior, we think intensifying pressure from the US will only increase the risk of trade retaliation from China.

As we have argued before, China has long searched for opportunities to exit the current RMB-US$ peg. We thought this year would provide a good opportunity for such a move, given conditions that would complement a flexible exchange regime, such as still-high economic growth, a less overheated investment sector, and a more fully developed financial structure. Indeed, the central bank had extended duration of its sterilization bills from the usual three months to one and three years, while cross-trading of foreign currencies in onshore foreign-exchange markets had expanded.

But politics appear to have gotten in the way of the exchange-rate decision over the past few months. As external political pressure for a massive 10% RMB revaluation intensified, Beijing's strategy shifted to export demotion via the introduction of export taxes and reduced export VAT rebates in the hope of trimming export expansion, especially with the US. At the same time, larger capital outflows were encouraged by the government through the expansion of the amount of outward investment by local institutions. This strategy was aimed at trimming the surplus in China's balance of payments, which could have helped to ease external trade tension and at the same time, would have allowed Beijing to conduct currency reform at a measured pace.

The sudden removal of export taxes suggests that Beijing is not too confident that it can negotiate away the import quotas and/or tariffs imposed by the US and EU which would effectively cause China-based exporting firms to be taxed doubly—by China as well as in overseas markets. It is reported that the US Commerce Secretary will visit China on June 2 and EU trade representatives have shown their willingness to have further talks with China. Nevertheless, at this point, it is difficult to gauge whether improved diplomatic efforts will help prevent the trade tension from escalating.

We believe that as a result, China's exchange rate policy will be on hold. Our expectations for RMB policy are presented below:

- A mid-year change (i.e., in the next one or two months) of currency regime now looks next to impossible.
- In the absence of an outright trade war, we still think the odds are more than even that China will go ahead with currency reform, with a modest 2% to 3% widening of the RMB trading band and a re-pegging to a basket of currencies by the end of 2005.
- On the other hand, a trade war will mean no RMB adjustment in 2005. But if that turns out to be the case, we hope that China will continue its foreign exchange reforms in 2006 at a measured pace. Our worst-case scenario is that the trade wars lead to a sharp economic slowdown and rising regional unemployment in China next year, which we expect would postpone an RMB adjustment indefinitely.

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