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The US-China Trade Conflict Will Hit Europe and the Euro

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While the trade conflict between the US and China seems to be abating, their rivalry on technology is heating up. Their race for leadership will likely extend into the monetary realm. China has indicated it could respond to tariffs or tech-related measures by the US with currency movements. If so, Europe will inevitably be dragged into the conflict. The euro area needs to be proactive to prevent the euro from becoming a variable in an economic conflict in which it cannot remain an innocent bystander.

In their last round of negotiations in November 2019, the US and China seemed to be nearing an interim deal on trade, which would prevent further escalation in the short term. This positive development, however, should not obscure the profound rivalry that has emerged between the two countries – a rivalry that will gradually take different forms of strategic competition. In summer 2019, US President Donald Trump announced levies of ten percent on a further $300 billion of US imports from China effective September 1, 2019. The move, which was prompted by the collapse of US-Chinese trade discussions in Shanghai at the end of July 2019, brought all $509 billion of Chinese imports to some level of tariff. Because China does not have the same amount of US imports on which to impose tariffs, it has to find alternative ways to retaliate if it wants to avoid absorbing the full cost of these US tariffs.

Beijing has several options. It can reinstate the tariffs on US cars that it had lifted in December 2018 as a gesture of goodwill. It can also further cut imports of agricultural goods from the US and impose tariffs on oil and gas imports, which would incidentally increase its demand from Iran. Of more global consequence, China can use the exchange rate to alleviate the pressure created by US tariffs on its economy. It has already started to do so by letting the exchange rate of the US dollar (USD) against the renminbi (RMB) surge through 7.0. This move, though, is largely symbolic because what truly matters is China's effective exchange rate – the rate against all its trading partners rather than simply against the USD. Still, it was an important warning indicating that China can and will extend the trade conflict to the curren-

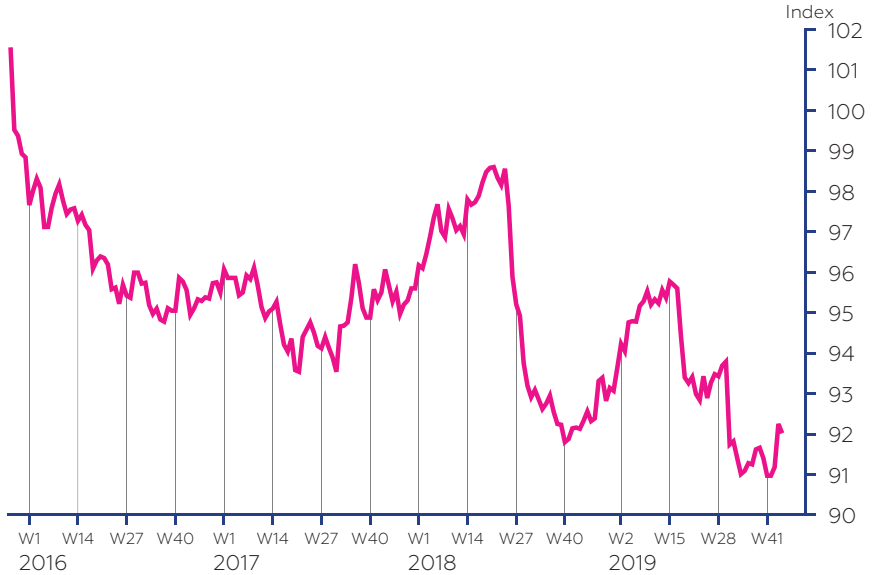
cy realm if necessary. Moreover, in addition to trade tariffs, other forms of rivalry between the US and China – for example, investment restrictions and regulatory constraints on Chinese companies – could bring about a Chinese response via the exchange rate.

CONSEQUENCES BEYOND CHINA AND THE US

The transformation of this trade conflict, which has so far been bilateral, into a currency conflict has far reaching implications. By weakening its exchange rate, China is spreading the cost of US tariffs on the rest of the world and, hence, internationalizing the conflict. The euro (EUR), for example, has appreciated against the RMB since April 2019, which has already negatively affected the exports of the euro area and Germany. Should this gradual devaluation continue, it will force other countries to take measures to limit the spillovers; fiscal and monetary reactions from other players will likely follow. So far, these reactions have been contained. But given the importance of China to Asian and global supply chains, a substantial devaluation would inevitably provoke a chain reaction – as the breadth of spillovers from the devaluation of the Chinese yuan (CNY) in summer 2015 suggests. A recent paper finds that trade tariffs have more effect on import/export elasticities than foreign exchange (FX) movements and highlights how large a devaluation should be if it were designed to respond to trade tariffs. The paper states that, in order to achieve a given trade deficit in a world made of two countries, a 14 percent depreciation of the RMB against the USD would be necessary to erase the effect of an average increase in US import tariffs of 5 percent.

The effective devaluation of the RMB required to offset further American tariffs could, therefore, be substantial and would provoke a realignment of global exchange rates that includes considerable appreciation of the EUR and the Japanese yen (JPY). Indeed, since February 2016, global exchange rate markets have been operating under a confidential framework that was agreed upon on the margins of a meeting of the G20 finance ministers and central bankers held then in Shanghai. After the shock RMB devaluation of August 2015, which had unleashed destabilizing capital flight from China and accelerated the appreciation of the USD, the Federal Reserve had tacitly agreed to delay its tightening cycle – provided that China also contain depreciation forces weighing on the RMB through a mix of interventions and capital controls. This basic agreement has largely held at the Federal Reserve since Jerome H. Powell became its chairman in early 2018. Since then, the Federal Reserve has remained quite sensitive to movement in the USD and, along with the US Treasury and US Trade Representative, insistent on China limiting depreciation of the RMB. Today, with this agreement at the heart of the truce on trade toward which the US and China seem to be moving, the Trump administration continues to insist on currency stability as an essential commitment from China. The question is whether China's commitment will last – especially if the conflict extends to critical elements of China's technological development. The US ban on opening critical 5G networks to Chinese telecommunications company Huawei or its ban on selling microchips to ZTE could, for example, be expanded to include a wider set of technologies or a wider range of firms.

Figure 1: The People's Bank of China is Undertaking a Slow, Managed Depreciation

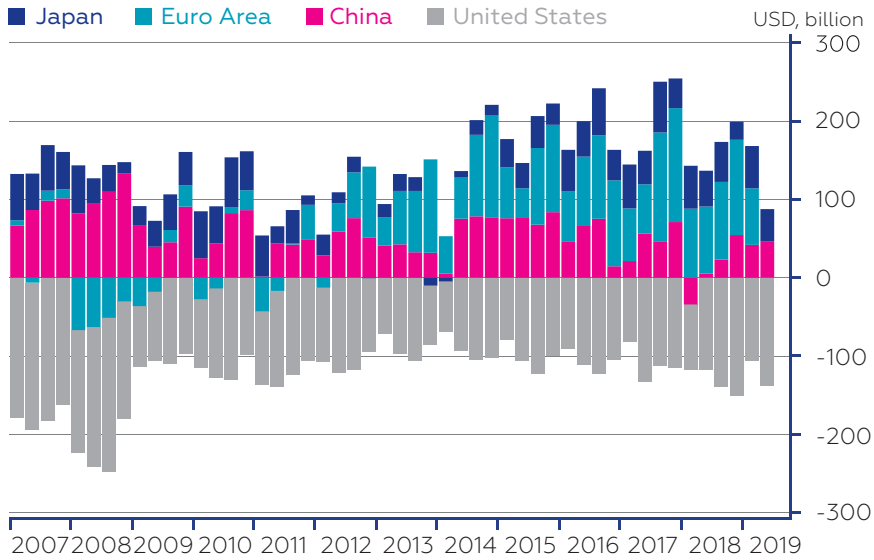


Source: Macrobond: China, FX Indices, China Foreign Exchange Trade System, CFETS RMB Index (SDR Currency Basket), Index

The use of such alternative barriers could intensify the trade conflict in the currency realm, inevitably forcing countries with the highest potential for currency appreciation to shoulder a greater part of the burden of the adjustment between the US and China. The tacit Sino-American agreement of 2015 had contributed to the policing of exchange rate volatility and capital flows. If China decides to make the trade confrontation monetary, it will first and foremost affect those surplus countries – such as Japan and the euro area – which had been most enjoying its indirect benefits. In addition, US adjustment efforts to weaken the USD might well increase if President Trump weighs in himself, intensifying pressure on the Federal Reserve – perhaps

up to the point of removing its chairman and even contemplating currency intervention. Trump's rhetoric against recent policy decisions by the European Central Bank (ECB) suggests that the US administration is alert and also prepared to export the currency discussions beyond China. While the recent G20 meetings and this summer's G7 meeting of finance ministers and central bankers in Chantilly have made every effort to avoid this sensitive topic by sticking to their previous (but vague) commitments on exchange rates, they will be insufficient to address the breakdown of the Shanghai truce.

Figure 2: Global Imbalances Remain with Euro Area as Biggest Contributor



Source: Macrobond: IMF BOPS, Balance of Payments, Current Account, Totals, Net USD

THE NEED FOR COORDINATED ECONOMIC POLICY IN EUROPE

These issues, which are likely to erupt at any time over the coming years, present challenges that Europe is wholly unprepared to deal with. The euro area's declaration that it is willing to strengthen the international role of the EUR hides the fact that the internal prerequisites for such strengthening are far from given. Broadening the circulation of its currency, for instance, would require the euro area to extend invoicing in EUR, broadening the reach of its payment system to secure global transactions outside of the extraterritorial reach of the United States sanctions regime. This, in turn, would require enhancing the role of the EUR as a store of value by reassuring global private investors about the ability of the euro area to stabilize both its banking and shadow banking systems, which entails extending the ECB's network of swap lines to prevent shortages of EUR liquidity outside of Europe. The euro area would also need to deepen the market for safe assets available from it to international investors.

Each of these challenges will spark profound discussions about economic policy coordination in Europe. Indeed, in the event of a real escalation, the euro area could only respond to foreign exchange destabilization caused by the US-China conflict if it could deliver a coordinated monetary and fiscal response on a sufficient scale to avert a substantial increase in the EUR's real effective exchange rate that would further reduce inflation expectations and growth. The only way to achieve this would be a significant and coordinated fiscal expansion, which would allow the ECB to expand its quantitative easing program in response to the deflationary impulse provoked by the escalation of the trade conflict in the currency realm. As it stands, despite growing risks of an economic slowdown, the euro area is only planning to expand by 0.2 percent of GDP in 2020. The euro area seems unable to challenge the strictures of the stability and growth pact, which creates some concern about its ability to summon the type of policy response that would be necessary in the case of a real currency conflict. The ECB does indeed have the power (under command of the Council) to undertake currency intervention, but such an intervention would only have limited effects if it was not backed by the right domestic economic policy.

The reality today is that Europe's economic governance makes it hard to imagine that it could combat an all-out US-China trade conflict in the currency realm. The euro area is indeed constrained by fiscal rules that would need to be revisited in a scenario where both the currency and the economy may come under such pressure. Europe might then be held back by a central bank that is probably the most independent in the world and may prove reluctant to cooperate with – or be instructed by – European finance ministers. It is divided on the use of trade retaliation and may, therefore, seem easier to bully. Consequently, if the euro area cannot achieve internal economic policy coordination, the EUR will become the external variable of adjustment that absorbs a meaningful part of the devaluation of the CNY.

Indeed, the last international currency arrangements – the Plaza Accord of 1985 and Louvre Accord of 1987 – were held at a time when the USD was more dominant and European countries each had their own currency. Then,

Europe could coordinate with the rest of world without really having to coordinate internally first. The rules of the game have now changed and – while they should, in principle, allow the euro area to stand taller in these international trade cum currency tensions – internal disagreements might hold it back. After such a lengthy period of moderation, the potential for monetary instability provoked by escalating Sino-American tensions justifies questioning Europe's ability to respond. It is critical for the euro area to think about – and prepare for – such a situation because it is, in fact, only by preparing for such cases that it can achieve its stated aim: expanding the international role of the EUR and enhancing Europe's sovereignty.

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