US-China trade war: What happens now?

China has retaliated against the US tariffs, but only mildly. We believe China could take a more aggressive stance towards the US if it wanted. Meanwhile, China is going to cut taxes to support the economy. The yuan is volatile but could be stable when the two sides meet at the G20 summit in June

Donald Trump, Xi Jinping. President Donald Trump, right, with China's President Xi Jinping, left

Source: Shutterstock

Gentle retaliation

As mentioned in our trade research, China's response to US tariff hikes has been relatively mild. The increase in tariffs on $60 billion goods varies from 25% to 5%, which is less than half of the 15% (25% - 10%) increase in tariffs on $200 billion goods imposed by the US.

Why did China respond in this way?

We believe that China wants to refrain from escalating the trade tensions and its response implies that it is willing to continue the negotiations.

What will China's reaction be if the US imposes 25% tariffs on all remaining goods

If the US retaliates by imposing 25% tariffs on all remaining Chinese goods ($339.5 billion, using data of US imports from China in 2018) China might react more aggressively.

For example, as a first step, China could stop businesses from investing in the US. The hot topic of whether China will stop buying US Treasuries depends on whether the US escalates the trade war, but we believe China will reserve this option as the last salvo.

China will step up tax cuts and targeted liquidity easing

As mentioned by Premier Li last Friday (10 May), the government is prepared to cut taxes and fees to further support the economy. We think these fiscal measures will be combined with more targeted monetary easing. The increase in liquidity will put downward pressure on interbank interest rates.

Will China allow yuan to depreciate further?

We think that yuan depreciation is not the answer to boost exports. If export orders fall as a result of tariffs, a small depreciation of the yuan will not help.

In fact, if the yuan depreciates further (USD/CNY spot 6.8817) in a short period of time, it will fuel concerns of capital flight. The central bank wants to prevent this from happening, mainly through stabilising the daily fixing of the exchange rate, so as to send a signal to both onshore and offshore markets that the yuan is stable.

By the time President Xi and President Trump meet at the G20 summit in June, the yuan should stabilise further. We maintain our USD/CNY forecast 6.75 by the end of 2Q19, though we don't rule out increased volatility in the pair in the run up to the G20 meeting.