

FX Insight

RCEP, A Partial Hedge Against US-China Trade Tensions

Creation of Largest Trading Bloc; AxJ FX Sentiments Anchored

The RCEP agreement signed on 15 Nov 2020 is the largest FTA pact in the world, with its 15 member countries accounting for 30% of the world's nominal GDP and population, and nearly 28% of global trade. RCEP member countries need to ratify the agreement for it to come into force, possibly sometime in 2021. Trade and investment flows are expected to increase, but we expect the full benefits will take time to play out.

On FX price action post-15th Nov, we noted the modest gains in most Asian-ex INR FX—we had hinted for the (positive) risk event in our daily reports last week and developments were largely in line with expectations. Going forward, we opine that for Asia, such regional trade pacts could form a natural conduit for the diversion/substitution of trade or investment flows if stress points appear in various parts of the US-China relationship. In FX terms, especially for ASEAN currencies, one possibility is that CPTPP and RCEP taken together help form a partial hedge against drags from bouts of US-China tensions.

Hopes for Free & Fair Trade

The impact of free trade agreements (FTAs) on exchange rates is somewhat mixed in the literature. Theoretically, FTAs have the potential to influence macro outcomes and exchange rates via channels such as:

- Reducing cost of imported inputs for producers, leading to improved margins and higher economic growth.
- Encouraging efficiency and innovation in tradable industries, and inducing higher wages, infrastructure investments. Higher labor productivity, narrowing savings-investment gaps etc. are usually associated with more appreciated exchange rates.

But these positive effects take time (multi-decade shifts). Studies by organizations such as Peterson Institute for International Economics (PIIE) also broadly find that FTAs may not lead directly to outsized impacts on a country's structural trade balances.

In some sense, especially in the early stage of signing or ratification, the main means of spillover to asset prices would likely be through the sentiments channel still. In particular, there is some evidence of short-term announcement effects which can impart an interim boost to risk-on moods.¹ This effect is generally stronger when:

- Trade agreements are signed between countries that already engage in high volumes of trade. (See discussion below.)

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¹ See Rose, Moser (2014), "Who Benefits from Regional Trade Agreements? The View from the Stock Market".

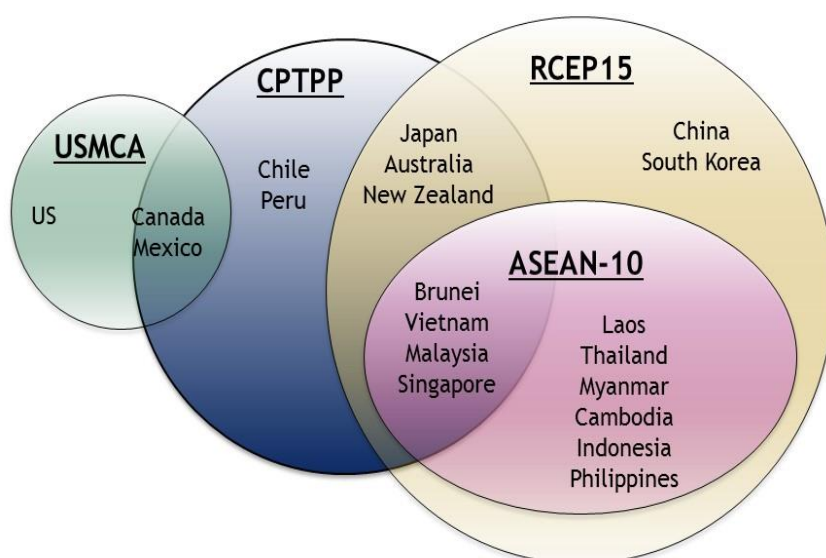
- Some of the countries entering trade agreements are lower-income (i.e., potential for growth in GDP/trade from low base).

RCEP arguably satisfies both criteria to some extent. And more critically for market confidence, it is a sign that the Asia-Pacific economies, in particular China, remain receptive to building external linkages and growing the regional trade & investment pie, a stark contrast to the bouts of trade conflicts and protectionism we have witnessed over the past few years.

To recap, the Regional Comprehensive Economic Partnership (RCEP) was signed virtually on 15 Nov 2020 at the 4th RCEP Summit. The agreement involves 15 countries in the Asia Pacific region including 10 ASEAN members alongside 5 regional countries which ASEAN has FTAs with, i.e., China, Japan, South Korea, Australia and New Zealand. (see [here](#) for Summary of RCEP Agreement)

This is the world's largest free trade agreement (FTA), with member countries accounting for 30% of the world's nominal GDP and population, and nearly 28% of global trade.

Trade Grouping: ASEAN in RCEP, CPTPP; USMCA



Source: PIIE, EIU, Maybank FX Research & Strategy

Some of the objectives of RCEP include facilitating the expansion of regional trade and investment, improve market access with tariffs and quotas eliminated in over 65% of goods traded, bring about market and employment opportunities and enhance protection of intellectual property rights beyond the level of WTO Agreement of Trade-related aspects of intellectual property rights (TRIPS agreement).

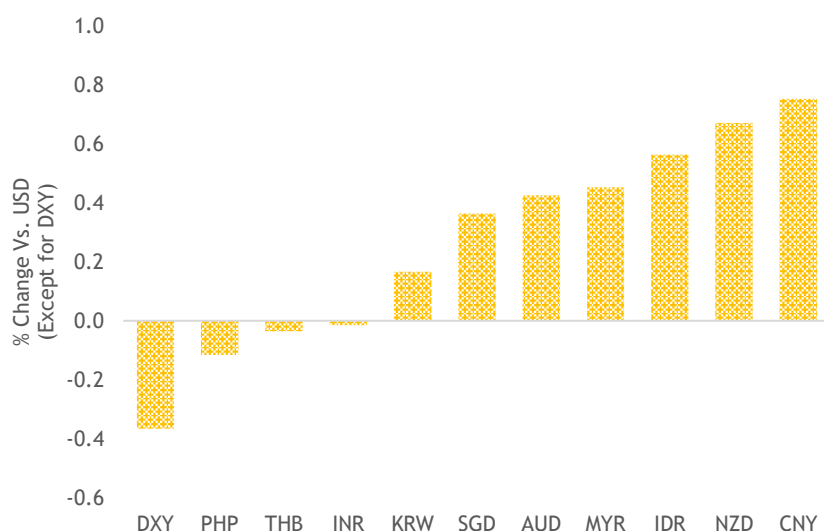
Most importantly, the RCEP aims to reduce non-tariff barriers by creating common rules of origin (ROO). While many countries within RCEP already have bilateral FTAs, their products can still be subjected to tariffs or trade barriers when moving outside the bilateral FTA. For instance, the products need to be either 100% from the member countries in the agreement or it needs to be shown that the product has been “substantially transformed” in the member countries to qualify for preferential benefits. Some product, say a moisturizing cream may contain imported ingredients from outside the parties in the FTA and hence may not qualify for the benefits of lower tariffs. Under RCEP,

having a common ROO in place now means that these products can qualify for preferential benefits so long that it can be established that the imported ingredients come from anywhere among the 15 RCEP countries. Technically this should foster closer regional trade integration, reduce cost, streamline procedures for companies and increase the appeal of the region.

Asian FX Strengthened - A Reflection of Positivity on RCEP

While it is difficult to distill RCEP-induced optimism from other news flow, a quick glance at FX changes early this week (end Tues vs. end last Fri), bearing in mind that the RCEP deal was inked over the weekend, suggests to some extent that positive announcement effects (as discussed earlier) are indeed in play.

CNY and Regional Risk-Sensitive FX Outperform Modestly Post RCEP Inking (17 Nov vs. 13 Nov.)



Source: Bloomberg, Maybank FX Research & Strategy

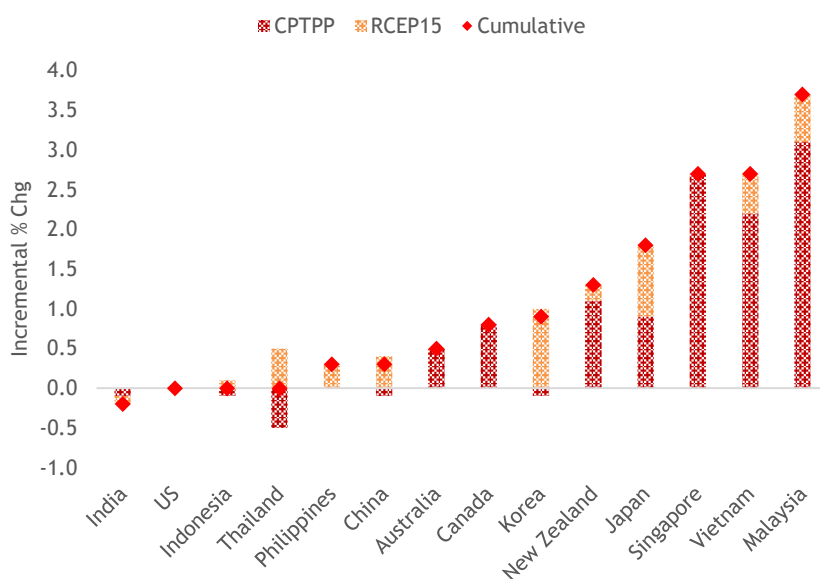
A Partial Hedge Against US-China Tensions

A somewhat less appreciated aspect of RCEP (taken together with CPTPP) is also that they have the potential to be a natural hedge against any rise in US-China tensions, from the perspective of exposure in Asia ex-China risk assets.

For instance, PIIE estimates that Asia could lose up to US\$289bn in 2030 income terms in a sustained US-China trade war scenario, with most of the income losses borne by China. Given China's close economic linkages with the region, there could be second-round negative spillovers to regional economies from reduced China demand and investment flows etc.

But CPTPP and RCEP can potentially add US\$53bn and US\$179bn to the Asian 2030 real income pie respectively (PIIE estimates), helping to mitigate a significant portion of the drags from any US-China trade tensions.

Incremental % Change to 2030 Real Income from CPTPP and RCEP (Under PIIE's Sustained Trade War Scenario)



Source: PIIE, Petri & Plummer (Jun 2020) Working Paper

Notably, the PIIE estimates suggest that the direct real-income effects from increases/shifts in trade flows as a result of CPTPP/RCEP differ significantly among nations. China benefits most in absolute terms (US\$85bn in 2030 real income in “business as before” scenario; US\$100bn in “sustained trade war” scenario) from RCEP, but this naturally translates into a smaller % change given its size.

Countries such as China, Indonesia, Philippines, Korea and Thailand are also not part of CPTPP, so they could see mild to modest drags from CPTPP (diversion of trade flows), which are in turn expected to be offset or more than offset by their participation in RCEP.

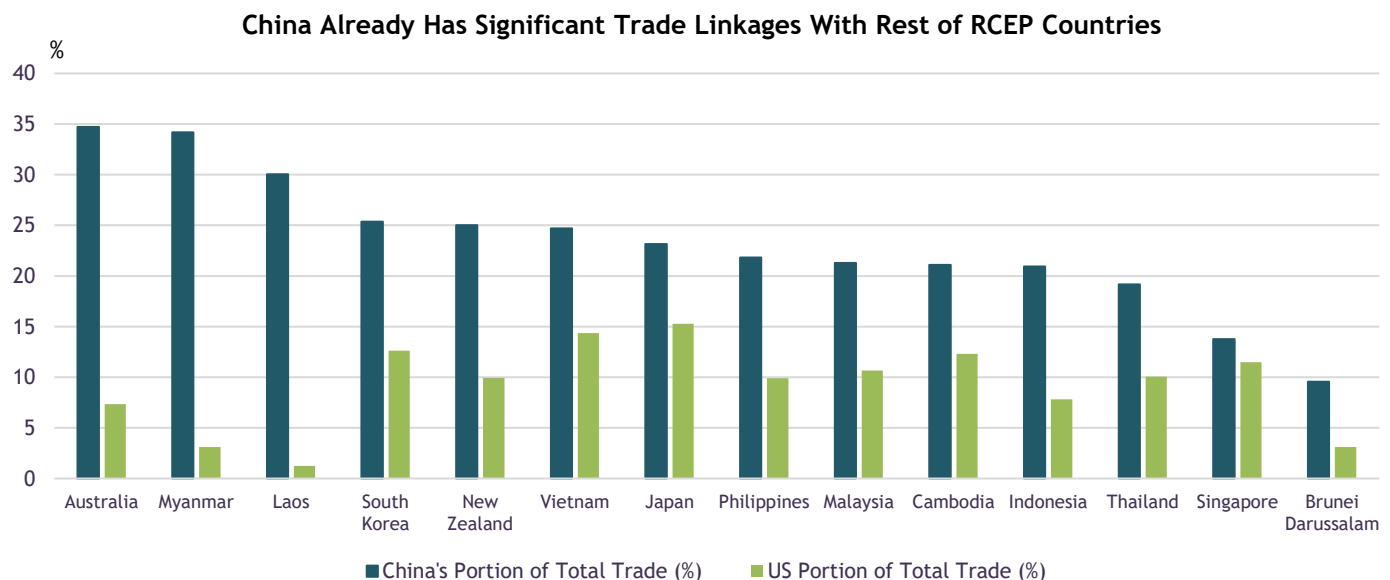
Singapore, by virtue of its presence in many existing FTAs, could see limited direct gains from RCEP (especially once CPTPP is taken into account), given that the RCEP pact is partly a consolidation of other smaller existing agreements. But indirect benefits which are more challenging to estimate should not be under-appreciated. Network and confidence effects are in play, particularly as the RCEP connects ASEAN to heavyweights China, Japan and Korea and as discussed earlier, simplifies rules of origins requirements and improves supply chain efficiency, which could in turn amplify Singapore’s value as a regional transport and financial hub.

On net, what this means for Asia is that there is a natural conduit for the diversion/substitution of trade or investment flows if stress points appear in various parts of the US-China relationship. In FX terms, especially for ASEAN currencies, one possibility is that CPTPP and RCEP taken together help form a partial hedge against drags from bouts of US-China tensions.

China's RCEP Involvement is Strategic in its Endeavour for Dual Circulation

From China's perspective, its involvement in the RCEP is broadly aligned with President's Xi Jinping's recent push for "dual circulation". Apart from the tariff eliminations that could spur trade volume growth, key to the RCEP agreement would be the common rules of origin for businesses to ship their products to anywhere within the 15 participating countries under the RCEP agreements (overcoming the "noodle bowl" problem of businesses encumbered by multiple FTAs that come with different rules for each country). This would greatly enhance the access to markets for exporters across the regions and draw the 14 other countries which already have substantial trade volumes with China, closer to the country.

Most RCEP Countries Already have Strong Trade Ties with China



Source: Bloomberg, Maybank FX Research & Strategy

Note: Trade numbers in the chart are based on 2019 annual trade values. Each bar can be read as China or US' share of the respective country's total trade with the world.

Recall that the "dual circulation" is a shift in priorities towards building a stronger domestic economy as the global environment becomes increasingly hostile, exacerbated by the COVID-19 pandemic and the trade/tech war with the US. China thus finds it imperative to reduce its reliance on US technology, become more independent in its supply chains and strive to diversify its critical supply channels. And so, the "dual circulation" endeavours stronger consumption at home that would enable the country to increase its domestic production in the hope that a smoother internal circulation (internal supply and demand) would give China that competitive edge on the global platform.

With RCEP, China may be able to ensure market access to the region for its domestic companies amid potential tensions with certain major countries, attract capital flow from participating nations (in line with its aim to attract foreign investment), and perhaps eventually provide the opportunity for China to increase its influence in the region via outward investments to the region.

According to the Director of the Department of International Trade and Economic Affairs of the Ministry of Commerce, RCEP facilitates China's endeavour of a new dual circulation development pattern, promote market competition for all industries and improve the country's resource allocation capacity in domestic and overseas markets.

Concluding Remarks - Shifting Focus from RCEP to Covid, Tails Risks of US Elections

Taking stock, most USD-AxJ pairs continue to trade near fresh 2020 lows this week as US election uncertainties faded, vaccine hopes were reignited (thanks to Pfizer/BioNtech's BNT162b2 and Moderna's mRNA-1273) and the world's largest trade pact (RCEP was signed over the 15th Nov weekend). In particular, USD softness was rather broad-based across most Asian FX.

The short-term announcement effects are clear, the longer-term effects likely less so. But on an optimistic note, China's implementation of its "dual circulation" strategy, alongside potential post-Covid return of investment and portfolio flows to Asia over the medium term, could continue to bode well for yuan and other AxJ currencies, especially when regional linkages are strengthened by RCEP and other trade pacts. In addition, CPTPP and RCEP can potentially add US\$53bn and US\$179bn to the Asian 2030 real income pie respectively (PIIE estimates), helping to mitigate a significant portion of the drags from any potential US-China trade tensions (PIIE estimate of US\$289bn losses in 2030 Asian real income in scenario of sustained US-China trade war). This implies that such trade pacts could help to hedge against downsides in the regional macro outlook induced by bouts of US-China tensions. Taken together, this could mean that AxJ FX continues to be anchored by yuan strength in "good times", while drags in regional sentiments from escalation in US-China tensions could be more contained.

In the interim, we expect focus to shift back to Covid situation (vaccine optimism vs. second wave scare) and to some extent the tail risks of US election. On the former, we think caution is still warranted despite vaccine optimism especially with Covid infections seeing sustained increases in US, Europe and UK. In Asia, Japan, Korea and HK saw record spike in infections as well. This raises concerns if the risk of recurrent waves of infection could outpace vaccine availability/distribution and hospital capacity. If cases continue to climb, more stringent measures could be put in place to contain the spread. Germany already warned that curbs could be extended through Christmas and stricter social distancing measures could be extended for at least the next 4 - 5 months while New York City is on partial lockdown as schools, high-risk non-essential businesses are closed while public gatherings are limited.

On the latter, it's been more than 2 weeks since US elections on 3 Nov and the vote count finally ended last weekend (14-15 Nov). Several media outlets including NBC, CNN have called for Biden as the President-elect after vote counting ended in Georgia (for Biden) and North Carolina (for Trump) last Sat. Biden takes 306 electoral college votes while Trump has 232 votes (as of 18 Nov per CNN taking into consideration Georgia electoral college votes in favor of Biden; a recount is underway there

and Biden is in 12k lead; this is expected to be concluded within next 24 hours). Democrats retained the House while Senate remains an unknown till 5 Jan run-off. Over the weekend, Trump acknowledged Biden's win for the first time but backtracked 2 hours later and said he "concedes nothing". This suggests that we could expect some surprises from Trump in coming days but the impact of his tweets or action may have diminishing powers. Nonetheless there are still some risks ahead (constitute to risks of USD bounce) to keep in view. Focus on certification schedule of swing states and 14 Dec when electors cast votes in electoral college. Trump would need to overturn results in at least 3 states to prevent President-elect Biden from reaching the 270 electoral votes required by Constitution, which we see low likelihood of it happening.

On net, we expect FX markets to trade range-bound in the near term, driven by recurring Covid spread and vaccine optimism until vaccine rollout. To some extent for USD-AxJs, we are also mindful of *leaning against the wind* activities from regional policymakers in attempts to slow the pace of AxJ FX appreciation.

Beyond the near term, material progress towards vaccine availability/rollout soon could potentially be a game changer as the containment of pandemic suggests that travel restrictions, social distancing measures could be lifted and the global economy could be closer to a more sustainable growth recovery. In light of this, we remain better buyers of pro-cyclical FX, including AxJs, AUD, NZD on dips while USD remains a sell on rally.

Vote Certification Deadlines and Key Timeline to Inauguration

Date	State/ Remarks
20 Nov 2020	Georgia certification deadline
23 Nov	Pennsylvania and start of 20-day window for Michigan to complete certification
30 Nov	Arizona certification deadline
1 Dec	Nevada, Wisconsin certification deadline
8 Dec	"Safe Harbour". Congress cannot challenge any electors named by this date.
14 Dec	Electors meet in each state to cast votes in the Electoral College
5 Jan 2021	Senate run-off in Georgia (2 seats)
6 Jan	Congress counts Electoral College votes
20 Jan	Presidential inauguration

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