

FX Insight

Mirror Mirror on the Wall, Who's the (un)-Fairest of them All?

Mixing Currencies and Trade Discussions

One clear difference between the Trump team and previous administrations is that he seems much more ready to mix currency discussions with trade policy. Previous administrations had avoided doing so, as it could lead to legal challenges at the WTO or further retaliatory action by the accused country. Notably, the US has not labelled any major trade partner a currency manipulator since 1994—China was named five times from May 1992 to July 1994.

Recently however, there are clear signs that this is changing. First, the US managed to include a currency provision into the trade deal struck with Canada and Mexico last year during the NAFTA revamp. It is expected to push for similar currency clauses in its trade deal with China too, if one can be reached. Second, the semi-annual US Treasury report on foreign currencies released this morning lowered the threshold for inclusion into report coverage, and also the threshold required to be put on its “monitoring list”—a smaller list of countries the US believes it needs to engage more closely as they meet a number of criteria for currency manipulation. With regards to the overall report coverage, the number of countries covered has increased from 12 to 21, after the US used a new threshold of “> \$40 bn” in defining a “major trading partner”. Criteria (2) and (3) were also adjusted accordingly. (Table 1)

Table 1: New Treasury Thresholds

Criteria	Benchmark	Previous threshold	New threshold
Major Trading Partner Coverage	Total Bilateral Goods Trade (Imports plus Exports)	12 largest trading partners	\$40 billion¹
(1) Significant Bilateral Trade Surplus with the United States	Goods Surplus with the United States	\$20 billion	\$20 billion
(2) Material Current Account Surplus	Current Account Balance	3% of GDP	2% of GDP
(3) Persistent, One-Sided Intervention in Foreign Exchange Markets	Net FX Purchases	2% of GDP	2% of GDP
	Persistence of Net FX Purchases (months)	8 of 12 months	6 of 12 months

Source: US Treasury

¹21 trading partners exceeded this threshold as of 2018.

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As a result of the lower thresholds, 9 more countries were added to the report coverage (12 to 21), and the smaller monitoring list also saw new entries—Italy, Ireland, Singapore, Malaysia and Vietnam. India and Switzerland were dropped from the monitoring list. *SGD largely shrugged off the news, given markets' familiarity with the currency as a monetary policy tool. MAS also argued that deliberate weakening of SGD will actually compromise price stability due to Singapore's high level of trade openness. BNM reiterated its stance that Malaysia doesn't engage in unfair currency practices and the USDMYR actually rose slightly in early morning trading.* Despite the larger number of countries being “monitored”, one key finding remains that no major partner met all three criteria in the reporting period and hence no country would officially be named as a “currency manipulator”.

Notably, the conventional approach to deal with “currency manipulators” is generally deemed to have less “bite”, as it usually starts with a period of negotiation, nudging the country to adopt appropriate policies to correct the currency. If negotiations fail, the IMF can be asked to intervene, or funding from the US Overseas Private Investment Corp (which supplies US funding to new projects in emerging countries) can be cut. However, recent OPIC projects are concentrated in Africa and Latin America, and impact on Asian countries, especially China, from such channels, could be limited.

Proposal of Countervailing Duties by US Department of Commerce

Not to be caught in the Treasury's name-calling, we think that in terms of potential impact, a new notice issued late last week by the Department of Commerce (DOC) bears a bit more attention, even though **it remains a proposal at this stage and it is unclear what final form of the proposal will be adopted, if at all.** It proposed to impose countervailing duties on countries that “act to undervalue their currency relative to the dollar, resulting in a subsidy to their exports”. The proposal drew attention by setting broader standards for what constitutes “currency undervaluation”. These new tariffs could also be theoretically more damaging than the existing approach to deal with “manipulators”, as it places an actual dollar value penalty on the “manipulator”, dependent on the estimated level of benefit its goods exports was deemed to have received as a result of the undervalued currency.

Here, we engage in a hypothetical exercise and use a sequence of quick metrics to identify countries which may be potentially implicated. First, we identify the Top 20 countries with the largest (goods) trading surpluses with the US. This is similar to criterion (1) used by the Treasury, but with one crucial difference. Notably, countries such as Singapore, UK and Hong Kong which have **goods trade deficits with the US** are included in the Treasury coverage (they might violate other criteria) but do not appear in Table 2 below. We think it less likely that the US can credibly argue for a case of “subsidy from lower-valued currency” if these countries actually have a trade deficit with it, i.e. the US is actually gaining from goods trade with these nations. It is also unlikely that with countries such as Germany, Ireland, Italy and France being members of the Euro Area and being subject to Euro monetary policy as a bloc, the DOC would suggest to impose widespread countervailing tariffs on European countries for failing to appreciate the euro. This would likely be a black swan event.

Table 2: Countries with Highest Goods Surplus with US

Country	Goods Surplus with US	CA Balance (% GDP)	Country	Goods Surplus with US	CA Balance (% GDP)
China	408 bn	0.4%	Korea	21 bn	4.7%
Mexico	86 bn	-1.8%	Thailand	19 bn	6.9%
Japan	68 bn	3.5%	Canada	18 bn	-2.6%
Germany	68 bn	7.3%	Taiwan	17 bn	12.2%
Ireland	48 bn	9.1%	France	17 bn	-0.3%
Vietnam	44 bn	2.7%	Russia	14 bn	6.9%
Italy	32 bn	2.5%	Indonesia	12 bn	-3.0%
Malaysia	27 bn	2.1%	Saudi A.	10 bn	9.2%
India	22 bn	-1.8%	Iraq	9 bn	7.8%
Switzerland	21 bn	10.2%	Austria	9 bn	2.3%

Source: CEIC, Maybank FX Research & Strategy

Note: 4Q Trailing data (Q2 2018 to Q1 2019) was used to compute Goods Balance, while CA balances are as of 2018 for most countries listed except Vietnam and Iraq (2017).

Notably, the DOC does not explicitly identify the specific criteria it would use to evaluate whether a product's US pricing was artificially low due to the source country's exchange rate. However, it did suggest that in the calculation of the undervaluation benefit, "one method is to employ the concept of an equilibrium "real effective exchange rate" (REER) or its equivalent, consistent with International Monetary Fund (IMF) methodologies." In this case, it could be useful for us to look at what IMF's latest assessments of currency valuations for potential suspects imply. We do this for countries in Table 2 (except Euro nations) meeting the Treasury's criteria (i) and (ii). We also add in Thailand as it was a near-miss for criterion (i).

The first column in Table 3 details the latest IMF estimates of REER mis-alignments for the selected countries (mid-point of IMF estimation band), while the second column shows the REER's % change since the assessment. For instance, for Switzerland, the currency is deemed to be largely in line with fundamentals in the last IMF assessment in 2018 (using 2017 data), and its REER has actually shown a mild appreciation since then (end-2017 to Apr 2019). It is hence unlikely to be impacted by the new Department of Commerce proposal.

Table 3: Estimates of Exchange Rate Misalignment

Country	Extent of Mis-alignment (Midpoints of IMF estimated ranges, -ve implies undervaluation)	REER% Change since IMF Assessment
Thailand	-9.5	+4.2%
Vietnam	-7.0	- ^
Korea	-5.0	-3.0%
Malaysia	-4.8	-0.3%
Japan	-3.5	-1.5%
China	-3.0	1.6%
Switzerland	-0.1	+0.9%

Source: IMF 2018/19 External Sector Reports, CEIC, BIS, Maybank FX and Research & Strategy

Note: External reports for Thailand, Malaysia, China and Switzerland were as of 2018 (2017 data); Reports for Korea, Japan, Vietnam were as of 2019 (2018 data).

^BIS/IMF estimations of VND REER change were unavailable.

From the results of this hypothetical exercise, countries like Korea and Japan appear to be more likely candidates (to be implicated by DOC), due to a significant estimated misalignment in their currencies and a further depreciation in their REER since the last IMF assessment. However, it is also important to note that comments on Korea and Japan in the Treasury report this morning were largely balanced. These and other comments on Asian countries are highlighted below in Table 4 for quick reference. Parts of the assessments which are beneficial to the individual countries are coloured in blue.

Table 4: Treasury Comments on Individual Countries in FX Report

Country	Latest Treasury Report Comments
China	"... in light of the exceptionally large and growing bilateral trade imbalance between China and the United States and China's history of facilitating an undervalued currency... China needs to aggressively address market-distorting forces, including subsidies and state-owned enterprises, enhance social safety nets to support greater household consumption growth, and rebalance the economy away from investment."
Japan	"Japan maintains the fourth-largest bilateral goods trade surplus with the United States, at \$68 billion in 2018. Japan's current account surplus in 2018 was 3.5 percent of GDP, down from 4.2 percent of GDP in 2017. Japan has not intervened in the foreign exchange market since 2011... Treasury's expectation is that in large, freely-traded exchange markets, intervention should be reserved only for very exceptional circumstances with appropriate prior consultations. "
Korea	"Korea's large external surpluses continued to moderate gradually in 2018, as the current account surplus narrowed to 4.7 percent of GDP in 2018. Similarly, Korea's goods trade surplus with the United States continued to trend down, reaching \$18 billion in 2018, the first time since 2013 that the goods trade surplus has been below \$20 billion. Treasury assesses that on net in 2018 the authorities intervened to support the won, making small net sales of foreign exchange. The won depreciated 4.1 percent against the dollar in 2018, while depreciating slightly on a real effective basis. Treasury welcomes Korea's first disclosure of its foreign exchange intervention, which covers activity in the second half of 2018."
Singapore	"Notwithstanding this large external surplus with the rest of the world, Singapore has consistently run a bilateral goods trade deficit with the United States, which in 2018 totaled \$6 billion. Singapore's monetary policy is uncommon, since it uses the exchange rate as its primary monetary policy tool. To meet price stability objectives, the authorities use foreign exchange intervention frequently to help guide the exchange rate and keep it within a target band... Singaporean authorities announced in May that they would begin publicly disclosing intervention data in 2020. Treasury welcomes this development."
Malaysia	"Malaysia's current account surplus has narrowed substantially over the past decade on higher consumption and investment, falling to 2.1 percent of GDP in 2018. Malaysia's central bank has over the last few years intervened in both directions in foreign exchange markets. ... Malaysia's external rebalancing in recent years is welcome, and the authorities should pursue appropriate policies to support a continuation of this trend."

Vietnam	<p>“Vietnam’s goods trade surplus with the United States has risen over the last decade, reaching \$40 billion in 2018. ... Despite changes to the exchange rate regime in 2016 that increased the de jure flexibility of the exchange rate, in practice the Vietnamese dong remains closely managed against the U.S. dollar. As a result, foreign exchange intervention has been used frequently, and in both directions, to maintain the close link to the dollar. The Vietnamese authorities have credibly conveyed to Treasury that net purchases of foreign exchange were 1.7 percent of GDP in 2018. These purchases came in a context in which reserves remained below standard adequacy metrics and there was a reasonable rationale for rebuilding reserves. Further, while purchases of foreign exchange outweighed sales over the course of the year, the central bank intervened in both directions, with foreign exchange sales used to resist downward pressure on the Vietnamese dong in the second half of 2018. ..”</p>
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Source: US Treasury, “Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States”

Implications for Asian Currencies?

The Department of Commerce will be collecting comments from the public until June 27, and details of refinements or implementation could potentially be released in 3Q or 4Q, if Trump wishes to turn on the heat for countries that he’s entering into trade negotiations with. In the meantime, as a result of the DOC notice, there is a chance that aforementioned countries could be slightly more motivated to smooth excess volatilities in their currencies, to lower the likelihood of being targeted for countervailing duties. Hence we see this latest development as being a new (mild-impact) factor in limiting further upward movements in USD-Asia currency pairs. Nonetheless, if FX-related criticisms or announcements coming out of the US continue to escalate, it could be viewed as a broadening of the dimensions of the current US-Sino trade conflict, which could be more severe in macro impact.

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