



Economic and Strategy Viewpoint

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Global: Summer lull?

- Concerns about China, weaker commodity prices and a stronger dollar signal a spell of slower growth for the world economy. The trade wars are likely to have created a boom and bust as importers front loaded their spending to avoid higher tariffs and are now cutting back.
- Unless the trade wars undermine business confidence and investment the world economy should recover, but the combination of trade tariffs and tax cuts is likely to bring higher inflation in the US.

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UK: Brexit consequences brought into focus

- The UK government has finally outlined its proposed future relationship with the EU, allowing negotiations to progress with little time remaining. Both sides of the Brexit debate are at war, and the prime minister's compromise pleases nobody.
- The proposal is seen as a 'soft' option for manufacturers, as it pushes for a free trade deal and frictionless borders. However, services are facing a very 'hard' Brexit, with no trade deal being pursued. This is likely to be negative for financial services, especially investment banks. The consequences of Brexit have come into focus, with the chance of a no-deal or cliff-edge Brexit as high as 35–40%. However, our baseline view (60–65% chance) is that the UK moves into the transition period from the end of March 2019.



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No, China has not started the currency wars

- Recent concerns around Chinese currency weakness are overblown; this is not an opening shot in a currency war.
- Devaluation is a policy option for China, but it carries sufficient risks that it will be a weapon of last, not first, resort.



Craig Botham

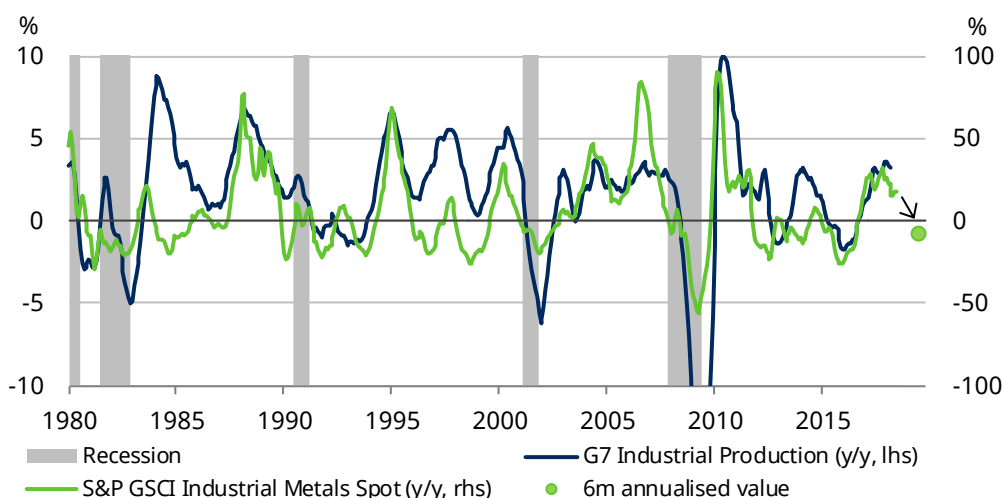
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Views at a glance

- A short summary of our main macro views and where we see the risks to the world economy.

Chart: Commodity prices signal industrial weakness



Source: Thomson Reuters Datastream, Schroders Economics (G0011), 25 July 2018.

Global: Summer lull?

“Tariffs are the greatest!”

President Trump
24 July 2018.

**China concerns,
weaker
commodity prices
and stronger dollar
signal slower
growth**

Perhaps it is the extraordinary summer heat in the northern hemisphere, but there is a sense that global activity is flagging. After the sharp recovery in economic activity in 2017 when the world economy was firing on all cylinders, growth has been slightly less synchronised in 2018. The US has held up well, recording 4.1% GDP growth in Q2, but activity in Asia and Europe has lost momentum.

Near term activity indicators remain steady. The widely followed purchasing managers' indices are holding up in both the developed and emerging markets, while our G7 activity indicator (which combines national surveys) also signals healthy growth. However, three factors suggest that we may be moving into a summer lull.

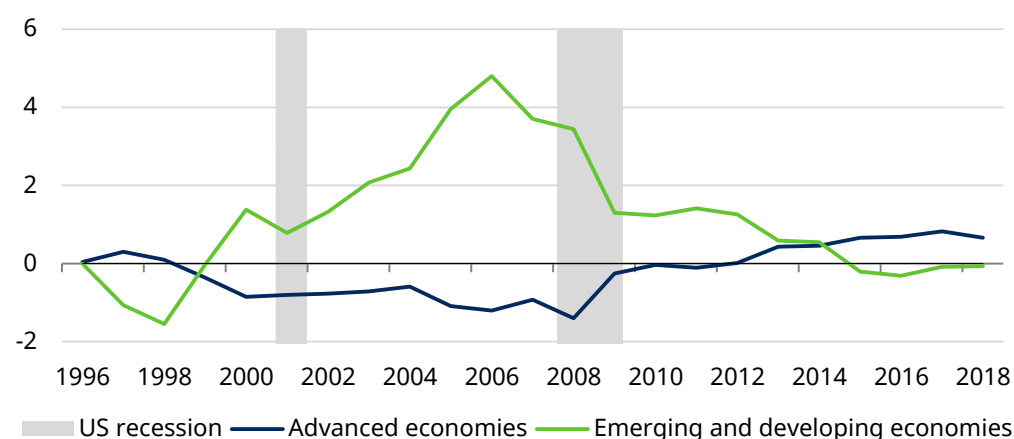
First, China is cooling. Although China recorded GDP growth of 6.7% year-on-year in Q2 and only 0.1 percentage point weaker than in Q1, higher frequency data points to a sharper slowdown. For example, monthly retail sales, investment and exports all indicate a greater slowdown in activity during Q2.

Second, commodity prices have been falling. Since the end of June, oil prices are down around \$5/barrel and industrial metals have fallen by around 14%. Whilst lower oil prices may help relieve inflationary pressure, the drop in metals prices is a signal of weaker industrial production growth. Given their role in production, swings in industrial metals prices have a good record in tracking swings in activity. The current level of prices suggests that G7 production will stall in the coming months (see chart front page).

Third, the stronger dollar will weigh on activity. Since mid-April the broad trade weighted dollar is up by nearly 7%, squeezing financial conditions around the globe and putting pressure on trade growth. The widespread use of the US currency in financing and transacting trade means that it has a disproportionate effect on activity beyond that suggested by the weight of the US in exports and imports¹.

Chart 1: Shift in the savings glut from emerging to advanced

Current accounts, % of GDP



Source: Thomson Reuters Datastream, Schroders Economics Group (G0010), 26 July 2018.

¹ For more on this see [“Why investors are wrong about the role of the dollar”](#), Craig Botham 24 July 2018.

Emerging markets more vulnerable to dollar strength given shift in current account

Emerging markets have borne the brunt of the dollar's move so far with a sharp increase in currency volatility. One potential reason for the vulnerability is the disappearance of the current account surplus for emerging markets (see chart 1 above) which means that the region is now dependent on external capital. The latter has been largely driven by a decline in China's current account surplus. Today, the principal current account surplus in the world economy is being generated by the developed world, primarily the eurozone led by Germany. In this way, the savings glut has shifted from Asia to Europe, which means that the dollar is potentially more important in capital flows given the stronger links to the former through currency markets.

How much of a slowdown?

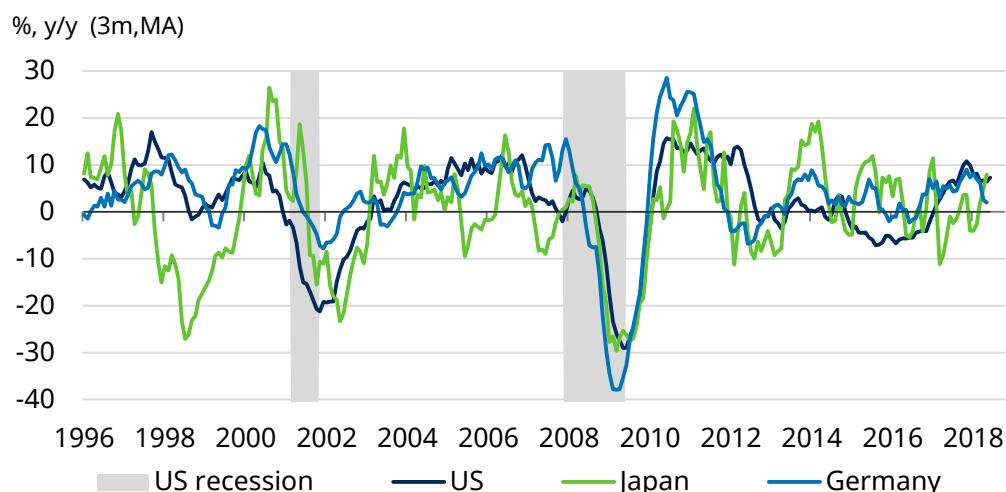
Coming back to the current outlook, clearly all three factors are interrelated. China is a major consumer of commodities, which also tend to be depressed by periods of dollar strength. The common factor though is the effect of trade wars. There is some evidence that firms increased their orders ahead of the increase in steel and aluminium tariffs on 1st June and before the US-China tariffs on 5th July. Now the tariffs have come in, firms are trimming back with the effect that commodity prices have experienced a boom and bust.

One indicator which suggests there has been an effect is the sharp drop in the number of licences for steel imports into the US. Applications had surged ahead of the tariff increase on 1st June, but have subsequently collapsed. Such a move seems perfectly rational on the part of steel users who would want to avoid the 25% tariff the president has slapped on imports. Nonetheless, it suggests that trade growth is likely to decelerate in coming months and with it industrial activity. On the export side the US is set to see a drop in soya bean sales as China's tariffs bite.

The question then is how much of a slowdown are we likely to see? We would see this as a correction, a mid-summer lull, rather than a major downswing. Underlying orders growth in the world economy remains robust (see chart 2 for capital goods) and more generally surveys suggest there is no major imbalance in the level of inventory relative to orders.

Sharp drop in licences for importing steel into the US

Chart 2: Capex orders remain healthy



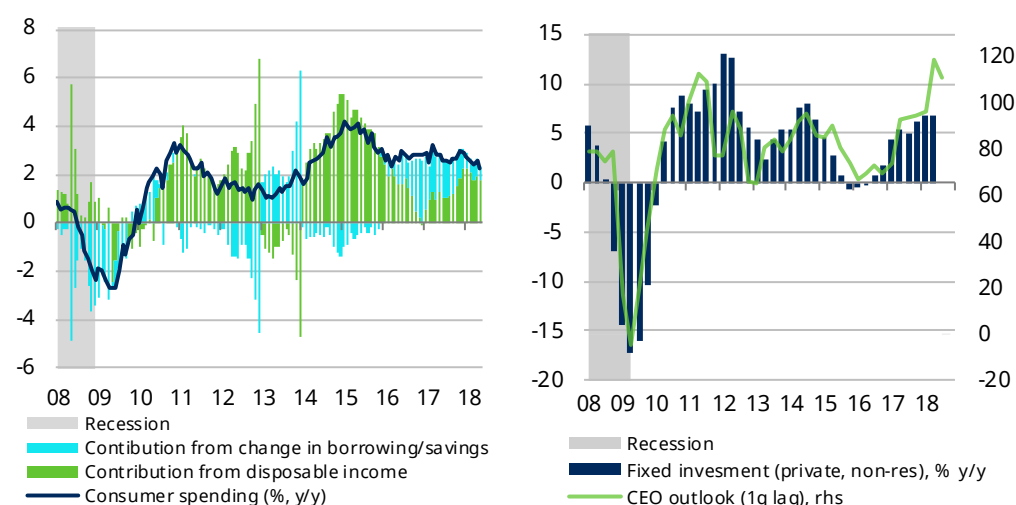
Source: Thomson Reuters Datastream, Schroders Economics Group (G0014), 26 July 2018.

The US economy looks robust. On the consumer side, confidence is generally buoyant and spending is holding up against a backdrop of strong employment growth which is supporting incomes. Business confidence signals stronger capex. Meanwhile, the tax cuts in the US will continue to support both household and

Slowdown should be temporary as underlying demand is well underpinned

business spending. This suggests that a slowdown will be temporary as underlying demand remains firm.

Chart 3: US consumer and business spending well underpinned



Source: Thomson Reuters Datastream, Schroders Economics Group (G0015), 27 July 2018.

The risk to this outlook is that trade tensions cause business confidence to falter and companies to cut back on their capital spending. The latter has played an important part in the upswing, but could fade if business takes fright at political developments. News that the US and EU have reached a deal (even if it is only to talk) is positive, but tensions with China remain high.

Not surprising then that the authorities in China have shifted the bias of monetary and fiscal policy from tightening to easing. They have also allowed the renminbi (CNY) to fall against the US dollar, a move which is consistent with its policy of targeting the trade weighted exchange rate, but significant enough to attract the ire of President Trump (see the emerging market section below).

Tariffs, the US economy and politics

So, the real impact of tariffs is just starting to be felt. In the last Viewpoint we speculated on whether there will be a political backlash as consumers realise the cost of having to pay more for imports. President Trump continues to promote their merits (see above), but many Republicans are against and business is hardly thrilled about the impact on their supply chains.

It would seem though that many voters are willing to give the president the benefit of the doubt and that he is doing what is best for America. Judging from analysis by the Brookings Institute the impact on the wider public will take time to feed through particularly in key agricultural states and may not be fully felt before the mid-term elections.

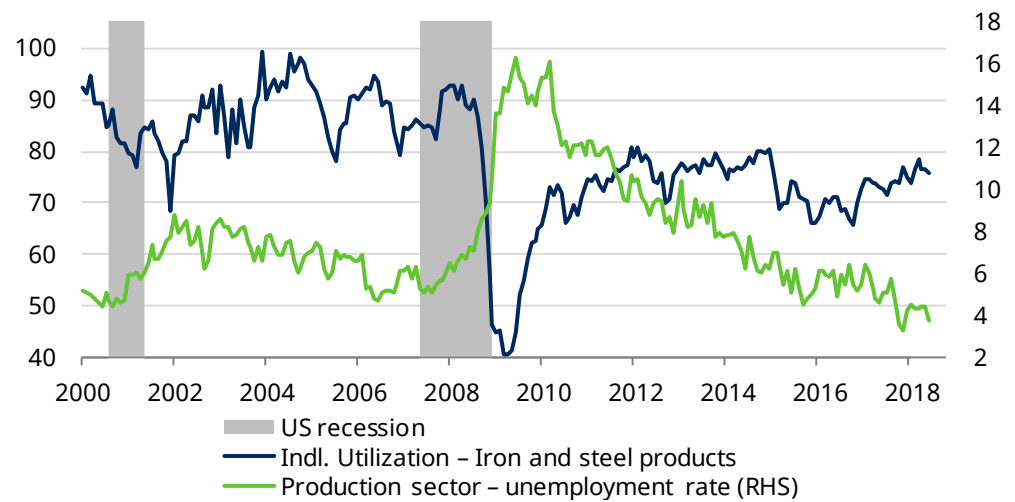
Nonetheless, the president is taking no chances and in response to complaints by farmers he has put together a package of \$12bn to offset the effect of tariffs. There are parallels here with China's response as both nations are trying to offset the tariffs with fiscal spending. It also suggests that the president is setting up for a more drawn-out battle with China.

As a policy to foster domestic production, the combination of fiscal expansion and tariffs on imports might be quite effective. However, as we have argued before, at this late stage of the cycle where unemployment rates are low and capacity utilisation rates relatively high, the most likely outcome is higher inflation rather than output (chart 4). This would be in addition to the direct effect of higher tariffs

Tariffs will take time to influence voters, but will soon be felt by the wider economy

which is estimated at 0.6% percentage points on core CPI as the targeted items account for almost 6% of the index.

Chart 4: A good time to boost domestic demand?



Source: Thomson Reuters Datastream, Schroders Economics Group (G0012), 26 July 2018.

Alongside higher inflation, the trade war is also affecting corporate activity with China flexing its muscles by failing to approve the bid by Qualcomm to take over chipmaker NXP. As expected, China is finding plenty of ways to respond to US tariffs. As summer temperatures begin to peak it looks like the US-China trade war is still heating up.

UK: Brexit consequences brought into focus

“BREXIT: (n) The undefined being negotiated by the unprepared in order to get the unspecified for the uninformed.”

Unknown protestor, London,
June 2018.

After more than two years since the referendum to leave the European Union, the UK government has finally laid out its plans for its future relationship with the EU. Neither Brexit supporters nor Europhiles are happy with the compromise, but time is running out and the risk of leaving without a deal at all is escalating.

The UK sets out its proposals

The UK government has set out its proposal for the relationship with the EU after Brexit

The publication of the UK government's white paper² outlining its approach to Brexit marks a significant and long overdue step towards the UK leaving the EU.

Negotiations with the European Commission have largely been on hold since the initial outline of the withdrawal agreement last December as the UK government could not agree on the direction of travel with regards to the customs union and single market access. However, with time running out, Prime Minister Theresa May has pushed a softer version of previous Brexit plans with the agreement of the majority of her cabinet.

The so-called “Chequers agreement” overrode the position of the Secretary of State for Exiting the EU David Davis, forcing him to resign in protest. Following him was hard-core Brexiteer Boris Johnson (former Foreign Secretary), who is seen as a potential leadership challenger to May.

While softer than expected, the government's white paper is still harder than what most consider as a soft Brexit and harder than EEA membership. Key features include:

The UK wants free and frictionless trade in goods, but is not seeking the same for services

- A free trade agreement for most goods including agri-food, with common rules on standards but with the ability of the UK parliament to diverge should it choose to
- A new Facilitated Customs Arrangement, which would remove the need for customs checks and borders, but would require the UK and EU to charge the correct customs tariffs for goods travelling through one zone and heading for another
- The ability for the UK to agree separate trade deals with other countries/regions
- No free trade agreement for services, with the freedom to diverge on regulations. This is likely to lead to some loss of access to EU markets
- End of free movement of labour. Reciprocal travel visas for tourism, short-term business travel and study
- Ongoing participation in EU agencies such as the European Chemicals Agency, the European Aviation Safety Agency and the European Medicines Agency
- A commitment to a common rulebook on state aid, keeping UK state aid at similar low levels to the past
- A commitment to high environmental and climate change standards

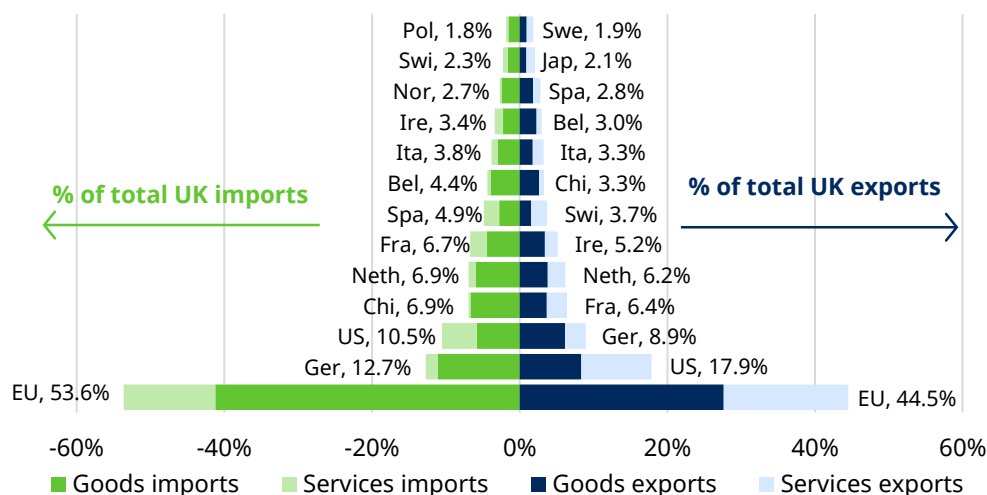
² The Future Relationship between the United Kingdom and the European Union. UK Government. 12 July 2018.

- Commitments to explore options for agreements for road transport, rail, energy, a civil nuclear relationship, maritime and aviation travel
- The end of the jurisdiction of the European Court of Justice in the UK, but with an institutional framework taking the form of an Association Agreement between the UK and EU. This would be overseen by joint committees for dispute resolution

Overall, the proposal looks like it sits somewhere between the Canada trade deal and the European Free Trade Association (EFTA), also known as the Swiss option. A free trade deal covering all goods would certainly be a soft option from the perspective of manufacturers. The EU as a region is the UK's largest trading partner, with the UK particularly dependent on imports from the EU (chart 5.)

The EU is the UK's biggest trade partner

Chart 5: UK's top trade partners (2014–2016)



Source: ONS, Schroders Economics Group. 24 July 2018.

Unfortunately, the government has decided to take a harder position on service. With services making up 80% of UK output/GDP, and more than half of the UK's exports, we are disappointed that the government has not pushed for a free trade agreement in services.

The government is right to highlight that only 38% of UK services exports are to the rest of the EU, and that the single market in services is far from complete. The government also argues that freedom to have regulatory divergence is important to maintain high standards and to grow the UK's services exports elsewhere in the world.

While the paper does not specify any particular areas where divergence is required, we think that the government is anticipating a tightening of financial services rules, including the wider use of a Tobin tax (transactions tax) which the UK has opposed over the years.

Reduced market access for financial services

The government accepts that its position is not to replicate the 'passporting' of financial services, and has now also dropped the proposal of mutual recognition of rules. Instead the white paper states *"The decision on whether and on what terms the UK should have access to the EU's markets will be a matter for the EU, and vice versa."*

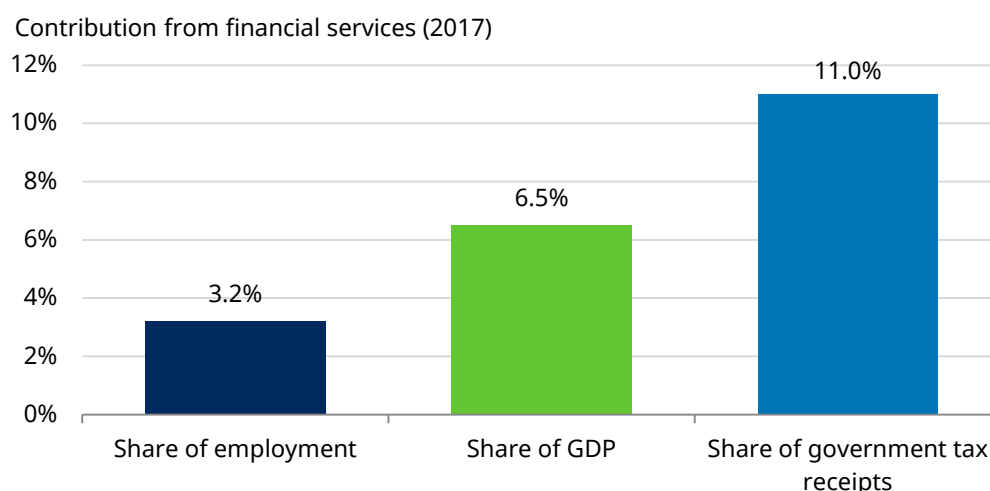
It is clear that market access for the UK financial services firms will be materially lower, as the paper states that the government *"...acknowledges that there will be more barriers to the UK's access to the EU market than is the case today"*.

Financial services are likely to be the losers from the deal, despite the importance of the sector for the UK economy

For many financial services firms, especially investment banks, this is the hardest form of Brexit they could face. Initially, enhanced regulatory equivalence could keep the status quo going, although officials in Brussels have already played down the suggestions as undesirable for the EU. The real danger comes from a possible change in rules on whether business can be done in the EU, but with risk management and hedging to still be done in the UK. If rules diverge materially, then business will certainly be lost to mainland Europe.

It is worth highlighting the importance of financial services to the UK economy. In 2017, the financial services sector employed 1.1 million people in the UK, 3.2% of all jobs. It contributed £119 billion to the UK economy (6.5% of total economic output) with £23 billion or 19% directly attributed to the UK's net trade in financial services with the EU (chart 6).

Chart 6: The importance of the UK's financial services sector



Source: Parliamentary Library Research, PWC, Schroders Economics Group. 24 July 2018.

Lastly, the sector is estimated to have contributed £72.1 billion in tax in 2017, or 11% of government receipts. Damaging financial services will not only lead to the loss of high value-added jobs, but also hurt public finances and public spending.

As for asset managers, they rely on the EU's so-called "delegation" regime, which allows funds to be domiciled and regulated in an EU country, while being actively managed from outside the EU. The white paper has no mention of these rules, which in any case need not be affected by Brexit.

EU will push back on some proposals

The EU will push back on a number of elements, including free movement of labour

Moving on to trade in goods, the pursuit of frictionless trade is admirable, and crucial for the preservation of the Northern Ireland peace deal. However, the practicality of the Facilitated Customs Arrangement proposal is highly questionable, and will leave the party with higher tariffs open to fraud. This has already been called into question by the EU's chief Brexit negotiator, Michel Barnier, stating that *"...the EU cannot, and the EU will not delegate the application of its customs policy and rules, VAT and excise duty collection to a non-member who would not be subject to the EU's governance structures."* It will be up to the UK government to persuade other EU leaders to change Barnier's position on this issue.

The end of the free movement of people (a divergence from the Swiss option) will be another as the EU will argue that the UK is "cherry picking", and that the EU's "four freedoms" (goods, services, capital and persons) are indivisible.

Divisions in the government risk the UK leaving without any deal

The European Commission is likely to push back and attempt to water down some of the white paper's proposals, but it may also compromise on some areas that were seen previously as red lines.

Brussels will also demand additional annual payments to the EU budget in exchange for the level of access the UK has proposed. This is not currently being discussed, and will certainly anger Brexiteers, despite similar arrangements being in place for Switzerland and Norway.

Westminster split could lead to a cliff-edge Brexit

The reaction in Westminster to the proposals has been poor. The majority of Brexiteers are outraged, referring to the proposals as *"the Chequers fudge"* and the *"...death of the Brexit dream"*. Even US President Donald Trump has criticised May's approach.

The problem for the prime minister is that the cabinet reflects a divided country on this issue. 48% of those that took part in the referendum voted against Brexit, and while some are now content with leaving the EU, the majority want a soft Brexit, which would include access to the single market and free movement of labour.

Meanwhile, Brexit supporters are split on these issues, but a worryingly large number are happy to see a 'no-deal' or 'cliff-edge' Brexit happen, as they argue that this would be the easiest and quickest route out of the Union. Moreover, they argue that this would allow the UK to negotiate from a clean starting position with the EU and the rest of the world.

Brexiteers complain that the UK will become a satellite state of the EU, being forced to be a rule taker without having any influence over how those rules are made. Of course, without offering an alternative solution their complaints only serve to highlight the benefits of the status quo.

Brexiteers are also being short-sighted. If they truly believe that the country agrees with their vision of a hard Brexit, then they should back the current proposal as it stands, then seek to change the relationship in the future. The current proposal sets out a Swiss-style arrangement, where most new rules introduced in Brussels will require either a bilateral agreement or a vote in parliament. This offers parliament the ability to reject a proposal from Brussels, though the consequences of such action may be the loss of the ability to trade in some areas.

The risk going forward is that the prime minister loses further support from both sides of the debate, potentially leading to a leadership challenge or even a general election. This would almost certainly delay Brexit proceedings, but could even lead to a cliff-edge Brexit at the end of March 2019.

Possible Brexit scenarios

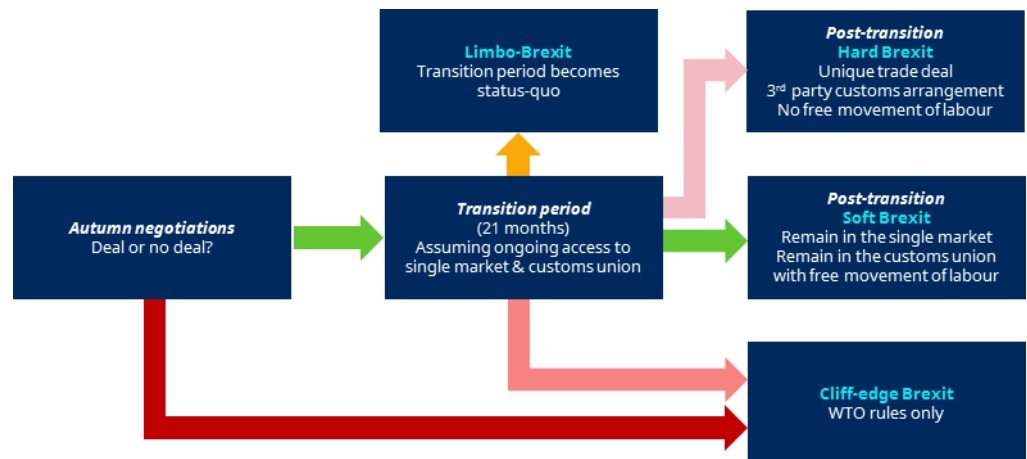
With talks finally progressing, the trade-offs and consequences of Brexit are sharply coming in to focus. In an attempt to provide some guidance, especially for our international readers, chart 7 illustrates potential scenarios for Brexit going forward. We are the first to admit that this is very high-level analysis and over simplifies the situation.

As evident from the note so far, the UK is towards the end of its 'Autumn negotiations'. Most hope the UK will strike a deal with the EU, which would allow it to enter the 'transition period', also sometimes referred to as the 'implementation period'. If no deal is agreed in time, and the 29 March 2019 Brexit date is not postponed, then the UK would leave the EU without any deal. This is referred to as a 'no-deal' or 'cliff-edge' Brexit.

In order to progress into the transition period, both parties have to agree and conclude the 'Withdrawal Agreement'. This began at the end of 2017, covering citizens' rights, the divorce bill and Irish border, with the latter being the outstanding issue remaining. If the UK government's proposal of a Facilitated Customs Arrangement is agreed, then the UK will proceed to the transition phase. If a compromise cannot be found on Northern Ireland, then the UK has agreed to a 'backstop' solution, where it would remain in the EU's customs union. The cabinet seems opposed to this option, so there is a considerable risk that the UK pulls out of the agreement if the backstop solution is the only option on the table. As a result, we assume that there is a 35–40% chance of a cliff-edge Brexit, but a 60–65% chance of the UK entering into the transition period.

Chart 7: Possible Brexit scenarios

Possible Brexit scenarios ... moving into the transition period is important in the near-term



Source: Schroders Economics Group. 25 July 2018.

Before we discuss the next stage, we should mention that we have excluded the option of remaining in the EU. This is because there is not enough support for parliament to override the referendum result, and there is not enough time, or the political will, for a second plebiscite.

Once in the transition period, the UK could take one of several paths. A 'Soft Brexit' would be akin to being a member of the European Free Trade Agreement, with full single market access, being inside the customs union, and importantly, still having free movement of labour. A 'Hard Brexit' could have a partial trade deal, being outside customs union, and without free movement of labour. In reality, the government's proposed path is somewhere between these two options.

Alternatively, if the government cannot find a majority in parliament for its preferred path, then the UK could lapse into a 'Limbo Brexit' – where the UK extends the transition period indefinitely. This would be a very soft outcome, although the uncertainty over its longevity is still not as preferable for investors as a soft Brexit.

Finally, talks between both sides could break down, causing the UK to still end up with no-deal or a cliff-edge Brexit.

Progress welcome but much uncertainty remains

For investors, progress on Brexit will be welcomed as uncertainty is paralysing businesses

For investors, progress from the UK side has to be welcomed, as the high level of uncertainty is paralysing businesses. Current infighting in the government is a concern, which is being reflected by weakness in sterling.

Compared to the current arrangement or a soft Brexit such as being a member of the European Economic Area (EEA), the proposal introduces a risk that at any point in time, a UK government could reject or even withdraw from an agreement,

affecting trade and business. Clearly, this is negative for long-term investors who will demand an additional premium to compensate for such risk.

Finally, it's worth noting that the white paper has tied the 'Withdrawal Agreement' from the end of 2017 to the framework for the future relationship currently being discussed, *"The UK and the EU have also been clear that nothing is agreed until everything is agreed"*. The government has started to issue advice to businesses and government departments about the potential impact of such an outcome. This extraordinarily includes the need to stockpile food and medicine. Even at this late stage in the negotiations, and with clearly no majority in parliament to back a no-deal Brexit, the government still maintains the pretence.

No, China has not started the currency wars

“China, their currency is dropping like a rock, and our currency is going up and I have to tell you, it puts us at a disadvantage...”

US President, Donald Trump, CNBC interview, 19 July 2018.

The market starts watching China again

President Trump is not the only one to have noticed the weakness of the Chinese renminbi. The currency's sudden depreciation, around 5% in the space of a month, has raised eyebrows and prompted speculation that the Chinese authorities have deployed a new weapon in the trade wars. However, focusing on the last month to the exclusion of what preceded it entails the loss of important context.

A focus on the Chinese currency against the dollar ignores important context

Chart 8 shows the behaviour of the renminbi (CNY) exchange rate against the US dollar, and in terms of the trade-weighted basket (CFETS), which was established in late 2015 following the last devaluation scare. We would make two points connected to chart 8.

The first is that the official currency policy is that the CFETS basket is a more appropriate reference for the CNY than a bilateral exchange rate. That is, the authorities are more focused on controlling the CFETS basket value than the CNYUSD rate. The chart reflects this; since mid 2016 the CFETS valuation has been much more stable than the CNYUSD rate. Any argument that the authorities are engineering a deliberate devaluation with the aim of countering tariffs needs to take this into account. An alternative interpretation of CNY weakness in the past month would be that the authorities are simply returning the basket to its 'target' level, of around 94. If we begin to test the basket lows of around 92, suspicions of targeted devaluation might be more warranted.

Chart 8: Currency weakness has followed unusual strength

Index 100 = 31/12/2014



Source: Thomson Datastream, Schroders Economics Group, 24 July 2018. CNYUSD has been rebased to the CFETS basket at the start of the period.

In any event, recent weakness largely unwinds earlier strength

Secondly, even if we look at the move against the dollar in isolation, this weakness follows a period of considerable strength for the CNY. Given the timing, it would appear that the authorities leant against a strong dollar tide during the trade talks, with the result that the CNY was one of the few global currencies not to lose value against the dollar in the first half of 2018. Once talks broke down, this policy was abandoned and policymakers reverted to targeting the basket. Given the strength of the dollar this necessitated CNY weakness as the currency 'caught up' to the rest

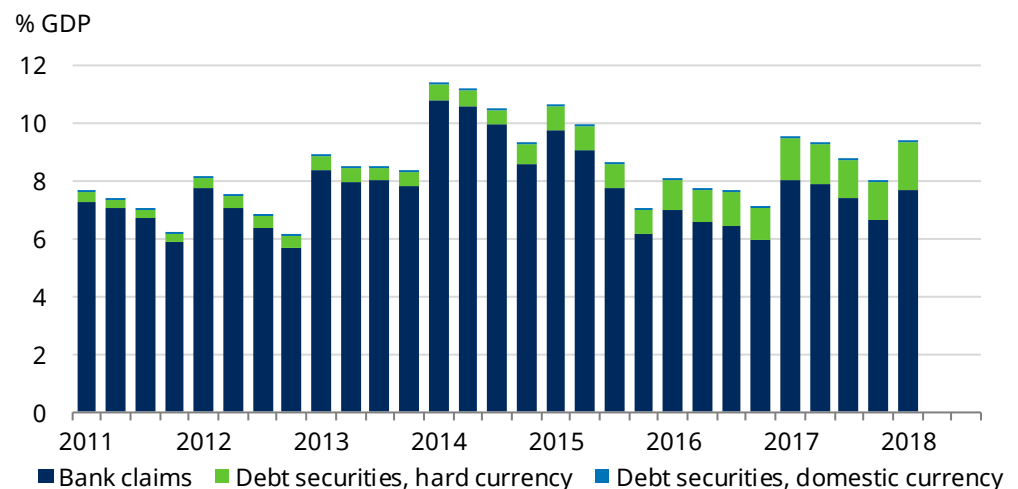
of the world. Even so, we are now back only to mid 2017 levels. It is not clear that this offers much in the way of an edge in bilateral trade.

Is devaluation a realistic prospect?

Of course, just because we are not yet in currency war territory does not mean China will not take us in that direction. A large devaluation would be one obvious way to deal with tariffs; a blanket 25% tariff on all Chinese goods, for example, could be largely offset by a 25% devaluation, at least initially. However, this is not a costless exercise. The history of emerging markets is littered with the wreckage of devalued pegs. China itself was one of the few Asian economies to escape the carnage of the late 1990s.

The first problem is commonly referred to within economics as 'original sin'; the tendency for emerging markets economies to borrow in foreign currencies because their own financial systems are not developed enough to provide a deep pool of local currency credit. While we can accuse China's financial system of many things, something it does not lack is depth or innovation. The overwhelming majority of outstanding Chinese debt is in local currency terms, and is held by locals. Even when we incorporate cross border bank claims, the external liabilities of China look rather small as a share of GDP, despite recent increases (chart 9). If China undertook a 25% devaluation, its foreign debt burden would increase by about 2% of GDP, or \$290 billion. Set against foreign exchange reserves of \$3 trillion, this seems manageable. We do not think this on its own is a sufficient deterrent to prevent devaluation.

Chart 9: China's external liabilities are limited



Source: Thomson Datastream, Schroders Economics Group. 24 July 2018.

A bigger risk is capital flight. The common reference point in China's case is the 2015 devaluation, when an initial 3% weakening of the currency was followed by further depreciation as households and corporates hastily converted local currency holdings to dollars and sought to pay down dollar debt, in fear of further currency weakness.

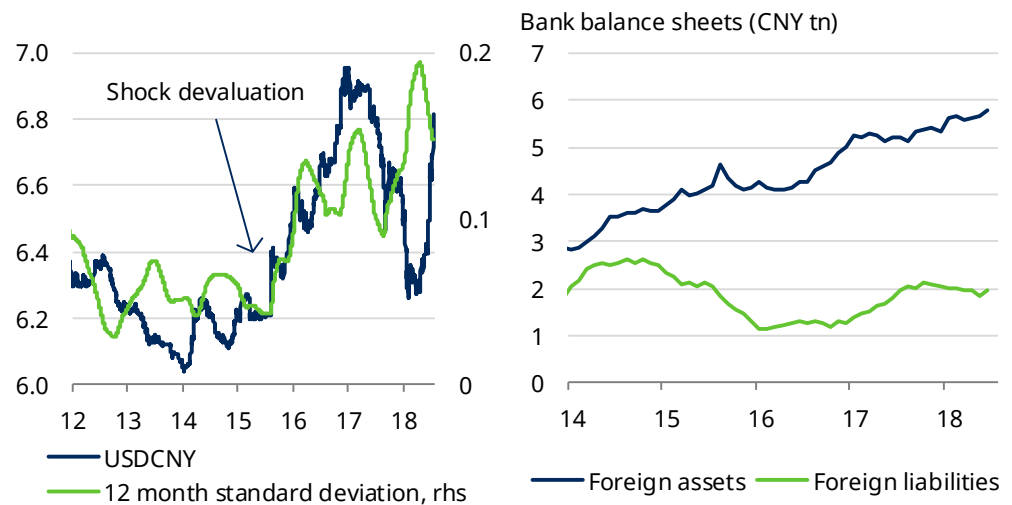
A repeat is certainly possible today, particularly if Chinese residents become convinced of significant future depreciation. But there are some important differences between today and 2015. The devaluation in 2015 was a true shock, in that it marked a change of regime for the Chinese currency. In the years prior, the renminbi had been remarkably stable; chart 10 shows the rolling 12 month standard deviation of the currency, which illustrates that from 2012 to mid-2015 investors could be confident of extremely limited volatility. In a low yield environment, this drew carry trade investors, and encouraged Chinese firms to

China's dollar exposures are small and would not be a major obstacle to devaluation

Capital flight is a bigger concern, but today is different from 2015

borrow in foreign currency without hedging their exposure. Essentially, the CNY had become something of a one way bet, and a stated policy goal following the 2015 devaluation was to increase two-way volatility of the renminbi to prevent this. As the chart shows, the authorities succeeded in this aim.

Chart 10: CNY is no longer a one way bet



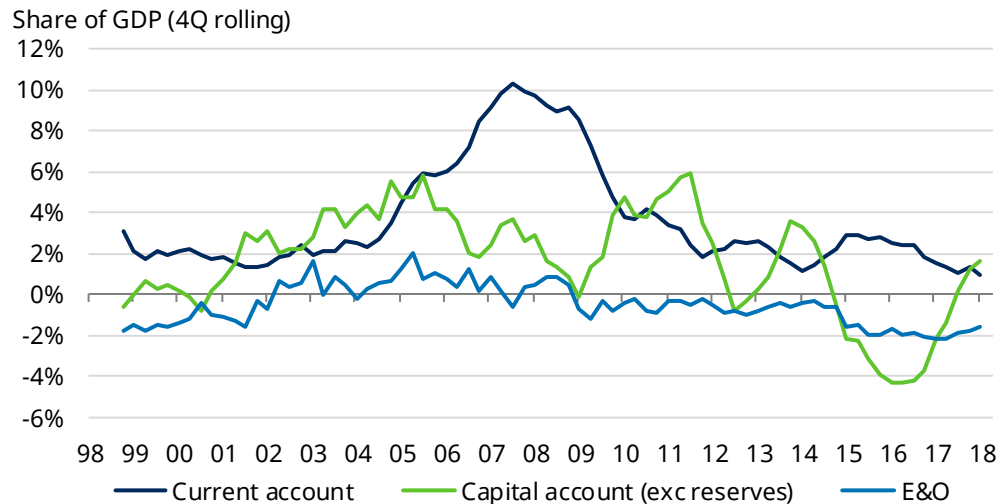
Source: Thomson Datastream, Schroders Economics Group. 25 July 2018.

The economy is better prepared for currency weakness now

Today, no one should be taken by surprise by currency weakness. In 2015 we saw a panicked rush by Chinese corporates to repay dollar debt, or else implement hedges, for example. Firms should be better prepared now. Likewise, banks had also positioned themselves on the assumption of currency stability, with only small net foreign asset positions (chart 10). The events of 2015 have materially altered this stance. The impact of any currency weakness should therefore be much less destabilising than it was three years ago.

However, if expectations of ongoing currency depreciation build, we would expect to see outflow pressures follow. Should the authorities permit an uncontrolled and prolonged depreciation, it risks feeding on itself as households and corporates rush to dollarise. If such action manifests as capital flight out of the banking system, this presents a big problem. Any attempt to devalue would need to find a way to counteract this risk. If devaluation is attempted via gradual depreciation, there would need to be substantial two way volatility to prevent the accumulation of short bets on the currency, and the entrenchment of expectations for further depreciation. However, it is questionable how long this trick would work before the central bank lost credibility and markets priced in a much weaker CNY. Capital flight would follow and the central bank would be forced to intervene heavily to re-establish credibility.

Chart 11: Capital controls in the wake of 2015 proved effective



Source: Thomson Datastream, Schroders Economics Group. 26 July 2018.

Government control of the capital account is effective but not perfect

Capital controls, introduced since the 2015 devaluation, would be useful here in limiting the extent of capital flight. Chart 11 shows the capital account evolution over time, and it would seem that controls implemented following the 2015 scare have been quite effective in reducing outflows; though the errors and omissions item shows that some money will always trickle out; the need for central bank credibility is not obviated.

Go hard or go home?

Arguably the less costly way would be a 'one and done' devaluation, in which the People's Bank of China (PBoC) weakened the CNY overnight by a significant amount (say, 20–30%) and then committed to defend the new level – additional reserves having been acquired in the process of devaluing. Having learnt from 2015, capital controls could be tightened simultaneously to prevent outflows.

This is still a risky choice, despite a level of government control over the economy many states would envy. The sheer quantity of liquidity in the Chinese system means that the authorities would be severely outgunned in any attempt to defend the new peg against a concerted attempt to move capital out; M2 is over eight times FX reserves. Capital controls obviously help here, but even the best dam can spring leaks.

As a result, devaluation is definitely not a weapon the Chinese government will reach for casually. Central bank rhetoric has been carefully worded in recent days to present a message of stability. Matters are not yet so bad that China needs a drastically weaker currency to support growth; a 10–20% tariff on all exports to the US still only covers about 20% of Chinese trade, and on many estimates would slow growth by 0.1 to 0.2 percentage points. An aggressive devaluation risks provoking other trade partners and uniting much of the World Trade Organisation membership against China. If the current détente between the US and EU manifests in co-ordinated action against China, however, that calculus may change.

Conflict will remain focused on trade for now

For now then we do not see devaluation as a likely prospect. It may be less disastrous for China than is often assumed, but it is not costless, and the ultimate consequences for financial stability are hard to predict. Even if the state is able to prevent capital outflows, the level of control needed would hinder China's internationalisation efforts; a secondary goal in comparison to growth and stability, but still an aim of Chinese policy.

**Devaluation is a
weapon of last, not
first, resort**

Instead we believe that the currency will largely follow its basket, weakening against the dollar when the dollar is strengthening against the world, but otherwise not following a noticeable depreciation trend. There is the possibility that policy easing in China sees increased outflow pressure, as adding more liquidity to the system increases the odds that some of it leaks out, but we would not see this as the intent of policy.

However, should the EU, US and others unite against China, imposing tariffs on the majority of its exports and taking other measures in an attempt to punish China for violations of international norms, devaluation will begin to look much more attractive.

Schroder Economics Group: Views at a glance

Macro summary – August 2018

Key points

Baseline

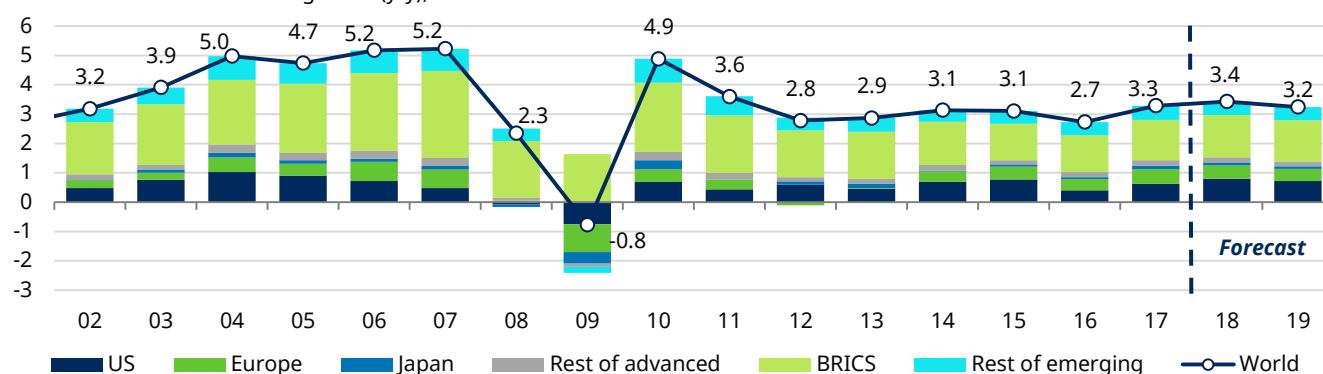
- Global growth is expected to reach 3.4% in 2018 after 3.3% in 2017, before moderating to 3.2% in 2019. Inflation is forecast to rise from 2.3% in 2017 to 2.7% in 2018, before falling back to 2.4% in 2019. Core inflation in the US is expected to rise back above 2% in 2018 and the world economy moves firmly into the expansion phase of the economic cycle.
- US growth is forecast at 2.9% in 2018 and 2.6% next, incorporating president Trump's fiscal stimulus packages. The Fed has now started balance sheet reduction (quantitative tightening) and with core inflation rising, we expect four hikes in total in 2018, and two more in 2019 with the Fed funds rate ending at 3%.
- UK growth is likely to slow to 1.4% in 2018 as Brexit uncertainty weighs on confidence. Inflation is forecast to fall back slightly to 2.6%, as sterling depreciation effects are replaced with energy and domestically generated inflation. 2019 is very uncertain given Brexit, but we assume a transition period will be agreed that preserves the status quo of single market and customs union membership. The BoE is expected to hike once in 2018 and two more times in 2019 (to 1.25%).
- Eurozone growth is forecast to moderate to 2.4% in 2018, but remains robust overall. Italian political risk is back which will reintroduce volatility. Growth should moderate in 2019 to 2.1%, but this remains above trend. Inflation is expected to remain under 2%, with higher energy price inflation in 2018 replaced by higher core inflation in 2019. The ECB is expected to end QE in December 2018, before raising interest rates in the second half of 2019. The refinancing rate is forecast to reach 0.50%, and the deposit rate to reach zero.
- Japanese growth is forecast to slow from 1.7% in 2017 to 1.3% in 2018, as inflation more than doubles to 1.2% owing to higher oil prices. We expect a change to yield curve control in 2019 in the form of a 10bps increase in the target yield for 10 year JGBs from zero.
- Emerging economies are forecast to see growth largely unchanged near 5% over 2018 and 2019. China's GDP growth is forecast to continue its secular decline, but this is offset by recoveries in the rest of the BRICs.

Risks

- Risks to the baseline forecast skewed towards a more stagflationary outcome. 'Inflation accelerates', 'oil back to \$100' and 'rise in global protectionism' are the main causes. 'Mid-cycle slowdown' and 'secular stagnation' make up the deflationary scenarios, but these are offset by two reflationary scenarios: 'global trade boom' and 'global fiscal expansion'.

Chart: World GDP forecast

Contributions to World GDP growth (y/y), %



Source: Schroders Economics Group, 21 May 2018. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2017	2018	Prev.	Consensus	2019	Prev.	Consensus
World	100	3.3	3.4	↓ (3.5)	3.3	3.2	↓ (3.3)	3.2
Advanced*	62.8	2.3	2.4	↓ (2.6)	2.4	2.2	↓ (2.3)	2.1
US	27.1	2.3	2.9	↓ (3.1)	2.9	2.6	↓ (2.9)	2.6
Eurozone	17.4	2.5	2.4	↓ (2.6)	2.2	2.1	↓ (2.2)	1.8
Germany	5.1	2.5	2.3	↓ (2.8)	2.0	2.2	↓ (2.4)	1.7
UK	3.8	1.8	1.4	↓ (1.7)	1.3	1.6	↑ (1.5)	1.5
Japan	7.2	1.7	1.3	↓ (1.5)	1.1	1.1	(1.1)	1.2
Total Emerging**	37.2	5.0	5.1	(5.1)	5.0	5.0	(5.0)	4.9
BRICs	24.2	5.7	5.9	↓ (6.0)	5.8	5.8	↓ (5.9)	5.8
China	16.4	6.8	6.6	(6.6)	6.6	6.4	↓ (6.5)	6.4

Inflation CPI

y/y%	Wt (%)	2017	2018	Prev.	Consensus	2019	Prev.	Consensus
World	100	2.3	2.7	↑ (2.4)	2.7	2.4	↓ (2.6)	2.5
Advanced*	62.8	1.7	2.1	↑ (1.9)	2.0	1.9	↓ (2.1)	1.9
US	27.1	2.1	2.8	↑ (2.5)	2.5	2.4	↓ (2.6)	2.2
Eurozone	17.4	1.5	1.6	↑ (1.2)	1.7	1.5	(1.5)	1.6
Germany	5.1	1.7	1.8	↑ (1.5)	1.9	1.8	(1.8)	1.9
UK	3.8	2.7	2.6	↑ (2.5)	2.5	1.9	↓ (2.3)	2.1
Japan	7.2	0.5	1.2	↑ (1.1)	1.0	1.4	↓ (1.6)	1.1
Total Emerging**	37.2	3.2	3.6	↑ (3.4)	3.8	3.3	↓ (3.5)	3.6
BRICs	24.2	2.2	3.0	↑ (2.8)	2.9	2.9	↓ (3.0)	3.0
China	16.4	1.5	2.4	↑ (2.2)	2.2	2.0	↓ (2.3)	2.3

Interest rates

% (Month of Dec)	Current	2017	2018	Prev.	Market	2019	Prev.	Market
US	2.00	1.50	2.50	(2.50)	2.66	3.00	(3.00)	3.03
UK	0.50	0.50	0.75	(0.75)	0.91	1.25	(1.25)	1.15
Eurozone (Refi)	0.00	0.00	0.00	(0.00)	-0.30	0.75	(0.75)	-0.12
Eurozone (Depo)	-0.40	-0.40	-0.40	(-0.40)		0.25	(0.25)	
Japan	-0.10	-0.10	-0.10	(-0.10)	0.09	-0.10	(-0.10)	0.12
China	4.35	4.35	4.35	(4.35)	-	4.00	(4.00)	-

Other monetary policy

(Over year or by Dec)	Current	2017	2018	Prev.	Y/Y(%)	2019	Prev.	Y/Y(%)
US QE (\$Tn)	4.4	4.4	4.0	(4.0)	-9.1%	3.4	(3.4)	-15.0%
EZ QE (€Tn)	2.2	2.2	2.4	(2.4)	9.1%	2.4	(2.4)	0.0%
UK QE (£Bn)	425	445	445	(445)	0.0%	445	(445)	0.0%
JP QE (¥Tn)	529	521	551	(551)	5.7%	567	(567)	2.9%
China RRR (%)	17.00	17.00	15.00	↓ 16.00	-	14.00	↓ 16.00	-

Key variables

FX (Month of Dec)	Current	2017	2018	Prev.	Y/Y(%)	2019	Prev.	Y/Y(%)
USD/GBP	1.32	1.30	1.35	↓ (1.40)	3.8	1.35	↓ (1.36)	0.0
USD/EUR	1.17	1.15	1.18	↓ (1.28)	2.6	1.20	↓ (1.25)	1.7
JPY/USD	110.9	115.0	110	↑ (105)	-4.3	108	↓ (110)	-2.3
GBP/EUR	0.89	0.88	0.87	↓ (0.91)	-1.2	0.89	↓ (0.92)	1.7
RMB/USD	6.78	6.60	6.35	↑ (6.20)	-3.8	6.30	↓ (6.37)	-0.8
Commodities (over year)								
Brent Crude	74.0	55.6	71.6	↑ (64.0)	28.8	59.7	(59.7)	-16.6

Source: Schroders, Thomson Datastream, Consensus Economics, July 2018

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data as at 25/07/2018

Previous forecast refers to April 2018

* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

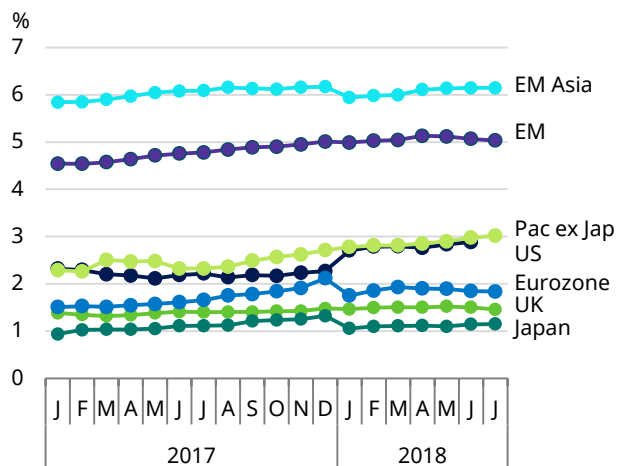
** **Emerging markets:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

2018



2019

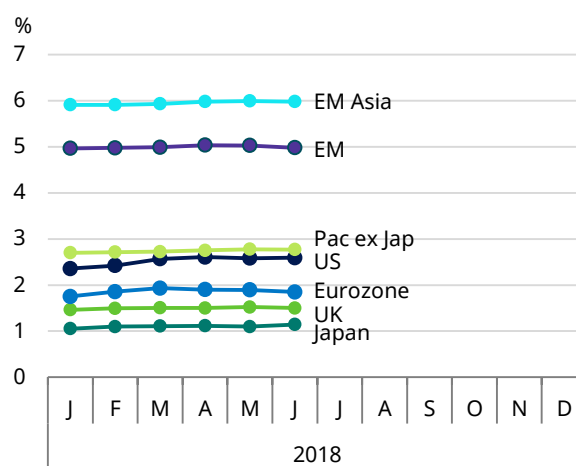
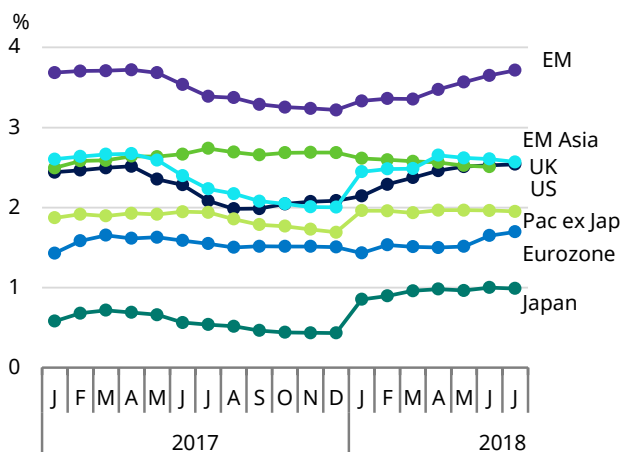
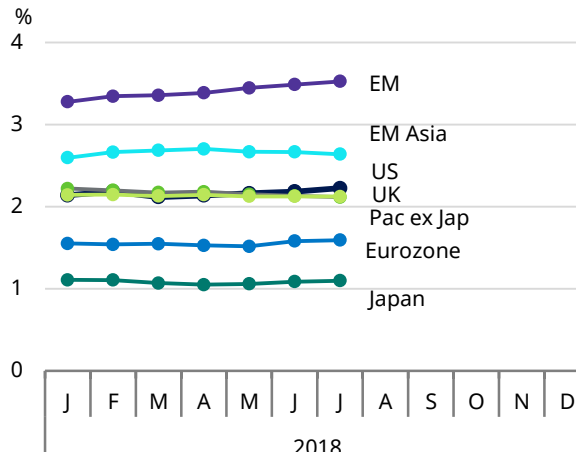


Chart B: Inflation consensus forecasts

2018



2019



Source: Consensus Economics (July 2018), Schroders.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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