Unless It Can Raise Tariffs Without End, Will China Devalue Its Currency?

In response to the tariffs announced by the United States on July 6, the Chinese authorities introduced 25% tariffs on U.S. goods totalling US$34B. The tariff escalation is not over yet, however, as the U.S. administration is now considering imposing new 10% tariffs on US$200B of goods imported from China.

China might have more difficulty retaliating against this fresh round of tariffs. China–U.S. bilateral trade is far from symmetrical. The United States imports approximately US$500B worth of goods from China and exports around US$130B to that country. Other options will have to be found if the tit-for-tat response is to be maintained.

It might become very tempting to devalue the yuan, which would make Chinese exports more competitive on the international markets. The yuan has already shed close to 5% of its value since mid-June. However, a lower yuan affects all of China’s trading partners. This could spur other countries to place trade restrictions on China or simply play with their own exchange rates. There is also a major issue with capital flows. If investors foresee a significant drop in the yuan’s value, they might want to move their assets out of China en masse.

These are primarily short-term assets, such as portfolio investments, which could be moved quickly. The Chinese authorities have ample foreign exchange reserves to offset these negative capital flows. Devaluing the yuan might even require boosting these reserves, but the reserves could then decline depending on investors’ reaction and make China more vulnerable to other potential shocks.

IMPLICATIONS

The risks involved suggest that the Chinese authorities may be reluctant to sharply devalue the yuan. The fact remains that there will be little interest in supporting it in the coming months. If U.S. trade measures negatively impact the Chinese economy,