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Chi on China

FROM A SINO-US TRADE WAR TO A COLD WAR AND GLOBAL DISRUPTION

If you can, help others; if you cannot do that, at least do not harm them.

Dalai Lama

SUMMARY

- The Sino-US trade tension risks escalating to a new cold war, which could potentially cost dearly not only China and the US but also the world economy.
- A potential collateral damage on the global system could be another round of currency war in the short-term with new volatility dynamics coming from China.
- If the end of the last Cold War fostered global economic integration, the beginning of the next cold war between China and the US will produce fragmentation, with long-term impact on even technological innovation and climate change.

Rising Sino-US trade tension is already contributing to an economic decoupling that is reverberating across the global system. The breaking up of the global supply chain will extremely disruptive to the world's production ecosystem by destroying the comparative advantages of different economies.

It is conceivable that the world could be divided into two trading blocs, with each centring on a global power – China and the US. Intra-bloc trade may still thrive, but there could be no links between them. This scenario will be bad enough to unwind many of the globalisation benefits that the world has enjoyed for over two decades.

THE COLLATERAL DAMAGE

Let us play the devil's advocate and consider if the US's trade tactics were successful to push China into an economic hard-landing (with GDP growth less than 5% YoY). That could potentially lead to irrational Chinese policy response manifested in another round of currency war.

I have long argued that devaluation is not in China's best interest because the costs of doing that far outweigh the benefits[1]. But experience tells us that domestic economic woes are the main cause of currency wars when countries resort to competitive devaluation to escape the economic pains that they no longer want to bear.

The US subprime crisis inflicted severe damages in the world economy and prompted many countries to devalue their currencies, triggering the currency war in the late 2000s and early 2010s. Before this, the world also experienced a fully-fledged currency war in the early to mid-1930s when the major economies were still anchored to the Gold Standard.

When the Great Depression hit in 1929, the rigid rule of the Gold Standard inflicted severe economic pains in the global economy. The UK became the first country to devalue against gold and, hence, the gold bloc currencies, by taking the pound sterling off the Gold Standard in September 1931. Then Norway, Demark and Sweden followed suit.

These rounds of competitive devaluation hurt US competitiveness, and eventually in January 1934 forced it to drop the Gold Standard and devalue too. The remaining gold bloc countries, including France and Germany and some smaller countries finally joined in the currency war in 1936, ending the Gold Standard.

The main lesson learned from these events was that domestic economic conditions were the culprit. It was painfully high unemployment in the UK that drove it to devalue the pound sterling and set off a competitive devaluation process. Crumbling economic conditions around the world after the US subprime crisis triggered the recent currency war when many governments seek a quick-fix through devaluation instead of pursuing painful structural reforms.

In the unlikely event that China was pushed over the edge by the trade war, combined with its domestic problems, the tail risk of renminbi devaluation setting off a currency war would jump sharply if policy panic in Beijing overtook rationality. At this stage there no evidence for such outcome yet.

GLOBAL DISRUPTION

An increase in Sino-US rivalry will also unravel the global system. The Trump administration has shown its ability to hurt its targeted countries by using sanctions to deny them access to the USD-denominated international payment system. To hedge against this liquidity risk, America's strategic rivals, China and Russia, and even its ally, the EU, are trying to establish alternative payment systems (notably the China Cross-border Interbank Payment System or CIPS[2], which uses SWIFT messages and SWIFT standards and modelled after the US FedWire).

Such financial fragmentation will disrupt the global technological landscape. This is because restrictions on technology transfers and linkages, justified on the national security basis, will give rise to competing and non-compatible standards, just like the VHS versus Betamax battle in the consumer video market in the late 1970s and 1980s. Today's internet will break up into competing domains, giving rise to excessive or cut-throat competition, hurting innovation and leading to higher costs, slower adoption and even inferior products.

A more imminent concern will be the disruption to the global supply chains. To avoid being hit by US tariffs, firms producing or assembling from China and exporting to the US will be forced to move their production facilities to other unaffected countries. With China standing at the centre of the global supply chains, such a

[1] See "*Chi on China: Renminbi Devaluation Not China's Best Option*", 7 May 2014; "*Chi on China: Will China Join the Currency War?*" 12 August 2015 and "*Chi on China: Is China Joining the Currency War?*" 25 January 2017.
[2] See "*CIPS - China's Hybrid Net Settlement Clearing System*", by David Blair, Acarate Consulting in https://www.treasury-management.com/article/1/355/2929/cips-chinas-hybrid-net-settlement-clearing-system.html

wave of relocation will be very disruptive in the short-term. The broken supply chains will be inefficient as the benefits of the other countries leveraging on China's industrial infrastructure, technology and the size and skill of its labour force will be gone.

IMPACT ON CLIMATE CHANGE

Another potential consequence of economic fragmentation will be a lack of coherent action to combat climate change. China and the US are the world's two largest carbon dioxide emitters. Together they account for about 38% of annual global carbon dioxide emission. If they fail to work together on combating climate change, there is little hope for concerted global action against global warming.

A Sino-US Cold War would make this outcome very likely because neither country would be willing to cave in to the other side's demand. International climate-change negotiations, already stuck with challenges, would end in deadlock. Without the cooperation between China and the US, any agreements struck by other countries would be insufficient to produce any meaningful impact.

A related disruption will be on technological innovation that enables progress in renewable energy development. Such progress depends crucially on the relatively free flow of technology across borders with China as the driver for economies of scale and cost reduction. Cold-war inflicted economic fragmentation and restrictions on technology transfers will make the much-needed innovations and breakthroughs much more difficult to achieve.

DISRUPTION TO STAY!

If the US and China are to work together, both Mr. Trump and Mr. Xi will have to broaden their focuses from national interests and personal political aspirations to global cooperation. This is a tall order, given the rivalry approach pursued by both leaders.

Together with other geopolitical risks, all this suggests that global disruptions of various sorts are here to stay. The ability of the world's central banks to soothe the resultant economic pains may be limited due to political pressure on their moves. With the world's two largest economies at loggerheads, any agreements on tacking climate change seem unlikely in the short-term. Even if the world somehow manages to achieve the goal of capping global warming to less than 1.5 degrees Celsius, global growth is set to slow as a result. The consequences will be dire if the world fails to tackle climate change with political and economic disruptions aggravating the resultant problems by creating global fragmentation.

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