



GLOBALISATION OUTLOOK

by Joe Zammit-Lucia

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Almost every mainstream economist and commentator has, to date, roundly condemned President Trump's protectionist policies, his use of tariffs, and his fiscal policies. I was therefore somewhat surprised to see this commentary in a Merrill/Bank of America recent analysis:

Is the US benefiting from President Trump's protectionist policies...

The United States...easily emerged as the number one location for new greenfield investment based on announced projects. Some 1,581 projects were announced in the U.S. in 2018, more than double the level of projects in China (796), and nearly 25% greater than second place United Kingdom (1,278)...

We do not believe there is any country that has such favorable economic DNA for FDI as the U.S., with corporate tax reform and yes, rising threats of U.S. protectionism, contributing to rising FDI projects in 2018.

*Merrill Capital Markets Outlook
20 May 2019*

This contrasts with the World Bank's June [report](#) – Global Economic Prospects that starts as follows:

...while the rest of the world struggles?

Global growth has continued to weaken, and momentum remains fragile. As this edition of Global Economic Prospects report documents, investment is sluggish. Downside risks to growth predominate, including rising trade barriers, a buildup of government debt, and deeper-than-expected slowdowns in several major economies.

*Global Economic Prospects
World Bank, June 2016*

A perception of 'victory' may lead Trump to double down on his trade policies.

If the picture continues to emerge that the US is doing well while the rest of the world is sluggish, President Trump might well conclude that he is winning the trade war and double down on his policies.

The Federal Reserve has also indicated that it is ready to intervene should growth stall in the US.

Given that picture, it would be wise to prepare, in as much as it is possible to do so, for a possible escalation of trade conflict.

ESCALATION HAS STARTED

We believe that escalation is now more likely than not

An escalation of the trade conflict – particularly between the US and China – now seems more probable than it was.

The two countries are at an impasse. We have reached a point where it is not easy for either of them to give ground without losing face and/or emboldening the other with the perception of impending victory.

Some escalation has already started. In the wake of the US ban on doing business with Huawei, China has targeted FedEx and announced its own list of unreliable foreign companies and individuals.

China has also just released a [white paper](#) on the state of US-China trade relations. It includes these statements:

"China does not want a trade war but is not afraid of one and will fight one if necessary."

The State Council Information Office of
The People's Republic of China

Since it took office in 2017, the new US administration has threatened additional tariffs and other measures and provoked frequent economic and trade friction with its major trading partners. In response to the economic and trade friction, China has had to take forceful measures to defend the interests of the nation and its people...

...China is willing to work together with the US to find solutions, and to reach a mutually beneficial win-win agreement. However, cooperation has to be based on principles. There are bottom lines in consultations. China will not compromise on major issues of principle. China does not want a trade war, but is not afraid of one and will fight one if necessary. China's position on this has never changed.

*China Position on China-US Economic and Trade Consultations
June 2019*

We pointed out in a [previous edition](#) of this Outlook, that the US-China trade conflict should not be read narrowly in international trade terms, but rather as part of a battle for geopolitical supremacy.

Given that, and the impasse now reached, we believe that escalation is now more likely than not.

A straight-out trade war will likely damage China more than the US

WHAT COULD FURTHER ESCALATION LOOK LIKE?

China has a significant trade surplus with the US and, to date, US companies have had less access to the Chinese domestic market than Chinese companies to the US market.

While China has made significant technological progress, it is still way behind the US. Some have argued that, in certain key technology fields, China is as much as ten years behind. And it will fall further behind if access to US technological know-how slows down or dries up.

A straight-out trade war combined with harassment of foreign corporations by both sides will therefore likely damage China more than the US.

China's near monopoly control of rare earths highlights a weakness in the Western economic model

China's ace up the sleeve? Or a step too far?

China has hinted that, in any conflict escalation, it could limit exports of rare earths¹ – vital components for the modern economy.

China's near monopoly control of such a vital part of the global supply chain highlights one of the weaknesses of the Western economic model where market players do only what is in their best financial interest with little heed to national or security interests. This may come back to haunt the West if this conflict escalates.

That said, choosing to limit exports of rare earths would represent a major escalation from which there may be no way back.

A further double-edged sword is China's holding of around \$1.3 trillion in US government bonds. Yet any mass selling, or even the threat of such a move, could hurt China itself by sinking the value of its own holdings. And it's not clear what China would do with the money if its US bond holdings are liquidated.

President Xi does not have to worry about having to stand for re-election

China has one further advantage: President Xi does not have to stand for re-election. Imposing discomfort on the Chinese population as a result of a trade war is therefore easier. And all the pieces are in place for a narrative

¹ It is worth noting that 'rare earths' are not actually rare. They are difficult to extract making it costly to do so while respecting environmental standards. China has accumulated rare earths because its environmental standards are low. Rather than developing environmentally sound extraction methods, the West has outsourced rare earth production (and the attendant environmental damage) to China.

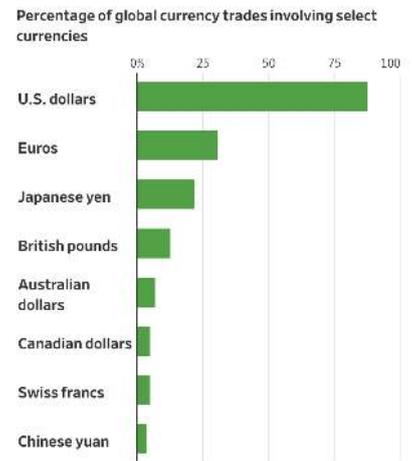
based on national pride and the usual recourse to the 100 years of humiliation narrative.

How would the US respond?

The power of the dollar remains unchallenged

Were the conflict to escalate as described above, what additional weapons are available to the US to respond?

First of all, we need to remember that the dollar remains, by far, the world's major trading currency (see figure). The yuan remains almost non-existent as a reserve currency.



Note: Percentages add up to more than 100 because these trades involve more than once currency
Source: Bank for International Settlements

As the conflict with Iran has shown, the US is willing to use its control of the dollar to strangle other economies. China will be wary of risking being put in any similar position.

Oil and Gas

China is highly dependent on imports of oil and gas

China is the world's largest importer of oil and natural gas. Eighty-two percent of those imports pass through the narrow Malacca Straits that are easy to blockade. China's oil reserves would barely last 40 days if it were starved of import supplies.



Attempting to starve China of its oil and gas imports would represent a huge escalation and might be considered tantamount to a declaration of war. It would also likely cause oil prices to tank – with significant negative consequences for the US.

We may be getting perilously close to the point of no return

WILL IT ALL GET THAT FAR?

To many it is inconceivable that things will be allowed to get that far.

But then again, history is full of examples of countries stumbling into conflict that was all but inconceivable – a series of small but cumulative mis-steps following some less than major trigger.

If China reaches for its rare earths weapon, all bets are off

As far back as October 2018 we [wrote](#):

As China rises to a major geo-political power, we should be thankful if its conflict with the US remains restricted to skirmishes around international trade when most previous transfers of power have ended in armed conflict

*RADIX Globalisation Outlook
October 2018*

Many felt that assessment was alarmist. And, thankfully, we are not there yet – and hope we will never get there.

The way out of the current impasse are not clear. But if China chooses to reach for its rare earths weapon, all bets may be off.

About Radix

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