

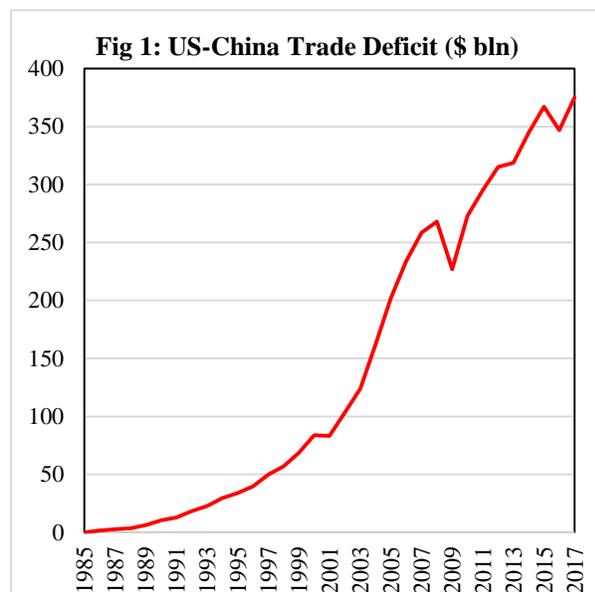
The end of Globalization?

Mushtaq Khan & Danish Hyder, April 18, 2018

This title may not seem shocking given the newsfeed of recent days and weeks. But it is important to appreciate the gravity of the statement – global trade has dominated our society for three decades and shaped the world as we now know it. It has given us the *Asian Tigers*, a profusion of consumer electronics, and made China the world’s factory. The end of this era would be significant and unsettling.

The advantages of globalization are obvious to consumers. The dizzying choices at supermarkets, exotic fruits/vegetables at affordable prices, the ease of logistics, and the growing market share of online retailers, have clearly increased consumer welfare. It is only quite recently that traditional retailers have come into decline, which has created a degree of negativity as retail jobs are shed and malls empty out. Nevertheless, there is growing public appetite for the fruits of globalization (i.e. ease of shopping, choice and competitive pricing).

Globalization has given rise to complex supply chains the world over, which will be threatened by the trade wars championed by President Trump. While many will dismiss this as political bluster from an unpredictable US president, we believe there are good reasons to check the momentum of globalization. The awkward first steps taken by the US (and China’s retaliatory actions) could unwittingly create a new philosophy for the global economy.



Theoretical underpinnings

As we discussed in an earlier paper (*A Self-Induced Challenge to the US Dollar – Part 2*, October 13, 2017), lopsided trade between the US and China is inherently unsustainable.¹ We have a dominant consumer (US) and an equally dominant producer (China), with a trade deficit that has increased from \$ 50 billion in 1997 to \$ 375 billion in 2017. This trajectory is alarming (see **Figure 1**).²

The study of economics uses abstractions (simplified models) to make fundamental points. So let’s assume there are only two countries in the world, and the importing country (M) persistently consumes what is produced by the exporting country (E). To finance this, country M borrows from country E, which means E keeps accumulating M’s debt. If this

consumption/production behavior is left unchecked, country M’s debt with E will become so large, that E

¹ While the trade & services imbalance between the two countries is smaller, we assume that President Trump (and his administration) focused just on the trade imbalance to zero in on the sort of blue collar jobs that Trump’s political base is interested in. The services surplus that the US enjoys over China would entail finance/insurance, travel & logistics, software, higher education, intellectual property rights, licensing and entertainment, where the beneficiaries are not Trump supporters.

² It is interesting to note, that the trajectory accelerated after China joined the WTO in 2001, which could explain why candidate Trump was so vocal against this multilateral.

will fear M's imminent bankruptcy.³ This suggests the US-China trade imbalance (disequilibrium) cannot be sustained.

A more sustainable model would require this trade imbalance to narrow. As discussed in the abovementioned paper, exchange rates would have to adjust to reduce the trade imbalance. In the real world, this means the Dollar would weaken and the RMB would strengthen. Hence, Chinese exports to the US would become more expensive (reducing US demand) while US exports to China would become cheaper (increasing Chinese demand). Theoretically, this currency adjustment would continue till the trade balance narrowed to zero.

This all makes sense. Considering the long-term goals of the US and China, this narrowing of the trade imbalance is good for both countries. More specifically, President Trump would like to see an increase in US exports to China (which means jobs, especially blue-collar ones), while China would be happy shifting its economic focus away from exports and towards domestic consumption. But while trade theory and long-term policy goals appear to be aligned, the required transition in the real world, would be very painful.

With a weaker Dollar, foreign lenders would not be willing to lend more unless US interest rates increased; this is also to be expected as US inflation will rise as the Dollar weakens. Unfortunately, an increase in US interest rates would exacerbate US debt dynamics, while a weak Dollar would increase the discomfort of holding US debt – this could severely disrupt global financial markets.

The challenges for China are equally daunting. A shift towards domestic consumption would enhance the welfare of the Chinese people, but the financing of this consumption as export jobs are being shed, would be difficult to manage. Theory suggests that the Chinese would have to dip into their savings (surpluses) to increase consumption, but such behavioral change will not be easy given the savings culture that exists in Asia. Families save for ageing parents and, without a government safety net, spending may remain restrained. On the flip side, Americans would have to stop borrowing to consume and start saving – an equally difficult behavioral change.

As these policy (and behavioral) changes are too difficult to justify on economic grounds alone, they may require political impetus. The goal to narrow the US-China trade imbalance could be imperfectly achieved via a trade war. The real insight, is that while a trade war between the US and China may appear ominous and would likely be destructive, this adjustment is required not only for long-term sustainability, but also because of the likely changes in the geopolitical world order.

Geopolitical changes

The Cold War between the US and the Soviet Union was lopsided. The US emerged unscathed from WW2, and became an industrial and financial superpower. It led the world in armament technology, military bases and diplomatic clout – it also developed the largest economic market with the greatest financial and corporate reach, and became a bastion of educational excellence and innovation. The Soviet Union, on the other hand, barely kept pace militarily, as its inherent economic weakness made it no match for the US.

³ Some would argue that since the US issues the universal currency (the Dollar), exporters would be happy to keep accumulating Dollar debt. As discussed in our October 2017 paper, this gives the US an enviable ability to run external deficits and pay for them by just printing Dollar bills. However, for a large accumulator of this debt (China), the value of this asset will eventually become a liability as it will make China vulnerable to US economic policies.

The Cold War ended with the fall of the Berlin Wall in 1989, creating one hyper power. But things have changed in the past three decades – the most prominent being the rise of China as an economic powerhouse. China now challenges the US in many other dimensions.

In an earlier paper (*The Changing Global Order*, May 10, 2017), we talked about the dawn of a new bipolar world order that is remarkably well-balanced. We suggested two groups: the US Allies (America, India, Saudi Arabia, Israel and the UK) and the Sino-Soviet Axis (China, Russia, Iran, Turkey and Pakistan), and compared these two in terms of economic power and potential, populations and the number of nuclear weapons in each group's possession. Unlike the US-Soviet rivalry, this bipolar world is balanced both in terms of military power and economic strength.

These two groups will only be a credible check on each other if there is a degree of economic/financial independence between the two, as this creates geopolitical flexibility. More simply, the US and China would not have policy flexibility if their economies were closely intertwined. As stated in an earlier paper (*A Self-Induced Challenge to the US Dollar – Part 2*, October 13, 2017), the Dollar dominance of global trade, allows the US to unilaterally target specific countries by restricting Dollar clearing of certain national banks, which impedes trade and investment flows to that country. This vulnerability is something China would like to reduce to ensure that the US cannot take steps against its allies if China were to take a stance against the US.

This is not to suggest that China and the US should disengage economically. It does imply however, that both countries would seek to monitor their economic vulnerabilities, so that each can credibly show that any untoward policy shift by the other, will have consequences.

Where do we currently stand?

The trade war started slowly, developed Dollar-for-Dollar, and has recently been eclipsed by other events. While US tariffs on steel and aluminum pushed South Korea to negotiate directly with the US (see **Appendix 1**), China opted to retaliate – it announced tariffs on \$ 3 billion worth of soybean and pork products from the US. The US responded by announcing tariffs on \$ 50 billion worth of Chinese exports, which China matched by targeting \$ 50 billion of US exports. The next day, the US threatened an additional \$ 100 billion, and China followed suit.

Although there is a time-lag before imposition, the political rhetoric from both sides is disconcerting. The US blamed China's \$ 3 billion announcement to justify its escalation, while China has warned that it is prepared to retaliate beyond US exports if required (total US exports to China in 2017 were only \$ 130 billion). In the last week, the Chinese tycoon, Jack Ma (owner of Alibaba, the world's second largest online retailer) warned that if the US government continues on its current path, the US would lose 10 million jobs.⁴ The ex-Governor of the People's Bank of China has stated that a trade war would hurt the US more than China, while a leading think tank in China has warned that a trade war would be very hard to contain.

As the only country specifically targeted by the US, China has shown that it will not bow to US pressure, even if this means that China could lose its largest export market. Although Premier Xi has announced China's strong preference for cooperation over confrontation, his retaliatory steps against US tariffs, and the recent initiative to embed the Chinese Communist Party (CCP) in foreign companies operating in China, suggest he intends to play hardball (more later).

⁴ In January 2017, Jack Ma stated in front of President Trump that his company would increase US jobs by 1 million.

What does President Trump want?

The ideological divide between the post-WW2 *Pax-Americana*, and President Trump's vision for the US, is obvious. This anti-global viewpoint dates back to the 1980s, when Donald Trump was already expressing his anger at free trade, specifically the shifting of US jobs to Asia. His campaign promises have built on this viewpoint, as his managers connected him to a political base that shared his anti-global, anti-elite sentiment.

We would argue that a standoff against both China and Mexico is an integral part of Donald Trump's campaign for president. Trump feels he must deliver on these promises, however destabilizing this may be. He has repeatedly stated that multilateral agencies like NATO, the UN and WTO, and trade treaties like NAFTA and the Trans Pacific Partnership (TPP), have not served American interests for decades.⁵ Liberals may be appalled by Trump's regressive policy agenda, which just goes to show the unbreachable gulf between them and the mindset of Trump supporters.

Taking stock of the intense media coverage that President Trump generates – and its incessant nature – we would make the following observations:

- Donald Trump prizes his media presence. Whether its Twitter, an impromptu comment to a journalist, or an orchestrated message to the country (and the world), President Trump relishes the media's fascination with him. He also plays the media very well;
- Donald Trump views his public messaging through the lens of his domestic political base. If this bothers foreign leaders, he will use their annoyance to prove his commitment to his base;
- Donald Trump has decided that mainstream media will never embrace him or his policies.⁶ Hence, there is little to gain from reaching out to this segment of American media. Trump would rather confront CNN, MSNBS, BBC, etc. ("fake news") and energize his support base to do the same;⁷
- Since Donald Trump is against the established order⁸, he is remarkably flexible in how he approaches foreign policy challenges; and
- Finally, the known unpredictability of a US president creates an opportunity to upend time-honored US policies, and almost makes it palatable. Once Trump's ideas are out in the global forum, they could generate a domestic or global constituency, which may redefine America's role in the world.

To conclude, Donald Trump wants: (1) to be remembered as an agent of change, even if it is globally disruptive; (2) to champion a forgotten segment of Americans that has been marginalized by globalization; (3) to question the wisdom of being the global policeman, for something as intangible as global goodwill; and (4) to dumb-down policy choices to gain traction with the average American voter. In our view, Donald Trump is single-minded in energizing his base to remain loyal, even if it creates deep fissures in American society.

What does Premier Xi want?

Sensing the momentous changes that lie ahead, we believe that Premier Xi feels the need to position China as a counterweight to the US, which means he must reduce his country's dependence on the US

⁵ This is a stark dismissal of the global institutions created by the US after WW2 to influence global trade/capital flows, and conflict resolution.

⁶ In our view, the fixation of mainstream media on the inherent flaws and chaos in the Trump White House, is missing the point. This coverage only reinforces the sense of dismay and frustration within its captive audience, but does little to reduce President Trump's approval ratings.

⁷ This has generated a degree of political activism (in between elections) that is unprecedented in recent US history.

⁸ This entails diplomatic norms & past US positions, supporting institutions that maintain the global order, and bearing the burden of the global responsibility the US has taken since WW2.

economy. He perhaps also feels that President Trump's outsized personality and recent trade war, provide an ideal opportunity to push through significant economic and political changes within China, which could be justified as a response to an unstable global leader.

After all, Xi Jinping is an ambitious man. He has diligently worked the state machinery, and is now in a position to achieve his ambitions. While Mao Zedong made China, and Deng Xiaoping made China prosperous, Xi Jinping intends to make China powerful. Premier Xi's push to remove term limits on his leadership, has been interpreted as an effort to remain China's leader for life.

We do not share this viewpoint: we believe that Xi's second term, which ends in 2023, may not be viewed by him as long enough to ensure that China's superpower status is irreversible. China's strength is its ability to plan decades ahead (not years), which means Premier Xi wants to ensure that his policy direction is not thwarted as his term winds down.

This long term planning is in contrast to the US, and the political uncertainty about the survival of the EU. China's planners know that its growth engine of the past several decades is no longer viable. Its ambitious *One Belt One Road* initiative reveals that it is now looking at creating an Asian trading zone that includes Iran, the Middle East and Central Asia (*One Belt One Road: Building Asia on China's Strength*, August 12, 2016). It also means that China's own economy will have to transition away from its dependence on the US and EU, and slow down the massive infrastructure build that it has engineered in the past decade.

One thing is clear, China will carry out this transformation in its own unique way. China's planners intend to keep the state firmly in charge of economic reforms, and shape the structural changes. According to a recent *NYT* article (April 16, 2018), many state-owned enterprises have allegedly rewritten their founding charter to include a more prominent role for the Chinese Communist Party (CCP), not just in terms of recruitment and education of employees, but also in terms of strategic decision-making. Foreign companies operating in China as JVs are also being targeted.

This is almost unthinkable at this stage of global interdependence. Imposing a socialist ideology onto the workplace of foreign companies is almost surreal, as is having to inform and listen to the political wishes of CCP leaders. While it is too early to gauge how foreign firms will respond, and exactly what level of political influence the Chinese government seeks, it does show that the CCP (which is led by Xi Jinping as Secretary General) is willing to leverage the global importance of China to ensure that foreign companies operate in a manner that suits the CCP.⁹ The threat is: take it or leave it.

Demise of multilateral institutions?

In this environment, there is little room for multilateral discussions. Despite the implicit invitation to China (by some multilaterals) to fill the void created by the Trump administration, China may only play along for appearances. In our view, China could find it more advantageous to remain passive for several reasons:

1. Initiating a trade war is a show of unilateral sovereign intent that may trigger retaliation. This means multilaterals will gradually lose ground to bilateral negotiations.
2. Trying to resolve a bilateral conflict through multilaterals, may not provide a resolution and will certainly take up a lot of time (multilaterals are bureaucratic).

⁹ While state influence on Chinese firms is clear enough, the CCP wants to ensure that it can similarly influence foreign companies that seek to retain their presence in China. One could even argue that while trade tariffs have been used by Western countries to pursue national interests, perhaps the Chinese approach is to indigenize the way foreign companies operate in China.

3. A trade war is easy to announce, but it is very difficult to disentangle the incidence of the impact. This is because global supply chains involve many countries, and often entail two-way trade. Bilateral negotiations are easier: the two parties negotiate and the winner is the one with greater economic or geopolitical clout. And,
4. The nature of the One Belt One Road initiative and China's need to re-orient its own economy, suggest that bilateral arrangements will be preferred:
 - a. OBOR entails various land and sea corridors, which are intrinsically bilateral (e.g. CPEC only involves Pakistan and China). Resolving conflicting interests related to trade, investment, technology transfer, tariffs, logistics, etc., are better suited to bilateral negotiations; and
 - b. China needs to change its economic orientation. It needs to promote domestic consumption and shift resources out of export industries. In our view, China's policymakers will be interventionist, which goes against the free market ideology that still dominates multilaterals.

Concluding thoughts

We could be witnessing the gradual end of the globalization era. In a bipolar world that is evenly matched, countries may trade more cautiously with countries on the other side (*A Self-Induced Challenge to the US Dollar* – Part 2, October 13, 2017). More simply, the creation of a bipolar world could influence the priority attached to economic and foreign policies. Commercial interests could become more subservient to sovereign goals, regional interests would outweigh global interests, and trade and investment flows could become more regional.

Since the impetus for this change is coming from the US (e.g. *America first*, unfair trade practices, allies should pay for American protection, etc.), US economic policies could become more populist, whereby American voters demand and secure economic protection, even at the cost of the private commercial interests (big business and globalists). In exchange, China may be able to secure its sphere of influence in Asia Pacific (see **Appendix 1**).

As discussed earlier, a contained trade war characterized by bare-knuckled bilateral negotiations, could suit both the US and China. If there is a shift away from multilaterals, individual European countries (specifically Germany and France) would seek to secure their own national interests. These countries are already interlinked in global supply chains, and would be forced to rethink their trade orientation. With China squaring off against the US, and the latter taking a very different tack under President Trump, trade-dependent countries will face an uncertain and difficult future.

In our view, the real change would be in mindsets. The dominant free-market, free-trade, globalization that coincided with the end of the Cold War, is being challenged and could be defeated.

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Appendix 1: The outlook for the two Koreas in a new world order

The recently concluded trade agreement between the US and South Korea (on March 25th), is somewhat disconcerting. The *NYT* reported that these negotiations had stalled last year, but were revived and swiftly concluded after the US agreed to permanently exempt South Korea from US tariffs imposed on steel and aluminum. In return South Korea has agreed to: (1) reduce steel/aluminum exports to the US by 30%; (2) lift the limit on US automobiles that can be sold in South Korea; and (3) extend the tariffs imposed on Korean trucks exported to the US till 2041.

We are unable to conduct a cost-benefit assessment to gauge which country got a better deal, but most observers are of the view that the optics favor the US. Against temporary waivers given to trading partners like Canada, Mexico, the EU and Brazil, South Korea has assured itself a US market, albeit a smaller market than it used to be.

Optics are a significant prize for President Trump: he gets bragging rights while showing that disregarding the WTO does not have consequences. He is also able to tell his political base that American cars will find a larger market in South Korea, while American trucks will be protected from South Korean imports. More ominously, he is able to signal that if US trade partners want greater clarity on their relationship, they should prepare themselves for bilateral negotiations.

What does South Korea want?

As the world's fourth largest steel exporter, South Korea wants to secure the US market. It also wants to ensure that the standoff with North Korea is resolved, without the US getting involved in an armed conflict. South Korea seeks US support for the talks between the two Koreas, and to ensure that President Trump succeeds in the historic meeting with Kim Jong-un. The global spectacle this promises to be, could incentivize President Trump to approach the talks with the end goal of ensuring that the outcome is celebrated by global media.

In effect, it makes sense for South Korea to concede some economic ground to the US to generate goodwill on the geopolitical front. More specifically, Seoul is hoping that if North Korea shows its willingness to halt its nuclear and missile programs, in exchange for a US guarantee that it will not attack North Korea, both the US and South Korea could take credit. This understanding could become more ambitious: President Trump may also agree to withdraw the entire US military presence from South Korea, something that China would welcome with gratitude and a sense of indebtedness.¹⁰

What does North Korea want?

North Korea does not want to be "totally destroyed" by the US. It also wants to be seen as a legitimate player in the global order, and have US sanctions lifted. For economic growth and political stability, Kim

¹⁰ There is good reason for the US to withdraw from South Korea. The US military presence was required as part of a UN mandate to protect South Korea when North Korea invaded the South in 1950. While the Soviet Union was not involved in the military exchange, China (which at that time was not recognized by the US) was backing North Korea to the point that the US threatened China with the use of its nuclear weapons. The UN mediated the armistice in 1953, which means the two Koreas are technically still at war. Other than the need to put into place a formal peace treaty between the two, China is no longer viewed as a threat to South Korea, while the North's military buildup is justified by credible fears that the US could attack North Korea. The Korean standoff is a relic of an outdated period, and could easily be resolved with the willingness of the two Koreas, China and the US.

Jong-un would like to open up trade/investment flows with South Korea and China, within the existing political regime.¹¹

Valid concerns have been raised that President Trump's attitude towards the Iran nuclear deal, could undermine his ability to secure concessions from North Korea. Kim Jong-un would be justified in doubting President Trump's sincerity in a possible nuclear agreement with North Korea. However, unlike the Iran nuclear deal, an agreement between North Korea and the US could be brokered by China, which may act as a guarantor. Given President Trump's aversion to multilateralism, and his fascination with China, this could actually be sufficient to defuse the nuclear standoff in Korea.

What does China want?

From China's perspective, the priority would be to defuse the tension between the US and North Korea. It would also want to give sufficient comfort to Kim Jong-un, to voluntarily roll-back his nuclear and missile programs. China is aware that unless the North Korean issue is credibly resolved in a mutually beneficial manner, it could become a trigger point between the US and China. China also wants to ensure the denuclearization of the Korean peninsula, as a continuing standoff between the US and North Korea, could incentivize Japan and South Korea to develop their own nuclear arsenals. It is clearly in China's interest to be the sole nuclear power in the Asia Pacific region.

As stated earlier, China would be even happier if the US were to withdraw its entire military presence from South Korea.¹²

What could be negotiated?

We will simply list what could happen if the US and China sit down to negotiate behind closed doors:

- President Trump wants to deliver on his campaign promises to put China "on notice", and take real action. This bragging point is invaluable for Trump's political life, but it carries the risk of China retaliating.
- If China allows for this, and even concedes some economic ground to the US, China could push the US to withdraw its entire military presence from South Korea. While this will enrage the US establishment, President Trump could appeal to his base, by showing that the resources freed up from its military presence in South Korea, would be earmarked to uplift those parts of Middle America in economic decline.
- The US and China could agree that the UN will spearhead a peace treaty between the two Koreas, which is win-win for all concerned.
- With a nudge from both the US and China, North and South Korea could begin a partial unification that is anchored to each country downsizing its armed forces. Economic ties and travel between the two Koreas could be a very helpful first step.
- Partial unification would carry an implicit assurance that a democratic government in a united Korea, is not the end goal. Since an authoritarian China is partnering with a democratic US, there should be no political predisposition on the Korean issue.

¹¹ Unlike his father and grandfather, Kim Jong-un has a unique opportunity to enter the global order after meeting both the leaders of China and the US.

¹² From China's perspective, denuclearization would make it possible to encourage the two Koreas to formally end the Korean War. This would create an environment wherein the US has little reason to keep a military presence in South Korea, which China sees as its sphere of influence. While the US establishment would resist this move, this is an issue that President Trump would willingly engage his political base with.