THE ECONOMIC COST OF CONFLICT

We consider two scenarios to understand the impact that a conflict between China, Taiwan and the US could have on the global economy - the first being armed conflict and the second being an escalation of tensions through reduced economic cooperation or the weaponisation of trade. Importantly, these two scenarios are not mutually exclusive.

Armed Conflict

According to a study by the National Bureau of Economic Research (NBER) released in November 2020, around 80% of global trade is carried by sea; estimates of the volumes carried through the South China Sea range from 20-33%.[14] As such, a conflict in the Taiwan Strait, that extends into the South China Sea, would be expected to have a dramatic impact on global trade between Southeast Asia and the rest of the world.

According to the study, if the conflict is severe, it would be expected that shipping from Europe, the Middle East and Africa that is destined for Southeast and East Asia and the US west coast, would need to be rerouted around the south of Australia. The Torres Strait that runs between Australia and Papua New Guinea is not a reasonable alternative for shipping because of its shallow depths and abundant coral reefs. This would have a dramatic impact on shipping costs, global trade and economic activity. The implications of the recent week-long blockage of the Suez Canal should provide an indication – around 12% of global trade passes through the canal, translating to more than US$9 billion worth of goods per day.

Figure 3: Map of Southeast Asia and Australia

Source: US Central Intelligence Agency

[14] Refer to https://www.nber.org/papers/w28048

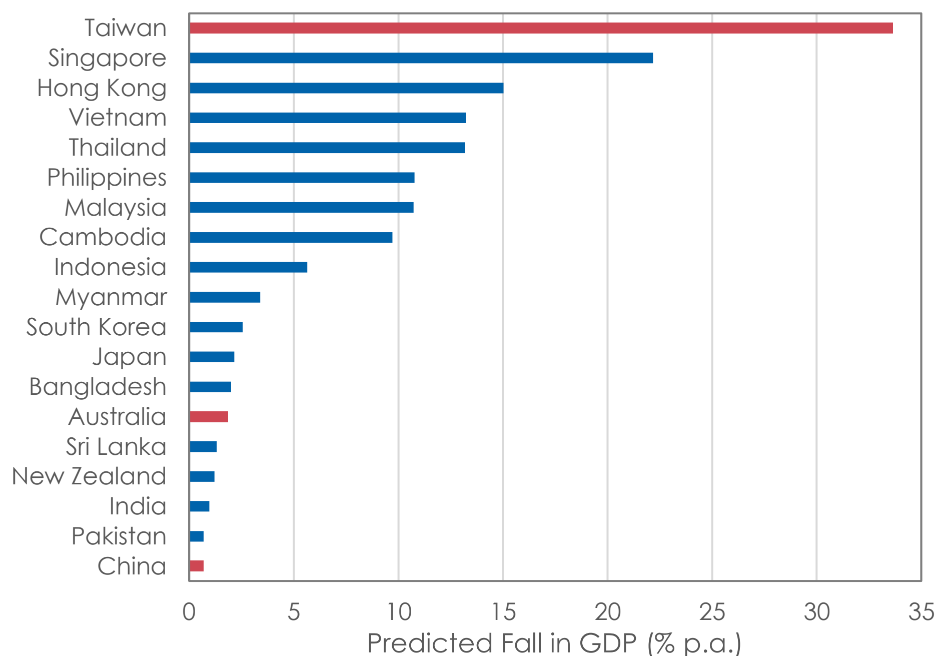
Asian countries with ports in the South China Sea would be expected to be most economically harmed by a conflict in the region. Chart 1 shows the modelled results of the NBER study, which assumes that all shipping through the South China Sea is rerouted around Australia. The predicted fall in GDP calculated in the study estimates the trade and welfare impact due to the cease of trade through the South China Sea, as well as expected military spending due to the conflict.

Countries expected to be most gravely impacted are Taiwan and Singapore. The importance of shipping through the South China Sea to Australia would be expected to cause a 2% fall in Australia's annual GDP. Meanwhile, the contraction in China's economy could be limited to as little as 0.7%, thanks to the abundance of Chinese ports outside of the South China Sea and the strength of the domestic economy. This analysis demonstrates China's strong positioning in the conflict.

The discussion above and the analysis presented in Chart 1 only considers the trade impact of the conflict. It is worth noting here that there would be plenty of other economic implications, such as increased wartime spending, low inflation and an increase in unemployment - economic settings consistent with a global recession. The likely total impacts on GDP would be expected to be far worse than the trade impact alone, although a very wide range of scenarios are plausible.

It is important to note that countries outside of those in close proximity to the conflict stand to be greatly affected as well. The supply shock caused by the forced closure of a significant portion of China's manufacturing sector in an effort to stem the spread of COVID-19 in the first quarter of 2020 exposed the interconnectedness and rising interdependence of global supply chains, particularly the reliance on China. China is the largest trading partner of many nations, including Australia, Taiwan and the European Union (when considered as a single entity). Disruptions to supply caused by armed conflict in the region would be expected to cause economic trouble for any country who is heavily reliant on China for trade.

Chart 1: Predicted Fall in GDP in Event of Armed Conflict in South China Sea



Source: NBER

Trade as an Instrument of Power

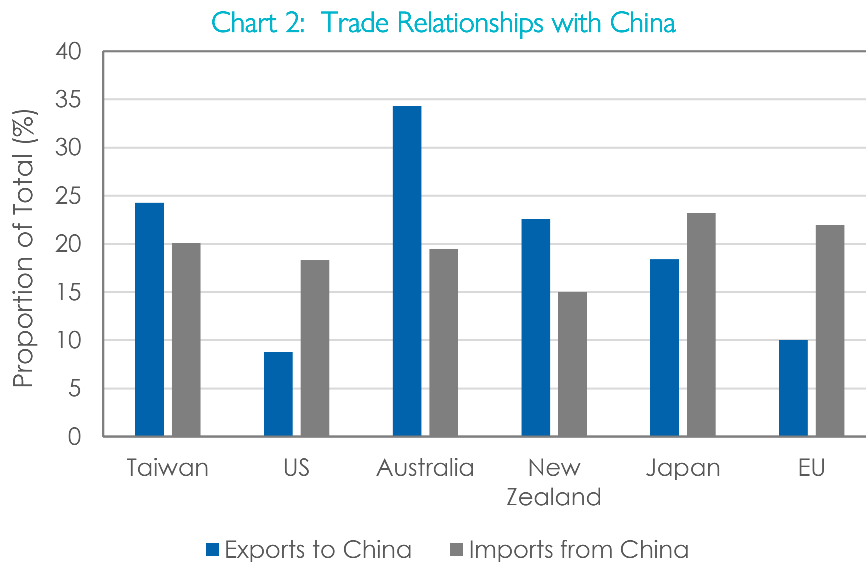
With or without armed conflict, an escalation of geopolitical tensions between China, Taiwan and the US and its allies, could bring about considerable use of economic sanctions and the weaponisation in trade as a means to inflict harm.

China is well-poised to use trade as an instrument of power. For so many countries, China accounts for a significant portion of their total trade but they only account for a very small portion of China's total trade. China is therefore able to interrupt trade, and thus economic and financial outcomes – allowing it to exert significant coercive power over other nations.

Chart 2 shows the extent of the trade relationship between China and a selection of relevant countries.

There is a long history of countries using economic sanctions for political gains. The US has exploited its extraordinary influence over other countries' economic wellbeing by limiting a country's access to USD-based financial systems. China is increasing its use of sanctions as it expands its global economic footprint. China's use of bans and tariffs on select Australian imports in 2020 due to the Australian Government's calls for an inquiry into COVID-19 is a recent example.

Chart 2: Trade Relationships with China



Source: International Trade Administration, US Census Bureau, Australian Government DFAT, Statistics New Zealand, Ministry of Finance of Japan, Europa

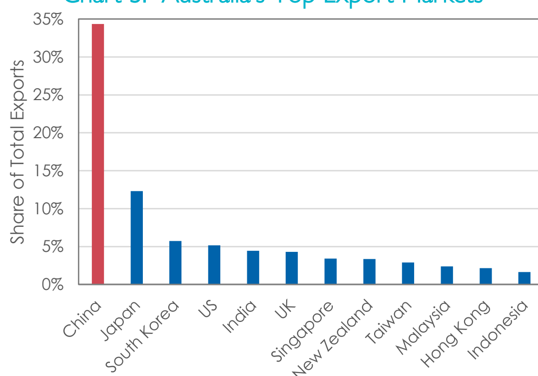
To illustrate the effect China relying on economic coercion could have on any one country, we use Australia as an example. Australia has an incredibly asymmetric trade relationship with China – as shown in Chart 3, China is by far Australia's largest export market, accounting for more than a third of its exports. Meanwhile, the significance of Australia to China's export markets is relatively minimal – Australia is China's 12th largest export market, accounting for only 2% of total exports. It is worth noting that the only Australian market of significance to China is minerals – according to the World Bank, Australia supplies about 37% of China's minerals imports overall. In August 2020, Australia's Deputy Prime Minister Michael McCormack claimed: '*We need China as much as China needs us.*'[15] Based on the nature of the trade relationship, this assertion is questionable.

China targeted Australia's barley, beef and lamb, wine, cotton, lobster, timber and coal in 2020 through its use of tariffs, blacklisting and boycotting. While the measures did not have a significant impact on Australia's overall level of economic output, the significance of China as an export market to each of these products was felt among the various industries. In the event of Australia supporting Taiwan and the US in some sort of conflict with China, it is likely that China would target more industries with more severe sanctions. Taken together, this could have a meaningful impact on Australia's trade and economic activity.

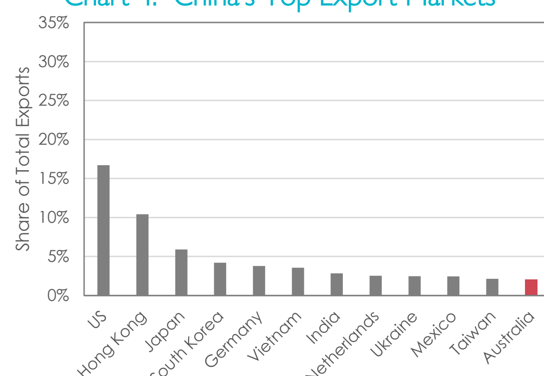
One Australian export that stands out from the rest is iron ore. China sources two thirds of its imported iron ore from Australia, which accounts for approximately half of all iron ore consumed in China. If China were to implement tariffs or bans on Australian iron ore, it would likely have devastating consequences for the Australian economy. But iron ore is one of the only commodities where there is mutual interdependence – China does not have another source ready to fill the gap of Australian iron ore, in the short term anyway.

However, China is clearly trying to diversify its sources of iron ore. Africa has a similar level of iron ore reserves as Australia, the majority of which are untapped. In May 2020, major Chinese steelmakers called on the government to increase both domestic iron ore production and invest in the exploration of iron ore deposits in Africa. In June, the Global Times, China's state-controlled newspaper, claimed that if required or pushed, China was willing to curb Australian iron imports and would pay more to seeking alternatives from Brazil or Africa.

The Australia example is one of many. If conflict ensued, whether armed or not, China would be expected to use all the tools in its toolbox, and its standing in the global economy and its outsized influence over so many countries is certainly a powerful tool. The full extent of the implications is ultimately dependent on the nature and duration of the conflict.



Source: Australian Government DFAT



Source: Observatory of Economic Activity

[15] Refer to https://www.michaelmccormack.com.au/media-releases/2020/8/26/transcript-parliament-house-press-conference-26-august-2020

A Change to the World Order?

Embedding global supply chains in China has been happening for the past few decades, marked by multinationals offshoring their manufacturing processes to China, largely to take advantage of cheaper labour conditions. The Trump-led trade wars, and the impact that tariffs had on the price of intermediate manufactured goods made in China, brought about increased costs for multinational companies. Then, the COVID-19 outbreak caused headaches of a different kind to multinational companies, through major supply disruptions. These two issues caused multinational companies to reconsider, or at the very least better appreciate, the complexity of their supply chains.

An armed conflict, or an economic conflict, could be the straw that breaks the camel's back in terms of multinationals choosing to diversify their supply chains. As we previously discussed, either type of conflict would be expected to have significant implications on trade, supply chains and economic activity. Reworking supply chains to avoid China would be an expensive and taxing endeavour, impacting profit margins, and thus equity returns, as new supply chains would be expected to have a higher cost base.

However, at this juncture, it is important to note a scenario where multinationals do not have the choice about their supply chains. An extensive conflict between China and the US and its allies could lead to a formal separation in the existing world order. A landscape where it is China and its allies versus America and its allies is not entirely inconceivable. A fulsome discussion of this scenario is beyond the scope of this article, however it is worth noting that this would be an incredibly monumental shift in global politics and global economics.

THE RISK FOR INVESTORS

The financial market implications of conflict are obviously highly dependent on the nature of the conflict, which is inherently difficult to predict. There have been wars in the past that have not had any substantial widespread financial market impact because the wars have had little impact on the global economy, whereas others have caused significant market sell-offs and volatility.

Table 2 shows that share markets were often rattled in the lead-up to, or in the early days of, conflict, but rebounded well before a resolution was reached. It is important to note however, that often the share market implications were not just the result of war, but of other influences on the market.

Table 2: Historical Periods of Conflict and Equity Market Implications (in US dollar terms)

Event	Date	Change in S&P 500 from conflict onset to market low	Time from market low to conflict resolution	Change in S&P 500 six months after market low	Change in S&P 500 12 months after market low	Comment
World War II	Sep 1939 – Sep 1945	-34%	34 months	+25%	+54%	US shares fell by 34% from the outbreak of WWII, with a 20% fall following the attack on Pearl Harbour. The share market low was three years before resolution in 1945. By the end of the war, shares were up by 108% from the mid-war low.
Korean War	Jun 1950 – Jul 1953	-8%	36 months	+29%	+31%	The US share market initially fell by 8% at the start of the war, but this coincided with the recession that was happening at the same time. Shares were at their low point in the first half of the conflict, and trended upwards in the second half.
Vietnam War	1955 - 1975	N/A	N/A	N/A	N/A	The Vietnam War lasted for so long that the US share market went through both bull and bear markets throughout the war. A secular bull market ended in the 1970s, in part because of the end of the war, but also because of rising inflation.
Cuban Missile Crisis	Oct 1962	-7%	5 days	+30%	+36%	Shares initially dropped by 7% over eight days as the crisis escalated, but this coincided with a concurring bear market. As soon as it became clear that the situation had been resolved, share prices rose sharply.
Iraq War I	Aug 1990 – Jan 1991	-11%	19 days	+21%	+34%	Shares fell by 11% from when Iraq invaded Kuwait to their low in January 1991, but this was part of a much bigger fall that was associated with a concurrent recession.
Iraq War II	Mar – May 2003	-14%	51 days	+21%	+34%	Shares fell by 14% as war seemed imminent in early 2003, but bottomed nine days before the first missiles landed and then rose substantially, although this was in part because of the end of the bear market at the time.

Source: AMP Capital, Whitehelm Advisers

In the case of conflict in Taiwan, the Taiwan Strait and the broader South China Sea, we would expect to see an initial 'flight to safety' in markets, with investors moving capital towards the more traditional and robust safe haven asset classes such as US Treasuries and gold, as well as safe haven currencies such as the US dollar, Japanese yen and Swiss franc. These are all typically stable and highly liquid asset classes that have proven to be strong performers during risk-off events in the past (a notable outlier being the COVID-19 market turbulence in March 2020 which led to unprecedented illiquidity in US Treasuries). Asian currencies and equities would likely sell-off aggressively, especially if conflict were to lead to the disruptions in regional trade, manufacturing supply chains and investment flows.

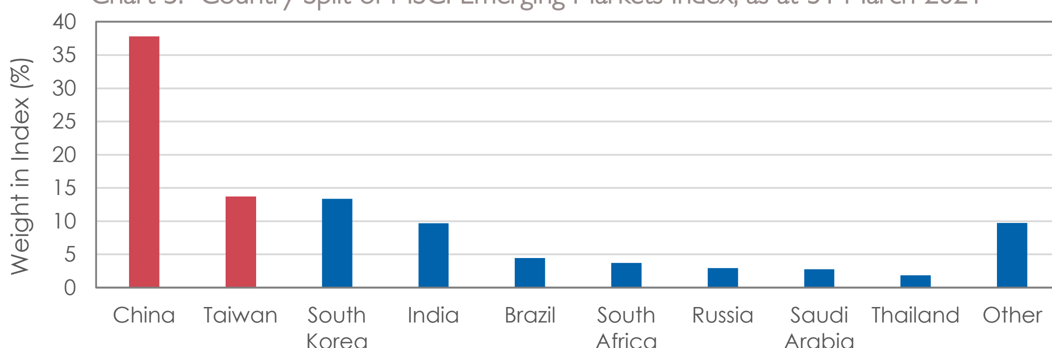
The impact would likely be much more severe for countries that are directly involved – particularly Taiwan and China. This would have significant implications for the performance of emerging market equities given that Chinese and Taiwanese shares account for 38% and 14% of the MSCI Emerging Markets Index respectively, per Chart 5.

Aside from the impacts to specific markets and industries caused from trade restrictions, the impact on other equity markets, such as US and Australian shares, and investment markets more broadly, is also dependent on the extent to which these nations get involved in the conflict, and the sentiment surrounding their involvement. Outcomes are also dependent on the length and intensity of the conflict. However, if there is sustained military and economic conflict, we would expect to see low inflation and high unemployment, and with that, falls in cash rates (assuming they are at higher levels at the time of conflict than they are today!) and bond rates as they respond to the deteriorating macroeconomic environment. Australian government bonds would be expected to perform well, on the basis that markets continue to assume a high degree of creditworthiness of the Australian government, despite its involvement in the conflict.

As investors consider the weaker medium-term outlook and contemplate the implications for supply chains as China severs trade links with the US and its allies, we would expect large falls in a range of risk assets, including substantial falls in listed equity, particularly Australian and emerging market shares, and to a lesser but still notable extent, developed overseas shares. The Australian dollar would be expected to depreciate sharply, so for Australian investors, foreign currency exposure would offset a degree of the fall in overseas shares. Assets that are bond proxies would likely have a mixed journey, depending on the nature of the assets. Those with GDP-exposed business models (and thus, a greater degree of economic exposure) would likely struggle.

Depending on the result of the conflict, particularly if we see a shift in the world order, such as the division of countries into the US and its allies and China and its allies, markets would be expected to be volatile while countries and investors alike figure out what the new landscape means for geopolitics and business models.

Chart 5: Country Split of MSCI Emerging Markets Index, as at 31 March 2021



Source: Bloomberg

CONCLUSION

We began this article by noting that the current tension between China and Taiwan is a concerning geopolitical risk. This is not a new risk the potential for escalation of tensions, and all-out conflict between the two entities, has existed for decades. Yet, the invasion that Taiwan has feared has not yet come. It is easy to say 'this time is different'. Is it?

China has certainly become more brazen on the global stage. Paired with the four tumultuous years of Trump's presidency, the relationship between the two largest and most influential countries has deteriorated to the worst it has been in decades. President Biden will not be a quick fix either. But the tension has not distracted China from making headway on its Taiwan reunification ambition. While China's grey zone warfare tactics in recent months may not be intended to incite an armed conflict, it has certainly had the effect of making us believe this time could be different.

Our central case investment environment outlook for the short to medium term does not involve an all-out armed conflict between China, Taiwan, the United States and its allies (including Australia). However, we consider it is an important scenario to not overlook when determining investment strategy settings. Australian investors need to be particularly mindful because of the outsized impact that Australia's involvement in either military or economic conflict with China could have. The importance to Australia of its trade relationship with China highlights the vulnerability (nearly 35% of Australia's exports go to China).

Conflict, whether intentional or precipitated by strategic miscalculations, would be expected to escalate quickly and financial markets would react in a similar fashion. Thus, considering portfolio positioning while the scenario is still a risk and not a reality increases investor preparedness. This geopolitical risk will exist until there is a clear resolution to the matter – when that happens is anyone's guess.

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