OPINION

Apr 8 2018 at 9:33 AM
Updated Apr 8 2018 at 11:07 AM

China has the 'financial arsenic' to ruin the US - but will it use it?

China to 'fight back' against US trade tariffs

by **Ambrose Evans-Pritchard**

China's leaders must be sorely tempted to activate the "nuclear option" and punish the capitalist running dog, the tango dancer in the White House.

They could at any time start to liquidate their $US1.2 trillion ($1.5 trillion) holdings of US Treasury debt, switching the proceeds into euro, sterling, krona, Aussie, or peso debt to stop the yuan exchange rate soaring.

Even a small dose of this financial arsenic would - in the minds of Beijing's ultra-nationalist faction - set off a salutary panic. It would crater the US bond market at the very moment when Donald Trump's fiscal depravity is driving the US budget deficit to a stratospheric $US1 trillion.

The contagion would spread instantly through US mortgages and consumer credit, and would detonate a Wall Street equity crash - the "Trump crash" in blood and gore.

Timed astutely, it might decide the midterm elections and deliver a Democrat Congress, one with control over the impeachment machinery. The demise of Trumpism would then be in sight, either because the Mueller inquiry establishes collusion with the Kremlin or because the president commits perjury in one of sundry lawsuits ensnaring him.

China need say nothing. Action would speak loud enough. If pressed to explain, it could state, with some justification, that US fiscal policy is out of control and that the Trump administration is not a fit custodian of any country's wealth.

This drastic possibility is on the radar screen after China's commerce ministry upped the ante with talk of "comprehensive measures", which appear to go beyond trade. President Xi Jinping cannot retaliate symmetrically to Mr Trump's new threat to impose tariffs on another $US100 billion of Chinese exports. China does not buy enough imports from the US to match it.

The Communist Party leadership will not kowtow to Mr Trump. The "opium century of humiliation" at Western hands is too fresh in the collective Chinese psyche to yield to such crude intimidation. Beijing said that the nation is "willing to make any sacrifice" to uphold its dignity.

The hardline tabloid Global Times has been writing daily editorials proclaiming that China is a coequal superpower with an arsenal of reserves and limitless tolerance for pain, so make our day. "To take China down would mean an unimaginably cruel battle for the US," it said.

Yet the nuclear option is in reality almost useless. "The US Federal Reserve could counter it easily with emergency open market operations," said Geoffrey Yu from UBS.

If the Fed can buy more than $US3 trillion of US Treasuries and mortgage bonds under its quantitative easing programme, it can equally soak up China's entire holdings if necessary. A stroke of the electronic pen would do the job. Jeffrey Gundlach from DoubleLine Capital said China cannot fruitfully deploy its weapon. "It is more effective as a threat. If they sell, it would only eliminate their leverage," he said.

'Not worth the risk'

Let us suppose as a Gedanken-experiment that Xi Jinping did succeed in triggering a US financial crisis by this method, the consequences would be deeply destructive for China itself. The ensuing rout would engulf "risk assets" across the world, as the Chinese central bank (PBOC) has patiently explained to fire-breathers on the State Council. "It is just not worth the risk," said Mr Wu.

The global mayhem would violate China's solemn pledge to "protect the multilateral framework" and would drive away the very allies that it is so systematically cultivating. It would undermine the grand plan to steal the mantle of world leadership from the US, a fallen Trumpian dystopia that is abandoning the international system that Americans built and ran with such high statecraft for 70 years.

The Chinese equity and bond markets would crash, triggering a rerun of the capital flight crisis in early 2016, but this time with greater intensity. Mark Ostwald from ADM said it would lead to a worldwide scramble for US dollars, the reflex default in times of trouble for an international financial system that is leveraged to the hilt on dollar credit. The dollar would go through the roof. Never forget that it spiked 53 per cent against the euro as the Lehman crisis unfolded.

The Bank for International Settlements says offshore dollar debt has ballooned to $US25 trillion in direct loans and equivalent derivatives. At least $US1.7 trillion is debt owed by Chinese companies, often circumventing credit curbs at home. Any serious stress in the world financial system quickly turns into a vast dollar "margin call". Woe betide any debtor who had to roll over three-month funding.

The financial "carry trade" would seize up across Asia, now the epicentre of global financial risk. Nomura said the region is a flashing map of red alerts under the bank's predictive model of future financial blow-ups. East Asia is vulnerable to any external upset. The world biggest "credit gap" is in Hong Kong where the overshoot above trend is 45 per cent of GDP. It is an accident waiting to happen.

China is of course a command economy with a state-controlled banking system. It can bathe the economy with stimulus and order lenders to refinance bad debts. It has adequate foreign reserve cover to bail out its foreign currency debtors. But it is also dangerously stretched, with an "augmented fiscal deficit" above 12 per cent of GDP.

It is grappling with the aftermath of an immense credit bubble that has pushed its debt-to-GDP ratio from 130 per cent to 270 per cent in 11 years, and it has reached credit saturation. Each yuan of new debt creates barely 0.3 yuan of extra GDP. The model is exhausted.

China has little to gain and much to lose from irate and impulsive gestures. Its deep interests are better served by seeking out the high ground - hoping the world will quietly forgive two decades of technology piracy - and biding its time as Mr Trump destroys American credibility in Asia.

The US president is a strategic gift if handled carefully. He is so ignorant and fundamentally shallow that he might even be induced to hand over Taiwan in exchange for a face-saving frippery on trade.

That truly would be the "art of the deal". For China.

The Telegraph, London

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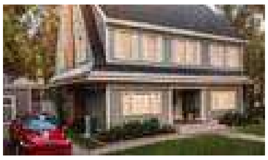

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