Why investors need to be alert to China's moves on Taiwan

By **Stirling Larkin**
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It is becoming clear that China has every intention of militarily reoccupying Taiwan within the next five years – this reality appears imminent and its conviction real.

For financial markets and global investors, this would have immediate and capacious consequences that remain poorly measured, woefully misunderstood and arrogantly discounted as a scenario that if it did happen, would be comparative only to Russia invading Crimea.

For those who hold such views, this would be a grand financial blunder.

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These reoccupation intentions are by no means clandestine. In his conquest for absolute political dominance in China, President Xi Jinping said in October 2017: "Achieving full reunification of the motherland is necessary for realising the great rejuvenation of the Chinese nation", which mimicked identically the words of Mao Zedong.

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Analysts believe Xi could launch a military attack as early as 2020, sitting centrally within Beijing's parochial foreign policy objectives and cementing its centrality within the Asia Pacific.

Ever since the Xinhai revolution of 1911 and the Chinese civil wars of the late 1940s, the division of China has remained a deeply visceral source of trauma for Han, Cantonese and Formosan Chinese and the reunification of "the motherland" remains the first, last and only priority of Xi and the Chinese people.

Few to the rescue

But the reason such a military conflict would sizeably punish international financial markets and global investors is because it is also becoming accepted that neither the United States nor the international community would come to Taiwan's military defence. Under President Donald Trump, the White House has not been playing its traditional stabilising role.

As a consequence, the real reprisal, conflict and volatility will be borne out across financial markets that are coaligned with China and its predominance throughout global trade.

With Beijing becoming more aggressive, Taipei more defiant and Washington more erratic, the US Senate's Economic and Security Review Commission recently concluded: "By 2035, if not before, China will likely be able to contest US operations throughout the entire Indo-Pacific region."

Further, think tank RAND Corporation argues that the continued militarisation of the South China Sea is compelling members of "the Quad" – Australia, India, Japan and the United States – to intensify defence cooperation with one another, in preparation for confrontation more hostile than that seen during the 1996 Taiwan Straits crisis.

Innes Willox, CEO of Australian Industry Group, adds: "Conflict between China and Taiwan, even limited, is the nightmare scenario for Australia because it stands at the intersection of our security and economic interests. It is not a choice our policy makers want to make, nor is it a choice our exporting business want to countenance. It is hard to think the outcome could be anything but devastating for Australia's national interest."

While the financial markets repercussions for Russia's annexure of Crimea were arguably limited, China's reoccupation of Taiwan would have immense and immediate market consequences.

First, the bedrock of the existing global economy is the preeminence of US Government 10-year Treasuries anchoring what is referred to in economics as the "capital stack". As America's largest foreign creditor of US Treasuries - somewhere in the vicinity of $US1.1 trillion ($1.5 trillion) - China would be forced to "fire sale" these contracts not only in the United States but also in Europe.

This is because much of China's tally of US Treasuries is held in accounts in Belgium, given it is home to publicly-declared Chinese custodial accounts.

Catastrophic consequences

Fang Xinghai, vice chairman of the China Securities Regulatory Commission, said last week at a World Economic Forum panel in Davos, Switzerland, that he doesn't think his country "will in any way significantly reduce its investment into US government bonds".

This raised concern that if it did execute this unilateral bond sale with additional renminbi internationalisation contingencies that would help "de-dollarise" intra-Asian trade, "de-dollarise" oil and offer a substitute for the dollar, the "weaponisation" of the renminbi would have catastrophic consequences for Australian policy makers and investors alike.

Above and beyond the obvious anxiety caused by a military conflict, the destabilisation of the US Treasury capital stack this late in the global business cycle would force the Reserve Bank of Australia to deploy emergency interest rate measures, during a window of time in which the Australian dollar would be punished by European and American foreign exchange trading desks given that our currency is seen as a proxy for Chinese trade, mercantilism and renminbi internationalisation.

Any unilateral attempt by China to de-dollarise oil would immediately affect Australia's leading sharemarket, the S&P/ASX 200, given that Australia's oil and gas majors rely on Tapis crude benchmarking, a pricing benchmark domiciled in Singapore.

This benchmark depends on the stability of the Singaporean dollar, which since 1985 has adopted a market-oriented exchange regime, classified as a monitoring band, in which the Singapore dollar is allowed to float closely monitored by the Monetary Authority of Singapore (MAS).

It is little secret that the MAS directly shadows the US FOMC's monetary guidance. This combination of a de-dolarised Asia-Pacific oil price, the weaponisation of the renminbi and the consequences this would immediately present intra-Asian and Australian trade should concern all Australians.

As a rising superpower coveting global influence, China has more to lose from being ostracised than a fading empire like Russia. But its blatant and deeply felt determination to achieve full reunification should never be underestimated, with Xi willingly paying the significant punitive financial price that it would take to attain his most desired asset, a reunified Taiwan.

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