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Elevated Sino-U.S. Tension Over Taiwan to Accelerate Economic De-Coupling

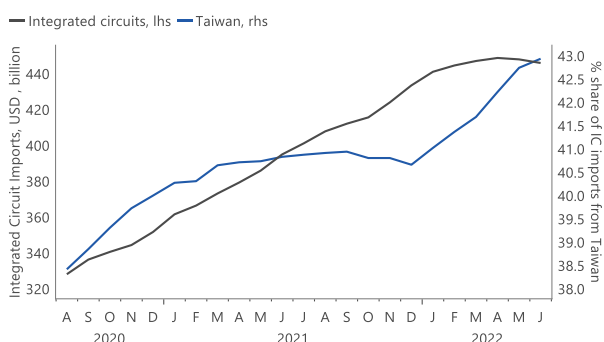
Global Economics & Investment Analysis, August 12, 2022

Summary

- U.S. support for Taiwan’s democracy and its efforts to stem the island’s further isolation against China’s demonstration of its ability to assert its sovereignty is becoming a chronic threat to the status-quo in the Taiwan straits.
- However, an outright invasion remains unlikely as China will most likely prioritize regional and global stability, but avoid signaling any weakness, ahead of its Party Congress (in November) and considering its own hefty dependence on Taiwanese semiconductors (see exhibit 1) as well as a nearly matched array of capabilities vis-à-vis the U.S. military presence in the region.
- But that being said, there are no visible off-ramps with the upcoming quinquennial political transition in China and the mid-term elections in the U.S. (both, are due by November) --which likely constrains politicians from being magnanimous (or appearing weak).
- What’s more, recent developments have set in motion a long-term strategic competition centred on Taiwan –these developments range from the recent de-prioritization of economic goals, and elevation of ideological objectives, in China to the adoption of more active industrial policy in the U.S. geared towards semiconductor autonomy.
- Elevated geo-political risk in East Asia will likely prompt faster semiconductor production and supply-chain shifts.
- Risk premiums in Taiwan’s currency are starting to harden (exhibit 5); moreover, its equities have also come under relatively greater pressure since late July and China’s expected equity recovery has fizzled (that’s also because of its property sector woes, see exhibit 2).

Exhibit 1: As much as 40% of China’s integrated circuit imports come from Taiwan

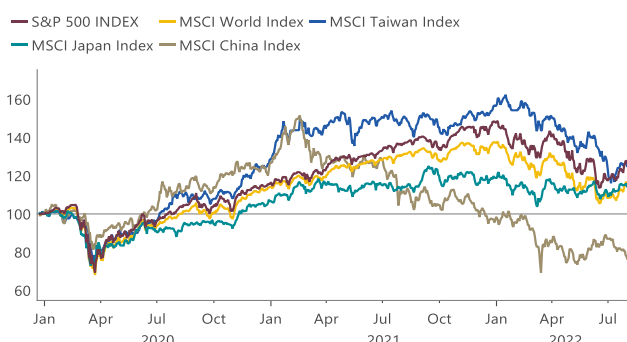
Chinese Imports of Integrated Circuits & reliance on Taiwanese ICs



Source: Macrobond, BNY Mellon Investment Management, China General Administration of Customs (GAC) Data as of 8/10/2022

Exhibit 2: Taiwanese equities have seen a bigger fall since late July, China resumes its underperformance

Equity Market Performance: China, Taiwan, Japan & U.S. (rebased to 100 in Jan'2020)



Source: Macrobond, BNY Mellon Investment Management, Data as of 8/10/2022

All data downloaded on August 10, 2022.

Nancy Pelosi's August 3 visit to Taipei, whether appropriate or not, has set off the most serious threat to Sino-U.S. and Taiwanese relations in decades --with potentially widespread regional and global ramifications. Right or wrong, China has seized on the visit as a provocation and used the occasion to demonstrate its ability to impose a blockade of the island.

That being said, in our view, an outright invasion is probably not imminent for three reasons.

- First, China has a sensitive political transition ahead of it. The Party Congress is due in late October or early November --at which time President Xi is widely expected to extend his hold on power for a third term. This will cement the President's dominance in Chinese politics as has not been seen since the time of Deng and Mao and, on account of which, we think China's leadership will likely prioritize regional geopolitical stability in the run up to and shortly following this important event.
- The second reason is China itself is heavily dependent on imported semiconductors, and around 40% of this is sourced from Taiwan (exhibits 1 and 3). With self-sufficiency still distant, we doubt if China's political leaders will embark on a precarious course which may further imperil the country's access to advanced technology and critical components.
- The third reason is that China's military capability towers over Taiwan but even then it could face dogged local opposition (with Taipei taking cues from Ukraine); moreover, [China's capabilities seem evenly matched against the U.S.](#) -should it choose to defend Taiwan- and which lowers the odds of a quick, doubtless or easy takeover.

However, the restraints on further escalation or prolonged tension have also been loosened as evident from two recent developments.

- One is China's economic goals are becoming overshadowed by political considerations and it coincides with slowing growth and the stoking of strident nationalism. At its recent Politburo meeting [the annual growth target was more or less abandoned](#). To be sure, this is not entirely surprising. In fact, we have been skeptical of a lofty growth target (of 5.5%/y) for quite some time as evident from our below consensus views as we explained [here](#) and [here](#). At the same time adherence to Zero-Covid policies was explicitly tied to [political preferences](#). The conflation of non-economic priorities and [rising nationalism](#) is unprecedented since the start of China's reforms since the early 1980s.
- The second development is the U.S.' recently passed CHIPS and Science Act of 2022 which specifically earmarks \$53 billion in new spending for boosting semiconductor manufacturing in the U.S. This is in addition to tax credits for semiconductor investments in the U.S. --all of which are also widely seen as potentially [drawing next-generation manufacturing and research away from China](#), including from Taiwanese and Korean semiconductor companies which are well established there.

Moreover, neither country currently has an incentive (no off-ramps) to de-escalate the charged rhetoric over Taiwan --with China wanting to establish its sovereignty on the island and the U.S. seeking to uphold democracy and ease its isolation. This is because China will undergo its quinquennial political transition by November and the U.S. heads for its mid-term elections around the same time. Amidst upcoming political transitions, leaders will likely not risk seeming dovish on national security.

What all this probably means over the next few months is that, while we do not expect a full-blown conflict, there is a much narrower path ahead for the stability of Sino-U.S.-Taiwanese relations. A period of intense or prolonged tension could easily bedevil markets, especially in Asia, for several more months. On-and-off Chinese exercises --effectively amounting to a partial blockade- could become an enduring feature of the Taiwan straits or the East China sea. Taiwan could be forced into taking retaliatory actions to preserve what remains of its political and military space. China could take bolder action, such as taking over an outlying or uninhabited Taiwanese island or two, to gauge the U.S. response. Any or all of these developments could eventually evoke a more pointed response from the U.S. and its allies in the region.

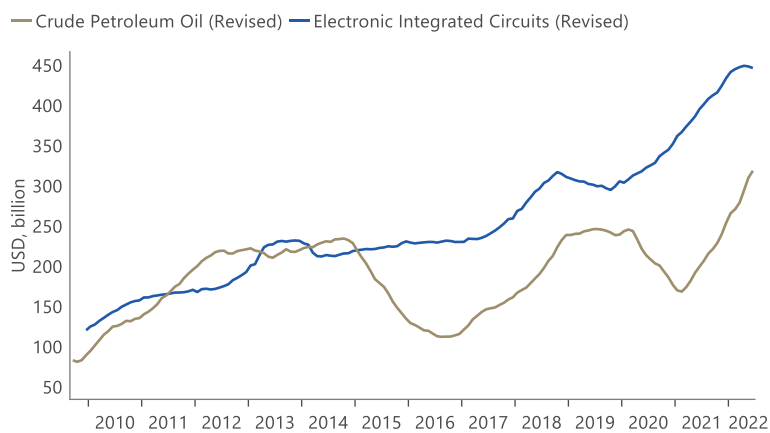
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Over a longer time horizon, unless there is a new modus vivendi that is acceptable to all three parties, we could be staring at a considerably narrower path for geopolitical stability in Asia. Basically this amounts to a new structural feature: a thinner line between escalation and capitulation in the Taiwan straits. Even if no protagonist seeks to actively, or actually, alter the status quo, the risk of mis-calculation may now be chronically elevated.

We think this will weigh on long-term investment decisions across East Asia. The heightened risk of a semiconductor supply shock, and the launch of industrial policy in the U.S., will likely prompt more meaningful shifts –amounting to a faster pace of economic de-coupling between China and the U.S. (and its allies). That could cast a darker cloud, especially, on the medium-term outlook for China which is relatively more demand-dependent on the U.S. and its allies (than the other way around, see exhibit 4).

Exhibit 3: China’s integrated circuits exceeds its energy import bill

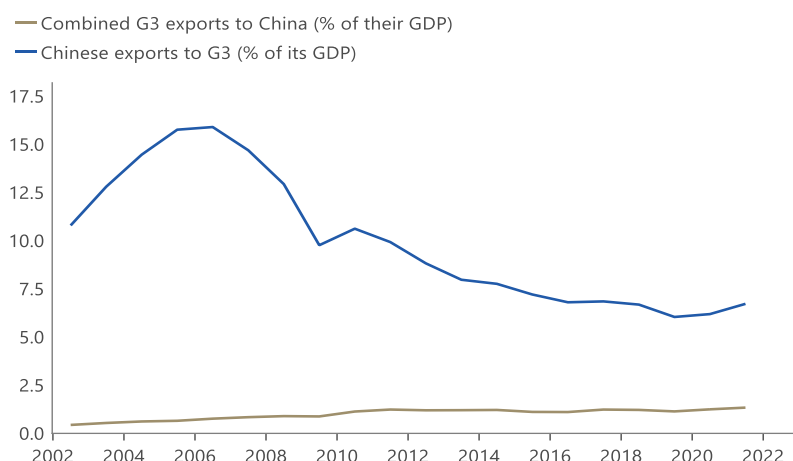
China: Imports of Oil & Integrated Circuits (USDbn, 12M rolling sum)



Source: Macrobond, BNY Mellon Investment Management, China General Administration of Customs (GAC)
Data as of 8/10/2022

Exhibit 4: China is more dependent on G3 demand, than the other way around

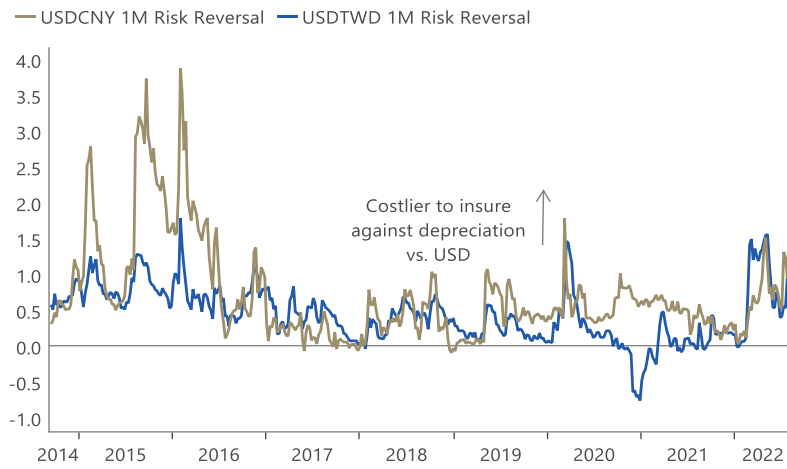
China Vs. G3 Economies: Export Dependence (% of GDP)



Source: Macrobond, BNY Mellon Investment Management, International Monetary Fund (IMF)
Data as of 8/10/2022

Exhibit 5: Taiwan dollar falls shortly after Russia's invasion, pressures have stayed elevated

USDTWD & USDCNY Risk Reversals



Source: Macrobond, BNY Mellon Investment Management,
Data as of 8/10/2022

Data for exhibits 3,4,5 was downloaded on August 10, 2022.

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(IS-292818-2022-08-10)

GU-285 – 10 August 2023