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THE GREAT SPLIT BETWEEN CHINA AND THE WEST IS COMING

April 2022

Summary

- China is still intent on reunification with Taiwan, and by force if needs be.
- Any such move would likely invite heavy sanctions by the West, if the response to Russia's invasion of Ukraine is anything to go by.
- Any action would not be one way: Beijing has passed laws demanding countermeasures for companies complying with Western sanctions.
- The result of Western sanctions triggered by an invasion of Taiwan would therefore be a deep and rapid decoupling between China and the West, both economically and politically.
- China is already preparing for this *Great Split*; Western governments and countries need to start preparing for it too.

Introduction

For all the economic damage caused by the invasion of Ukraine on top of the two years of Covid before that – huge increases in commodity prices, soaring inflation, the biggest fall of living standards since the 1950s – it could have been worse. It could have been China, not Russia on the other side of the sanctions.

Russia's economy is relatively small – a little larger than Spain's – and it has a significant position in only a small number of commodities, albeit important ones. China, on the other hand, is central to the global supply chain. It accounts for about 28% of global manufacturing and 18% of the world trade in goods, and so any action that cuts China off from worldwide supply chains would cause mutual economic damage on a much larger scale.

The Great Split

The bad news is that there is a high possibility that this will happen, in what we are terming the *Great Split*. The logic is straightforward. America, Britain, Europe and their allies have set a precedent for themselves by sanctioning Russia for trying to upend the status quo. If China was to do the same – either by helping Russia, or by trying to invade Taiwan – then Washington and its supporters would in all probability place similar sanctions on Beijing, not least because it is in America's strategic benefit to do so.

China could of course accept these sanctions without much pushback, and so minimise the fallout. The problem is that Beijing has recently passed laws that allow for, and actually demand, a counter-sanction list to be created for any company complying with Western sanctions, with punishments including visa revocation and the freezing of assets. Although Beijing has kept its guidance on exactly how this would pan out (in a typical move by the CCP, which likes to keep a grey interpretation of laws for as long as possible), we can assess in all probability what would happen should sanctions be initiated. Multinational companies operating in China (and probably Hong Kong too) would face the prospect of having to pull out of either the West or China, assuming that Boards would be intent on keeping their companies functioning and their in-country managers out of trouble. It is not hard to predict that with Western economies representing the lion's share of world GDP that many, if not most would immediately pull out of China at the onset of sanctions.

This would be the *Great Split*: the quick, deep, and politically-pushed decoupling of the economies of China and the West.

The pain to come

The *Great Split* would be a significant economic shock that most would want to avoid. The difference is that China is preparing for it; the West, less so.

In recent years Beijing has put in place a number of measures aimed at lowering the cost of Western sanctions, planning that was invigorated by the actions of President Trump following the launch of his trade war and the investment blacklist against the People's Republic.

There are a number of layers of defence. One is the “Dual Circulation” strategy, which seeks to make the country more self-reliant, including in technology. Another is the move to create an RMB bloc which would allow Beijing to use its own currency to buy critical products (like food and fuel) using its own currency rather than relying on dollars. This “de-dollarisation” has been a feature of trade with Russia for several years now, and is being accelerated by the adoption of the digital Yuan. A third form of defence is the opening up of China to Wall Street investment. As of the end of 2020 American investors owned USD 1.2 trillion of Chinese securities (USD 1.1 trillion of equities, and USD 100 billion of debt), and would likely lose much or all this in the event of a Great Split. This makes the American investor community a useful ally in trying to dissuade the US Administration from launching sanctions against China.

Western plans, by contrast, are either nascent or non-existent. This may be because there remains a sense of optimism that economics will trump politics, despite history repeatedly proving the opposite: Britain and Germany in 1914, and the US and Japan in 1941 were both examples of highly integrated economic relationships that failed to stop war. Although there are signs that Western governments are starting to prepare for the worst, there does not yet appear to be the understanding of the breadth and depth of influence that China has over countries in the West, in everything from raw materials to investment in education.

Take rare earths, a group of 17 elements that are vital for the modern economy, including for the clean energy transition. American officials made a great effort to reopen the Mountain Pass rare earths mine in California so that they could say they were no longer dependent on Chinese minerals. However, the ores mined in Mountain Pass are sent to China for processing because the US has effectively no domestic processing capacity. This is of major strategic concern given that Western manufacturing and defence is dependent on rare earths – each F35 fighter jet, for example, contains 416 kg of these metals. America and Australia in particular are looking to open some processing facilities to become more self-sufficient, but this will take time to implement.

Looking at the UK specifically, it is clear that China has built up considerable influence in the country across myriad sectors. In education, the UK hosts more students from China than there are undergraduates from Wales, and without them many universities would be financially devastated. The banking industry is also particularly exposed, as HSBC, Standard Chartered, and other British institutions have USD 600 billion in loans to China and Hong Kong, and rely on the former British colony in particular for much of their profits. In the event of the *Great Split* it is likely that British banks and other firms with significant China exposure would see their Chinese assets taken away, in effect splitting these companies in two.

Desperate as these consequences of the *Great Split* sound, they are overshadowed by what could be the biggest shock of all: the disruption of the global supply chain in microchips.

At the heart of the worldwide economy lies the computer chip, powering everything from your mobile, to your car, to your office. At the heart of the computer chip industry lies Taiwan. Just one of the island's companies – TSMC – has more than half the global market share of semiconductor manufacturing, and four of the top ten companies are based there. 92% of the world's most advanced microchips are produced in Taiwan.

The world has already had a taste of a microchip shortage thanks to Covid. The lack of supply over the last year and a half caused by interruptions to the semiconductor supply chain have had a dramatic effect, costing the auto industry alone an estimated USD 210 billion just in 2021; car production in the UK fell to its lowest level in 65 years thanks to the shortages.

A forced attempt at reunification will undoubtedly interrupt the supply of these chips at a scale considerably in excess of anything caused by Covid. This could be because of a Chinese blockade of the island, or the banning of the export of chips to Western nations by a CCP-compliant Taiwanese government, or because of collateral damage from any fighting. Whatever the reason, the West's industrial and consumer economies will suffer heavily as a result.

Western Governments and Companies Need to Prepare for the Great Split

The future is never written in stone, but the prospects of the *Great Split* happening are real enough that governments and companies should at least prepare contingencies for it.

Many of the required trends, such as the onshoring of supply chains and the establishment of strategic reserves of goods, have already been encouraged thanks to Covid. But much more needs to be done, including the full mapping of country and company direct and indirect exposure to China and Taiwan.

We don't know exactly when any push to reunification will happen, although before 2027 seems to be the date that some in Beijing are talking about. This gives the West time to get its act together, but only if contingencies are started soon.

This will be a substantial undertaking. But if the pandemic taught planners anything, it is that not being prepared is a lot more expensive in the long run.

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