

Investment Strategy Bulletin

Our current scenarios for US-China tensions over Taiwan

Investment Solutions

3 August 2022

Key takeaways

- US Speaker Nancy Pelosi's Taiwan visit has raised the risk of accelerated decoupling and even direct conflict between the US and China
- Prolonged or regular drills in the Taiwan Straits could create significant disruptions in Taiwan's trade with the rest of the world, and in global supply chains
- We set out three scenarios for US-China tensions over Taiwan in the next 3-5 years - the most likely being a prolonged one-off military drill around Taiwan that causes intermittent disruptions to trade flows

US House Speaker Nancy Pelosi's visit to Taiwan and China's aggressive responses compel us to put forward our medium-term scenarios for the US-China relations and the stability of the Taiwan Strait. **We do not believe that this sequence of events necessarily presages an immediate destabilising conflict** in the region, as Beijing seems to have chosen carefully calibrated responses instead of risky military operations designed to physically disrupt Ms Pelosi's visit. In the long-run, however, investors will probably have to cope with elevated risk of **accelerating decoupling** and even potential direct confrontation between China and the US.

Immediately on the confirmation of Ms Pelosi's visit to Taiwan, **China announced "live fire" drills in six areas surrounding Taiwan's main island** (some deliberately set to breach both territorial and internal waters from Taiwan's perspective) and effectively closed them to civilian airplanes and vessels for the four day period from 4-7 August. China also seems to have begun other types of military exercises today, and it has imposed a slew of economic restrictions such as a ban on imports of citrus fruits and fish from Taiwan.

In our view, **Beijing has clear incentives to aggressively test the limits of Taiwan's maritime territorial claims and air defence identification zones (ADIZ)** in the foreseeable future. The White House is maintaining that this visit does not represent any shift to the US's 'One China' policy (which is different from China's own One China principle). Yet we suspect that it will be rather difficult to change Beijing's growing perception that the visit is part of their US counterparts' long-term strategy to hollow out the existing commitments that underpin the two countries' bilateral relationship. There is also a strong incentive for Beijing to prevent copy-cat visits from the legislative leaders of other G7 countries and publicly retaliate against Ms Pelosi's conspicuous refusal to consider its stern public warnings and political calendar sensitivities (i.e. the Chinese Communist Party's leadership promotions in late autumn). It is inevitable that China's responses will represent a step-up from what it carried out during the Third Taiwan Strait Crisis of 1995-1996.

While **China's main drills will happen after Ms Pelosi leaves Taipei** (a prospect that likely added to markets' relief last night), it is **too early to predict their exact**

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Page 1/6

nature and duration at this moment. Such uncertainties – likely underappreciated by markets at the moment – are disconcerting, as they hint at an outline of the potential quarantine or blockade of Taiwan that could be the next step in the strategic escalation between China and the US. Although the drills could turn out to be a one-off gesture, they could easily become a prolonged or regular occurrence, creating significant disruptions in Taiwan's trade with the rest of the world. We note, however, that the combined naval forces of the US and its allies operating in the region will constrain the magnitude of China's actions depending on the modality of these attempts.

With these facts and considerations in mind, we can put forward three potential scenarios for the US-China tension on Taiwan in the next 3-5 years:

- 1. Scenario A (likeliest):** The likeliest scenario would be a **1-2 year long (or shorter) one-off military drill around Taiwan, causing intermittent disruptions for trade flows through the Taiwan Strait** and the waters and air spaces in the vicinity, without any major direct military confrontation between China and Taiwan or between China and the US. This scenario, similar to the template of the Third Taiwan Strait Crisis but more aggressive in its magnitude, would minimise western sanctions risk for China and also offer a degree of strategic flexibility on 2024 election outcomes in the US and Taiwan or any new mutual strategic understanding in the intervening period. The costs for the global economy would be additional disruption in global supply chains, the risk of a sudden shift to a more dangerous confrontation, and accelerated decoupling between China and the US. **The overall strategic status-quo would be maintained, although the long-term outlook would remain highly uncertain.** Markets would face bouts of volatility in line with the evolving perception of direct confrontation risk for the US and China.
- 2. Scenario B (less likely):** The less likely (and more dangerous) scenario would be **China's deliberate push toward a "quarantine" or even blockade of Taiwan**, in which China gets to decide who enters the area around Taiwan. The difference between quarantine and blockade would be that most exchanges and trade flows would be permitted in the former, except cases that Beijing deems inappropriate. In either case, Taiwan would be strongly incentivised to challenge the attempt militarily and the US and its allies would respond with either sanctions or military operations, even at the risk of a direct military confrontation with China. For example,

China's attempt to control the flow of US arms or energy exports to Taiwan could be challenged by Taiwan's forces who might decide that they have nothing to lose. In this scenario, the disruptions to global supply chains would be far more significant than the scenario of a prolonged one-off military drill, and the hard decoupling between the US and China would be all but assured, given the scope for decisive sentiment shift in the west.

- 3. Scenario C (still extremely unlikely but not negligible):** The least likely but most dangerous scenario would be a **rapid descent into a 'hot war' between the US and China around the Strait**, with the latter attempting full political control of Taiwan through military means. This scenario would send extremely large shockwaves through the entire global economy as it would likely lead to the complete bifurcation of global supply chains and the collapse of multilateral governance framework.

For now, we assume that China will not be keen to change its military postures on smaller islands such as Kinmen, Matsu, and Pratas, as the cost of subsequent western sanctions might outweigh the small benefit of strategic signals to both Taiwan and the US and its allies. In other words, attempting a takeover of these islands only makes sense as a prelude to a 'hot war' that we think China is still keen to avoid.

Different configurations of outcomes are possible due to the high level of uncertainty on the behaviours of both the US and China, but we believe that they will ultimately converge to one of the three aforementioned scenarios in the medium-term. Needless to say, an extremely short military drill followed by mostly verbal confrontation between the two countries would be the best outcome. But we currently view that scenario as unlikely given the need for response on China's side.

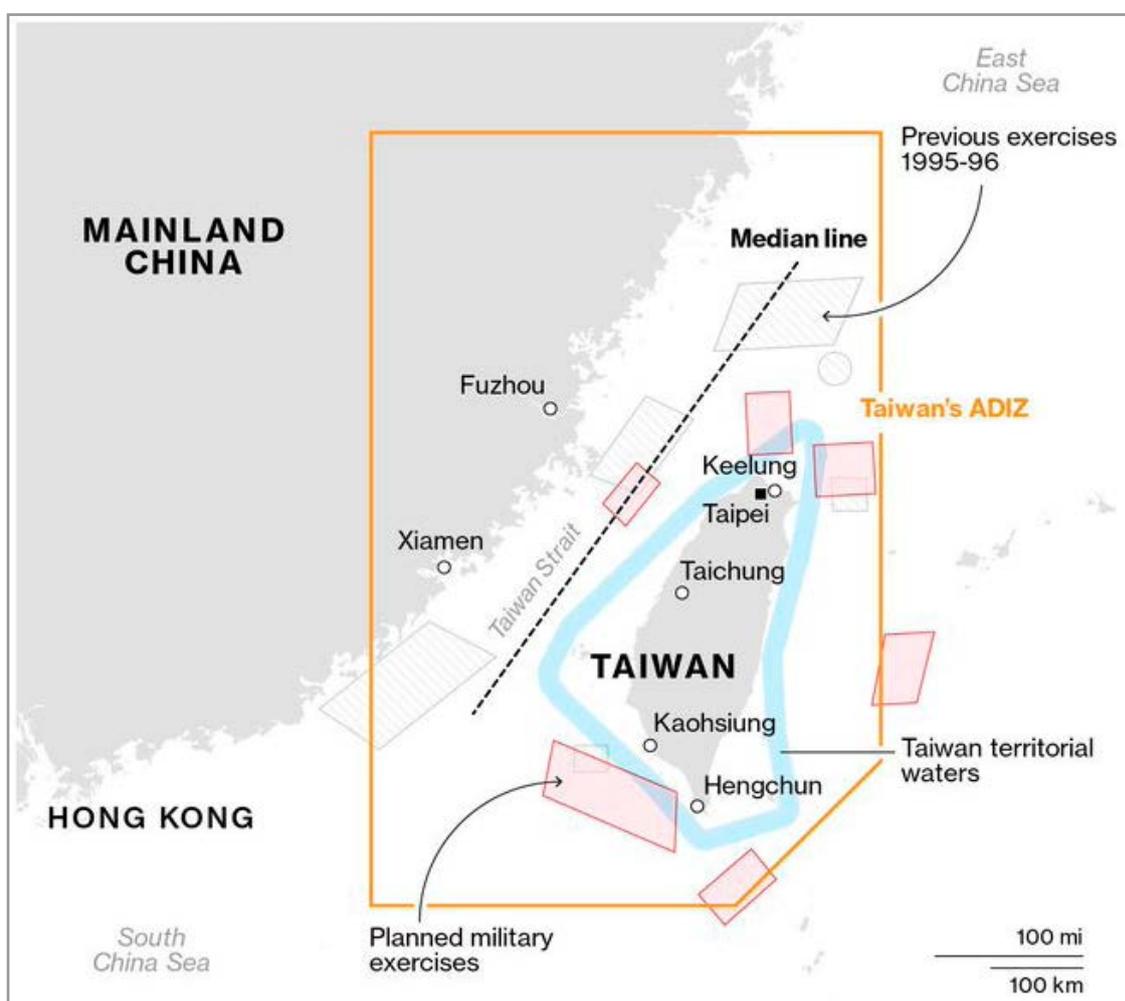
The bottom line is that we still think a 'hot war' in the Taiwan Strait is unlikely in the medium-term, even though China's responses to Ms Pelosi's visit will open the door for more meaningful escalation toward that outcome. If the strategic status quo can be maintained despite disruptions to trade, then the impact on the global economy could be somewhat more manageable – although still negative. The collateral damage of the heightened tension on Taiwan could be setbacks in US-China discussions on tariff reversals and de-listing of Chinese companies from US markets as well as secondary sanctions restraint in regard to Russia. These relatively modest setbacks are likely largely priced in to markets already.

Two ASEAN hosted meetings later this week should provide a clue for the future direction of US-China tensions, as the foreign ministers of both countries will participate together. Another signpost that could be useful is the tentative agreement between Presidents Biden and Xi to hold an in-person summit before the end of the year. Any visible progress on this front could brighten the outlook for

an eventual de-escalation. In any case, we will continue to monitor the relevant developments closely and provide updates as needed.

Homin Lee, Macro Strategist - Asia

China Drills Around Taiwan



Sources: Xinhua, Flanders Marine Institute, Australian National University, Bloomberg

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