Economics

Understanding China

The COVID-19 is a stress test on Globalization

Economics/China

Group Research

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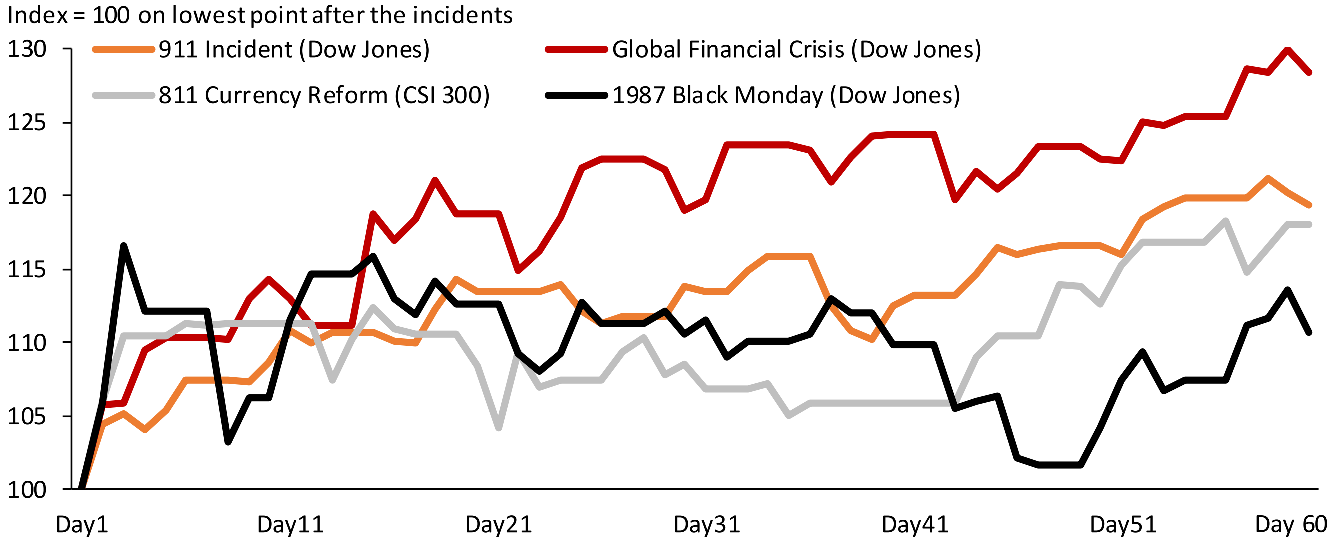
- *Globalisation distributes economic interest of everyone into everywhere. A thorough comprehension of globalization from a historical context seen from the lens of Sino-US relationship is needed in order to understand the present situation.*

- *The global economy is infrastructurally homogenous and functionally heterogenous. This structure remains intact. However, impetus to reform supranational institutions facilitating better international cooperation will be very strong.*

- *The COVID-19 will trigger some degree of relocation of health/pharmaceutical/medical devices related industries in China back to the West.*

- *Under the reign of globalization, stock markets hit by crisis of whatever sort usually recover very fast. This round is likely to be a bit longer as the COVID-19 is the first real stress test.*

Since the GFC, stock markets rebounded by over 20% from the bottom within 60 days



Source: Bloomberg, DBS

Historical Background

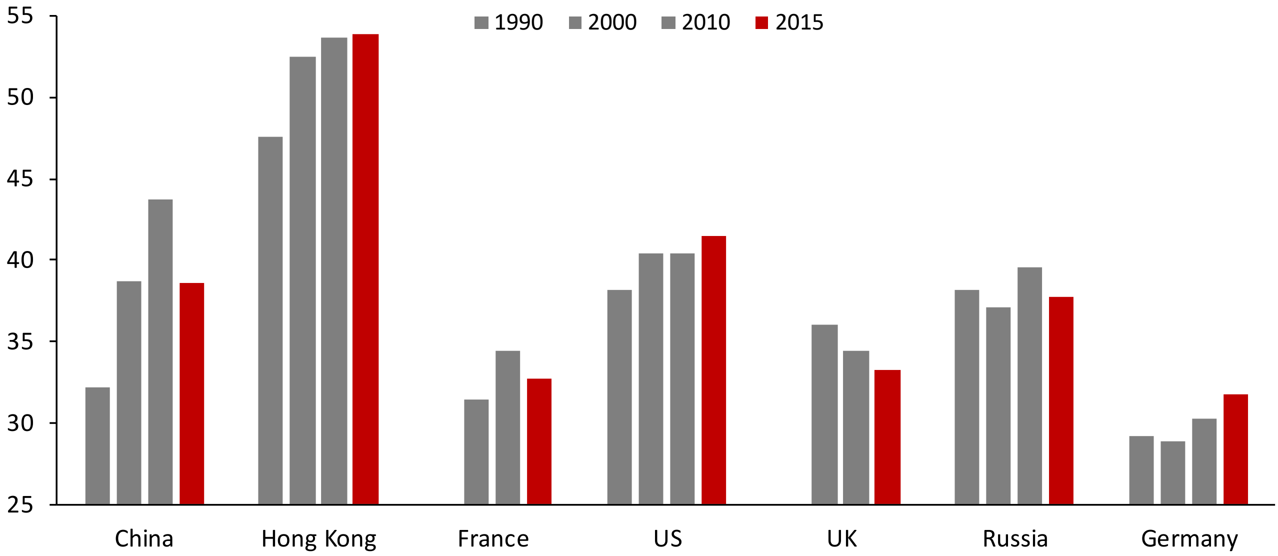
"Capitalism is the last ideology of humanity."
- Francis Fukuyama

After the dissolution of Soviet Union, the West led by the US successfully radiated the merits of capitalism worldwide. The doctrine of "globalization" champions the concept of free market, shrunken state and self-interest maximization to drive economic growth. Rapid advancement of communication technology subsequently integrates the world (particularly in trade and finance) so tightly to a degree that was simply unimaginable by anyone a few decades ago. Alan Greenspan, U.S. Federal Reserve Chairman once commented in 2007, "It hardly makes any difference who will be the next president. The world is governed by market forces." Francis Fukuyama went as far as arguing "capitalism is the last ideology of humanity".

It had been functioning well for quite some time until 2008 when the global financial system suffered a severe meltdown. It was caused by the crisis in the subprime mortgage market consequentially led to the collapse of Lehman Brothers and many other banking institutions in the world. These subprime mortgage securities were packaged into many other financial products and were sold freely without governance around the world.

Long before the Global Financial crisis in 2008, the tangible world of international trade already saw fractures. WTO multilateral negotiations firstly failed in Seattle (1999), and then Doha (negotiations began in 2001 and subsequently broke down in July 2008). Citizens of the world questioned the opaqueness of the negotiation framework and the absence of their participations to make decisions in high-stake trade negotiations. The loss of manufacturing jobs in the west ever since China's WTO entry fanned the flame further. State and the market are becoming way too dominant severely downsizing the voice of the community, eloquently argued by Raghuram Rajan, author of the "Third Pillar". Indeed, in Hayek's view, the state should actively

Gini Index of selected economies



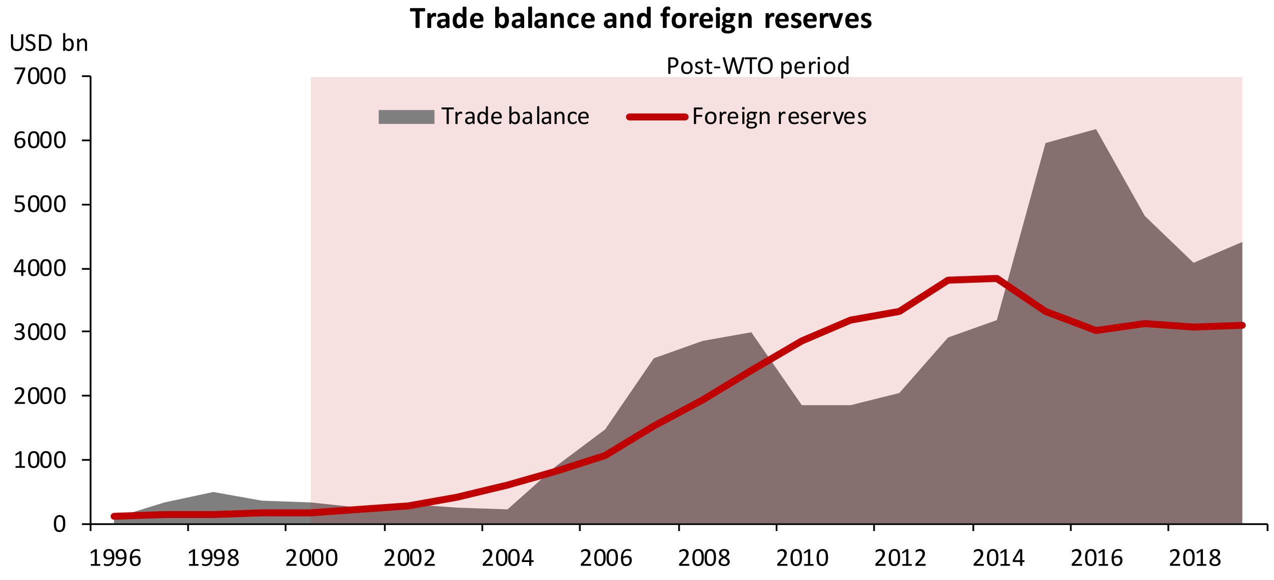
Source: World Bank, Hong Kong Government, DBS

involve in regulating the functioning of a market economy even at the expense of “income inequality”.

Communist China had been benefiting tremendously from the Hayekian capitalist world order.

Ironically, China under the rule of Communist Party had been benefiting ever since her WTO entry in 2001. FX reserves jumped exponentially from USD212bn in 2001 to a peak of USD3.99trn in 2016. The subsequent economic demises of the US after the financial crisis in 2008 coincided with the rise of China.

It is not easy for the US to accommodate the rise of the middle kingdom because of her extensive array of industrial policies to sustain an unlevel playing field at the expense of US interests. The persistent refusal of integrating China into international institutions such as the IMF, World Bank, ADB etc drives Beijing to create her own institutions. For example, the establishment of Asian Infrastructure Investment Bank (AIIB) is meant to augment the financial funding of the “Belt and Road Initiative”. This in turn elevates “the competitive threat” between them further, as the US sees China contemplates to change the exiting world order. As a result, the US has clearly chosen to confront China, a major departure from decades long of engagement strategy. From US perspective, this status quo has failed because it did not transform China’s behaviour internally and externally.



Source: Bloomberg, DBS

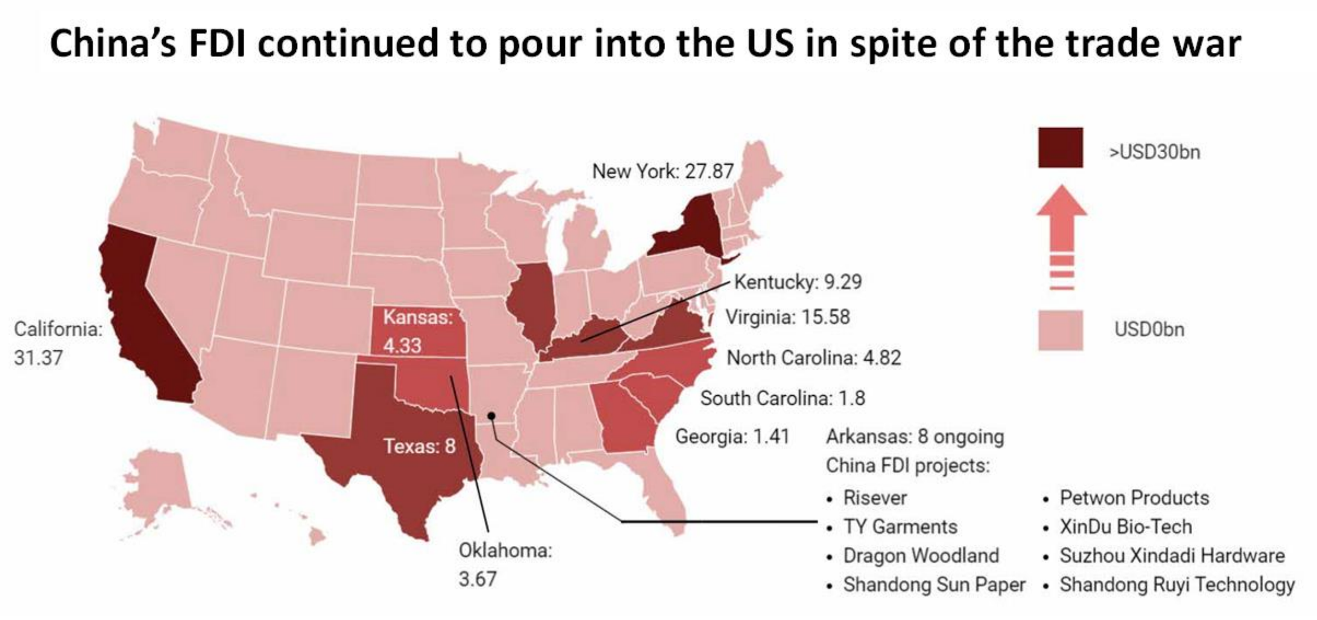
De-coupling is so far a concept

Imposition of tariffs disrupts trade. Restrictions of technology exports hamper productivity. Impediment to scholarly exchange restricts sharing of knowledge. US' withdrawal from participating in multilateral institution such as the TPP upended the status quo. In response, China began floating the idea of "Self-Sufficiency" in late 2018 (See 'Understanding China: Self-Sufficiency 2.0', March 13, 2019.). Such global developments create huge uncertainty for everyone.

Globalization distributes economic interest of everyone into everywhere.

That said, it is difficult to reverse the course. Globalization distributes economic interest of everyone into everywhere. At the trough of Sino-US relationship last year, there had been strong direct investment inflow from China into US states such as Arkansas, Tennessee, Louisiana, Georgia, North/South Carolina and Mississippi etc. In Arkansas alone, there are seven ongoing Chinese investment projects.

State governments are friendly to Chinese investment. Hostilities towards China usually come from the federal level at Washington DC, albeit without a clear road map to reach well-defined goals. For example, DT administration wants China to import more from the US and improve market accessibility for US enterprises. This is an integration. On the other hand, US does not want technological sharing with China. US lobbied 61 countries not to adopt Huawei's 5G standard. But only 3 complied.



Source: Nikkei Business Review, Visme, DBS

COVID-19 – a stress test on globalization

COVID 19 is the first large scale black swan experiment undermining physical connectivity.

Trade war initiated by the US is in fact a kind of stress test on the Hayekian world order in the past 2 years. Relocation of supply chains is a complex subject matter that consumes time to make it happen, let alone the time to make such decisions prior. To compare, the COVID-19 had instantly inflicted to the world in merely 2 months by disrupting "supply chain" (See "China Chartbook: Understanding the impact of COVID-19 in 10 charts", February 18, 2020.). Globalization roots from "interconnectivity". This is the first large scale black swan experiment undermining physical connectivity, where majority of social activities are grinded to a standstill hampering all parts of economy worldwide.
That also explains why the Dow Jones lost almost 7,000 points since March (such sharp corrections in the past were triggered by domestic incidents such as 911 Incident, Asian Financial Crisis, and subprime mortgage crisis etc) that subsequently triggered the Fed to cut rates aggressively despite absence of systematic risks alongside robust economic performances. The sell-off could well be an over-reaction but it is also true that there were no empirical experiences of global supply chain disruptions of such magnitude prior. In other words, the viral outbreak is a serious stress test of globalization.

The world is unitary. All parts of the world nowadays are all interdependent. It is "infrastructurally homogenous", comprising material network of rails and airplane, phone lines and the internet in the cyberspace. Meanwhile, it is "functionally heterogeneous" with

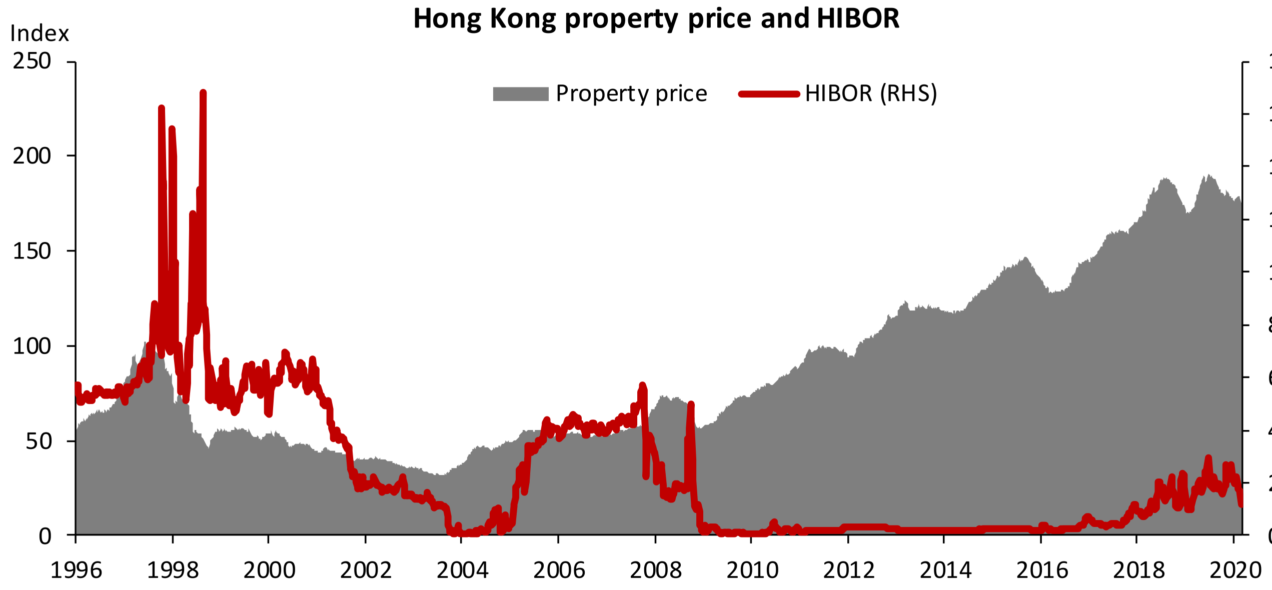
Source: Bloomberg, DBS

different countries specializing in economic activities with respect to endowments and comparative advantage. This international division of labour is governed by "supranational forces" comprising of international institutions and augmented by central banks in times of financial difficulties. In short, globalization distributes economic interest of everyone into everywhere.

There are issues at the "supranational" level this round with respect to concerns over leadership of WHO in managing this global viral outbreak.

The fact is that COVID-19 had not destroyed the physical infrastructure. It merely stopped people from utilizing it temporarily. Division of labour amongst countries at the global level certainly remains at large[1]. And the virus cannot disrupt movement of capital, or else global equities selloff won't happen. But there are issues at the "supranational" level this round with respect to concerns over leadership of WHO in managing this global viral outbreak. Improvement of global governance is a complicated subject matter that takes tremendous time to execute. The prevailing crisis exposes weaknesses so that they can eventually be improved subsequently over time.

[1]Enterprises related to medical supplies/pharmaceuticals in China will likely face intensifying political pressure to move back to the west. For instance, China ranked second amongst countries that exported drugs and biologics to the United States, and first for medical devices including mask and basic syringe, according to the Federal Drug Agency.



Source: Bloomberg, DBS

Major stock market equity indices during episodes of major financial crisis usually rebounded 20% after 60 days from the trough.

Real world conflicts panning out in the physical world hitherto had not correlate too much with the Hayekian world until the onslaught of COVID-19. Empirically, major stock market equity indices during episodes of major financial crisis usually rebounded 20% after 100 days from the trough. A sudden supply shock to a globalized economy due to a virus is unprecedented in recent history. This supply shock will translate quickly into demand shock if the viral outbreak cannot be contained in a short period of time. Rate cut does not help too much at the margin under this scenario. That explains why US markets continued plunging on March 9 even though the Fed had delivered an emergency cut of 50bps on March 03 and subsequently 100bps on March 15. In short, the world is held slavery to uncertainty brought by the virus. It may take a longer for market to return to normalcy this round. Let's also not forget consumer/investor confidence always swings from one extreme to another.

Seen from a positive light, this black swan event is going to drive governments worldwide to improve policy responses to future epidemic outbreak alongside beefing up resources on public health, a key component of social contract between the state and the people.

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Sources: Data for all figures, charts and tables are from CEIC, Bloomberg, and DBS Group Research (forecasts and transformations).