

## Blocus Continental

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China's response to the imposition of big new US tariffs will be different than if it happened 20-odd years ago

If China is cut out of US markets, other Asian economies will take its place and the region as a whole will still benefit

In the 1970s and 1980s, French author Michel Audiard wrote scripts for films in which Jean-Paul Belmondo and Gérard Depardieu played signature roles. Quips from these movies have entered French popular culture. One runs that when a 120kg fellow expresses an idea in a bar, the 60kg fellow keeps quiet. This is a decent summary of US diplomacy over the last 40 years.

The problem is that over the last 40 years, a few fellows who used to weigh 60kg are now tipping the scales at 120kg. These big boys may just keep quiet, they could fight back, or they may just go to another bar. The world, after all, is full of bars. Consider, by way of example, the US-China relationship.

President-elect Donald Trump says he wants to slap 60% tariffs on all Chinese exports. In response, many people expect China to let the renminbi depreciate in order to compensate for this tariff imposition. This is what we might have expected in 2002 but, in my view, the most likely reaction in Beijing is for policymakers to do nothing and just let Apple take a beating.

After all, China has plenty of countries to which she can export her cars, telephones, fast trains and nuclear power plants. Moreover, China seems to have offered other Asian economies an implicit guarantee that it would never devalue the renminbi against their currencies (see chart overleaf).

The deal between China and the rest of Asia seems to be: you stabilize your currency against the renminbi and I will stabilize the renminbi against the US dollar. The implicit promise is: I will not repeat what I did in 1994 by devaluing massively against other Asian currencies (see [Clash of Empires](#)).

If the US places swinging tariffs on Chinese imports, the message to Asian policymakers will likely be: since China is already your main market, keep targeting your exchange rate against the renminbi. Go ahead and grab our slice of the US market, as it will make you more prosperous and so able to buy from us, cars, trains and nuclear power stations. Moreover, we will help you finance these projects by lending you the necessary long-term capital.

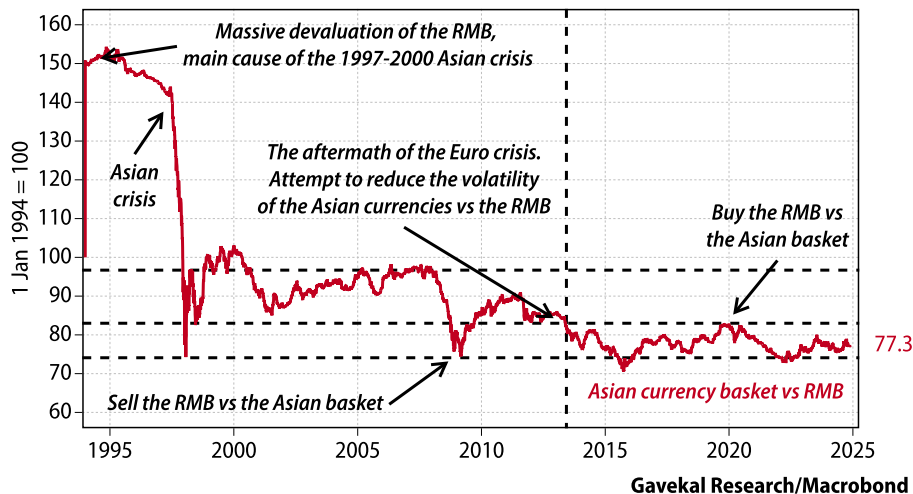
### Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
<b>US housing starts fell -3.1% MoM to 1.31mn in Oct</b> , down from -1.9% in Sep	Below expected -1.5%; building permits fell -0.6% MoM to 1.42mn in Oct vs -3.1% in Sep	Rise in mortgage rates hurting affordability and constraining housing demand
<b>Eurozone current account surplus rose to €37bn SA in Sep</b> , up from €35.4bn in Aug	NA; 12m rolling CA surplus rose to €425bn in Sep, up from €408bn in Aug	Eurozone external surplus vulnerable to a trade war with the US
<b>Eurozone job vacancy rate fell to 2.5% in 3Q24</b> , down from 2.7% in 2Q	NA	Eurozone labor market cooling down; supports back-to-back ECB rate cuts into 1H25
<b>Canada CPI rose 2% YoY in Oct</b> , up from 1.6% in Sep	Above expected 1.9%	Uptick driven by low base effects; reduces scope for BoC to continue aggressive easing

### The renminbi is being tightly managed against other Asian currencies

Equally weighted basket of Asian currencies (SGD, THB, MYR, IDR, TWD, KRW, PHP)



For the last decade the renminbi has traded in a very tight corridor against other Asian currencies

China will take a hell of a short-term hit on its US exports, but should pretty quickly see those to its neighbors soar. At that point, the renminbi is likely to rise against the US dollar, with all Asian currencies following it higher.

My point is simple: Teddy Roosevelt used to say that the art of diplomacy was to speak softly and carry a very big stick. In recent years, it seems that the US has been speaking loudly, while carrying a very small stick.

What the US seems to infer is that China's economy will collapse if Chinese firms are denied US market access. They seem to forget that the US can buy from China only if the Chinese central bank recycles China's surplus into treasuries and so offers abundant financing to US consumers (see [The Demise Of Imperial Privilege](#)). Should China stop this financing, I wonder how well Walmart stores will be doing at Thanksgiving and Christmas in future.

Put another way, if you are an insolvent retailer who tells your supplier that you no longer want to use their services, do not be surprised if this supplier halts the vendor financing that it had been offering you.

I have a simple question: has anybody in the US simulated what will happen to US companies if Chinese companies are forbidden from exporting to the American market? I suppose that Apple would go to zero in no time.

In macroeconomic terms, it would mean a big rise in Asian consumers' spending capacity, with cheaper Chinese goods freeing up purchasing power to be spent on non-imported goods. The Chinese inflation rate will likely fall, while the reverse will happen in the US, where goods' prices are likely to rocket higher, even as service industries endure a deflationary depression, with the US standard of living falling sharply.

In such an environment, gold should rise materially in US dollar-terms but, at best, end up stable versus long-dated Asian government bonds. Other long duration Asian assets can be expected to follow local government bonds.

Conversely, as budget deficits explode higher in the US, I would expect consumer shares and the bond market to really take a beating.

The US can only buy from China in high volume if China's central bank recycles the Chinese trade surplus into US treasuries

A US-imposed trade war will likely result in high US inflation and low Chinese inflation

US policymakers should consider how Napoleon's attempt to blockade the British economy worked out in the 19th century

I would almost rather not think what happens to the euro and European bond markets, as excess savings in Asia will up invested neither in bunds nor in French government bonds.

Imagine that in 1806, Napoleon, who controlled continental Europe militarily, had declared that nobody was going to buy anything from the UK, as his aim was to force Britain's economy into a depression and therefore London into submission. In effect, he did just this and the result was to spur the UK into becoming more competitive in non-European markets.

The net result was that when the wars stopped in 1815 at the Battle of Waterloo, the UK economy was left as the most efficient in the world. As a result, the 19th century was dominated by British industry.

If I were a US policymaker, I would read knowledgeable historians on Napoleon's continental blockade and draw the following conclusions:

- 1) Never force your main competitor to become more competitive because you are not competitive enough.
- 2) Improve on your competitiveness by deregulating, privatizing, lowering taxes and never, never punish someone for being too good. It will backfire.