How the financial system would respond to a superpower war.

Date: May 3, 2024
From: The Economist
Publisher: Economist Intelligence Unit N.A. Incorporated
Document Type: Article
Length: 1,261 words

Full Text:

The idea that economic integration can safeguard peace is old, intuitive and spectacularly wrong. In a popular book of 1910, the economist Norman Angell argued that great-power conflict was irrational, since "the complexity of modern finance makes New York dependent on London, London upon Paris, Paris upon Berlin, to a greater degree than has ever yet been the case in history." A century later, similar wishful thinking in western Europe fostered the building of Nord Stream 2, a gas pipeline from Russia to Germany. In a globalised world, war has no winners. But that did not stop Europe from digging trenches in 1914, nor Russian troops from storming Ukraine in 2022.

It is tempting to conclude that the fragmentation described in this special report—of capital flows, payment networks and financial institutions—might be spurred by geopolitics, but has little bearing on it in return. A single, globalised financial system is neither necessary nor sufficient for peace. As they chip away at it, officials from Washington to Beijing might regret the opportunities and connections being lost. They need not worry they are hastening Armageddon.

This is the final chapter in a six-chapter special reportThe global financial system is in danger of fragmenting How crises reshaped the world financial system The movement of capital globally is in decline National payment systems are proliferating The fight to dethrone the dollar How the financial system would respond to a superpower war

Yet they are certainly making war more feasible, while simultaneously normalising the sense of conflict between nations. A world in which countries bar foreign investment in "strategic" industries is one that will create all sorts of friction between enemies (as well as friends). That world is arriving: witness President Joe Biden attempting to block the acquisition of US Steel by Nippon Steel—a competitor from Japan, one of America's closest allies. And companies are throwing up financial firewalls themselves as they adapt to each new wave of sanctions. Economic integration might not ensure peace. But with the costs of disengagement increasingly being borne already, the marginal cost of war is falling.

That is not to suggest the cost would be anything other than enormous. For a sense of the turmoil that would engulf financial markets, look to the latest stress test prescribed by the Bank

of England. "A sudden crystallisation of geopolitical tensions causes a sharp deterioration in expectations of economic fundamentals," begins the Sahara-dry description of the warlike scenario the City of London is required to simulate. Stocks tank, volatility explodes and investors scramble to de-risk their portfolios. Ominously, big sovereign-wealth funds start dumping American, British and euro-zone government debt. By day ten a mid-sized hedge fund has defaulted and "there are no signs of tensions abating even in the medium term".

War, what is it good for?

Should one much-discussed catalyst for war come to pass—an invasion of Taiwan by China, opposed by America—the bank's scenario seems worryingly plausible. As in 1914 and the 1930s, the government bonds of key belligerents would come under significant pressure. For American Treasuries this would be balanced against investors' wish to de-risk and their reputation as the world's safest asset. But even then, anticipation of ballooning defence spending on top of existing deficits, leading to bumper bond issuance, might well send yields soaring and prices crashing. With supposedly safe asset prices plunging, all sorts of financial institutions would start to wobble. Think of the hedge funds and banks that fell over in 2022 and early 2023, writ large. This time, the danger of a systemically important outfit collapsing would be all too real.

Stockmarkets, too, would be in freefall. Taiwan produces the world's most advanced semiconductor chips. This hardware is vital to companies everywhere, but especially to America's tech giants. The "Magnificent 7" alone (Microsoft, Apple, Nvidia, Amazon, Meta, Alphabet and Tesla) comprise more than a sixth of the value of MSCI's broadest index of global stocks. At a stroke, a Chinese blockade of Taiwan could snap their supply chains and send share prices plummeting. And that is before considering the impact of the trade sanctions that would surely follow from America and its allies, the tit-for-tat response from China and the hit to non-military economic output. Shareholders of all stripes would, with good reason, be stampeding towards rapidly narrowing exit doors.

Amid all this, it is difficult to imagine the world's financial system surviving in its present, still-globalised state. Just how far it fragmented would depend on the belligerence of policymakers in Washington and Beijing. They would probably stiffen cross-border investment barriers to prevent domestic firms from sending capital anywhere it might enrich the enemy. Capital flows between geopolitical blocs, already far smaller than in globalisation's heyday, would dry up further.

The marginal cost of war is falling

The same impulse would apply to payments. It is easy to imagine Chinese banks being shut out of SWIFT and dollar clearing—but harder, given the time they have had to prepare for such treatment, to see these measures being game-changers. The greater effect would be to force the division of global payments into separate spheres of influence, thereby accelerating the growth of China's CIPS network. In time, Indian initiatives to export open-source, UPI-like systems might provide other countries with more palatable alternatives. For now, that is some way off.

As for the dollar's dominance, its prospects would depend on the position in which the conflict left America. The world's previous reserve currency, the pound sterling, was dethroned after

decades of decline followed by two all-out wars that dissolved Britain's empire and left it saddled with debt. Small wonder that it also lost its financial hegemony. Short of something similarly catastrophic befalling America, it is difficult to see the dollar losing its pre-eminence.

In fact even if investors were to do the unexpected and dump their greenbacks, it would at least in the near to medium term perversely strengthen America's financial position. Eswar Prasad of the Brookings Institution points out that its foreign liabilities, denominated in dollars, sum to $51trn, while its foreign assets, often denominated in other currencies, total $33trn. From an American perspective, a weaker dollar would leave the liabilities unchanged but the assets more valuable. It would be the foreign owners of dollar debt who would take a hit.

None of these changes would decisively alter the course of a superpower war. The temptation then for America and China would be to go further, threatening foreigners with secondary sanctions should they continue to do business with the enemy. In effect, they would force the world to pick a side and shun the other. Such measures would seem especially appealing to America: with the linchpin-like role its currency and banks still play in international finance, many countries would abandon their remaining economic links with China. They would also be the final nail in the coffin for a financial system that is in any sense global, and the biggest incentive yet for non-aligned countries to leave America's orbit altogether.

Even without the catastrophe of a war between the world's superpowers, their urge to turn its financial system into ever more of a battleground shows no signs of fading. If only it would. In spite of its flaws, there is a good deal to recommend today's setup. It is no longer just a few Western countries that can access the growth-spurring benefits of international finance while insulating themselves from its recurrent crashes. There is the tantalising promise that technology can bring even more into the fold. What a waste it would be to divide the world into parochial blocs instead.

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Source Citation (MLA 9th Edition)
"How the financial system would respond to a superpower war." *The Economist*, 3 May 2024, p. NA. *Gale Academic OneFile*, link.gale.com/apps/doc/A792455695/AONE?u=cornell&sid=bookmark-AONE&xid=230642d5. Accessed 8 May 2024.

Gale Document Number: GALE|A792455695