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This trade war will get out of control

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I have been researching, writing and speaking about economic statecraft for more than two decades. I know some things. On occasion, people pay me some coin to talk about what works, what does not and what is likely to happen. And when I talk about the myriad kinds of economic statecraft that could be in play, I always save the “deterrence via mutual interdependence” category for last. It is both the rarest and most important category. The basic argument is that if two countries are mutually vulnerable to disruption of bilateral exchange, then this dependence has a deterring function. The likelihood of economic conflict escalating between two close trading partners is low. Former treasury secretary Larry Summers once described the Sino-American relationship in this way, calling it a “balance of financial terror.”

There is a catch, however. Mutually assured destruction ensured geopolitical stability during the Cold War, but anyone who lived through that era can tell you that the assurance part of it was only clear in retrospect. At the time, it made everyone very jittery. This did not matter too much for nuclear deterrence, because only the leaders of the United States and U.S.S.R. had decision-making authority. In an economic conflict, there are more decision-makers, more chances for trembling hands, and less of an understanding of the carnage that can be wreaked from an all-out economic conflict. So while deterrence from mutual interdependence should function as a deterrent, there is no guarantee that it will. If matters do escalate, then the speed of financial markets reacting can be as quick as that of a second-strike missile launch.

I raise all of this because since I warned readers last week that Donald Trump was sanctioning the U.S. economy, things have gone from bad to worse. A meeting between U.S. and Chinese negotiators in Shanghai did not go well. Trump, in response, announced a new 10 percent tariff to be implemented by September over the objections of his economic team.

China, in turn, retaliated in two ways over the past 24 hours. First, according to CNBC’s Kate Rooney, “a spokesperson for the Chinese Ministry of Commerce said Chinese companies have stopped purchasing U.S. agricultural products in response to President Trump’s new 10% tariffs on $300 billion of Chinese goods.” Second China stopped defending the yuan to keep it above the seven-to-one exchange rate with the dollar. Given that Xi Jinping called on Chinese citizens to “brace for a period of hardship,” it is possible that further moves, including citizen boycotts, a rare earths embargo and the targeting of U.S. firms in China, could be on the horizon.

And how has the Trump administration responded? By taking the symbolic but extraordinary step of labeling China a currency manipulator for — wait for it — not manipulating its currency enough. If you think I’m kidding, please read Bloomberg’s Saleha Mohsin: “[Treasury Secretary Steven] Mnuchin said in June that China was intervening in currency markets to prop up the yuan, and warned it could be designated a manipulator if it stopped.”

Mohsin's story is chock-full of experts pointing out that: (a) China is not in fact a currency manipulator; and (b) this is a dumb dumb move. The Center for Strategic and International Studies' Bonnie Glaser tells Mohsin, "The timing couldn't be worse. The potential for compromise has passed. Both sides are digging in and both leaders are first and foremost concerned about their domestic audiences. Politics is in the lead."

U.S. equity markets did not have a good day on Monday, and futures trading suggests even more bad news will be coming tomorrow.

Could this escalation of tensions be reduced? I'm getting more and more dubious. The problem, as I've long said, is that there is no bilateral deal that both sides can credibly commit to. Others are making this point as well. Edward Alden correctly notes in Foreign Policy that by May of this year, "Chinese leaders became convinced that the Trump administration would never do a deal on terms they could accept and turned to other ways to shore up the economy." I have little faith in Trump's resolve to stand firm, but even he would be hard-pressed to do a 180 on this issue as tension ratchet up.

A few days ago Paul Krugman characterized the Sino-American conflict as a "quagmire." Others are using similar military analogies, likening it to a "forever war." My fear is that these analogies are too optimistic. The past 24 hours alone demonstrates that this will not be a low-intensity conflict. This has the potential to get out of control extremely quickly. And no matter how dispassionately one tries to game this out, Cato Institute trade lawyer Scott Lincicome's point still holds: "The guy who lost money selling steaks, vodka, gambling & football may soon be piloting a global currency war I'm sure it'll be fine."

This business will get out of control.

It will get out of control, and we'll be lucky to live through it.