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The Great Game of Global Trade

But which game is it, exactly?

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Summary

- President Trump's inaugural speech makes it clear US protectionism is set to return via 'America First'
- Free-trade theory argues that would be a tragic mistake: that may prove true - but free-trade theory itself is also flawed. The historical record shows protectionism has proved very successful for many countries – the US of the past included
- Indeed, the Great Game of Global Trade has rarely been as we perceive it today
- Crucially, a smaller USD trade deficit has huge global implications: with USD the centre of our financial architecture, *where will they flow from*? That threatens a secular USD squeeze
- China is proposing itself as the centre of a new trading block; but without replacing the US as a key consumer, what currency can that block use? CNY would not be appropriate
- A world without easily-available USD liquidity threatens to move us from a free-trade game of 'Snakes & Ladders' back towards a giant global game of 'Risk', as in the early 20th century. As such, Trump and China can also be seen as playing *very* high-stakes poker!

America First: who's next?

"For too long, a small group in our nation's capital has reaped the rewards of government while the people have borne the cost. Washington flourished but the people did not share the wealth. Politicians prospered but the jobs left and factories closed. The establishment protected itself, but not the citizens of our country…

From this moment on, it's going to be America first. Every decision on trade, on taxes, on immigration, on foreign affairs, will be made to benefit American workers and families. We must protect our borders from the ravages of other countries making our products, stealing our companies and destroying our jobs. Protection will lead to great prosperity and strength…

We will bring back our jobs. We will bring back our borders. We will bring back our wealth. And we will bring back our dreams. We will get our people off of welfare and back to work, rebuilding our country with American hands and American labour.

We will follow two simple rules: buy American and hire American."

Excerpts from President Trump's 2017 inaugural address

"National self-sufficiency, in short, though it costs something, may be becoming a luxury which we can afford, if we happen to want it.

Are there sufficient good reasons why we may happen to want it? There are many friends of mine, nurtured in the old school and reasonably offended by the waste and economic loss attendant on contemporary economic nationalism in being, to whom the tendency of these remarks will be pain and grief. Yet let me try to indicate to them in terms with which they may sympathize the reasons which I think I see.

The decadent international but individualistic capitalism, in the hands of which we found ourselves after the war, is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous - and it doesn't deliver the goods. In short, we dislike it, and we are beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed."

Keynes – a former Free Trade advocate, "National Self-Sufficiency", 1933

2016 was a year of major political shocks. Such shocks look set to continue in 2017 too, based on President Trump's early acts in office. In particular, it appears that he was serious about protectionism, based on his inaugural address. Indeed, he has already officially withdrawn from the Trans-Pacific Partnership (TPP), and is talking about bringing in a "very major" border tax. In short, the long-standing consensus in favour of global trade has been shattered by the US, with markets now wondering which of the other populists seeking election in various European countries this year may want to follow suite: 'America first' – but who, if anyone, next?

This is another in our series of extended special report 'thought experiments' that will take a look at the now-controversial issue of free trade. In the case of this report, we will examine free trade from a long-run historical as well as theoretical view of the subject.

Although history is usually over-looked in contemporary analyses of free trade, we will make the clear point that this is a mistake: indeed, there are very clear - and worrying - lessons from the past for us to ponder today. In terms of the theory, we will also attempt to show that things are not quite as easy as free-trade advocates would have us believe. Rather, there are major 'devils in the details'.

In order to better illustrate our key message, we will use the analogy of popular board and card games to explain the changing global political trade dynamic and its implications for financial markets. Besides being more fun than a traditional dry analysis, it also seems only appropriate given that the Great Game of Global Trade certainly seems to be changing rapidly at the moment!

Slytherin…

First, it is important to underline the conventional view about free trade held by the vast majority of economists and politicians: **it is a very, very good thing.**

In fact, it is *extremely* hard to find an economist who is not in favour of increased free trade at all opportunities. Therefore it is no surprise that since 1980 the political trend had, until very recently, been towards ever-greater deregulation of the global trade environment.

There is clearly an elegant logic behind the argument for free trade, and its co-joined intellectual twin, comparative advantage. Put simply, *if each country specializes in what they are relatively best at, then more can be produced overall*. An example of how this theory works, which will be recalled by every economics student, can be seen following:

Table 1: Ricardo's Trade Example

Hours of work necessary to produce one unit

Country	Cloth	Wine
England	100	120
Portugal	90	80

Source: Principles, Ricardo

We can clearly see above that England needs 100 hours of labour to produce 1 unit of cloth. In the same time it can also produce 100/120 or 5/6 of a unit of wine, and so is better at making cloth. Portugal needs 90 hours to make the same unit of cloth and 80 hours to make the same unit of wine; as such, it is better at making wine, and at making both cloth and wine, than England. That argues that Portugal doesn't need English production at all.

However, if both countries specialize where they have the *relative* comparative advantage, then England can produce the most cloth with its time, and Portugal can produce the most wine. If the two countries then *trade freely* with each-other, both countries can consume more than if they had produced both commodities themselves. The logic - and math - are simple and compelling.

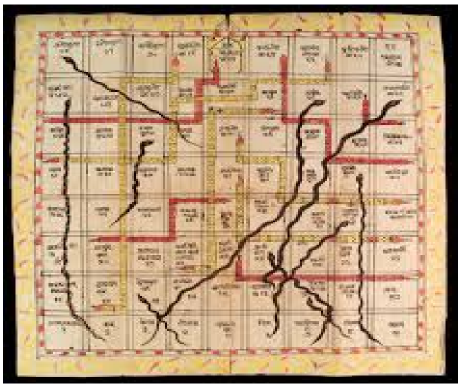
So let's think about the Great Game of Global Trade. One could argue that free trade is best conceived of as a game of ***Snakes & Ladders***. We are all better off by using our relative comparative advantage. However, that advantage can – and does – shift.

For example, forty years ago Thailand had a clear comparative advantage as a producer of agricultural produce – and its geography means that it still does today. However, forty years ago Thailand had zero comparative advantage as a manufacturer of cars and car parts: today it is one of the world's leading exporters of those high value-added products. In short, the Thai economy has rapidly moved up the value-added ladder in places.

By contrast, countries that do not invest enough in technological and human capital can slip down the snake of comparative advantage and find themselves losing much of an industry to rivals abroad, e.g., ship-building in the UK. That can obviously hurt, economically and politically.

Nonetheless, the economic – and political – assumption has remained that **we are still all better off playing this game of Snakes & Ladders together because global output is increased in all scenarios**.

Figure 1: The current Great Game of Global Trade?



Source: Wikimedia Commons (The Game of Heaven and Hell)

...and Hufflepuff

Economics likes to consider itself a science, indeed perhaps even a 'hard' science like physics. Contemporary economics research papers are certainly replete with complex mathematical equations that *look* impressively scientific. Yet science tests its hypotheses by observation, so let's do that.

Given the obvious benefits of free trade and comparative advantage, one would imagine that throughout history countries would have aggressively pursued such policies in order to increase their own, and global, prosperity. Have they? (Here is where history comes in useful!)

If we start our sample from 1980, which most economists might, and perhaps if we stop again in 2015, then that can be argued to be true. However, this is most assuredly *not* the case when one looks at the longer-run historical evidence. While trade has always been a hugely beneficial and enriching part of human culture, history shows us that **for the majority of the last 5,000 years global trade has usually been highly-politicized and heavily-regulated.**

Indeed, *global free-trade only began following the abolition of the UK Corn Laws in 1846*, which reduced British agricultural tariffs, brought in European wheat and corn, and allowed the UK to maximize its comparative advantage in industry, where it could dominate by virtue of having been the first state to industrialize.

However, that first flowering of free trade was already under stress within decades, and collapsed bloodily in 1914. Free trade soared again in 1919, but burned-out as spectacularly in the 1930s. (As to why, please see the 'Thin Ice' series of specials from last year.) After WW2, most developed countries had moderately free trade, but most developing countries did not. As noted, we only started to re-embrace global free trade from the 1980s onwards.

Where the problems lie

Given we've therefore only tried global free trade for around 100 years in a total of 5,000 years of civilization, and it has failed twice when tried, we can therefore infer that either:

- (i) *Mankind is stupid*, as free trade's gains were always obvious; or
- (ii) *It has clear global benefits – but not sufficient to prevent 'cheating'* by individual countries; or
- (iii) *Something must be wrong* with the positive picture of free trade so often painted for us

Given the intellectual – and mathematical - achievements of ancient Egypt, Greece, Rome, the Aztecs, the Renaissance, etc., it seems unlikely that lack of intelligence is the answer. Moreover, if a game-theory style 'cheating', like with OPEC oil production quotas, is genuinely an issue, then this suggests that the actual logical and mathematical benefits must not be quite as compelling as they appear – clearly something must be able to outweigh them if that is indeed the case.

So let's assume that the problem seems to then lie in free trade itself. If so, where might it be? It all seems so logical, after all. Yet, when examined closely, the theory actually has some very deep flaws.

- **It is atemporal**. That is to say it assumes every country moves to specialize in an area of comparative advantage painlessly and instantly. That is never the case. We always have 'frictional' unemployment and problems with retraining, etc., in real life.

- **It assumes full employment at all times**. In reality, structural unemployment can be caused by switching from one area of comparative advantage (which might have high labour demand, for example) to a new one (if it has low labour demand).

- **It assumes capital between countries is immobile**, i.e., that you don't get foreign investors shifting money and technology from one country to another. However, that channel is precisely how most exporting nations developed in the last few decades! The competitive Thai auto industry, for just one example of many, is the product of Japanese, Korean, European, and US FDI. Thailand had no *inherent* comparative advantage as a producer of cars relative to those FDI-exporting countries apart from lower labour costs and a good location.

Importantly, if intellectual property is developed in one country but can quickly flow to another, lower-cost producer, *comparative advantage can shift at a dizzying pace that society cannot always keep up with*.

There is, of course, a mainstream economic view that such flows of knowledge are justification alone enough for free trade. However, how does it benefit the intellectual property *producing* country - not the firm using it - to share IP instantly with another country? It's like a fisherman teaching another man to fish rather than selling him fish: it's a great and noble way to share skills – unless there is only work for one fisherman in the town!

- It assumes all goods are equal. In the classic example of Ricardo, cloth, produced in the UK, and wine, produced in Portugal, are politically equivalent as they are both nice to have, but not essential.

Yet some sectors provide well-paid jobs, and others badly-paid employment: why only produce the latter if one has a choice? Even the IMF has recently argued that "*Trade raises productivity but may hurt some unless policies redistribute the benefits*." In short, *free trade presumes a benign domestic political environment, which has rarely been the norm for long alongside rising inequality.*

And what if the choice is between *steel* and wine? You can't invade neighbours armed with booze: it is far easier to do so with steel. Equally, countries concerned about food supply in case of a foreign embargo might opt to stick with domestic supply over cheaper foreign competitors. In short, *free trade presumes a benign global political environment that has rarely been the norm for long either*.

That is the theoretical critique of free trade - which, if past experience is any guide, will have made perfect sense to everyone except died-in-the-wool economists!

An inconvenient truth

Now let's look at history again in a little more detail to support this counter-intuitive view.

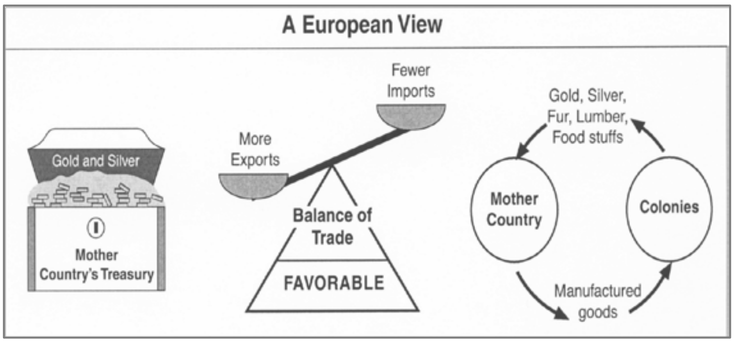
First of all, we have to see that the two points above – the need for domestic political stability and a presumption that foreign political stability would not last – were some of the key intellectual beliefs under-pinning the European policy of *mercantilism*: by this we mean running your economy like a business to ensure you export more than you import, or at least to not run a trade deficit. To use a games analogy, it is like playing ***Solitaire*** – a safe game for just one player.

Figure 2: The Old Game of Global Trade

Source: Wikipedia

That kind of economic strategy lasted for around 500 years in most of Europe, underlining that it must have been of real practical use; that fact alone seems to justify part of the critique of free trade we've just covered. Indeed, history is replete with examples of countries trying to prevent the export of technology or expertise/artisans to foreign rivals.

Figure 3: The scales of injustice



Source: Wikipedia

Moreover, after 1846's introduction of free trade in the UK there was still a need for most countries to remain defensive in terms of trade. Indeed - and very ironically - *free trade does not just require an absence of political violence: it has often required the imposition of violence!*

The unpalatable historical record is that during the 'golden age' of UK free trade, the British:

(i) Destroyed the Indian textile industry to benefit their own manufacturers;
(ii) Started the Opium Wars to balance UK-China trade by selling China addictive drugs;
(iii) Ignored the Irish Potato Famine and continued to allow Irish wheat exports regardless;
(iv) Forced Siam (today's Thailand) to open up its economy with gunboats in Bangkok; and
(v) Colonized much of Africa and Asia.

In short, to use our games analogy again, British 19th century free trade was not Snakes & Ladders, as it said on the box. Rather, it was a violent version of ***Monopoly*** (of global trade on pro-British terms: sell to us cheap, buy from us dear). For some reason, economics textbooks don't tend to focus on this easily-verifiable 'series of unfortunate events'.

Figure 4: The British Game of Global Trade?

Source: Wikipedia

Of course, there were good reasons for the UK to use that military force: it *could* do so, as the major industrial and military power, and it *needed* to do so in order to find new markets for its industrial supply.

But why were other countries so reluctant to buy industrial goods from it? Shouldn't they have seized them with both hands, as Ricardian free trade theory suggests?

In fact, as we showed in our 'Currency and Wars' special in 2015, after an initial ideological embrace following the UK's free trade revolution of 1846, the major European powers - and Japan, after it had been opened up by US gunboats - grew dissatisfied with British tales of Snakes & Ladders.

They saw *they were incentivized by relative comparative advantage to remain at the bottom of the development ladder* as agricultural producers, while Britannia sold them high value-added industrial products, ran a huge trade surplus, and ruled the waves militarily. It was a two-tier world.

To use another analogy, free trade works as efficiently as people agreeing to only drive on the left or right: I use this lane, you use that one, and we have no crashes/military clashes. But that presumes we use both lanes for a return journey – which in Ricardian theory we don't – and that both lanes are equally nice. What if one is pot-holed and flooded and terrorized by wild dogs, while the other is smooth and has nice restaurants? Wouldn't you want to try to move out of your lane into the other one, even if it causes crashes (or clashes)?

We're in the monetary!

There was also a good related ***monetary*** reason to want to run a trade surplus back then, if you were British, and to avoid buying UK products and develop one's own if you weren't.

When using gold as money - as was the case from 1815 to 1931 in the UK, and technically until 1971 in the US - unless one was lucky enough to be a natural source of bullion, *every import represented a drain on the money supply*. As such, a trade deficit meant a liquidity squeeze and higher interest rates; and/or it could mean accumulating foreign debts from powers that could invade you if you failed to make payments on time.

Every country therefore wanted to run a trade surplus or avoid a deficit: yet every surplus must *always* see a matching deficit.

That is to say, *with fixed monetary resources, global trade was a zero-sum game with big upside for the winners and even bigger downside for the losers.* That dynamic was just as true during medieval mercantilism as it was during 19th century free trade (again, see 'Currency and Wars') – a very important point that underlines how important it is to have a free-flow of liquidity, something we will return to later in this special report.

Risk on…

As a result, by the 1870s there was a clear shift back towards protectionism in the new nation states of Europe, such as Germany and Italy, and also in Japan, in order to try to catch up with the UK in industrial and military terms and 'level the playing field'. Import tariffs rose after having declined post-1846, and a **frantic process of national industrialization - totally opposed by Ricardian theory - ensued.**

Indeed, this new model was so pervasive that if one looks at the actual historical evidence of government policies to draw up a list of how many countries developed via the free-trade/comparative advantage path, one will find a *very* short short-list: basically, Luxembourg, the Netherlands, and Switzerland – although this is not drawn from an official data-set as such, but rather by reading the historical record of general policy choices made and tariffs imposed.

Almost *everyone else used some form of protectionism in order to catch up*. Of course, post-WW2 the same model was used by Japan again, then by Korea, and, since the 1980s it has also propelled China forwards rapidly.

...and Risk on, big time!

Yet back in the late 19th and early 20th century it wasn't enough just to keep British industrial products *out*. It was also necessary for rising European powers to find weaker countries to provide them with cheap raw materials, and who would in turn then become markets for *their* new wave of industrial products.

That was the basis for Europe's second 'race for empire', centuries after the first. Indeed, that tendency towards violence was no surprise: it is something that usually occurs during periods of exogenous money/bullion money according to David Graeber in his anthropological/historical work 'Debt: The First 5,000 Years', which looks at the history of global monetary systems.

That shift changed the game being played again. Global trade was still not Snakes & Ladders. Yet neither was it Monopoly, as the British global position had been undermined. Now it was ***Risk***, i.e., a global battle for control of territory, in both economic, national, and military terms.

Indeed, that toxic combination of pressures regrettably led in time to WW1, even if Gavrilo Princip pulled the trigger; and, almost exactly as the French general Ferdinand Foch warned in 1918, 21-years later once again to WW2.

Figure 5: Late 19th century Great Game of Global Trade

Source: Wikipedia

The exception(al)

Astute readers might notice that we have pierced the theory of free trade, and have shown specific historical examples that most of today's developed countries managed to develop without it; however, although we started with the US, we have not mentioned it since.

As noted, there has been understandable consternation over the protectionist rhetoric in President Trump's inaugural address. We have already shown that such policies are *not* historically unprecedented - and in the US case this is particularly so. Table 2 on the next page contains a list of the thoughts of US presidents on free trade from Washington (1789-97) to Franklin D. Roosevelt (1933-45): what can clearly be seen is that **until 1934 the US was resolutely protectionist, just like Trump**.

Read some of their presidential statements we have provided: they sound exactly like the kind of theoretical criticisms of free trade we have already listed.

President Monroe in particular chimes with "*The conditions necessary for Free Trade's success - reciprocity and international peace - have never occurred and cannot be expected*", though Teddy Roosevelt's "*Thank God, I am not a Free Trader*" is fairly to the point!

Furthermore, Alexander Hamilton, one of the US founding fathers and its first Secretary of State under President Washington, was the author of the 'infant industry' argument that protectionism was required to prevent foreign goods stifling industrial development.

Moreover, *these US presidential words were matched by deeds*. US import tariffs remained high throughout the late 18th, 19th, and early 20th centuries, even as Europe experimented with free trade for around thirty years from 1846 to 1873. In fact, what was considered a "low" US tariff in this period was 18%, which was briefly introduced in 1857 followed the repeal of the UK's Corn Laws - though they were later raised again by later administrations.

This Hamiltonian policy continued even once the US was firmly established as the pre-eminent global manufacturing powerhouse due to its vast economies of scale: as the London Daily Mail stated in 1900, "*We have lost to the American manufacturer electrical machinery, locomotives, steel rails, sugar-producing and agricultural machinery, and latterly even stationary engines, the pride and backbone of the British engineering industry."* In short, UK industrial decline is a story that far pre-dates the election of Margaret Thatcher in 1979!

Admittedly, an intellectual camp and lobby groups in favour of free trade did emerge in the US during this period, but they failed to achieve the same kind of traction that the UK industrialists had in 1846. After all, the US policy was clearly working, as the country continued to over-take the struggling British, and no problems with expensive food supply like the UK had had.

Table 2: The way we very often were

President	*Stance on free trade*
Washington 1789-1797	*"I use no porter or cheese in my family, but such as is made in America."*
Jefferson 1801-1809	*"Keep pace with me in purchasing nothing foreign where an equivalent of domestic fabric can be obtained, without regard to difference of price."*
Monroe 1817-1825	*"The conditions necessary for Free Trade's success - reciprocity and international peace - have never occurred and cannot be expected."*
Jackson 1829-1837	*"It is time we should become a little more Americanized, and, instead of feeding the paupers and labourers of Europe, feed our own..."*
Lincoln 1865-1865	*"Give us a protective tariff and we will have the greatest nation on earth."*
Grant 1869-1877	*"...within 200 years, when America has gotten out of protection all that it can offer, it too will adopt Free Trade."*
McKinley 1807-1901	*"Free trade cheapens the product by cheapening the producer. Protection cheapens the product by elevating the producer."*
Roosevelt 1909-1913	*"Thank God, I am not a Free Trader."*
Coolidge 1923-1929	*"We need protection as a national policy, to be applied wherever it is needed."*
Hoover 1929-1933	Signed Smoot-Hawley Tariff Act into law in 1930
F. D. Roosevelt 1933-1945	His Reciprocal Trade Agreements Act of 1934 lowered US tariffs if other countries did the same – and the US was still a net exporter

(Note that even the roll-back of tariffs that finally began in 1934 under FDR came at a time when the build-up to WW2 was already starting to float many boats - and planes, and tanks, etc.)

Smoot, schmoot

As such, it is crucial to see that the infamous US Smoot-Hawley tariffs of 1930 - which modern economists still refer to as an example of US protectionism that did not work, even if their bête-noire role as the cause of the depth of the 1930's Great Depression is highly controversial - was not a policy aberration. Rather, for a century and a half, the US pursued a strategy of active protectionism that worked – and very successfully.

Contemporary free-trade theory says that the US stance should have made it a stagnant and irrelevant backwater devoid of technology transfers and productivity gains; instead it emerged as the world's largest and most dynamic economy.

It seems President Trump's thoughts on free trade fit well with pre-WW2 US ideas on the subject rather than emerging from nowhere. In our Great Games of Global Trade analogy, is the US therefore about to move away from modern Snakes & Ladders back towards either ancient Solitaire, or an attempt at a new version of Monopoly? i.e., a shift towards running more balanced trade, or a trade surplus?

But will it work? Who knows!

To summarize what we have tried to show so far, **free trade theory has a powerful logic to it**, and an equally powerful set of supporters in the modern economics profession and political circles. **However, the theory has significant practical flaws**, which are too often brushed aside.

Moreover, **its long-run track record is poor**. It has only been in place for around 100 years from the past 5,000 – for such an obvious line of thought and given mankind's long experience with international trading.

Even when it has been tried fully, it has usually ended with some form of political breakdown – as it may be about to again. Concretely, in the 19th and 20th centuries, many countries found they developed far more rapidly without embracing free trade for their own domestic markets.

In short, clearly **this is a far more complex issue than the binary "free trade = good, protectionism = bad' meme we often see**. Free trade can, of course, be very good in the right set of circumstances; and, evidentially, so can protectionism!

Yet the truly critical question now is: ***can protectionism work if Trump tries to reintroduce it now***? We addressed that issue briefly – among other Trump policies - in a recent special report ('Trump World'), and clearly there is room for a great deal of scepticism on many fronts.

It must be recognised, for example, that the global economy is now far more complex than it was in the 18th, 19th, or early 20th centuries. Indeed:

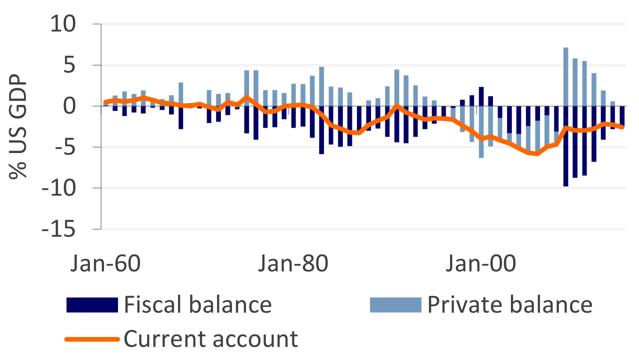
- **The US services sector is vastly larger today than in the past relative to industry**, suggesting that there are less jobs that could benefit from on-shoring. Does that mean the US will also have to withdraw from the proposed Trade in Services Agreement (TISA)? And how can services protectionism work in a fully-wired world? Increasingly, jobs can simply be off-shored via the internet, for example. Of course, as China's 'Great Firewall' shows, the internet can also be sectioned off if needed – though Trump is not proposing that kind of wall yet!

- **US reliance on Chinese products means any on-shoring has a 'prices will go up' inflation issue attached to it**, with a degree of validity. The traditional US argument of 'we have enough economies of scale to drive prices down with local production', which it used under pre-WW2 protectionism, doesn't fly compared to China, for example. However, the question can be framed like this by Trump: inflation (for a while) and American jobs, or lower prices and no American jobs?

- **Value chains are now highly diversified** across different countries in order to squeeze out the comparative advantage each can offer at every stage of the production process, something we explored in another recent special: 'Growth in World Trade: From Hare to Tortoise'. Yet that doesn't mean protectionism won't necessarily force production to return to the US – it just means the economic- and supply-chain disruption globally would be all the greater if it were to occur!

- **The US balance-sheet issue is problematic**. By this we mean the simple fact that a country's external deficit (the current account, which is basically trade and services) is the sum of the public – i.e., fiscal - and private – i.e., business and household - sector balances, as below.

Figure 6: Balancing the balance-sheets will be tricky



Source: Bloomberg

In short, Trump wants to see a much smaller US external deficit. Yet his spending plans and tax cuts will mean a much *larger* fiscal deficit, which argues the opposite.

That means the only way that his policy can work is if the private sector runs a huge surplus. That implies either (i) businesses run a huge surplus or (ii) US households do. However, the only ways for either to happen are (i) to cut spending, i.e., a recession, or (ii) to see such large income increases that they can both spend and save.

In other words, *a balanced US trade position is a recipe for either a huge US boom or a biting US recession: no other outcome is possible with a large government deficit*.

...but there's a B-I-G catch

Let's leave that particular 'will it work?' argument there for the moment and go back to history in order to consider one other very relevant dimension of the same issue.

Crucially, we have already showed the many shifts of the Great Game of Global Trade: (i) starting with an isolationist and mercantilist Solitaire; (ii) moving to an idealised British free trade Snakes & Ladders; (iii) realising the actuality of a violent British Monopoly; and (iv) that Monopoly prompting a dangerous global game of Risk that ended in two ruinous World Wars.

As the rubble of WW2 was still being cleared away, the world's new financial architecture was put in place at Bretton Woods to try to prevent any repeats of that particular order of events – with good reason. There was no question at the time that economic and trade tensions had led us to WW2.

As such, the new global reserve currency was not to be scarce gold, as before the war, but rather the USD, which was nominally tied to gold (until 1971). That was the obvious choice given the US was the world's only remaining industrial superpower apart from the battered (and communist) Soviet Union.

In the simplest possible terms, therefore:

- The post-WW2 global order placed the US at the centre of the economic and financial system via the USD;
- The Dollar was to be made available freely to relieve all countries from worrying about having to run trade surpluses to access international liquidity; and
- That meant countries didn't have to worry as much about their comparative advantage position under free trade.

Snap!

Indeed, after initially giving out huge quantities of foreign aid and loans to rebuild Europe and Japan (e.g., the Marshall Plan), the US began to run a huge trade deficit as the necessary price for allowing the constant flow of USD that the growing global economy always demanded.

Let's underline that key point:

no US trade deficit = no net USD flow to the global economy

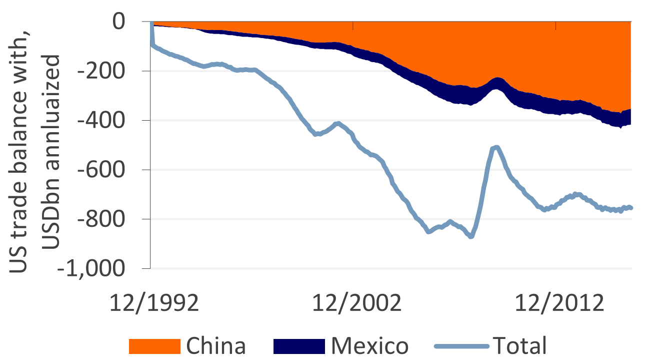
That was the so-called **Triffin dilemma**, identified back in 1960's by Robert Triffin, who correctly saw that *the country wishing to be the world's reserve currency must provide a supply of said currency via constant trade deficits. That is the price to be paid to be top dog in a 'soft power' economic system*.

On the pre-WW2 gold standard, to be at the centre of the global system involved running a huge trade surplus and physically dominating other countries to keep doing so – in that light, the 'Triffin model' was arguably a *big* upgrade.

Nonetheless, its clear implication is that any global reserve-currency based system is only sustainable as long as the country at its centre is willing to keep running sustained trade deficits. When the trade deficit stops, so must the FX reserve role, over time.

It is precisely that post-WW2 reserve currency arrangement that the US under Trump is showing it can no longer afford to support. (And the suggestions of matching US step-backs from financial commitments to the UN and other multilateral agencies only underlines that message.)

Figure 7: Two Trump trade targets



Source: CEIC

In truth, the post-WW2 global economic system was already under major pressure in the 1980s, when Japan ran a huge trade surplus with the US (by *not* using free trade!) that was ultimately resolved via the Plaza Accord of 1985; that saw JPY revalued hugely higher.

Yet since the 1980s the size of the global economy relative to that of the US has continued to grow. That has placed more and more strain on the paradigm. In particular, China is far too large a net exporter for the US to support via a constant outflow of USD and manufacturing jobs.

Only epic borrowing pre-2008 allowed the US to camouflage the increasingly costs of its 'exorbitant privilege': since 2008 even QE has failed to do so. Something had to give – and it already has, it seems: please read Trump's comments on the first page again in that respect.

Pop?

Hopefully one can now see that the implications of Trump's trade stance are *far* larger than a simple inflation effect of a tariff, or a controversial wall with Mexico. If the US shifts back to playing Solitaire (or even Monopoly!) on trade, then **the entire post-WW2 political, economic, and financial system starts to come under huge pressure.**

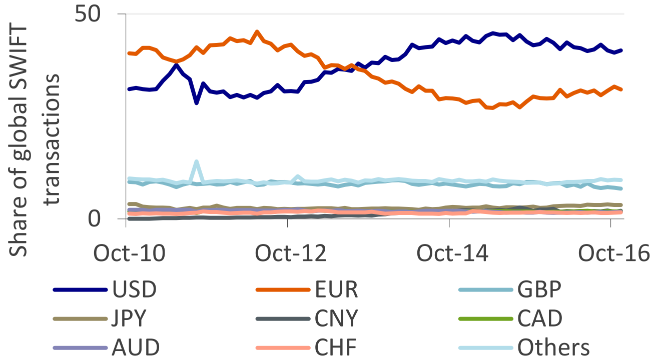
As our historic look at global trade has showed, without the USD 'on demand' to keep global FX liquidity flowing via a US trade deficit, everything is confusion.

Would a gradual USD shortage see the currency squeezed higher, as it becomes increasingly rare, like gold? Or might the US aim for a 'currency wars' approach of pushing the value of the USD down in order to rebalance its trade? Those are two radically different scenarios with a host of implications for commodity prices, for example!

Still thinking globally, what currency would two Asian economies use to invoice and trade together if the USD is no longer freely available?

Today all currencies are fiat (i.e., paper) and not gold. There is no physical shortage of them – at least domestically. However, many countries limit the off-shore availability of their currencies for a variety of good reasons, which means that they are not ready USD replacements.

Figure 8: It's a USD, USD, USD-man's world...



Source: Bloomberg

Moreover, not all currencies that *are* available off-shore would be acceptable for global trading/payment purposes. They might work between country A and country B, for example, but what if neither is accepted by third-party countries further down the trading channel: why accept trade payment in currency X if you know that it is not welcome as payment outside of region Y? That's the network effect that explains why we all end up on the same social media platform. (Another Great Game of Monopoly, it seems!)

And among the global FX reserve currencies or close equivalents that are easily available – EUR, JPY, GBP, CNY, and also CHF, AUD, CAD – none looks able to fill the gap the USD will leave.

EUR might do, except that Europe – besides political problems that rumble on – runs a trade surplus;

Japan runs a trade surplus too – and JPY is extremely volatile, while there are real questions over the sustainability of Japanese government debt;

GBP runs a large trade deficit, but is too small an economy to allow for a sufficiently large outflow, and there are also political issues around Brexit, Scottish independence, etc. – plus, "Been there, done that!";

CHF runs a trade surplus, and has seen active central-bank intervention in recent years and, like AUD and CAD, is also too 'small' a currency to play a major global role; and so

That only leaves CNY – which also won't work for reasons we shall return to in a moment.

In short, ***there is no potential replacements on hand for USD is we do see the US switch back to protectionism***.

On that basis, if the US plays 'Solitaire' or 'Monopoly' then the risk is that we see massive shifts and realignments in global trade towards economic and currency blocks that are seen as acceptable or workable: and both within and between those blocks, tensions will re-emerge over comparative advantage positions.

That is to say we will move back to a 19th century world – or a 1930's world, when this last happened - where everyone has to play 'Risk' to stay ahead in the Great Game of Global Trade!

Figure 9: A world we don't want to go back to, surely?

Source: Wikipedia

Eyes, stomach

Clearly, then we need someone to play the global role that the US is perhaps vacating...and China is very keen to step forward as the US steps back.

At the 2017 Davos summit, Chinese President Xi Jinping made an eloquent defence of the benefits of free trade that would have made Ricardo's heart soar. Moreover, a senior Chinese diplomat took the same week that Trump withdrew from the TPP to announce China is ready to assume global leadership if required.

Specifically, with the US-backed Trans-Pacific Partnership (TPP) now dead in the water, Beijing is proposing its own Regional Comprehensive Economic Partnership (RCEP), which encompasses itself, Japan, Korea, ASEAN's 10 members (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam), India, Australia, and New Zealand. That's a massive trading block encompassing around 3.4 billion people and 30% of world GDP at USD21.4 trillion.

Figure 10: Exit TPP stage left…

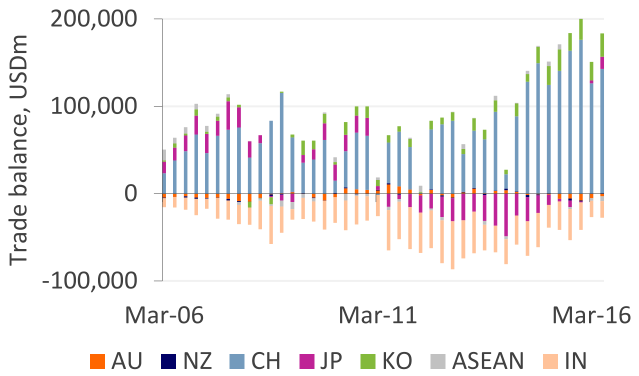
Source: Rabobank

Figure 11: …and enter RCEP stage right?

Source: Rabobank

Even so, it is still a block that is deeply lopsided in terms of its internal trade surpluses and its trade deficits: unless India is about to abandon its 'Make in India' campaign and buy Chinese goods on a truly vast scale, the RCEP will still require products to flow onwards to the US and European markets, which may not be an option going forwards, as Trump is showing us.

Figure 12: But who in the RCEP can buy what China sells?



Source: CEIC

OBOR boy!

Yet China's sights are set even higher than that as a result. **The official government goal is the mammoth USD3 trillion vision to build 'One Belt One Road' (OBOR), or the New Silk Road**, to link China via new road, rail, and ports to central Asia, Europe, and Africa.

Figure 13: Now THAT is a winning Risk hand!

Source: Rabobank

As can be seen from the vast scale of the project, it would effectively encompass most of Eurasia: indeed, with Germany involved, one can effectively include the Eurozone, Russia, Turkey, Central Asia/Middle East, Japan, Korea, India, ASEAN, Australia, and New Zealand. That kind of economic block would have no problems internally between supply and demand; it would have more than enough resources; it would have more than enough technology; and - in terms of *real politik* – it would have more than enough military resources.

In short, if OBOR ever comes to fruition – and especially if it happens alongside a US shift back towards isolationism and protectionism – then we would see a huge, and perhaps definitive, shift/return in global economic and political power eastwards to Eurasia. As the British geographer Mackinder stated in 1919:

"Who rules East Europe commands the Heartland; who rules the Heartland commands the World-Island; who rules the World-Island commands the world."

However, let's not delve into the geopolitical and military implications of that "World-Island" view. Instead, let's consider the simpler question: what currency might the block use? Surely, only one is possible: CNY.

And yet, the Triffin dilemma still holds for China. Just as with the US before it, the only way for Beijing to get the CNY accepted as a reserve currency along the New Silk Road is to:

(i) Give away vast amounts of CNY aid for free along OBOR – hardly popular with China;

(ii) Lend money to OBOR on a vast scale – and who wants to borrow that much from China? And who will be able to pay it back if they do borrow it?; or

(iii) Run a vast trade deficit, just as the US is doing – and which China does not. In fact, China remains a huge net *exporter*, which is what the US is complaining about.

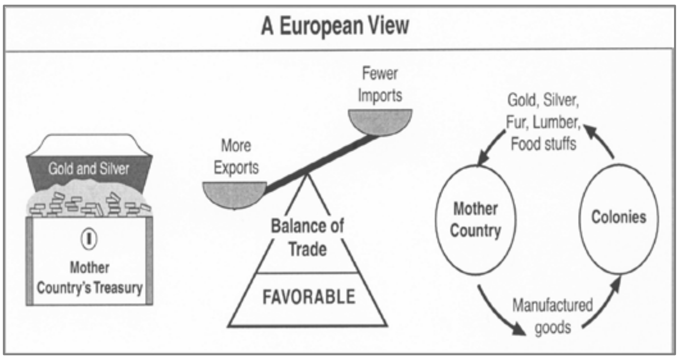
All this is true above and beyond the damage to the internationalization of CNY/CNH that China has inflicted with its recent heavy-handed interventions (capital controls, spikes in O/N interbank borrowing rates, etc.) that are aimed at maintaining the currency's stability - and, ironically, its "attractiveness".

In short, **China's OBOR vision is incredibly alluring**, especially with the US seeming to retreat from global free trade leadership under President Trump. **However, it is not something than can be easily realised – and then *sustained* - without transformative reforms of the Chinese economy** towards the US model...

...unless, that is, we return to the pre-WW2 method for assuming global trade primacy: buy raw materials from other countries, use a domestic value-chain to sell manufactured products back to them, run a vast trade surplus, and compel them to borrow from you to buy them. (And physically control trade routes to maintain the comparative advantage status quo, like the British did). Does that strategy sound familiar? (See figure 14 below!)

In terms of the supply- and value-chain, this is what China is *already* doing with ASEAN, at the margin; and it sounds a lot like what the US might like to do more of under a new Trump trade policy. That really does suggest we may be in for a renewed Great Game of Global Risk ahead!

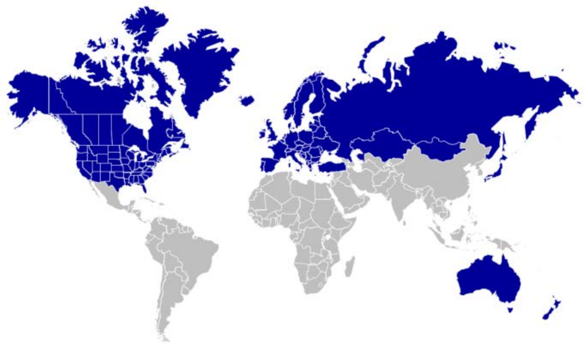
Figure 14: Once more unto the breach, dear friends?



Source: Wikipedia

Meanwhile, as an aside, consider this: if the US authorities have absorbed Mackinder's message about control of the World-Island, and wanted to prevent its creation, where is the pivot point? **The answer: Russia.**

Figure 15: But is this the Trump hand?



Source: Rabobank

One can chose to see both Hillary Clinton's evident bellicosity towards Vladimir Putin in the US presidential election campaign, and President Trump's subsequent friendliness, through that lens: stick or carrot, the aim is to shift Russia into a far more US-centric orbit.

If that requires Russian-European rapprochement, and Russian-Japanese friendship, and if Australia and New Zealand are encouraged to look back to their historic roots (rather than growing trade ties), then one can assemble a mental map as in Figure 15 above.

One could call it a 'Trump block' of economies with relatively similar GDPs and – Japan and Korea aside – relatively similar cultures; or one could call it the 'Former Empires Club'; or 'The Northern Hemisphere Club (with AU/NZ special membership)'. It might not be where the majority of global population is located, but it still has a large consumer base, vast resources, leading technology, massive military muscle – and relatively little potential internal trade tension.

Of course, whereas our theoretical and historical analysis of global trade was rooted in fact, this is pure conjecture - though Trump not attacking Canada within NAFTA, only Mexico, is at least circumstantial support for the view, and the rapidity with which he is allegedly offering the UK a post-Brexit trade deal also adds some tentative additional support.

What this kind of speculation *does* clearly underline, however, is the level of global uncertainty over trade we are already experiencing post-Trump, and which is set to grow significantly going forwards, it appears.

Indeed, on many fronts it suggests that **when President Trump and President Xi Jinping talk for the first time they will effectively be playing another Great global game - very high stakes Poker!**

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