



Chris Andrew
and Mustafa Zaidi
ca@clarmond.co.uk
+44 20 7060 1400

May 2020
Market Comment

CLARMOND

A Dialogue of the Deaf

The developing US / China tensions have an historical precedent in US / Japan relations of the 1930's. The US currently holds all the financial cards, but they have not yet decided how to play them. If and when that occurs, which we do anticipate, we are all entering a new world paradigm.

“WE NEED A QUARANTINE TO protect the health of our community against the spread of this disease” declared Franklin D. Roosevelt on an autumn day in 1937 - “an epidemic of world lawlessness is spreading...a contagion that can engulf people remote from the scene of hostility.” This speech, given at the opening of the Lake Shore Drive Bridge in Chicago, became known as the ‘Quarantine Speech’ which formed the basis of a financial siege upon the Empire of Japan. The US did not want actual war. This ‘paper war’ was the start of a series of financial policies meant to bring “Japan to its senses, not to its knees.”

Earlier that summer the EoJ and its Kwantung Army, launched a war on Nationalist China, a government that the US supported via loans and munitions. At the same time America was also Imperial Japan’s largest trading partner and export market; Japan exported raw silk to the US and this export was large enough at \$100m a year that it paid for all of Japan’s oil needs, almost all of which it imported from the US. The EoJ saved the remaining US dollars at the Yokohama Specie Bank located at 120 Broadway. A total of \$160m sat there, \$40bn in today’s terms, representing three years worth of critical energy supply.

Knees not Senses

The key legal instrument used to inflict financial penalty on the EoJ was the ‘Trading with the Enemy Act’ section 5(b) written in 1917 and initially used by Treasury Secretary William McAdoo in WWI to freeze German assets. As an aside, FDR

used the same powerful act in 1933 to declare a bank holiday and then confiscate gold from the American public. The man put in charge of implementing the ‘quarantine policy’ was an Assistant Secretary of State, Dean Acheson, a future leading light of the Cold War.

Using an ever tightening set of restrictions and tariffs Acheson was able to effectively deny Japan use of its Broadway-based money. All this action culminated in the Export Control Act of 1940 which curtailed the sale of any potential war material to Japan. This act was followed by the Two Ocean Navy Act for a Pacific and Atlantic fleet, creating a navy 4x Japan’s size; it meant that Japan’s naval parity in the Pacific would end by 1941. To pile further pressure on Japan, a \$50m aid package was given to sustain the Chinese nationalists under Chiang Kai Shek.

All these policies in aggregation whispered to the Japanese - ‘get on your knees and come to your senses.’ Japan dithered. And in July 1941, Japan’s \$160m was frozen under section 5(b). At the same time DuPont introduced nylon stockings, at a fifth of the price of silk stockings. Silk was transplanted and the market for raw silk, Japan’s key export, vanished. With no US money, no oil, no export market, and on its knees, Japan lost its senses.

Re-emerging strains

Such past strains are re-emerging today with a different Pacific nation, China. China is also a nation dependent on the US market for exports to earn dollars in order to

purchase energy, and it is a nation with massive US assets as savings. Currently, there is no coherent American ‘Quarantine Speech’, just a mishmash of policy objectives. These include curtailing intellectual property theft, 5G security concerns, Hong Kong’s special trade status, US GAAP accounting exemptions for US listed Chinese companies, One Belt One Road’s military implications, freedom of navigation in the South China Sea, occasional human rights, and, as always, US support for Taiwan. All these issues are tumbling around in search of a coherent response similar to FDR and Acheson. And, like the EoJ, the People’s Republic of China owns a vast stash of US Dollars in the form of US Treasuries. These form the basis of the PRC’s ability to manage the RMB/US\$ peg. This peg provides a 10x leverage to the local banking system to create credit in China. If these Treasury assets were ever frozen, for instance if Trump stumbles onto the Trading with the Enemy Act and realises its power, the banking system of the PRC is effectively bankrupt.

Play by the Rules

The fifth arm of the military is finance. The application of this dominance is a warning signal of a recalibration of US goals. Americans with financial power must offer hope of relief to those that play by their new rules. If not then the insolvency created by the subsequent monetary strangulation will develop into an old ‘dialogue of the deaf’, which often has deadly consequences. ■