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ON DAY ONE

An Economic Contingency Plan for a Taiwan Crisis

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China's Global Sharp Power Project

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CHINA'S GLOBAL SHARP POWER

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Executive Summary

Full economic decoupling from China is not possible or desirable today, but it may become necessary in some break-glass scenarios. Washington needs a plan to decouple from the People's Republic of China (PRC) starting on Day One of a Taiwan crisis, both as a contingency plan and as a part of integrated deterrence. However, trying to force a hard decoupling through sanctions would not serve US interests, and the PRC would likely prove resilient. Instead, Washington should publicly prepare a plan to trigger "avalanche decoupling" on Day One as part of a wider program of economic recovery and leadership. Supply chains would stay as open as possible in the short term, but unilateral US actions would create inexorable momentum toward full decoupling over time. Avalanche decoupling would harness market forces and incentivize third countries to cooperate, including by helping to secure US borders against mislabeled PRC products.

To achieve avalanche decoupling, Washington would embrace four guiding principles:

1. Impose no restrictions on noncritical supply chains on Day One, and thereafter give firms adequate time to reshore them.
2. Sustain dollar hegemony and prevent the rapid internationalization of the renminbi (RMB).
3. Refrain from asking other countries to decouple from the PRC; instead, build US decoupling into a wider program of economic support in response to the Taiwan crisis.
4. Commit the United States to enforce its anti-PRC trade policy against third countries in a rules-based manner, subject to appeal and external adjudication.

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Guided by these principles, we propose three policies to facilitate avalanche decoupling:

1. **Unilateral discriminatory trade policy**, likely ratcheting tariffs or quotas to take imports from the PRC to zero over a period of years, citing the World Trade Organization (WTO) national security exemption.
2. **Unilateral currency market intervention** against the RMB.
3. The establishment with Core allies of an **Economic Security Cooperation Board** (ESCB), which would provide aid to third countries, collective insurance against PRC economic coercion, and a rules-based system to support and adjudicate US and allied trade policy against the PRC.

The plan would sustain support for a revitalized rules-based trading system across much of the global economy, while the United States and its Core allies (e.g., Japan, the United Kingdom, Canada, and Australia) decouple through national trade policy. Publicly developing the plan in advance, alongside Core allies, would give the United States an additional option for Day One. It would also show Xi Jinping that if he moved against Taiwan, most of the global economy would cooperate with Washington, leaving China impoverished and isolated, even if it triumphed in a Taiwan war.

POLICY RECOMMENDATIONS

- Congress should systematically evaluate the Day One Plan and compare it to alternatives.
- Congress should introduce legislation authorizing the plan and leave it on the shelf as one of multiple options if the PRC moves against Taiwan.
- US and allied diplomats should explain the plan to nonaligned countries, and to Xi.

INTRODUCTION

As US deterrence weakens, the risk of conflict in the Taiwan Strait is rising. The US "strategy of denial" aims to deter aggression by showing that US forces could defeat a conventional Chinese attack on Taiwan.[1] The military buildup by the People's Republic of China (PRC) is undermining the strategy of denial and demonstrating the ability to blockade or quarantine Taiwan. The US "strategy of punishment" aims to deter aggression by showing that Washington could impose costs on the PRC if it disrupted regional peace and stability. However, the PRC is stockpiling energy, food, and critical supplies, building financial safeguards, and indigenizing critical supply chains—steps that make the PRC more resilient to short- and medium-term economic punishment. As a result, it is not clear from open sources to what degree PRC leader Xi Jinping remains deterred. CIA director William Burns has stated that Xi has asked the People's Liberation Army (PLA) for the capability to take Taiwan by 2027. In other words, if Burns is correct, Beijing seeks to render the strategy of denial moot by 2027.

If the PRC moves against Taiwan by force, the financial and economic effects will be immediate and enormous, and the United States will have to quickly decide on an economic response. The president will have substantial emergency authorities, but the true power will reside in Congress, which controls the purse strings and can broaden or restrict the president's economic authority if it wishes to do so. In short, the people's elected representatives will inevitably have their say in accordance with the demands of the moment. This fact makes it impossible to predict in advance precisely what America would do. However, in a moment of crisis, there will not be enough time on "Day One" to develop new ideas from scratch. Political leaders' realistic choices will be limited to strategies that were developed and vetted in advance. The task of economic contingency planning—and economic deterrence too, for that matter—is to develop coherent options, so that if Day One comes, the people's representatives have a meaningful choice.

Currently, US economic contingency planning for Day One is highly underdeveloped. As the bipartisan House Select Committee on the Chinese Communist Party concluded bluntly in December 2023, "The United States lacks a contingency plan for the economic and financial impacts of conflict with the PRC."[2] Many observers outside the defense community assume that a US-PRC war is inconceivable and that a major economic rupture would not be possible, even in crisis scenarios. Among those who believe that a rupture is conceivable, there is disagreement about the most likely pathway to conflict. These analytical challenges complicate contingency planning and make it hard to communicate in advance what the United States would do. Nevertheless, it is essential to show Beijing that the United States has at least one plan for Day One to advance its economic interests—and those of its allies and neutral nations—while imposing heavy long-term costs on the PRC. No one can know how the politics would change on Day One. However, if Washington has no visible plan that meets the above criteria, Beijing may become more likely to attack. The lack of any economic plan for a severe crisis also constrains the United States' ability to respond dynamically and maintain escalation dominance in the face of the PRC's escalating gray-zone coercion against Taiwan.

If a viable economic plan existed, it would strengthen deterrence—even if it would be politically possible only in an extreme crisis context. This report outlines one such plan.

In all plausible scenarios of Day One, Washington would probably tighten and expand export controls on "critical" products and components, such as semiconductors. The harder question is what to do about trade in "noncritical" products, from household cleaning supplies to electronics. The PRC exported $3.38 trillion in goods in 2023, of which $427 billion went to the United States. In the same year, the PRC imported $2.56 trillion of goods, of which $148 billion came from the United States. If these supply chains were abruptly cut, the resulting shortages and inflation would badly hurt consumers. However, the dependence of America and its allies on "noncritical" trade with the PRC is a strategic vulnerability. In principle, reshoring noncritical supply chains could create manufacturing jobs in the United States and third countries at the expense of the PRC. Around one hundred million PRC workers are directly employed in the export manufacturing sector, representing almost one-fifth of the country's GDP. The problem, of course, is that reversing four decades of outsourcing to the PRC is an enormous task. The faster firms have to reshore supply chains, the greater the economic disruption and political complications.

On Day One, Washington currently understands that it has two economic options:

1. **Symbolic punishment:** Impose symbolic sanctions that express US displeasure without actually breaking the broader trading relationship.
2. **Hard decoupling:** Impose immediate maximum pain on the PRC and try to disrupt the PRC's ability to trade with the world, mostly likely through the sweeping use of blocking sanctions on PRC financial institutions.

This report rejects this binary choice and develops a third approach:

3. **Avalanche decoupling:** Keep noncritical supply chains open on Day One but lock in a longer-term process to achieve a more orderly decoupling over time, building on incentives and market forces.

Which of the above options is politically possible will depend on the politics of the moment. If Taiwan submits to coercion without any shots fired or if the PRC engineers Day One so that its ultimate victory seems certain, there might be no political consensus in Washington for dramatic economic actions such as options two or three. By contrast, in other plausible scenarios—especially but not exclusively those in which the PRC starts a conflict with a surprise first strike—the political response in the United States and allied countries might be so strong that option one is ruled out. This report calls this latter possibility the break-glass scenario. In it, the PRC moves against Taiwan, and Washington concludes that it must decouple in some form.

We analyze option two and conclude that it is unviable. Any sanctions package seeking to force a "hard decoupling" of the PRC from the world economy would exacerbate the financial and economic crisis of Day One. It would devastate the US economy and the economies of its allies. Above all, it ignores a fundamental lesson of history: in times of great power competition, third countries do not face binary choices.[3] Any attempt to bifurcate the global economy by force will trigger organized resistance from neutral countries. It is implausible, even in the break-glass scenario, that the United States could maintain the political will to bear this pain indefinitely. Moreover, even if the United States were resolved to use sanctions or methods such as blockades to disrupt third countries' trade with the PRC, it would incentivize the rest of the world to develop work-arounds, including overland smuggling routes and trade settlement in currencies other than the US dollar. These US actions would break the rules-based trading system, probably irrevocably. And for what benefit?

Beijing is rapidly building resilience to option two, and open sources show that prominent PRC officials think this strategy is making rapid progress. Due to capital controls and the state's enormous foreign exchange (FX) reserves, Beijing would be in a strong position to prevent a banking system meltdown if sanctions were imposed. Beijing is also rapidly signing up banks across the world to the Cross-Border Interbank Payment System (CIPS), which enables secure cross-border payments. It is also using various levers to encourage use of the offshore version of its currency (CNH) across the Global South.[4] As this strategy advances, prominent PRC analysts are gaining confidence that dollar sanctions would not obstruct the PRC's ability to trade in a crisis. Instead, they predict that neutral countries and even many US allies and their firms will shift their payment processes across to CNH or some basket of other related currencies. The long-term risks for dollar dominance would be dire. Among other effects, US export controls and existing sanctions on Russia, North Korea, and other rogue states would begin to lose their effectiveness at the very moment when they are most needed.

In other words, option two would be so costly and so risky that it would not be a realistic option, even in the most extreme Taiwan crisis scenarios. However, if option two is unrealistic, and there is no other alternative to option one, then the PRC may be tempted to move against Taiwan. It is therefore essential to develop a plan for option three to show that it is possible in principle to achieve full decoupling over time.

This report therefore addresses the following question: *Conditional on the PRC having moved against Taiwan and the United States reaching a bipartisan consensus that decoupling is necessary but hard decoupling is unacceptable, what principles and policies should guide the US economic response?* In other words, how could the United States achieve full decoupling from the PRC in a way that maximally benefits itself and its allies and partners while imposing maximum long-term pain on the PRC? Surprisingly, no existing literature has considered this question. We find that executing gradual decoupling would involve both costs and risks for the United States. It would require an enduring bipartisan consensus. Above all, it would require the United States to take up the mantle of economic leadership and put time, effort, and money into sustaining the rules-based economic system. Nevertheless, in principle, a relatively orderly, market-driven, gradual decoupling is possible. If the United States takes the right set of actions on and after Day One, it can unilaterally trigger an avalanche that consolidates dollar hegemony, claws back high-end manufacturing jobs from the PRC on a timeline of Washington's choosing, and sustains the US-led rules-based trading system while destroying the PRC's terms of trade over the longer term.

It is important to recall that any large-scale PRC use of force against Taiwan would breach the foundational agreements that underpin the US–China diplomatic relationship. The United States' long-standing "One China Policy" is guided by the Three Communiqués, Six Assurances, and Taiwan Relations Act (TRA). As the TRA makes clear, Washington would "consider any effort to determine the future of Taiwan by other than peaceful means, including by boycotts or embargoes, a threat to the peace and security of the Western Pacific area and of grave concern to the United States."[5] The One China Policy reassures Taiwan that it need not submit to coercion while also reassuring the PRC that if it does not use force against Taiwan, Washington and Taiwan will respect the status quo.[6] It also hints that any attempt to limit Taiwan's access to global markets by force would trigger a decisive US response, including potentially the end of formal diplomatic relations. Since no other country has a TRA that makes such a threat, Washington should not assume that other countries would follow its political line on Day One. Still, a PRC decision to move against Taiwan would represent a point of no return in the bilateral relationship. The United States, under its own policy, would be fully justified in responding with strong unilateral action.

Since hard decoupling through sanctions is unviable, the only way to achieve trade decoupling is through national trade policy using tariffs or quotas to phase out bilateral trade over time. The challenge of this approach is that Washington currently lacks the policy tools and administrative ability to stop firms and third countries from transshipping PRC goods into the US market while taking steps to obscure their origins. If Washington tried to reduce bilateral trade with the PRC to zero without a plan for managing this problem, it would quickly find itself in simultaneous trade disputes with nearly all of the global economy. Supply chain disruptions, shortages, and inflation would result, and the global trading system based on WTO rules would quickly break down. If Washington persisted in its push for decoupling, it would give the PRC an opportunity to co-opt the system and deepen its partnerships with US allies and neutral states in the process. In short, unless the United States develops new unilateral tools and multilateral coordination systems that other countries are incentivized to join, it cannot decouple from the PRC without decoupling from much of the global economy.

At the same time, a violent PRC move against Taiwan would also represent a threat to the rules-based trading system. While Taiwan is not a US treaty ally, it is among the world's most important high-tech trading economies. If Beijing seized Taiwan and used it as a geographic springboard to project naval power into the Western Pacific, other US treaty allies in the region, including Japan, South Korea, and the Philippines, would become far harder for Washington to defend. Beijing would gain a far freer hand to coerce its neighbors with economic tools or use political coercion to impose its economic preferences, particularly now that the United States would have conceded that it could not break its dependence on the PRC. As Asia fell under the hegemonic control of the PRC, Beijing would be emboldened to flaunt global trade rules and practice economic coercion against states in other regions, heralding a shift to a truly multipolar world. In the wake of a Taiwan crisis, there would also be a risk that major economies, including the United States, would turn away from global trade, resulting in a disastrous rerun of the 1930s that would leave the United States far weaker and far less prosperous.

Given both the scale of the challenge and the unique position the United States holds in the global economy, US economic action on Day One must be conceived as a program of economic leadership and reconstruction to help the world deal with the challenge of a PRC gone rogue, not a strategy of impoverishing the world in order to punish the PRC. If Washington chose to decouple, it could not coerce other countries to facilitate a US pro-decoupling policy against their fundamental economic interests, let alone force them to decouple from the PRC themselves. Washington would have to articulate publicly and in advance that it was making a unilateral decision to preserve its own national security and that it would incentivize other countries to meet the minimum bar necessary to achieve that outcome as part of a wider program of economic recovery. That minimum requirement is that other countries that traded freely with the United States would need to report accurately which products they were exporting (or what share of the products by value) originated in the PRC.

Since successful avalanche decoupling would require the cooperation of third countries and private firms, the United States would have to commit to four principles that would guide its conduct through the decoupling process:

1. Impose no restrictions on noncritical supply chains on Day One, and thereafter give firms adequate time to reshore them.
2. Sustain dollar hegemony and prevent the rapid internationalization of the RMB.
3. Refrain from asking other countries to decouple from the PRC; instead, build US decoupling into a wider program of economic support in response to the Taiwan crisis.
4. Commit the United States to enforce its anti-PRC trade policy against third countries in a rules-based manner, subject to appeal and external adjudication.

Washington would have to respect all four principles, bringing them together in an *affirmative vision* to sustain the rules-based trading system in the face of an unprecedented challenge from a large rogue state. Only the United States and a small number of like-minded allies would be likely to decouple fully from the PRC.

Building on these principles, the report discusses three policy pathways that, if implemented together, could achieve avalanche decoupling on terms favorable to the United States, its allies, and the wider rules-based trading system.

1. **Unilateral trade policy:** Ratcheting tariffs or quotas on imports from the PRC.
2. **Unilateral financial intervention:** Treasury intervention in currency markets.
3. The establishment with Core allies of an **Economic Security Cooperation Board**, which would provide aid to third countries, collective insurance against PRC economic coercion, and a rules-based system to support and adjudicate US and allied trade policy against the PRC.

These are conceptual policy approaches, not specific policy recommendations. Each approach involves its own legal and political challenges. There is no guarantee that all three could be adopted. Indeed, even if all three were adopted at the outset, there is no guarantee that they could be sustained indefinitely. We discuss the political challenges of implementation and the severability of the policy pathways, including the scenario in which the United States changed its mind after the avalanche had begun. It is politically implausible that avalanche decoupling can be achieved in peacetime. On Day One, however, the politics would be likely to change profoundly. Multinational corporations, small businesses, labor unions, and other interest groups may prefer to avoid any economic rupture with the PRC at all. However, if that were not an option, they would also want to prevent a general collapse in global trade, maintain the US position as a responsible stakeholder on the international stage, and deny the PRC the opportunity to establish hegemonic control over large parts of the global economy.

In that spirit, this report's contribution is to begin the project of mapping out the contingent decoupling plan in consultation with key stakeholders whose support would be essential. This is not a traditional policy paper. We do not use quantitative forecasting; we discuss operational issues only at a high level, and we propose ideas that differ radically from the current Washington policy conversation. Our analysis is based on Chinese-language sources and economic and political reasoning, and it draws inspiration from historical study of the Anglo-American reconstruction of Western Europe after 1945.[7] Our goal is to snap readers out of "business-as-usual" incrementalism, encourage them to reexamine deterrence with fresh eyes, and propose a framework for further research and planning. Operationalizing the Day One Plan would be a vast and ongoing effort requiring coordination between nearly every US federal government agency, Congress, partner countries, academic and policy communities, and industry. The report concludes with an outline of an agenda for how the United States and allied governments can start the investigative and consultative phases of this project.

OUTLINE

Part 1 explores the economic challenges Washington would face on Day One of a break-glass scenario. It discusses the key US national interests at stake and the risks that these interests would face. It discusses the character of the potential financial market reaction in various scenarios using the outbreak of World War I as a benchmark. It lists some economic actions that the United States would probably take in all Taiwan contingencies, including breaking its dependence on the PRC for critical products. Finally, it sketches the United States' three basic economic options and discusses the politics of the break-glass scenario.

Part 2 scrutinizes hard decoupling and finds that it is unviable. It begins by defining hard decoupling and noting its continued appeal as an idea. It then examines the economic price and political risk associated with hard decoupling. The PRC's financial system would likely prove resilient if the United States imposed sweeping dollar sanctions. Russia's stabilization of its financial system and economy in March and April 2022 provides a template. Drawing on previously untranslated speeches and publications by prominent Chinese officials, economists, and military strategists, this section then examines the PRC's sanctions-busting strategy in detail and explains why Beijing is gaining confidence. Notably, this discussion shows that PRC elite observers think that their unique dual-currency system is a major strategic vulnerability. The Day One Plan that follows will exploit this insight.

Part 3, the heart of the report, presents the Day One Plan. First, it develops guiding principles. Second, it explains how to operationalize them and discusses political, legal, economic, and financial issues and second-order effects arising from implementation. Finally, it systematically reviews the PRC's potential retaliatory options, explains how the Day One Plan would deal with them, and evaluates implementation risks.

Part 4 explains why developing the Day One Plan publicly and in advance would contribute to the Trump and Biden administrations' policies of "integrated deterrence."

The conclusion summarizes the key findings, considers how the Day One Plan should be communicated to Beijing, and recommends a process for the US federal interagency and allied governments to study, develop, and ultimately operationalize the Day One Plan.

CORE TAKEAWAYS

- Current thinking about economic deterrence emphasizes the threat of immediate and overwhelming sanctions to break the PRC's ability to trade with the world.
- Rapid decoupling is not a credible threat.
- The United States and its allies need a plan for the break-glass Day One contingency that preserves their fundamental economic interests while punishing the PRC. The answer, in principle, is avalanche decoupling.
- On Day One, the United States could—and likely would—take unilateral measures to cut off trade with the PRC in critical products.
- Noncritical supply chains must be reshored gradually in an orderly and market-based manner. This would reduce the risk of shortages and rampant inflation, maintain coalition unity, and help preserve the rules-based trading system.
- This report is the first study of how avalanche decoupling can be achieved.
- Making avalanche decoupling work would require coalition building based on incentives and credible reassurances, not threats and moral appeals.

- Washington must explain to the world that if the PRC moves against Taiwan, it could trigger the avalanche unilaterally, and would offer economic leadership rather than turning inward, sustaining the rules-based system in the face of an unprecedented challenge.

- Avalanche decoupling of US–China trade would not require third countries to ever decouple from the PRC.

- It would, however, require that third countries meet a minimum bar: accurate reporting of what PRC products and parts they are re-exporting into the US market.

- Over time, market forces would create incentives for many of these countries to erect trade barriers against PRC goods.

- Developing the Day One concept into an operational plan will be an ambitious effort, requiring input from a range of stakeholders. The purpose of this report is to start that conversation.

TERMS DEFINED

CNH and CNY

The PRC's currency, known as the renminbi (RMB) or Chinese yuan, actually consists of two currencies operating in parallel. The onshore currency, which trades under the currency code CNY, is traded within the PRC and is not fully convertible on demand. The CNY is subject to capital controls and other regulations imposed by Beijing. The only way non-PRC institutions can acquire CNY in significant quantities is through swap lines with the People's Bank of China. China's offshore currency, known as the CNH, is freely convertible into other currencies. The CNH is traded in Hong Kong and other offshore markets, including London, where authorized banks conduct a range of transactions in the currency. Third parties are free to buy and sell the CNH. PRC monetary authorities maintain a de facto 1:1 peg between the CNH and CNY by tightly managing the money supply and liquidity of the onshore and offshore markets. In principle, however, PRC authorities could restrict convertibility between the two currencies, and the peg could break.

Capital Controls

A basket of policies that Beijing uses to regulate the flow of capital into and out of the country, including restrictions on the conversion of the CNY into foreign currencies and vice versa. PRC individuals and companies require regulatory approval to transfer money out of the country for investments, acquisitions, remittances, and other purposes. Capital controls are implemented in a dynamic fashion and can be tightened during periods of financial volatility to manage capital outflows. Capital controls are a key tool that Beijing uses to maintain financial stability and manage the exchange rate.

Decoupling

US–PRC decoupling (美中脱钩 *mei-zhong tuogou*) refers to the process of disentangling or reducing the economic interdependence between the United States and the PRC. The term has gained prominence in recent years as tensions between the two countries escalated and is often used loosely to cover technology, geopolitics, and trade. In this paper, decoupling refers to the total stoppage of bilateral trade over a certain period, including trade in noncritical goods.

Hard Decoupling

A scenario in which the US attempts to rapidly force its trade and financial relationship with the PRC to near zero.

De-risking

Presented as an alternative to decoupling in peacetime, an effort by one country or a group of countries to break dependencies in critical goods and technologies by building stockpiles, regulating the transfer of sensitive technologies, and reshoring critical supply chains to friendly countries. The term gained favor from the European Commission and was embraced by the Biden administration and the G7 in 2023. De-risking generally implies that supply chains for noncritical goods do not need to be reshored.

Gradual Decoupling

A scenario in which US or global trade and financial relations with the PRC decline gradually but steadily toward zero.

Break-Glass Scenario

A catch-all term for the universe of scenarios in which PRC actions on Day One persuade the White House and a bipartisan majority in Congress that the United States must end its economic relationship with the PRC. This is a political scenario, not a military one. It is agnostic as to how Beijing might choose to move against Taiwan, focusing instead on the United States' reaction.

Dollar Sanctions

An umbrella term for sanctions imposed by the US Treasury Department's Office of Foreign Assets Control (OFAC) that restrict transactions denominated in US dollars or involving the US financial system. Types of dollar sanctions include blocking sanctions, which freeze assets owned or controlled by designated individuals, entities, or governments that are subject to US jurisdiction; inclusion on the Specially Designated Nationals list, which triggers various restrictions and prohibitions on access to the US financial system and transactions denominated in US dollars; and other tools of a similar nature. In general, US persons and entities may not engage in any transactions with individuals or entities subject to dollar sanctions. The Treasury can also impose secondary sanctions under which non-US persons and entities caught engaging in certain transactions or activities with sanctioned parties can be deprived of access to the dollar financial system. Given that every significant global financial institution currently requires the ability to transact in dollars, the threat of dollar sanctions is highly effective at ensuring compliance with US policies, including export controls and existing sanctions. However, if a critical mass of global cross-border financial activity shifted from the dollar to other currencies, dollar sanctions could, in principle, lose their effectiveness.

In this report, "dollar sanctions on the PRC" refers to an attempt to use dollar sanctions broadly enough to disrupt the PRC's ability to conduct international trade.

One China Principle

The claim that there is only one sovereign state under the name "China," that Taiwan is part of China, and that the PRC is the sole legitimate government of China. The One China Principle is a fundamental aspect of PRC government policy. It has significant diplomatic implications because the PRC refuses to maintain official diplomatic relations with any country that recognizes Taiwan as an independent country, or that recognizes the authorities in Taipei as the legitimate government of China. The One China Principle asserted by China is different from the One China Policy espoused by many governments around the world.

One China Policy

A diplomatic formulation adopted by various countries and international organizations regarding Taiwan's legal status. These formulations vary widely, with subtle differences in wording and emphasis. In many cases, such as the United States, Japan, and the UK, the language of the One China Policy is sufficiently ambiguous in that it authorizes continued informal relations with Taiwan while maintaining formal diplomatic relations with the PRC. Under the One China Policy, countries that recognize the PRC usually do not have official diplomatic relations with Taiwan. Instead, they maintain unofficial relations through various means, such as representative offices or trade and cultural exchanges. The US One China Policy is "guided by the Three Joint Communiqués, the Six Assurances, and the Taiwan Relations Act."

Rules-Based Economic System

A framework of international economic relations governed by a set of rules and agreements aimed at promoting stability, fairness, and cooperation in the global economy, and arbitrated and enforced by multilateral institutions or coordination systems. The most prominent pillars of the system are the WTO, which governs international trade, and the International Monetary Fund (IMF), which offers policy advice and provides financial assistance to countries in crisis. The system also includes various multilateral agreements on financial, legal, and regulatory issues that are enforced through their own institutions or coordination bodies. One example is the Basel Accords, a series of international banking standards aimed at regulating banks' capital adequacy, liquidity, and risk management practices. Within broader rules-based systems, blocs of countries can form their own rules-based systems. The European Union Customs Union is one example. The current rules-based system is not entirely global in nature. North

Korea, for example, is not a member of the WTO or the IMF. However, in the 1990s and 2000s, efforts were made to support the accession of Communist and former Soviet states, including the PRC and Russia, into the rules-based system.

Rules-Based Trading System

A framework of international trade in which global commerce is regulated through agreements and institutions that apply rules fairly and consistently to all participants. The cornerstone of the current rules-based trading system is the WTO, which oversees rules regarding tariffs, subsidies, intellectual property rights set out in the General Agreement on Tariffs and Trade (GATT) charter, and other agreements. The WTO is predicated on a set of fundamental principles, including nondiscrimination, reciprocity, and transparency. The system was designed to facilitate international trade by streamlining customs procedures, reducing administrative barriers, and harmonizing trade-related regulations and standards, as well as the enforcement of intellectual property rights. Any change to WTO agreements requires unanimity among members. The advancement of the WTO has been frozen since the failure of the Doha Round, which began in 2001. The WTO's Dispute Settlement Understanding (DSU), which provides a structured process for resolving disputes through consultations, mediation, and adjudication by panels and the Appellate Body, has also ceased to function effectively because the United States has blocked the appointment of new members. Nevertheless, the fundamental principles that underpin the WTO still have powerful normative force.

Quarantine Scenario

This scenario features a declaration by Beijing that ships and aircraft transiting in or out of Taiwan be routed via a mainland port to clear customs. Beijing could, in principle, impose a quarantine at any moment, justifying it on the basis of existing claims. Unlike in a blockade, Beijing might refrain from using indiscriminate force against foreign vessels resupplying Taiwan. Instead, it would use a combination of legal, financial, political, and military tools to force private firms and other countries to comply. In principle, flows of goods and people in and out of Taiwan would not be disrupted, as long as airlines and private shippers met Beijing's customs and visa requirements. The quarantine scenario is potentially attractive for Beijing because it would not sound like an act of war and would push the burden of escalation onto the United States.

Blockade Scenario

In a blockade scenario, the PRC would forcibly obstruct ships and planes from resupplying Taiwan in an attempt to coerce the authorities in Taipei to accept unification on Beijing's terms. People's Liberation Army training manuals for officers specify procedures for "joint blockade and joint support operations," and PLA forces have exercised this scenario, most recently in August 2022. A blockade would be different from a quarantine in that it would seek to interdict all trade in and out of Taiwan, including food and fuel. Notably, the Taiwan Relations Act (TRA) of 1979 explicitly claims that the United States would regard a blockade of Taiwan as a threat to regional peace and stability and a matter of "grave concern," raising the possibility that US forces might become directly involved in breaking the blockade.

PART 1: IMAGINING THE DAY ONE CRISIS

Before analyzing the United States' economic options for Day One, it is first necessary to imagine what a Day One crisis would be like. Five key US economic interests are worth highlighting: (1) maintaining financial and macroeconomic stability, (2) breaking US and allied dependence on Chinese production, (3) preserving the rules-based trading system, (4) preserving dollar hegemony, and (5) punishing the PRC economically. Many countries would share—or at least understand—the first four interests. However, very few countries would share the fifth.

In the context of Day One, financial market responses would affect these interests in important ways. In the most plausible Taiwan crisis scenarios, the dollar would appreciate markedly, while the CNY would depreciate. As long as this trend lasted, it would have significant macroeconomic and strategic effects that Washington would have to deal with and could potentially harness. The US government would probably also take certain economic actions in all Taiwan crisis scenarios. For example, export controls would probably be expanded, and the Federal Reserve would probably try to stabilize the financial system. Any viable economic contingency plan must take all these considerations into account.

There are, of course, many plausible Taiwan crisis scenarios, each with important differences. The PRC could launch an amphibious invasion, blockade all traffic in and out of Taiwan, or attempt a quarantine to screen Taiwan's trade without shutting it down altogether. Beijing might also try to decapitate Taiwan's elected government through a coup or other means. Beijing is already ramping up "gray zone" pressure against Taiwan short of kinetic means, hoping to coerce Taiwan into bloodless capitulation. These options can be combined. In each scenario, the United States would have military, political, and economic options to react. While Taiwan is a close US partner, and Washington has unique strategic interests in maintaining peace and stability in the Taiwan Strait, Washington and Taipei currently have no formal political or military state-to-state relationship. Financial markets and supply chains would react differently in each case and respond dynamically to US and PRC policy shifts. The scenarios defy systematic modeling. This fact presents a fundamental challenge for economic contingency planning.

Nevertheless, a common set of US economic interests would apply in all contingencies, and the characteristics of the financial and supply chain reactions also have common features. This report does not take a position on how the PRC is most likely to move against Taiwan or how the United States would or should respond militarily. Rather, its goal is to provide a credible economic contingency plan for a break-glass political scenario. The guiding question of Part 1 sets the stage for this discussion. *Assuming Washington decides that it has to decouple from the PRC, what interests would it have to attend to in the process, and what related economic challenges would it face?*

US NATIONAL INTERESTS

FINANCIAL AND MACROECONOMIC STABILITY

On Day One, even as US policymakers scrambled to protect US strategic interests in the Western Pacific, they would also face a formidable challenge in managing the economic fallout. Major economies often grow rapidly during wartime, due to mobilization efforts and easy fiscal and monetary policies. However, an escalating great power conflict over Taiwan could be different. The sudden rupture of supply chains in and out of the PRC and Taiwan—which might take place by accident or design in a Taiwan contingency—could result in a sharp economic downturn, shortages, inflation, and unemployment globally.

The United States and its allies and partners would have a common interest in limiting the economic damage on Day One. Regardless of how the PRC moved and whether or how the US government wanted to intervene militarily, the president and Congress would face considerable pressure to maintain domestic financial stability and prevent an economic depression and a rise in the unemployment rate. Maintaining financial and macroeconomic stability would be a strategic concern, not just a political one. A global economic crisis would make it harder to maintain allied unity during a prolonged conflict with the PRC. It could also undermine other key US interests.

BREAKING US AND ALLIED DEPENDENCE ON CHINESE PRODUCTION

Countries in positions of strategic economic dependence are vulnerable to coercion that degrades their ability to defend their sovereign interests. It is therefore contrary to US strategic interests to remain dependent on a systemic national security threat or, self-evidently, a country with which it is at war. Similarly, the United States would have an interest in protecting vital allies in the Indo-Pacific region from economic coercion. In the course of time, this would require that they, too, unwind and ideally break their economic dependence on the PRC.

Regardless of the outcome of any Taiwan crisis, even if the outcome was decided quickly, there would be no going back to the status quo ex ante. Beijing, by resorting to force, would have demonstrated a willingness to completely disregard the Three Communiqués, the foundational agreements of the US–PRC diplomatic relationship. On Day One, breaking US and allied dependence on the PRC would, therefore, become an enduring new interest. The Chinese Communist Party (CCP) regime could no longer be trusted to abide by similar agreements in the future or to respect any particular international law.

RULES-BASED SYSTEM

On Day One, the United States would have a vital interest in preserving the global economic and trading system. By this, we do not mean the abstract concept of the “liberal international order.”[8] We mean the legal and political structures that underpin the free flow of international trade, prevent US adversaries from engaging in egregious economic coercion, and manage the responses to economic crises. Multilateral institutions such as the WTO, IMF, and World Bank play key roles in maintaining this system, as do smaller blocs of countries, including the G7 and G20. The system is also sustained through norms and historical path dependencies.[9]

For all its flaws, the existing system provides enormous strategic benefits to the United States. These include:

- Incentives and institutions to prevent a sudden collapse of international trade, which would devastate US prosperity.
- Structural guarantees that global trading rules cannot be rewritten in ways that disadvantage the United States and its allies.
- A mechanism for preventing US adversaries from bringing smaller countries—including in the Western Hemisphere—under their control through economic coercion.
- A mechanism for aligning interests between the United States and its allies and partners, signaling that it is safer to align with the United States than with US adversaries.
- A legal framework for imposing costs on US adversaries when they violate the system's rules and norms and for controlling the export of sensitive technologies through long-arm jurisdiction sustained by the position of the dollar.

These strategic and material benefits underpin US economic prosperity at home and facilitate US actions to protect its security interests around the world. They are longer-term structural interests that should be protected, if possible.

After the collapse of the Soviet Union in 1991, the United States pursued a vision of globalization that involved integrating former adversaries into the existing rules-based trading system. Russia and then the PRC were invited to accede to the WTO, on the assumption that history had repudiated the Communist model and that integration into the global system would facilitate economic and ultimately political liberalization.[10] In the process, the United States and its allies and partners became economically dependent on Russia and even more so on the PRC. This assumption has proven false with regard to Russia. A PRC attempt to seize Taiwan by force would prove that the assumption was entirely incorrect.

Following a Taiwan crisis, the system would face a high risk of collapse. The United States would be inclined to erect barriers to international trade, as would many other countries. Day One would be a moment without precedent since the signing of the General Agreement on Tariffs and Trade (GATT) in 1947, the foundational document of the WTO. A Taiwan crisis would provide an open-ended excuse for states to cite the national security exemption in Article XXI of the GATT Charter to justify any trade policy they liked. Either the United States or the PRC could potentially weaponize procedural rules that would render the WTO and IMF incapable of responding effectively to these challenges. The risk of the rapid unraveling of the global economic system would be higher than at any point since the 1920s.

Many argue that a PRC blockade or quarantine of Taiwan would threaten the viability of the rules-based trading system nearly as much as invasion. A physical close blockade of Taiwan has been a concern since the early 2000s, although it would be challenging to execute.[11] Robert Blackwill and Philip Zelikow have recently highlighted the quarantine scenario, in which the PRC Coast Guard would run "a clearance operation offshore or in the air to screen incoming ships and aircraft." As Blackwill and Zelikow point out, a targeted quarantine—for instance, one directed specifically at US arms supplies—would put Washington in an extremely difficult position.

Blockades and quarantines are less bloody than invasions, but they are no less violent.[12] As Thomas Schelling observed in *Arms and Influence*, his famous book on nuclear coercion, "the power to hurt is bargaining power," and "latent violence" when used as geopolitical blackmail can be an even more effective tool of domination than physical violence.[13] A blockade or quarantine of Taiwan would have the character of an ultimatum: submit totally to Beijing's authority or starve. If Taiwan crumbled under blockade or quarantine, US treaty allies, including South Korea, Japan, and the Philippines, would become vulnerable to similar tactics in the future. The rules-based economic system could not survive in its current form if the main regional power in the world's most important trading region were allowed to use this violent tactic indiscriminately against its neighbors.

In short, the rules-based trading system would face risks and challenges on and after Day One, regardless of what the United States and its Core allies decided to do:

- If they left the system essentially unchanged, they would allow themselves to remain vulnerable to economic coercion by a rogue authoritarian state that pursues territorial expansion through force. If the PRC succeeded in absorbing Taiwan and establishing regional hegemony in Asia, a future China-led coalition might, in time, co-opt the system or break it and build a new one that served the PRC's interests first.

- If they exited the system and retreated into economic autarky and strategic isolationism, they would gravely damage long-term US economic interests abroad, as well as potentially allow the PRC to co-opt or replace the system.

- If they sought to revitalize the system for a post–Day One era while unraveling their economic dependencies on the PRC, they would need a concept for preventing the system's collapse.

The US interest in preserving the rules-based trading system would be widely shared with allies, partners, and neutral states alike. If Day One were followed by a rapid collapse in global trade, it could take decades to restore the integrated global economy that had existed prior to Day One. For trade-dependent industrialized economies, such as the European Union (EU) and South Korea, as well as industrializing economies such as Brazil and India, which depend on open global markets, this would be an unmitigated disaster.

DOLLAR HEGEMONY

The United States has an extremely important national interest in preserving dollar hegemony. Among other economic benefits, dollar hegemony gives the US government the unique ability to enforce sanctions and export controls extraterritorially. Existing US sanctions play an essential role in preventing Russia, Iran, and North Korea from developing economically in ways that threaten the United States and its allies. The United States and allied countries also enforce export controls such as the Foreign Direct Product Rule through threats of civil and criminal penalties, denial of export licenses, administrative sanctions, and in severe cases dollar sanctions from the Treasury Department against offending firms.[14] These tools prevent dual-use US technologies from falling into the hands of rival militaries and being used against US and allied forces. Dollar hegemony also affords the US government unique enforcement capabilities. Most international trade is invoiced in dollars, and transactions are settled on the messaging platform SWIFT and the settlement platform CHIPS. The US government has a broad ability to monitor transactions on both systems.

Although the dollar faces little risk of being dethroned by a single rival currency, particularly the RMB, its power is gradually being eroded.[15] The RMB's lack of convertibility and shallow capital market make it unsuitable to replace the dollar as a reserve currency.[16] However, it is notable that the "BRICS" countries—originally Brazil, Russia, India, China, and South Africa, and now including Iran, Egypt, Ethiopia, and the United Arab Emirates—have signed agreements in principle to support de-dollarization.[17] US sanctions on Russia have accelerated the global process of de-dollarization. China now settles nearly half of its international trade in CNY, although much of this trade still involves an intermediate exchange of dollars. As rogue states, such as Russia and Iran, migrate their trade away from the dollar and onto China-controlled payment systems, it is becoming increasingly challenging for the US Commerce Department to enforce export controls. If this process of gradual de-dollarization in trade continues, the threat of dollar sanctions against noncompliant actors will weaken further. In the event of a Taiwan crisis, the PRC would accelerate its efforts to erode the position of the dollar. For the reasons discussed below, a Taiwan crisis by itself would likely strengthen dollar hegemony. However, if Washington imposed or threatened to impose dollar sanctions on the PRC after Day One, it might accelerate the shift toward a multi-currency system by incentivizing third countries to ramp up their de-dollarization efforts. Part 2 will discuss this issue in more detail.

The United States therefore has an interest in ensuring that whatever economic action it takes following Day One sustains dollar hegemony rather than undermining it. Notably, US allies and partners do not necessarily share the US interest in preserving dollar hegemony. Many, especially in Europe, would prefer a multi-currency system in principle.[18] However, in a world thrown into turmoil following Day One, many countries may prefer dollar hegemony to a world in which existing US sanctions against Russia, Iran, and North Korea stopped working effectively.

PUNISHING THE PRC

Finally, on Day One, the United States would have a strategic interest in punishing the PRC economically to impose a price for its bad behavior. If the United States threatened economic punishment before Day One, delivering on the threat would preserve the credibility of future US deterrent threats. In a prolonged conflict scenario, economic punishment could support a strategy of attrition against the PRC's war machine and degrade the PRC's ability to challenge US primacy in other regions. Economic punishment might help coerce the PRC to moderate its political aims for Taiwan and the broader region. If US–China political relations completely collapsed, economic pressure could also in principle become a way to push for regime change.

In certain circumstances, the US may have an interest in imposing intense economic pain on the PRC for an indefinite period of time. However, as long as the PRC is integrated into the world economy, few other countries are likely to share this interest. US policymakers need to bear this fact constantly in mind.

IMMEDIATE MARKET REACTIONS

The financial market reaction to Day One would likely be immediate and severe—and might well mark the high point of US financial power. As during other periods of heightened risk, including COVID-19, global investors would likely flee to safety in US Treasury securities and US bank deposits, as well as Swiss francs and gold. Financial markets may price in some risk as tensions mount in the weeks and days leading up to the first shots being fired. If this line were crossed, panic could ensue. There could be bank runs and liquidity crises across the world. PRC monetary authorities would likely tighten capital controls to prevent a systemic crisis.[19] The chain reaction of impacts would be both relatively advantageous to the United States and disadvantageous to the PRC in the immediate aftermath—but not necessarily in the long term.

FACTORS SHAPING THE MARKET RESPONSE

In general, markets would react dynamically to the perceived risk of economic and military escalation between the United States and the PRC, as well as the risk of the permanent loss of Taiwan's semiconductors.[20]

1. Markets would start to price in whatever threats of economic action Washington had made in advance of Day One, discounted according to the credibility of the threats.
2. Markets would react negatively to the probability of crisis escalation. In the dynamic context of Day One, the risk of escalation to a world war could be substantial and hard to quantify. The result would likely be a flight to safety, with a spike in volatility across all global financial markets and fire sales of risky assets in emerging and frontier markets and trade-dependent economies.

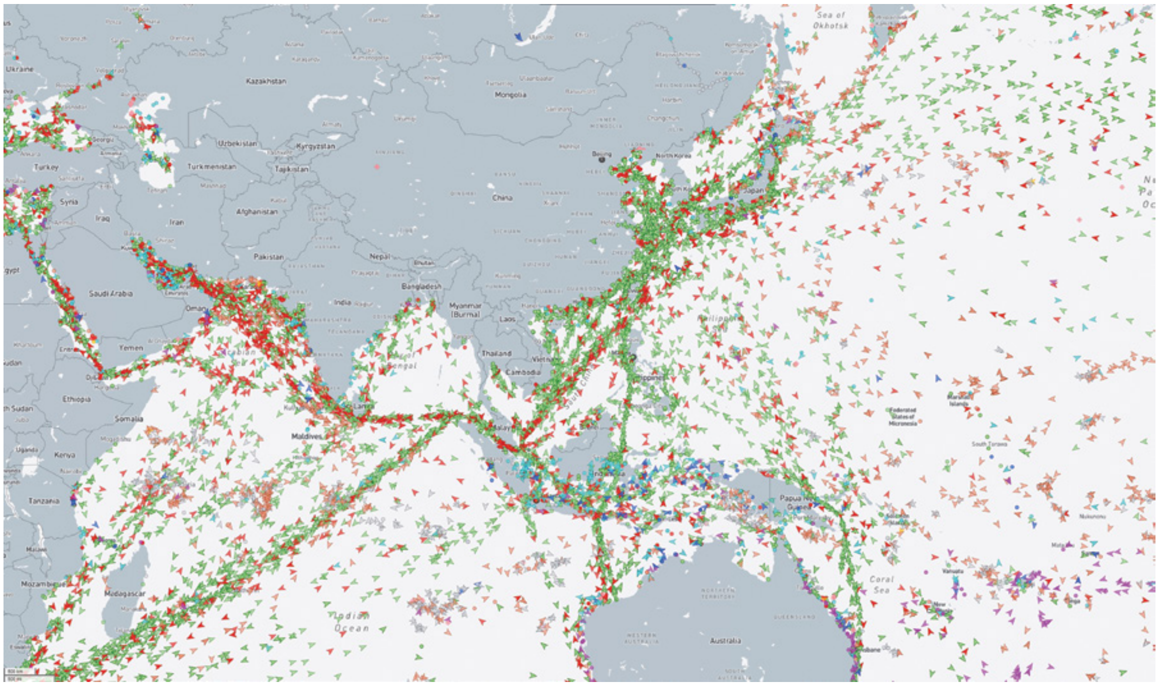
US advance statements about the character of the economic response would play the most important role in shaping the market reaction. If the United States shrugged off the PRC's move against Taiwan and declined to get involved, the market reaction could be muted. If more significant conflict was coming, however, market participants would want to get ahead of US government action by buying or selling relevant assets in advance. Estimates suggest that a total collapse in US–PRC trade could produce a 5–10% contraction in global GDP in the first year.[21] However, if Washington threatened this, market participants would also try to assess the credibility of the threat. If the market assessed that Washington was unable or unwilling to follow through on the threat, it would price the risk only partially and wait for more information.

Markets would also price in PRC escalation risks. If Japan signaled that it would join a decisive response, for example, the PRC could target civilian infrastructure on the Japanese mainland.[22] Markets would also assume a significant probability that even *without* a kinetic war, Taiwan's role in the global economy would be significantly curtailed and that the US–China conflict might escalate over time into the economic or financial domain, depending on what Washington said it would or would not do on Day One. Beijing might seek to expropriate Taiwan's semiconductor manufacturing base and cut off the supply of finished products to the rest of the world. Alternatively, the crisis might result in the destruction of Taiwan's semiconductor manufacturing base and ongoing disruptions to regional supply chains. Markets would respond dynamically as new information emerged.

Markets would be particularly concerned about the risk of escalation to kinetic war and its medium- and long-term effects on international trade. A kinetic war could badly disrupt commercial shipping in maritime East Asia (see fig. 1) and, in some scenarios, shut it down altogether for many months. Fully 48% of the world's 5,400 operational container ships passed through the Taiwan Strait in the first seven months of 2022, including 88% of the largest 10% of container ships.[23] Merchant ships sailing through an active war zone would cost a fortune to insure, if they were insurable at all. Littoral Asian states such as Japan and South Korea would try to redirect ships out of range of the conflict, but this might not be possible, since in a naval war over Taiwan, much of the fighting would take place in the waters of the Philippine Sea, on the eastern side of the First Island Chain.[24] With supply routes disrupted, prices for goods dependent on PRC components would spike. At least $3 trillion in annualized trade and financial flows, not including foreign reserve assets, might be disrupted.[25] There would also be the lingering question of how fast, if at all, these supply chains could heal after a war.

A blockade or quarantine of Taiwan would have less predictable effects on supply chains, but the financial reaction might also be extreme. In these scenarios, the economic effects would depend largely on the nature of Beijing's actions and Washington and Taipei's responses. The PRC Coast Guard might harass and forcibly board or redirect all noncompliant vessels and aircraft. Private carriers would be inclined to comply with Beijing's dictates; however, the authorities in Taipei might try to stop them, lest all the island's essential trade fall under Beijing's control. Washington might respond with a massive show of military force and a resupply effort, alongside other measures. Washington might also respond with political signals of commitment to Taiwan, which could involve a major revision or even abandonment of the One China Policy.[26] It is unclear under exactly what circumstances Taiwan's semiconductor facilities would shut down, but this would probably happen very soon after a blockade or quarantine were imposed.[27]

FIGURE 1 Cargo ships in Western Pacific sea-lanes, October 18, 2023



Source: MarineTraffic, accessed October 18, 2023, https://www.marinetraffic.com.

LESSONS FROM THE OUTBREAK OF WORLD WAR I

Today's political leaders have no experience of a great power war and financial crisis breaking out simultaneously, but the case of June and July 1914 sheds some light. If markets responded as they did upon the assassination of Archduke Franz Ferdinand on June 28, 1914, a global financial crisis could follow immediately, unless central banks took decisive action to prevent it. The forty years before Franz Ferdinand's assassination had been a time of relative peace in Europe and America, as well as rapid industrialization and technological innovation that created globalized systems of trade and information exchange. In 1870, trade accounted for 10% of global GDP. In 1913, on the eve of the war, it had risen to 22% of global GDP.[28] Today, international trade amounts to 57% of global GDP. The macroeconomic and financial ripple efforts of a US-China war today could be correspondingly greater.[29]

To understand the potential ramifications for the global reserve currency, it is worth considering the case of Britain, which in 1914 was the financial center of the pre-war economy—and, as the United States would be in a Taiwan crisis, a participant with a homeland geographically removed from the conflict. Franz Ferdinand's assassination sparked fears of war and a mass panic on stock exchanges across the globe. Europe had not seen a great power war in nearly five decades, a fact that heightened both the uncertainty and the resulting market response.

(*continued*)

Reflecting on the crisis, Permanent Secretary of the Treasury John Bradbury put it this way to Prime Minister H. H. Asquith:

> The absence of any experience of the effect of war between the leading commercial nations since the establishment of the machinery of modern commerce would in any case have made the situation created by the outbreak of a general European war a serious one for the City, and the rapidity with which the crisis developed during the last few days of July produced for the moment a condition of the nature of paralysis.[30]

The cause of this paralysis was a mass flight out of securities, bills of exchange (then the main currency trading instrument), and long-term debt and into gold and above all sterling.[31] Across Vienna, Berlin, Paris, London, and even New York, depositors rushed to withdraw funds from banks, which in turn began to call in loans and dump securities. Trading houses involved with trade with Germany and its allies were worst exposed, but so many banks faced cash withdrawals that the Bank of England asked Bradbury to suspend gold convertibility.[32] Instead, the Treasury decided to close most exchanges—in order, as Bradbury put it, "to enable people to get their bearings."[33] All this took place days before all the belligerents had officially declared war. The London Stock Exchange did not reopen until the following January, and even then with stringent restrictions on "speculative trading."[34]

Importantly, the rush into sterling came at the expense of the dollar, even though the United States was neutral. The fact that Britain was itself a belligerent mattered less than the fact that London was the global financial and trading center. The outbreak of a US-China war could trigger an even more intense scramble for safe assets. In 1914, public debt represented 23% of global GDP, and only industrialized countries had large quantities of debt. As of 2022, the equivalent figure was 92% of global GDP. No equivalent data series exist for global private debt in the early twentieth century, but according to the IMF, global private debt has more than doubled since 1950, rising from 105% to 242% of GDP.[35] Today, the specter of a possible imminent US-China war would force all investors to scramble to move their capital into the safest assets available. Only a few capital markets are deep enough to absorb trillions of dollars of inflows quickly.

One key difference between 1914 and today is that in a world of fiat money, central banks could and almost certainly would intervene decisively. If successful, these steps could manage the risk of global financial contagion and depression. However, they would be unlikely entirely to reverse the sharp movement in currency markets that would probably occur soon after Day One.

CURRENCY MARKETS

On Day One, the dollar would likely surge in value. Only a small number of assets consistently appreciate in moments of geopolitical crisis and "risk-off" sentiment. The dollar is one of them, as are gold and a handful of other "safe haven currencies."[36] In a Taiwan crisis, alternative assets, such as cryptocurrencies, may absorb some of the risk-off flows. However, there are several reasons to believe that the dollar would rally, at least at first. In geopolitical crises, investors tend to demand assets that are both safe and liquid. The US dollar is by far the world's most liquid currency. It is widely accepted in global trade, and most commodities, such as oil and gold, are priced in dollars. The currencies of the Gulf States are pegged to the dollar. Flows of capital into the United States drive up the demand for dollars and, consequently, its value. By contrast, as with America during World War I, economies that are more dependent on export-dependent manufacturing, such as the European Union, are exposed to a collapse in global demand and disruption to global supply chains.

In 1914, the gold standard checked the extent to which sterling could appreciate—a limiting factor that would not apply to the dollar if a Taiwan crisis broke out today. In a world where currencies trade freely and, in practice, the Federal Reserve underpins the global financial system, there is no single institutional check on the extent to which the reserve currency can appreciate. Most global trade today—including half of the PRC's overseas trade—is settled in dollars. Global central banks currently hold 58.41% of their FX reserves in dollars, as of Q42023, followed by euros (19.98%), yen (5.70%), and sterling (4.84%). Total reserves held in CNH amounted to 2.29%—less than the Canadian dollar.[37] During times of crisis, there is often increased demand for dollars to facilitate international transactions and meet financial obligations, which can drive up its value. Central banks of countries experiencing currency depreciation may increase their holdings of US dollars as a precautionary measure to ensure that their countries will be able to meet their import needs. (Central banks might behave differently if dollar sanctions on the PRC were on the table. In that scenario, the central banks would need to hedge in case their political leaders chose to continue to trade with the PRC in other currencies. A clear commitment not to impose dollar sanctions is therefore an essential prerequisite to ensuring that the dollar would appreciate on Day One.)

While the dollar strengthened, capital would likely try to flow out of the PRC, putting more pressure on PRC capital controls. As a result, there would also be downward pressure on both the onshore CNY and offshore CNH. PRC monetary authorities actively manage both currency markets using a variety of public and hidden tools.[38] In 2017, the People's Bank of China (PBoC) adopted a "countercyclical adjustment factor," committing in essence to intervene to stabilize the currency in moments of "irrational" or "procyclical" market action.[39] The PBoC has also intervened in offshore markets before, selling dollars to push up the CNH exchange rate.

In short, Day One would probably see substantial dollar strengthening and substantial weakening in the CNY and CNH. Beijing, as the instigator of the crisis, would presumably have prepared in advance to prevent uncontrolled capital outflows and bank runs, so the PRC's financial system would probably not collapse of its own accord. Third countries that depend on the PRC market for imports and exports, run current account deficits, and pay for their imports in dollars would probably bear the greatest pain. This category of states, which includes much of the developing world, would also be exposed to capital flight, and would likely require emergency dollar liquidity from the Federal Reserve to prevent outright financial crisis. Thus, even if the United States were engaged in a kinetic war with the PRC, the market's flight to safety on Day One would probably mark the high watermark of US financial power. Thanks to its position as the global reserve currency, the dollar would likely strengthen—as long as the United States had signaled in advance that it would not impose dollar sanctions on the PRC. However, this situation could change quickly, especially if Washington overplayed its hand economically and entered a war in which US forces struggled.

SECOND-ORDER EFFECTS

Assuming the dollar strengthened and the CNY weakened at the start of a crisis, a variety of significant second-order effects would result. Rapid dollar strengthening would compound the global economic crisis. A strong dollar is good for the US consumer, who buys goods denominated in other currencies, but bad for consumers in other countries, who use their own currencies to buy commodities and other goods denominated in dollars. This currency effect would compound price increases resulting from supply chain disruptions and shortages. The economic pain would be felt most acutely in the developing world. Poorer countries would therefore face strong political pressure to seek ongoing external support, including emergency financing from the United States, the PRC, or both countries.

Massive dollar strengthening would cause political complications within the United States. Dollar strength reduces the competitiveness of US exports and historically has been associated with domestic political pressure for protectionism, devaluation, or both. During the recession of the 1890s, for example, the United States responded to the effects of an overly strong dollar by increasing tariffs rather than breaking from the gold standard.[40] Similarly, between 1981 and 1982, when Fed Chairman Paul Volcker's interest rate hikes caused the dollar to strengthen and three million manufacturing jobs were lost, the Reagan administration and Congress responded with tariffs.[41] The share of US imports subject to trade restrictions rapidly rose from 12% to 21%.[42] After the 1984 election, the Reagan administration then used the Plaza Accord to weaken the dollar against the yen and leading European currencies, using the threat of additional tariffs as a negotiating tool.[43] Reagan later imposed 100% tariffs on Japanese electronics and 200% tariffs on key exports from the European Economic Community. Both tariffs provoked swift changes in policy, particularly in Japan. If the dollar strengthened sharply following a Taiwan crisis, there could be domestic political pressure in the United States calling for either a weaker dollar, or trade barriers to protect US industry.[44] The United States would need to be able to overcome its protectionist instincts.

Meanwhile, a weakening CNY would provide a massive competitive advantage for the PRC's export sector. The PRC's newfound export advantage might not be immediately obvious, especially if physical conflict in the Taiwan Strait made it hard for cargo vessels to acquire insurance to operate within the First Island Chain. In the longer run, however, if the PRC's currency remained very weak, the global economy would be flooded with cheap PRC products. In the late 2000s and early 2010s, when the PRC kept the CNY up to 30% cheaper than its fair market value, its manufacturing sector grew at double-digit compound rates, rapidly gaining global market share.[45] The PRC has since risen up the value chain, so a sharp weakening in the CNY exchange rate in the near future could have an even bigger effect. This would also have global political implications. Industrialized and industrializing countries in Europe, Asia, Latin America, and elsewhere might consider erecting trade barriers to protect their domestic producers from being ravaged by PRC competition. The United States would have to manage this trend carefully to harness it to its advantage, since challenges to the rules-based trading system would likely emerge from multiple quarters.

To summarize, the precise scope, duration, and character of the Day One economic crisis would depend on circumstances and is impossible to pinpoint in advance. What is clear is that on Day One, developed and developing economies would face a moment of extreme peril and uncertainty. The potential combination of a much stronger dollar and a much weaker CNY would threaten to upend the global economy, exacerbate the financial crisis, and stress the rules-based trading system. In that context, the world would look to the United States not to deepen the crisis but to provide economic leadership.

US ACTIONS LIKELY IN ALL CONTINGENCIES

FEDERAL RESERVE ACTION

In all plausible Taiwan crisis scenarios, particularly those involving kinetic conflict, the Federal Reserve would have to act decisively on or shortly after Day One. The Fed is formally independent, with a dual mandate to maintain stable prices and full employment. In practice, the Fed's role in crisis management has expanded in recent years to reflect lessons learned in the 2007–8 global financial crisis.[46] In a Taiwan contingency, the Fed would likely coordinate its actions closely with the White House and Treasury and act decisively, as necessary, to reassure markets and preserve global financial stability.

One of the first steps the Fed would likely take would be to extend dollar swap lines to key foreign central banks.[47] The Fed last did this at the beginning of the first COVID-19 wave, citing the need "to maintain the flow of credit to US households and firms, reduce dislocations to US financial markets emanating from financial turbulence abroad, and, by supporting foreign growth, maintain export markets for US producers."[48] In some Taiwan crisis scenarios, the Fed might need to go further, providing dollar liquidity in larger quantities and to a broader set of central banks. The Fed might also slash interest rates and activate emergency lending facilities as it did during the pandemic, pursuant to its emergency authority under Section 13(3) of the Federal Reserve Act.[49]

Access to dollar liquidity would enable foreign central banks selected by the Fed to extend zero-interest loans and other support to their own systemically important firms.[50] Offering the swap lines would serve US national interests because the US economy would suffer if major banks and industrial firms in allied countries collapsed. More broadly, it would serve US interests to stabilize the macroeconomic shock in strategic partner countries, cultivate diplomatic goodwill, and demonstrate a commitment to supporting the global economy through the crisis and into the postwar period to come.

If supply chain disruptions produced large-scale shortages, inflation would result, and the Federal Reserve would find itself in a challenging position. Managing inflation would eventually require raising interest rates, which would further strengthen the dollar. However, raising interest rates would exacerbate the global economic contraction and make it harder for struggling firms to avoid laying off workers. In such a situation, the Fed would probably face political pressure to tolerate inflation and keep rates low and the dollar weaker, even though this course of action could lead to major challenges down the road if inflation became entrenched.

It is impossible to plan a specific course of Fed action on Day One. The president and Congress could not legally force the Fed to take specific actions in a crisis. However, in recent years, the Fed has acted pragmatically to help mitigate major crises. Whatever economic course of action US political leaders chose to adopt on Day One, it is reasonable to assume that the Fed would try to support it rather than undermine it.

EXPORT CONTROLS

In any Taiwan crisis scenario, the Commerce Department would likely seek to extend and broaden export controls on critical technology to the PRC. Some critical supply chains would likely be broken as a result, and reshoring them as fast as possible would be a national security imperative. Close cooperation between the US government, allied governments, and the private sector would be essential. In the strategic context of Day One, export controls would be a policy of self-defense to ensure that US technology is not used to harm US troops or the citizens of US allies. Export controls would not, in and of themselves, constitute a major punishment against the PRC.

RESHORING OF CRITICAL SUPPLY CHAINS

In any Taiwan crisis scenario, the US government is likely to move to reshore the supply chains of some critical goods, such as active pharmaceutical ingredients, and expand stockpiles of critical inputs, such as rare earths. The context of the crisis would determine the scale of the industrial policy and government expenditures required.

THE “BREAK-GLASS” POLITICAL SCENARIO

On Day One, as US lawmakers were deciding on the nature of the US economic response, they would have to take all these factors into consideration. Given the dynamic nature of the crisis, lawmakers would have neither the time nor the institutional bandwidth to design an entirely original policy response from scratch. The initial choice would be simple: hit the PRC with symbolic retaliation and focus on domestic economic support and recovery; or adopt a more assertive policy that would meaningfully transform the US–China economic relationship.

Lawmakers would undoubtedly face considerable pressure from a wide range of constituencies to let the PRC off with an economic slap on the wrist. Wall Street and Main Street would likely be united on this point. Big and small businesses would partner with labor unions to lobby Congress and the White House not to take actions that would exacerbate the economic crisis for the United States. These groups would have a legitimate reason to fear that economic conflict with the PRC could be disruptive and significantly harm their vested interests. Regardless of how egregiously the PRC had moved against Taiwan—even if the PRC had fired first, killing Americans in the process—many would argue, if only in private, against taking any actions to disrupt the economic relationship. Depending on the political context, these groups may get their way. The case of Russia sanctions in February 2022 illustrates this point. Facing a much weaker economic adversary, the Biden administration accommodated interest group pressure to design sanctions in ways that minimized the economic costs to the United States and its Core allies. For example, partly to keep gas prices low for US consumers, the Biden administration's General License 8 gave exemptions to Russian banks so they could continue to facilitate Russia's energy exports.[51]

Despite the temptation to give the PRC a pass economically on Day One, there are many scenarios in which inaction is not a serious option, either politically or strategically. As will be discussed in Part 2, multiple US senators, congressmen, and former officials already believe that it would be necessary to break the bilateral economic relationship immediately after Day One.[52] The rest of this report focuses on this universe of scenarios, which we call by the umbrella term "break-glass" political scenario. In this event, the context of the PRC's actions on Day One persuades the White House and a bipartisan majority in Congress that the United States has no choice but to end its economic relationship with the PRC. We do not take a position on what exactly the PRC might have done to trigger such a bipartisan consensus. Our claim is simply that there are clearly multiple plausible pathways that could produce the break-glass political scenario in the near future and that the United States government therefore needs a plan for them.

The question, then, is the following: *Conditional on the PRC having moved against Taiwan and US lawmakers deciding that full decoupling is necessary, what is the best way to achieve decoupling?* Put another way: How could the United States achieve this goal in a manner that supports its key economic interests rather than undermining them—at the lowest possible cost to the taxpayer and consumer and the greatest possible cost to the PRC? How could the United States harness the financial reaction to Day One and leverage its unique financial incumbent advantages to sustain the rules-based trading system and dollar hegemony through this process of decoupling while maintaining its leadership and effective cooperation with a wide range of allied and neutral countries?

PART 1: CORE TAKEAWAYS

- On Day One, the United States would have several important economic and strategic interests other than punishing China. Policy would have to reflect a balance between these interests.

- In the context of Day One, a wide range of allied and neutral countries would share at least some of these interests with the United States.

- Potential market reactions vary widely across scenarios, depending on the anticipated US economic reaction, the plausibility of US threats, and the perceived likelihood of escalation to major conflict.

- Markets would react dynamically, taking cues from US statements and actions, as well as perceived escalation risks.

- In all scenarios, the dollar would likely strengthen, and the CNY and CNH would likely weaken. However, the magnitude of this effect is unknowable, and the trend could reverse over time, depending on US economic action and the outcome of the conflict.

- On Day One, US lawmakers would be under considerable domestic and international pressure to limit their response to symbolic sanctions. This report focuses on the break-glass political scenario in which there is bipartisan demand for a more substantial economic response.

PART 2: THE PROBLEM WITH HARD DECOUPLING

According to current thinking, Washington's economic option for break-glass Taiwan scenarios is to use the dollar weapon, and perhaps physical blockades as well, to trigger a financial crisis in the PRC and force a hard decoupling.[53] This section unpacks some of the flaws in that analysis. As we saw in the previous section, the United States would have important economic interests at stake on Day One that have nothing to do with punishing the PRC. Even if a hard decoupling could be achieved, it would advance one US economic interest at the expense of all the others.

The first argument against hard decoupling is impossible to ascertain in advance but would be decisive if true: that the PRC might prove resilient to the shock. The initial market reaction to a Taiwan crisis would present an unprecedented test for the PRC's financial sector. Washington could compound that blow if it imposed sweeping blocking sanctions on PRC financial institutions. Nevertheless, Russia's experience in 2022 provides a playbook for how PRC authorities could stabilize their own financial system in the medium term. If the PRC's financial system proved resilient to this initial shock, Washington would be left out of proverbial ammunition.

Meanwhile, the disruption to global supply chains would devastate the economies of US allies and partners, undercutting allied unity. In the worst-case scenario, a botched attempt to enforce dollar sanctions could break the rules-based trading system itself, push much of the world into a PRC-led trading bloc, and permanently undermine dollar hegemony. It is doubtful whether Washington could force the European Union to go along unwillingly with a hard decoupling, let alone developing economies that have not joined sanctions against Russia.[54]

In a crisis, most of the world would want to continue to trade with the PRC, whatever Washington did. If the United States tried to interfere, the PRC would be willing to pay a premium over the prevailing global price to access essential imports, so prices would rise and neutral countries and firms would face incentives for arbitrage. Meanwhile, the same arbitrage mechanism would help neutral countries acquire essential exports from the PRC. If the PRC were unable to settle trade in dollars, it could simply pull its trading partners onto CIPS and settle its trade in CNH or CNY instead. Thus, even close US allies would face incentives not to comply with a sanctions regime or even to collude to degrade it over time. As the United States learned in advance of Russia's invasion of Ukraine, only a few allies would be willing to commit in advance to automatically triggering sanctions that would cripple their own economies.

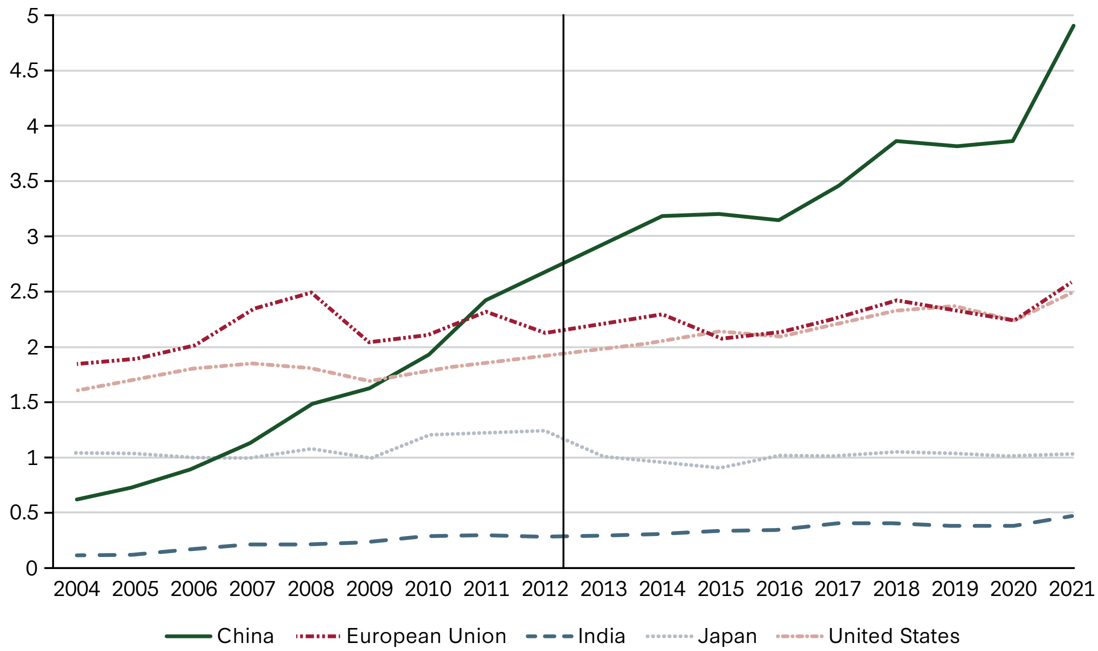
Worse, threats to use dollar sanctions to force broad trade decoupling undermine US efforts to maintain technological dominance through the "small yard, high fence" strategy.[55] Fundamentally, US export controls are enforced through the threat of dollar sanctions. There is no other realistic pathway for the US government to exercise long-arm jurisdiction over products that are only partially composed of US components and that circulate freely around the world, beyond the reach of US customs authorities. If Washington's first reaction to a Taiwan crisis were to impose secondary sanctions, it would also be weakening its ability to enforce export controls, which could put American lives at risk in a kinetic conflict.

THE THREAT

Economic decoupling was an explicit threat under the Trump administration, and it remains an implicit threat under Biden. "So when you mention the word decouple, it's an interesting word," President Donald Trump said in September 2020. "We will make America into the manufacturing superpower of the world and will end our reliance on China once and for all. Whether it's decoupling, or putting in massive tariffs like I've been doing already, we will end our reliance on China, because we can't rely on China."[56] When Biden took office in 2021, his team distanced itself from the word "decoupling," which antagonized US allies.[57] As National Security Advisor Jake Sullivan put it in April 2023, "We are for de-risking and diversifying, not decoupling."[58] However, the Biden administration's claim that it would not decouple from the PRC in peacetime arguably strengthened the implicit deterrent threat that decoupling is contingent on the PRC's behavior.

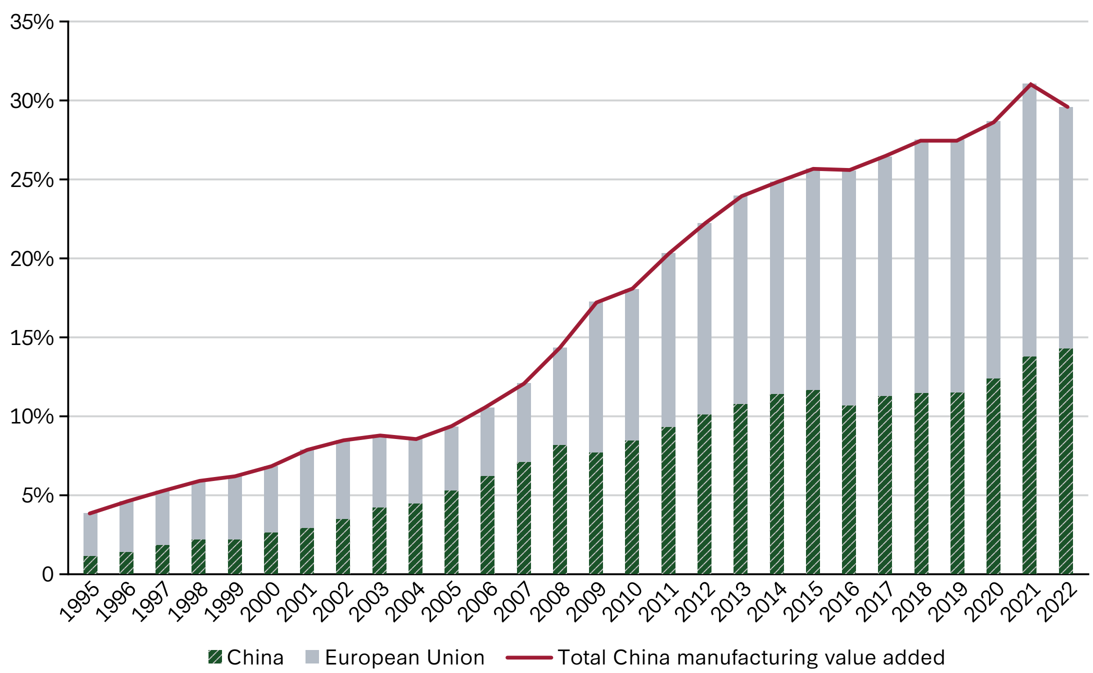
In principle, the PRC is extremely vulnerable to economic decoupling. Its model of political economy remains heavily dependent on global trade. It now represents nearly one-third of global manufacturing value added (see figs. 2 and 3). Over two hundred million PRC citizens—nearly one-third of the workforce—are employed in manufacturing. The domestic market is far too small to absorb this vast output, so about half of the PRC's manufactures are exported.[59] The PRC derives a greater share of its GDP from manufacturing than any other country except Ireland (see fig. 4). As Matthew C. Klein and Michael Pettis have noted, the PRC has built its manufacturing juggernaut through policies of financial repression that hold back domestic consumption.[60] Given that the PRC consumes much less than it produces, the rest of the world must consume more than it produces. In theory, then, the United States could punish the PRC by forcibly clawing back manufacturing jobs.

FIGURE 2 Manufacturing value added, in trillion USD, 2004–2021



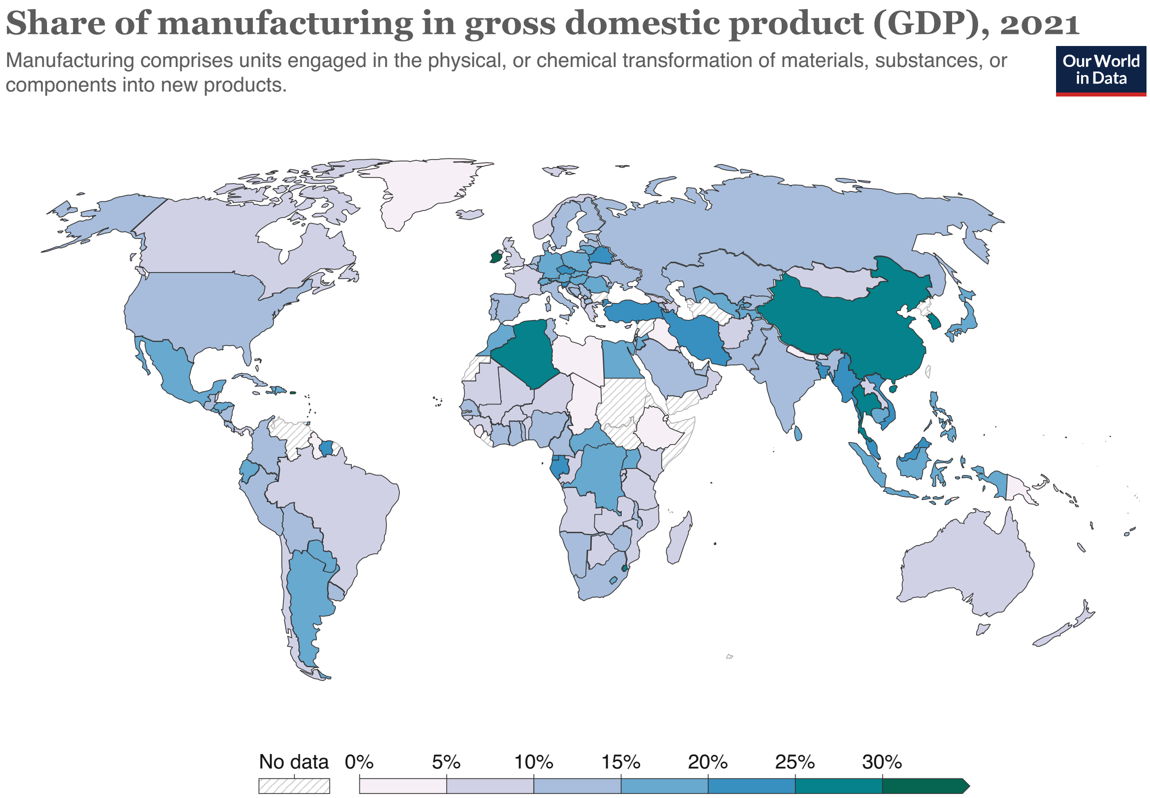
Source: Data from World Bank, "Manufacturing, Value Added (Constant 2015 US$)," https://data.worldbank.org/indicator/NV.IND.MANF.KD.

FIGURE 3 The PRC's share of global manufacturing value added



Source: Re-created from Andrew Batson, "Breaking Down China's Manufacturing," The Tangled Woof (blog), June 13, 2023, https://andrewbatson.com/2023/06/13/breaking-down-chinas-manufacturing; data from OECD, Trade in Value Added, TiVA database, accessed May 23, 2024, https://www.oecd.org/sti/ind/measuring-trade-in-value-added.htm#access.

FIGURE 4 Manufacturing as share of GDP, 2021



Source: "Share of Manufacturing in Gross Domestic Product (GDP), 2021," Our World in Data, data as of May 29, 2023, https://ourworldindata.org/grapher/manufacturing-value-added-to-gdp?time=2021.

Prominent US experts have recommended threatening the PRC with rapid decoupling through trade sanctions to deter aggression against Taiwan. In 2023, the Independent Task Force of the Council on Foreign Relations (CFR) discussed this issue in a major report, "US-Taiwan Relations in a New Era," endorsed in whole or part by seventeen luminaries, including Michael G. Mullen, former chairman of the Joint Chiefs of Staff, and Michèle A. Flournoy, former under secretary of defense for policy. The report argues that the economic damage of a PRC attack on Taiwan would be such that if sufficiently understood, the US public and allied nations would be prepared to commit to deterrence through economic sanctions, using anti-Russian sanctions over Ukraine as a baseline.[61] As a result, it recommends that the United States should immediately begin "intense consultations" with allies and partners "on the scope of a sanctions package that would be introduced immediately after a Chinese blockade or attack, while urgently working to lessen economic dependence on China."[62] Others argue that while economic sanctions are not a credible deterrent, a hard decoupling would be likely in any conflict scenario. In their recent report for CFR, Robert Blackwill and Philip Zelikow suggest that "the United States would cut off, and strictly control, any business transactions or dollar transactions with China. No trading with the enemy would be conducted" and US entities, including the Treasury, would stop paying interest on bonds held by PRC entities.[63] Many scholars and practitioners also assume that the United States could intensify the pressure with a counter-blockade of Chinese trade at the Straits of Malacca.[64]

The president has the authority to impose a range of sanctions on the PBoC, leading PRC financial institutions, and important PRC industrial firms engaged in shipbuilding and other sectors.[65] The Sanctions Targeting Aggressors of Neighboring Democracies with Taiwan Act (STAND Act) of 2022 would automatically trigger a raft of such sanctions on Day One, following a congressional resolution finding that the PRC had attacked Taiwan.[66] The House Select Committee on the CCP has endorsed the basic idea of automatically triggering sanctions in principle.[67]

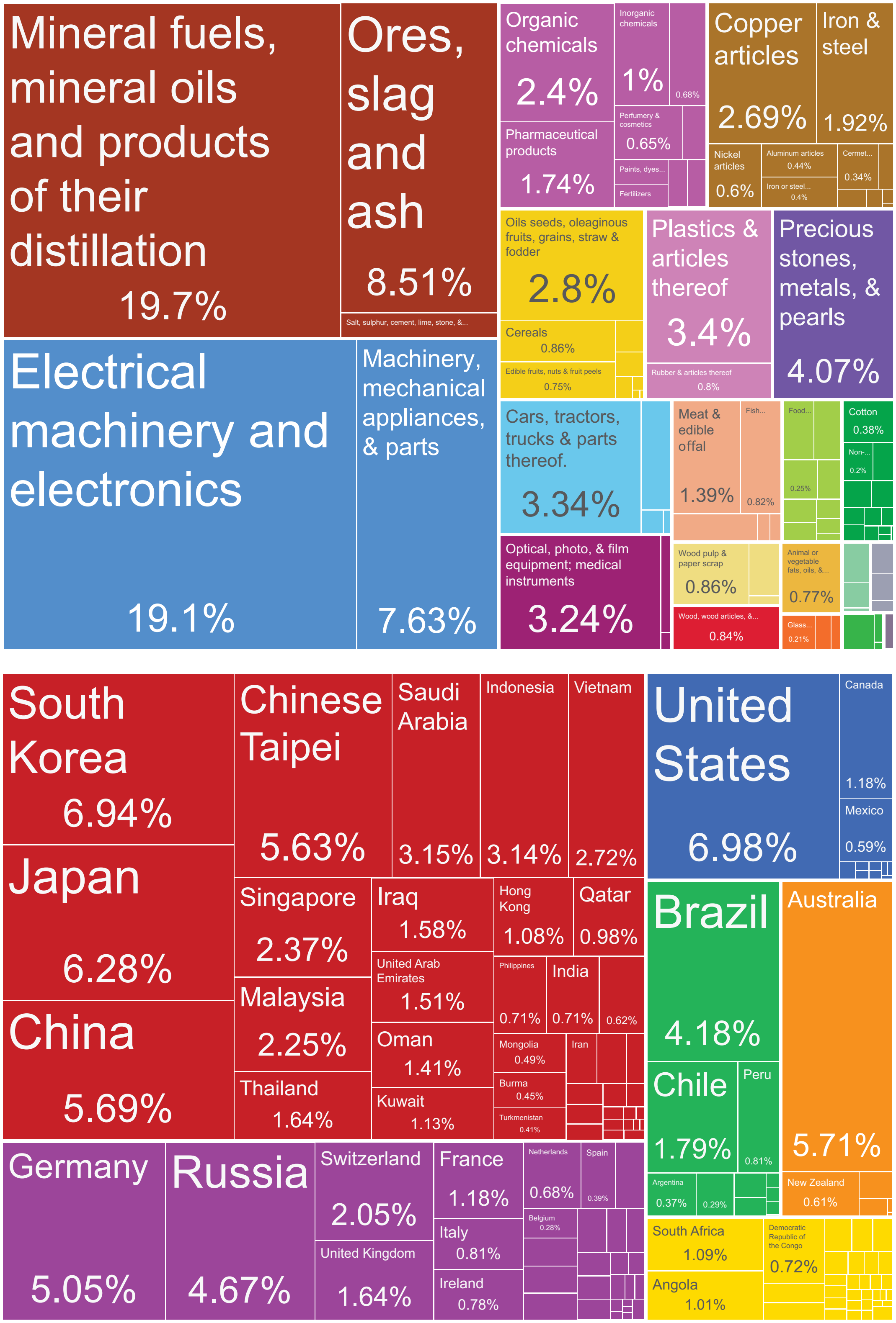
ECONOMIC IMPLICATIONS

Before brandishing threats of decoupling, however, the US government must confront the reality of what a rapid decoupling from the PRC would cost. No victorious great power has ever attempted to sanction half of global demand for key commodities and more than half of global supply of numerous essential goods. On the eve of the 2022 Ukraine invasion, Russia represented 13% of global oil production and 1.3% of total global imports. The PRC accounts for 55% of global copper demand and 79% of the world's lithium-ion battery production, to take just two examples.[68] Its manufacturing base is sophisticated and staggeringly diverse. It took decades and trillions of dollars of public and private investment to build. Decoupling too quickly would disrupt supply chains that depend on the PRC, imposing economic pain on the rest of the world, including the United States (see figs. 5 and 6). Further, the PRC is a much larger and more sophisticated economic adversary than Russia and would have more tools to fight back.

Most Americans are aware that the US economy is uncomfortably dependent on the PRC—but the dependence goes deeper than most people realize. Most people know that 95% of iPhones, iPads, Macs, and AirPods made worldwide are assembled in the PRC.[69] Most also know that the PRC dominates the value chains for critical minerals, representing roughly 60% of global production and 85% of processing capacity.[70] It is less widely known that a hard economic decoupling from the PRC could kill American civilians by disrupting supply chains for lifesaving drugs. Three of the four factories in the world that produce the active pharmaceutical ingredient for benzathine penicillin G are in the PRC. Global value chains for pharmaceuticals—especially generic drugs—and medical goods and devices are also highly dependent on PRC chemicals, materials, and electronic components.[71]

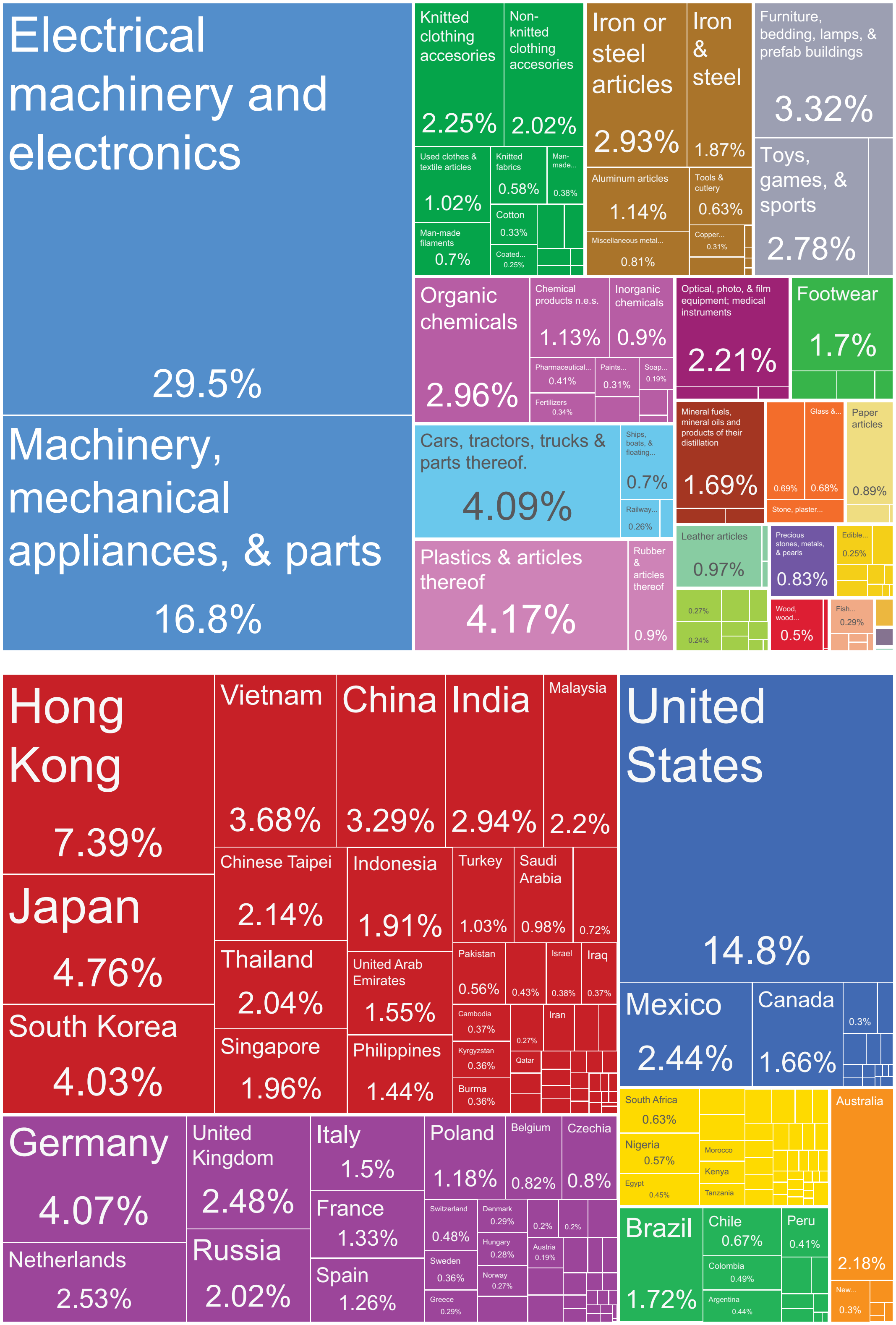
American small businesses would bear the brunt of a hard decoupling. Small and medium-sized enterprises account for 41.2% of US imports from the PRC but only 23.6% of imports from Mexico and 29.8% of imports from Canada.[72] More broadly, US small businesses have thinner margins and smaller capital buffers to survive economic shocks. Large corporations enjoy diversified access to multiple markets and consultants who can help them fine-tune their supply chain processes at a global level. However, most small businesses rely on a small number of existing relationships with suppliers, many of whom source their goods from the PRC. Many small businesses are also unaware of the extent of their dependence on the PRC, since they source their imports through middlemen or buy goods that are assembled elsewhere in Asia using PRC components that can't easily be replaced. Media coverage of supply risks tends to focus on "critical" products, but shortages of more

FIGURE 5 Composition of the PRC's imports by category and country of origin, 2022



Source: "OEC Profiles: China," Observatory of Economic Complexity, accessed May 30, 2024, https://oec.world/profile/country/chn#yearly-trade.

FIGURE 6 Composition of the PRC's exports by category and country of origin, 2022



Source: "OEC Profiles: China," Observatory of Economic Complexity, accessed May 30, 2024, https://oec.world/profile/country/chn#yearly-trade.

mundane goods could be even more devastating to the economy as a whole. If supply chains in and out of the PRC suddenly stopped, the economic engine of the American middle class could sputter and die.

If the US agricultural industry lost the PRC market, it would face a similar existential crisis. The PRC imported $35.5 billion of US agricultural products in 2022, constituting 18.4% of America's total agricultural exports. However, the more important value of Chinese demand is that it holds up prices for these products. The PRC imports 60% of the world's soybeans, for example. Soybean prices rise and fall on the back of PRC demand. If the PRC were suddenly cut off and unable to import soybeans, the three hundred thousand American farms that grow soybeans would face a devastating financial blow. More than eighty-nine million acres of farmland in the United States—an area the size of Montana—are currently dedicated to growing soybeans. If these acres were used for other crops instead, prices of those crops would fall as well.[73] Unlike the Trump administration's tariffs, which generated revenue to compensate soybean farmers for their lost sales, a hard decoupling from the PRC would be a pure deadweight loss and would give farmers no time to adapt. Other US export industries, such as aerospace and electronics, would face a similar fate.

Rapid decoupling from the PRC would, therefore, cause the prices of some products to collapse, but in general, it would trigger shortages and inflation globally. Recent experience of the impact of the COVID-19 pandemic provides a point of reference. At the peak of the supply chain crisis in October 2021, the average time for PRC goods to travel from factory to warehouse rose from the pre-COVID average of 40–50 days to 76 days.[74] That month, US inflation jumped to 6.2%. These supply chains ultimately healed because factories in the PRC rapidly returned to production. A hard decoupling would have a much greater effect on prices and would impact a much broader array of goods.

While America would suffer badly under rapid decoupling, its closest allies are significantly more vulnerable. According to modeling by Inoue Hiroyasu of the University of Hyogo and Todo Yasuyuki of Waseda University, if Japan's imports from the PRC were disrupted by 80% for two months, Japan's total production would decline by 15%, for a total annualized loss of 53 trillion yen ($360 billion)—nearly 10% of its GDP.[75] Roughly a quarter of Japanese imports of intermediate products come from the PRC.[76] According to a paper that calculated these estimates using a more elaborate methodology, a hard decoupling from the PRC could reduce Japan's total value added manufacturing output by up to 39.5%.[77]

All European countries would be badly affected, but Germany, which counts the PRC as its largest trading partner, would be among the hardest hit. A team led by David Baqaee at the Kiel Institute for the World Economy has calculated that a hard decoupling from the PRC would cause a 5% contraction in German GDP in the first year, roughly the same as in 2020, the first year of the COVID-19 crisis (5.3%). The "permanent loss of prosperity" would be around 1.5% annually after five years.[78] No good modeling studies exist on the potential effects of a hard decoupling on German employment, but they might be dramatic. Volkswagen sells 40% of its cars in the PRC, and the PRC accounts for 13% of Siemens' global revenue and 15% of BASF's. The PRC was also Germany's largest trading partner in 2021.[79] As German finance minister Christian Lindner noted in January 2023, "decoupling our economy from the Chinese market would not be in the interest of jobs in Germany."[80]

Australia is similarly dependent on the PRC, which buys nearly one-third of its exports. Trade is directly responsible for one in five Australian jobs.[81] Moreover, Australia's export sector is geographically concentrated. In Western Australia, exports comprise 56% of GDP, and the largest export segment is iron ore destined for the PRC. Permanent loss of the PRC market would devastate the state's economy and likely cause large-scale internal migration. In October 2023, the *South China Morning Post* reported that Australia's Department of Foreign Affairs and Trade and its Treasury Department had conducted three classified studies to explore the potential for complete economic decoupling from the PRC. All three found that it would be "impossible," according to two sources with knowledge of the matter. "No other markets could replace China as a market for Australian commodity exports," one of the sources said.[82] The Treasury secretary at the time ordered that the reports not be released to the public.

Saudi Arabia and other major oil exporters are similarly vulnerable. The PRC bought 27% of Saudi crude oil exports in 2021, or 1.75 million barrels per day.[83] However, oil is fungible, and the more significant impact of a hard decoupling from the PRC would be a collapse in the oil price. As of October 2023, Saudi Arabia requires a Brent price above $86 to balance its budget.[84] A hard decoupling that blocked the PRC's oil imports for an extended period could have a much greater impact on prices than the COVID shock in 2020.[85] The PRC currently imports 11.28 million barrels per day, and other major oil consumers would see demand decline steeply if trade with the PRC were permanently curtailed.[86] Saudi Arabia is also exposed, like all other countries, to a disruption in imports from the PRC. Saudi consumers are accustomed to a high standard of living and rely on cheap Chinese products in their daily lives. They would surely not appreciate shortages and rationing—and the country's leadership would strongly prefer to avoid a discontented population.

If decoupling were combined with a kinetic war with the PRC—or a counter-blockade at the Straits of Malacca, as many commentators have suggested—the economic loss could be greater still.[87] One RAND analysis found that it could reduce US GDP by 10% in the first year.[88] Physical disruption of trade flows out of Taiwan alone could cause over $2.5 trillion in economic losses.[89] War or even blockade-style operations short of war could also disrupt supply chains by making it expensive or impossible for shippers to insure their cargoes. A model produced by a team of Bloomberg economists predicted that US GDP would decline 6.7% in the first year of a Taiwan war, but that nearly every US ally would suffer a greater shock: Canada (6.9%), Australia (7.4%), India (8%), the EU (9.6%), Japan (13.5%), the PRC (16.7%), Southeast Asia (20.1%), and South Korea (23.3%).[90]

To summarize, while it is advantageous for the United States to have a plan for broad-based decoupling, instantaneous and permanent decoupling is not realistic. In every major war in US history, Washington has either banned or strictly controlled "trading with the enemy."[91] However, given how far globalization has come, threats to take actions that would devastate the US economy and the economies of US allies are not politically credible.[92] Beijing is aware of this. When the House China Select Committee war-gamed a Taiwan invasion scenario in April 2023, the "blue" team playing the United States chose to use only "moderate" sanctions against PRC state banks, fearing that stronger measures would trigger a financial crisis in the United States.[93] If the PRC's economy and financial system were so fragile that they would collapse instantaneously under sanctions, there might be an argument for accepting acute short-term economic pain to end a conflict quickly. Unfortunately, as we will see below, this is not the case.

PRC RESILIENCE

After more than a decade of assiduous efforts to prepare for the hard decoupling scenario, the PRC has become far more resilient than many US analysts recognize. In this section, we explain why financial sanctions or physical blockades, such as an operation to screen the PRC's oil imports as they passed through the Straits of Malacca, would not meaningfully impair the PLA's warfighting capacity, even if successful. They might also trigger organized resistance from neutrals. Moreover, according to untranslated PRC sources, Beijing likely believes that it would be resilient even if Washington acted on these threats, so the threats themselves do little to deter aggression.[94]

PRC scholars appear to have thought more carefully about these matters than their American counterparts.[95] The Chinese literature on financial warfare exhaustively references American authors and officials, including some of the same sources cited in this report. In addition to understanding the legal and political basis of the US financial warfare toolkit, PRC scholars take a keen interest in financial history, mining the historical record for clues about likely US actions and potentially useful counterreactions, going back to the privateer Francis Drake in the sixteenth century.[96] This coherent body of thought about economic warfare with the United States shines light on the PRC's strategy for dealing with the worst-case scenario.

Even extreme measures to shut down the PRC's essential imports would be unlikely to collapse the PRC's financial system quickly and would probably not work fast enough to change the military outcome of a war. Unlike Russia, the PRC has an almost entirely indigenous defense industrial supply chain.[97] It produces 4.1 million barrels of oil per day domestically, roughly a quarter of its total consumption. Its strategic petroleum reserve (SPR) has doubled in the last five years to approximately 950 million barrels, or three months of current imports.[98] The PRC may add several hundred million more barrels of capacity in the next few years. The PRC also has stockpiles for other strategic commodities. According to US Department of Agriculture estimates, it had 69% of global maize reserves, 60% of global rice reserves, and 51% of global wheat reserves in 2022.[99] A blockade would alarm markets, but Beijing could respond by halting trading in domestic financial markets and restricting withdrawals from banks. Meanwhile, if the PRC were unable to import essential goods but continued to export over its land borders, its current account surplus might sharply increase. This would support the CNY and reduce the pressure for capital outflows.

If the United States tried to shut down the PRC's international trade, these stockpiles would buy time for Beijing to set up alternative smuggling routes. The PRC has land borders with fourteen countries, several of which would happily re-export grain and oil at marked-up prices, even under the threat of US sanctions. As Gabe Collins has observed, the PRC could build new pipelines to Russia and Kazakhstan within a year, unless the US sabotaged them. Both countries already participate actively in the PRC's messaging and payment systems for trade settlement in CNH, and there is no reason to believe that they would stop participating during a crisis. The PLA itself would need only around five hundred thousand barrels per day to run a war, according to Collins's conservative estimates—around 12% of domestic production.[100]

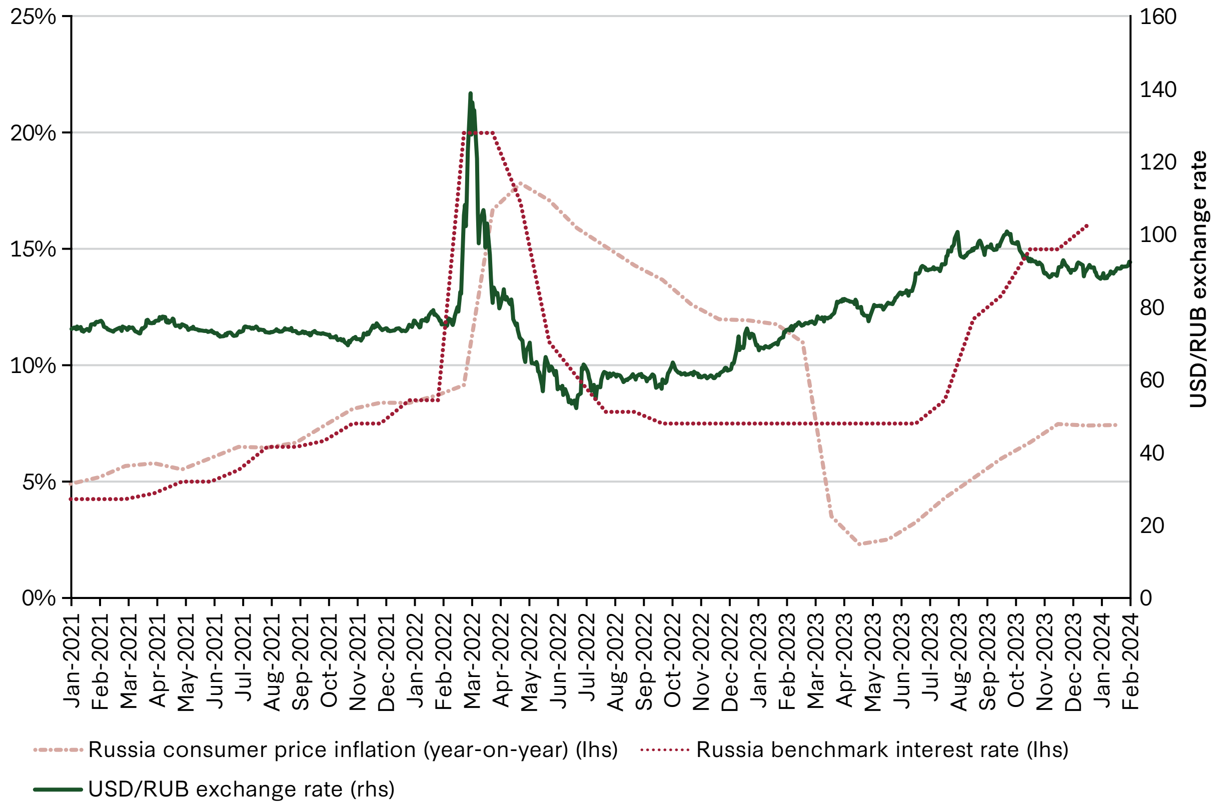
If the PRC still could not find sufficient resource supply to meet its needs, its domestic economy would adapt to shortages, as great powers have always done in wartime. Today, the PRC derives most of its protein from soybeans and meat (produced with soybean-based feed) imported from the United States and Brazil. However, this is only an illusory dependence. The PRC was almost entirely self-sufficient in protein until the early 2000s, when it began to import more because the population had grown rich enough to afford it.[101] Beijing has also signaled that it is preparing to respond decisively if protein supplies are cut off. In a 2021 speech, Xi called the PRC's food security a top-priority national security issue and called for research into "alternative proteins" from "plants, animals, and microorganisms."[102] Zhao Hongtu of the China Institutes of Contemporary International Relations put it this way in an important 2007 article: "The energy needs of a country in wartime are very different from those in peacetime. As a major energy and oil producer, China has sufficient domestic energy supplies to meet its wartime energy needs, especially its military needs."[103]

LESSONS FROM RUSSIA

Russia's experience in February and March 2022 illustrates the challenge that the PRC's financial system might expect on Day One of a Taiwan crisis if the United States imposed dollar sanctions or similar trade restrictions. Four days after Russia invaded Ukraine, the United States and its allies froze some $300 billion in assets held abroad by the Central Bank of Russia (CBR) and Russian Direct Investment Fund, the sovereign wealth fund.[104] On the same day, the US Treasury prohibited US entities from transacting with the CBR. Other sanctions followed. The goal was to destroy Russia's banking system by forcing a tsunami of capital outflows, debasing the ruble, and triggering rampant inflation. It was an unprecedented exercise in financial warfare—"a kind of financial nuclear bomb," as former Russian deputy finance minister Sergei Aleksashenko put it at the time.

Markets reacted violently (see fig. 7).[105] The ruble fell from 84 to the dollar on February 24 to 139 to the dollar on March 12. Russian inflation jumped to over 2% per week. Russian households withdrew $9.8 billion worth of FX from accounts in March alone.[106] The sanctioning countries did not want to shut Russian oil and gas out of the global market altogether, fearing a sharp rise in prices. Therefore, they did not impose sweeping dollar sanctions on Russia's entire financial system, allowing the country to continue to settle its energy trade in dollars and euros. Nevertheless, Russian authorities tried to shift trade into other currencies. Before the war, 86% of Russia's foreign transactions by value were settled in dollars or euros. Nine months later, that figure had fallen to 54%.[107] Russia began to settle trade in CNH, Indian rupees (INR), and Emirati dirhams (AED) instead.

FIGURE 7 Russia's exchange rate, consumer price inflation rate, and benchmark interest rate, January 2021–February 2024



Source: Data from Bloomberg L.P. (2024). Retrieved from Bloomberg database.

Russian financial authorities steadied the economy by acting decisively to stabilize the exchange rate, which reduced the pressure on the banks and contained inflation. On February 28, the day the sanctions were imposed, CBR Governor Elvira Nabiullina raised interest rates from 9.5% to 20%. This move dramatically increased the incentive for households and firms to keep their rubles deposited in Russian banks rather than withdrawing them and exchanging them for FX. In the following days and weeks, Moscow took several additional steps to increase global demand for the ruble and reduce Russian demand for the US dollar.[108] These included the following:

- Imposing capital controls
- Limiting bank withdrawals
- Ordering Russian firms to swap 80% of their FX revenues into rubles
- Banning Russian financial institutions from helping foreigners sell Russian assets

- Demanding that foreign countries pay in rubles for their purchases of Russian energy, even if the contracts were priced in dollars or euros

- Restricting imports to increase Russia's current account surplus

Together, these measures successfully stabilized the ruble exchange rate by creating incentives for market participants to buy and hold rubles rather than sell them. The United States and other sanctioning powers did not respond with additional policies to keep the ruble weak, so the exchange rate snapped back closer to its fundamental value. In April 2022, the ruble was the world's best-performing currency. By June, due to rising oil prices and reduced imports, the ruble had stabilized between 50 and 60 to the dollar—stronger than its pre-war average. Inflation remained substantially higher than the pre-war average because of difficulties acquiring essential imports, but high interest rates kept it under control. Over time, supply chains rerouted through Central Asia, the Caucasus, and the Middle East, allowing Russia to keep buying essential goods from the sanctioning countries, albeit at marked-up prices.[109] As long as Russia is willing to pay higher prices, these countries will keep their incentives to transship Western goods, despite the sanctions.

The PRC has much larger FX reserves than Russia and is therefore potentially much more resilient to the sudden imposition of financial sanctions. At the outset of the crisis, Russia's government controlled $630 billion in FX and gold reserves. Just over half were frozen by March 1, 2022.[110] By contrast, as of April 2023, the PRC's State Administration of Foreign Exchange (SAFE) held $3.2 trillion in FX reserves. According to Brad Setser's calculations, the PRC likely has up to $3 trillion of additional undeclared dollar assets, although it is not clear how liquid these holdings are.[111] According to the Bureau of International Settlements, PRC banks had only $1.56 trillion in cross-border liabilities ($471 billion net of cross-border assets, mainly from Belt and Road debtor countries), as of Q3 2021.[112] In short, Beijing has ample FX reserves to prevent a default on external debt. On Day One of a Taiwan crisis, it could copy Russia's playbook and, if necessary, sell its FX to support its exchange rate. With sufficiently tight capital controls, Beijing could inject an unlimited amount of domestic currency liquidity into the banking system, reassuring depositors that they had nothing to fear.

This discussion highlights three lessons about the PRC's short-term resilience to economic punishment. First, the PRC's financial system may well be resilient to Russia-style financial sanctions, due to the large FX reserves that Beijing could use to stabilize its exchange rate. Second, a Malacca blockade or a similar operation to shut off the PRC's imports would be unwise. In wartime or under blockade or quarantine, Taiwan could almost certainly not hold out long enough for economic attrition to persuade Beijing to change its policy.[113] Third, market participants and third countries would react opportunistically and dynamically to US economic punishment and the PRC's reactions, in ways that would probably support the PRC's short-term economic and financial resilience. Trade decoupling would therefore be a long-term process—with all that implies for the economies of the United States, its allies, and other nations.

BEIJING'S COUNTERSTRATEGY

To reduce its vulnerability to US sanctions, the PRC is pursuing a counterstrategy of internationalizing its offshore currency (CNH) while maintaining capital controls on its onshore currency (CNY). Prominent PRC officials and experts are clear-eyed about the potential risks of US financial power. Indeed, senior economists and PLA officers often exaggerate the US government's ability to manipulate global financial and currency markets for its strategic advantage, ostensibly in collaboration with private investors.[114] The PRC literature sees financial hegemony as the bedrock of American geopolitical power; recognizes that the various aspects of the dollar system are mutually reinforcing; assumes that the United States will use all available tools to defend the dollar's position; and fears that the US government has a formidable set of tools to engage in "monetary sniping" (货币狙击) against the currencies of rivals and noncompliant states.[115] Beijing likely sees these as reasons for caution. However, US financial power is not seen as impregnable. Beijing has been working assiduously to build financial resilience to allow it to maintain trading relationships with third parties in the event that dollar sanctions are imposed.[116]

Starting in 2018, the Trump administration's trade war convinced many PRC observers that a "financial war" (金融战争) could break out at any time and that the nation needed to prepare. PRC economists have long doubted that the United States could achieve full trade "decoupling" (脱钩).[117] They are more concerned about the US program of selective and gradual decoupling—the "small yard, high fence" policy—which they see as more credible and politically sustainable. Most of all, they fear that the United States could use dollar sanctions or other financial weapons to destroy the PRC's economy and financial system without trade decoupling, for example by challenging the Hong Kong dollar (HKD) peg.[118] There are fears that if the United States imposed dollar sanctions on the PRC before it had broken its dependence on the dollar system, the PRC's economy would be badly hit, although not necessarily as badly as Iran's or Russia's. PRC analysts also express concern that the United States might wage a financial war against the PRC in peacetime, replicating the financial war it supposedly waged against Japan in the 1980s and 1990s to derail Japan's "economic miracle."[119]

Beijing's quandary is that it cannot relax its capital controls—least of all in the midst of a crisis. Through years of intervention to support the value of the currency during a period of slowing growth, rising debt, and falling interest rates, PRC monetary authorities have bottled up trillions of dollars in potential outflows. In a war scenario, outflow pressure would increase further. In this context, loosening capital controls in a crisis would risk an uncontrolled collapse of the currency, followed by a systemic banking crisis—too great a risk to social stability for the CCP to bear. The greater the outflow pressure, the more untenable the possibility of easing capital controls becomes.

The uniquely effective capital control regime provides at least some defense against currency "sniping." Under regulations first established during the 2015 stock market crash, PRC individuals can currently take only $50,000 out of the PRC per year and are technically not allowed to invest in foreign securities or property. Bank card withdrawals from PRC bank accounts in foreign currencies are capped at CNY100,000 per year. All FX transactions must be made through approved banks. Regulators can freeze the capital accounts of foreign-invested enterprises, preventing firms from remitting dividend payments. In a crisis, the PRC authorities could reduce quotas to zero and lock capital inside the country. Ad hoc controls are also important for locking FX in the banking system. In 2015, the PBoC dealt with capital flight by instructing banks to limit overseas transfers regardless of quota allocations. Customs officials ramped up audits, and outflows stopped.[120]

During a Taiwan crisis, the PRC would have to dial the capital controls up to the maximum. PRC government ministries would also likely ration imports of goods deemed inessential to the war effort and limit foreign travel, which historically has been an outlet for unrecorded flows.[121] Even still, small cracks in the so-called capital dam could cause the currency to depreciate and place stress on the banking system.

The PRC's strategy to build resilience to potential US sanctions therefore assumes that full capital account liberalization is impossible under current conditions. However, even though the CNY cannot become a truly international currency as long as it is not freely convertible, the PRC can encourage other countries to hold CNH and use CNH payment systems to settle bilateral trade with the PRC. It can also offer swap lines to allow friendly countries to access CNY under controlled conditions. This tool enables the PRC to issue CNY-denominated loans in the developing world and to invoice import purchases in CNY. Xi Jinping himself has made it a personal priority to accelerate the expansion of swap lines, the development of the CNH market, and the international adoption of CIPS.

CIPS is the linchpin of the PRC's strategy to degrade US economic deterrence. Established in 2015, CIPS enables the PRC to settle trade in RMB without using the SWIFT messaging system and CHIPS settlement systems, both of which the US government effectively controls. Evading US sanctions is explicitly one of the goals of CIPS. In 2019, Gao Xingwei predicted that as the CIPS platform matured, it would first be favored by Iran and other countries already under US sanctions.[122] Not having to rely entirely on SWIFT for messaging would "significantly improve China's financial security and autonomy," he added.[123] In plain language, CIPS can be understood as an alternative plumbing system for global payments. In the event that Washington turns off the pipes that allow the PRC to trade in dollars, the PRC and its trading partners can switch their trade settlement to CIPS.

The PRC's strategy of building out CIPS as a sanctions hedge is making rapid progress. As of March 2022, it was used by around 1,300 financial firms worldwide, compared to 11,000 for the American alternative, CHIPS. The total transaction value was much smaller: $45.6 billion for CIPS compared to $1.8 trillion for CHIPS.[124] However, these figures are not indicative of how usage rates would change during conflict. Today, nearly all of the PRC's partner countries can settle payments in USD on established channels, so they have no particular reason to use RMB channels unless they are evading sanctions or doing a political favor for the PRC. The situation would be different if the alternatives were shut down and CIPS were the only way to transact with the PRC. What matters is that the system has been proven to work.

US sanctions against Russia have accelerated the adoption of the CNH abroad, without the PRC having to liberalize its capital account. Russia has explored alternatives to the RMB. In January 2023, the central banks of Russia and Iran struck a deal to link the ruble settlement system (SPFS) with Iran's payments system.[125] In April, Russia and India reached a similar agreement.[126] However, CIPS is clearly emerging as Russia's most important cross-border payment infrastructure. In the first half of 2023, the CNH was used to settle 75% of Russia's trade with the PRC and 25% of its transactions with other countries, according to Russia's Ministry of Economic Development.[127]

With tight capital controls plus CIPS, PRC authorities would be in a very strong position to weather the initial financial reaction to the outbreak of war, even if the US imposed dollar sanctions. To be sure, PRC regulators and monetary authorities would likely have to intervene decisively to stabilize the domestic financial system. However, the 2015 stock market crash and the outbreak of COVID-19 in January 2020 proved that PRC regulators have a viable playbook for managing sudden financial panic.[128] The PBoC could offer enormous liquidity facilities to banks and corporations, guarantee bank deposits and holdings in wealth management products held by shadow banks, and slash interest rates. Securities regulators could restrict the sale of real estate and more liquid financial assets. The State Council could issue special bond quotas to local governments to manage an anticipated fiscal crunch. Other economic planners could deal with the logistics of rationing and industrial policy for the wartime economy, setting quotas on key goods and perhaps imposing price controls. Monetary authorities could intervene in the CNH market, which would weaken sharply as foreign investors dumped their holdings. If the PRC financial system survived this initial shock, the US government would be essentially out of ammunition in the financial war.

After a break from the dollar system, the PRC has every reason to believe that its trading partners would be happy to resume trade through payment channels that the US government does not control. If needed, neutral countries could provide backdoors into the USD area. As Zhou Hanmin of East China University of Political Science and Law puts it, the PRC could "make use of international offshore financial centers to conduct offshore financial business, and continue to clear in dollars by concealing our own information, as Iran has done."[129] Unlike Iran, the PRC has close relationships with Gulf nations that would be happy to play this role. Other BRICS countries, notably India, have taken steps to promote their currencies through international trade settlement, in coordination with the PRC.[130] This is why, as Zhou further notes, "US foreign financial sanctions are indeed very severe and complete, but they are not invulnerable."[131]

The PRC probably imagines that in a crisis, trade links to the developed world would be strained, and developing countries would become even more important partners. Indeed, the RMB internationalization strategy is making the most rapid advances in the developing world. According to AidData estimates, the share of new PRC overseas lending commitments denominated in dollars fell from 93% in 2013 to 44% in 2021. In the same period, the share denominated in RMB soared from 6% to 50%. Most of these new RMB loans are emergency loans to countries in distress.[132] The PRC is also in the process of rolling over its existing portfolio of dollar loans to Belt and Road countries into RMB loans to create alternative sources of demand for RMB in the developing world.

POLITICAL IMPLICATIONS

Given this context, if the United States were to attempt dollar sanctions, would other countries respond by moving their trade with the PRC across to CNH or other currencies? The conventional wisdom is that they would not. As a major Council on Foreign Relations report puts it:

> Simply put, no country would be excluded from the economic carnage of a conflict in the Taiwan Strait, which would throw the world's economy into a severe depression by destroying supply chains, forcing production lines to grind to a halt, sending stock markets plummeting, and threatening global shipping. Once countries are aware of the consequences, and the fact that their economies would not be spared even if they choose to remain neutral during a conflict, they could be more willing to contribute to deterring China from using force.
>
> To raise awareness of the global consequences of a war over Taiwan, the U.S. government should conduct country-by-country analysis of the fallout of a major conflict, which U.S. embassies should then share with host governments. The United States should then work with its allies and partners to prepare a sanctions package that would go into effect immediately following a Chinese blockade or invasion. Policymakers could use the sanctions imposed against Russia following its invasion of Ukraine as a baseline, while also considering more severe financial sanctions. The United States and its allies should preview these sanctions to China, making clear the economic costs of an attack. Although the prospect of sanctions will not be decisive and is likely already factored into Xi's calculus, this strategy would bolster deterrence by demonstrating that sanctions would be deep, immediate, and imposed by many of the world's major economies.[133]

The assumption is that in a crisis, US allies, such as the member states of the European Union, would willingly go along with rapid decoupling, simply because the economic situation would already be extremely bad.

This assumption makes no sense. Plunged into a global economic crisis, most countries would try to preserve what they could, not aggravate the crisis. A general economic crisis would provide both a reason and an excuse for countries to renege on past commitments. Even if the United States had persuaded other countries to make the sanctions automatic, in actual crises, states can find excuses to avoid entrapment by past commitments. This applies to both US allies and the United States itself. While US allies have an interest in deterring a Taiwan war, they do not have an interest in creating an automatic trigger for economic Armageddon. While some countries might agree, in principle, to threats of punitive financial sanctions if the PRC attacked Taiwan, they could demand conditionality that would undermine the credibility of the threat. Furthermore, as in the case of Russia's invasion of Ukraine, different states would form their own intelligence assessments of whether a Taiwan crisis was "likely," which would, in turn, shape their willingness to commit to economic sanctions in advance. PRC diplomacy would encourage these divisions. In short, the United States should not assume that in its own break-glass political scenario, other states will see the crisis in the same way. This is a particular risk in break-glass scenarios that do not involve a PRC first strike on US forces.[134]

Some analysts have gone further, suggesting that the United States could use secondary sanctions to coerce neutral states and close allies alike to go along. As Jude Blanchette and Gerard DiPippo argue, "if US forces were engaged" in a war over Taiwan, "the sanctions [on the PRC] would be severe, and Washington would probably coordinate with—or even compel—major allies to join such sanctions."[135] They contend that major European allies would likely "support Washington's efforts to punish China economically" because European countries' "economic and financial ties to the United States are far deeper than those with China." They also note that if allies resist, Washington might "present European leaders with a binary choice they might otherwise hope to avoid." Presumably, this would mean threatening to weaken NATO commitments or threatening secondary sanctions against European companies and banks that facilitate trade with the PRC.

This analysis not only ignores the quarantine scenario but also ignores a lesson of history: when great powers wage economic war, third-party states have agency and do not face binary choices.[136] The very concept of neutrality as it exists in modern international relations was developed to facilitate trade between neutrals and multiple belligerent powers.[137] Even short of flat-out refusal, neutrals can use tortuous negotiation, foot-dragging, and ineffective enforcement to facilitate trade with all relevant belligerent powers. Retaliating against non-compliant neutrals is self-defeating, since it also involves losing access to their markets. In a war with the PRC, if the EU failed to enforce US sanctions within its own market, Washington could not impose secondary sanctions without deepening the economic crisis in the United States and putting dollar hegemony at risk by driving a critical mass of firms to transact in RMB. The EU and the PRC combined are close to 40% of global GDP. If they were sufficiently motivated to shift their trade into EUR or RMB settlement networks beyond Washington's control, they could do so quickly. In the event of a kinetic conflict, Europe would face a major economic crisis that might push it toward the United States. In a quarantine scenario, however, there might be no physical or legal barriers to sustained PRC–Europe trade.

If European cooperation is uncertain, support from non-Western countries, many of which have refused to support sanctions on Russia, would be even less likely. India, Brazil, the Gulf States, and most ASEAN economies would be strongly incentivized to create or join a loose non-aligned bloc. Their reasons would be practical, not ideological. These countries would prefer to live in a diverse global economy that offered them strategic agency rather than a permanently bifurcated one that denied them access to the PRC market. These countries could also anticipate that Washington could not sever its largest trading relationships all at once and, therefore, would eventually acquiesce to a situation in which trade with the PRC resumed. The countries most likely to resist US efforts to force hard decoupling are commodity producers and countries that have already largely abandoned Western platforms for PRC alternatives in high-tech sectors, such as telecommunications. These countries are scattered across Africa, Oceania, and Central and Southeast Asia, and some Latin American and Middle Eastern countries might be tempted as well. At the very least, these states could pursue a policy of rhetorical sympathy but lackluster enforcement, which the US would struggle to alter through punishment.

Countries that wanted to avoid economic decoupling would have political excuses to break from the US coalition. A total of 181 countries recognize Beijing as the sole legal government of China, and fifty-one of them accept Beijing's formulation of the "One China Principle"; the rest of them, including the United States, take ambiguous positions on Taiwan's status.[138] Only twelve countries recognize Taiwan as a sovereign state, and Taiwan is not a member of the UN. When Russia invaded Ukraine, it was indisputably an act of aggression by one sovereign member of the UN against another. If the PRC invaded Taiwan, Beijing would argue that the crisis was purely an internal matter, and other states could accept this argument without necessarily setting a bad precedent for international law. Whether or not countries actually believed this, the threat of devastating US-led economic warfare would provide an incentive to reason toward Beijing's position. It is therefore unclear whether a majority in the UN General Assembly would disagree or even condemn an invasion of Taiwan, let alone a quarantine.[139] Countries that wanted to escape prior punishment threats could use a UN resolution taking the PRC's side as a convenient excuse. Alternatively, they might blame Taipei (or Washington) for provoking the crisis and call on Taiwan to accept a coerced settlement. With each country that backed the PRC's position or joined the neutral bloc, the less costly it would become for the marginal country to abandon the US coalition, if it wished to do so.

In other words, if the United States went into a Taiwan crisis threatening secondary sanctions, it would start with a divided coalition that would almost certainly fracture further over time, breaking down the rules-based economic system in the process, and threatening an extremely important US interest. A maximalist sanctions policy would risk leaving the PRC with a bigger sphere of influence in global affairs than it enjoys today. US actions to save the rules-based system in response to a Taiwan crisis would have left it fundamentally broken.

THE FLAW IN THE COUNTERSTRATEGY

While the PRC's strategy of CNH internationalization is a sound approach for busting dollar sanctions, it does not provide a sound financial basis for global economic leadership. The CNH is freely traded in international capital markets on the far side of capital controls. The PRC can support it by spending FX reserves to bid up the exchange rate. However, if the PRC loses control and allows the stable relationship between CNH and CNY to break down, CNH will cease to be a reliable store of value, and no one outside the PRC will want to take payment in it. The CNH market is also vulnerable to financial contagion in the Hong Kong banking system, which is responsible for most global CNH clearing. The same crisis that took down the CNH might challenge the HKD as well, forcing the PRC monetary authorities to intervene there as well.

The PRC's strategy has an inherent deficiency: the impossibility of relaxing capital controls, especially in a crisis. What PRC commentators only hint at in their open-source analysis is that a massive US-led currency intervention against the CNH would derail this strategy. To persuade other countries to follow it out of the dollar system, the PRC needs the offshore currency to hold its value. We will return to this PRC vulnerability in more detail in Part 3.

STRATEGIC IMPLICATIONS

Washington must go back to the drawing board and devise a Day One Plan that works through incentives rather than threats. It must consider the PRC's assessments, capabilities, plans, and potential retaliatory tactics. It must minimize the chance of trapping the United States in a protracted, devastating, and unwinnable economic conflict. It must combine actions that the president could and likely would take unilaterally on Day One with a convincing framework for why most countries would want to accept US economic leadership on Day Ten, Day One Hundred, and Day One Thousand.

Fortunately, most countries would prefer to prevent the collapse of the rules-based global trading system and have little interest in seeing the PRC wrest control of it. A successful seizure of Taiwan by force would not only undermine rules and norms that maintain peace in the Indo-Pacific region but would also concentrate power in the hands of an authoritarian regime that rejects the rule of law and insists on CCP control over people and economic assets. In the long run, this outcome would be catastrophic for free markets and the interests of all free countries, as well as small countries that would be powerless to resist Beijing's dictates.

Although the US government cannot hold together an allied coalition through bullying and threats, it can articulate a positive vision of how it would preserve the global economy and align coalition interests at the PRC's expense. The critical number is $3.38 trillion—the value of goods that the PRC exported in 2023. America's message to the world will be simple: "If the worst happens, we are going to protect the rules-based system and minimize the economic disruption, but we intend to take the manufacturing jobs back. Would you like some?"

PART 2: CORE TAKEAWAYS

- A Day One economic strategy based on a hard decoupling would subordinate every other US economic interest to the goal of punishing the PRC.

- Even still, it would be likely to fail or even backfire in its political goals. It would be unlikely to break the PRC's war machine, force the PRC to abandon its designs on Taiwan, or destroy the PRC's financial system or economic model. Insofar as it would impose pain on the PRC, it is likely that Beijing could bear the pain longer than the United States and its allies could sustain it.

- An attempt to force a hard decoupling would also undermine other relevant US economic interests, including the preservation of the domestic economy, the preservation of dollar hegemony, and the rules-based trading system.

- A hard decoupling would inflict enormous costs on the United States, with agriculture and small businesses particularly affected. Key US allies and partners are even more vulnerable.

- The PRC's fallback plan, if it loses the ability to transact in dollars, is to transact in CNH through the CIPS payment system. Third countries are rapidly signing up for CIPS.

- In general, when great powers wage economic war, neutral states do not face binary choices—in fact, they face strong economic incentives to violate blockades and sanctions for profit.

PART 3: THE DAY ONE PLAN

On August 4, 1941, Winston Churchill and the chiefs of staff embarked on a risky transatlantic voyage on the battleship HMS *Prince of Wales*. Between August 9 and 12, off the coast of Newfoundland, Churchill held meetings with US president Franklin D. Roosevelt about the structure of the world system they hoped to create should the Allies triumph in the war. The result was the Atlantic Charter: eight succinct "common principles" that described their "hopes for a better future for the world." Among them were commitments to self-determination for all nations, the renunciation of territorial expansion, economic cooperation, and disarmament. Another was a commitment to free trade. Both sides committed to "endeavor, with due respect for their existing obligations, to further the enjoyment by all States, great or small, victor or vanquished, of access, on equal terms, to the trade and to the raw materials of the world which are needed for their economic prosperity."[140] The principles of the Atlantic Charter ultimately guided the creation of the Bretton Woods agreement, the United Nations, the Marshall Plan, and the GATT, the predecessor to the WTO. Notably, Allied and neutral countries alike enjoyed the benefits of these institutions, although the Soviet Union and its Communist allies were eventually excluded.

In the same spirit, as tensions rise in the Taiwan Strait, the United States and its allies should start consulting on the principles that should guide their economic response if the PRC goes rogue. These principles must be farsighted, applying not only to the immediate demands of the break-glass political scenario but also to the long-term future that would follow any US–PRC conflict. Washington should embrace these principles publicly, in advance, and in coordination with its allies and partners. Committing to these principles will increase confidence that the United States would act wisely and effectively if it chose to trigger avalanche decoupling on Day One.

The watchword of the Day One Plan is US *economic leadership*. To achieve avalanche decoupling while maintaining US economic leadership, Washington should establish four fundamental principles:

1. Refrain from breaking noncritical supply chains on Day One and thereafter give firms adequate time to reshore them.

2. Sustain dollar hegemony and prevent the rapid internationalization of the RMB.
3. Refrain from asking other countries to decouple from the PRC, and build US decoupling into a wider program of economic support in response to a Taiwan crisis.
4. Commit to enforcing anti-PRC trade policy against third countries in a rules-based manner, subject to appeal and adjudication.

The details of the policies are negotiable, but all four principles would be essential to instilling confidence in the chaotic context of Day One. Economic leadership would require showing the world that the United States sought to minimize the initial economic and financial shock of a Taiwan crisis, not to exacerbate it. Economic leadership must be grounded in a commitment to protecting the unique role of the dollar, which supports key US strategic interests, such as export controls and existing sanctions on rogue states. Amidst the uncertainty of a Day One crisis, economic leadership would require the United States to communicate a vision for preserving an integrated and inclusive global trading system based on common rules, even as major economies decoupled bilaterally from the PRC. Finally, economic leadership would require supporting third countries through the decoupling of the United States and its Core allies (hereafter called the Core) from the PRC, allowing them to draw shared economic benefits at the PRC's expense, and incentivizing them to help enforce the Core's trade policies against the PRC.

If Washington could stay true to these four principles, it could force avalanche decoupling unilaterally, on the timeline of its choosing, and in a form that sustains US economic leadership in an inclusive, rules-based trading system. There would be no wishful thinking that other countries would cut their economic ties with the PRC for high-minded moral reasons. All negative actions against the PRC could be taken by the United States and a small number of the Core. All coalition building would be built on incentives and rules-based multilateral mechanisms. By aligning US strategic interests with the economic interests of third countries, the Day One Plan would make decoupling much harder for the PRC to disrupt—and enable it to gain momentum over time as it harnessed market forces.

Guided by these principles, this report outlines three policy pillars to execute avalanche decoupling:

1. The Core would **use ratcheting tariffs or quotas to decouple bilaterally** from the PRC, as justified by the national security exemption in WTO rules.
2. The United States would **intervene unilaterally in global currency markets** to "go short" the PRC's currencies, dealing a short-term blow to its financial stability and committing the United States to destroying its terms of trade over the long term.
3. The Core allies would **establish an Economic Security Cooperation Board** (ESCB), a new institution with a mandate to deliver bilateral aid to member states, including as compensation for retaliatory PRC economic warfare, and facilitate the accurate reporting of trade with countries that members deem systemic national security threats.

The United States would trigger the avalanche unilaterally. Congress would agree through bipartisan discussion on how quickly the economic relationship with the PRC should be phased to zero. A five-year decoupling window would be much more ambitious than a fifteen-year window, for example. On Day One, coordinated action by the Federal Reserve, Congress, and the Treasury would preserve the world's access to dollar liquidity while sabotaging the PRC's strategy for internationalizing its own currency. Washington may choose to spend some taxpayer dollars reshoring a few critical supply chains into the Core as soon as possible. These actions would be ambitious, but they would be relatively straightforward to implement if the political context demanded them. Once the right policy incentives were put in place, most of the avalanche would occur organically through market-based mechanisms as firms and consumers responded to changing relative prices.

Notably, unilateral action alone would not shape the avalanche in the longer term in a way that would advance US interests. While it would not be necessary for third countries to decouple from the PRC themselves—or even to accept the US position on the Taiwan crisis—all countries continuing to trade with the United States would need to report accurate data on PRC goods being transshipped through their markets, including components and intermediate products. They would also need to be encouraged to remain committed to the rules-based trading system. As trade barriers on PRC goods rose higher, private firms would have increased incentives to mislabel and traffic PRC products into the US market, as they are already doing in response to the Trump and Biden administrations' tariffs. Governments in third countries might have neither the ability nor the will to stop them. Without a plan to prevent mass leakage, the United States would achieve "decoupling" in name only. US consumers would pay higher costs, but they would remain nearly as dependent on PRC products as before. The United States would find itself bogged down in trade disputes with its major trading partners—and the PRC would suffer minimal punishment.

Once the tariffs and quotas of the Core began to kick in, the challenge would be to incentivize the governments of third countries to conduct audits, enforce penalties that incentivized domestic firms to follow the law, and provide detailed and accurate data on the imports and exports of PRC goods and intermediate components. The ESCB would build essential trade supervision responsibility into a broader program of global economic recovery, led by the United States but administered through an independent agency. Its customs enforcement operations could be developed institutionally over time because the Core would impose no restrictions on noncritical PRC goods on Day One. How fast the system would need to be established would depend on how quickly the Core wanted the avalanche to proceed. Crucially, the Core would have to refrain from treating the ESCB as an instrument for forcing its geopolitical agenda on the rest of the world.

The history of US economic leadership during and after World War II should be an inspiration for policymakers today if events force the creation of the ESCB. In the early 1940s, US and British leaders decided that the postwar economic order would be based on compromise, incentives, and rules-based institutions. The postwar international economic order had a geopolitical rationale—to ward off the threat of communist expansion—but this logic was always implicit. Instead, the United States focused on laying the foundations for shared prosperity and an inclusive order for the free world. On Day One of a Taiwan crisis, American lawmakers should take their inspiration from this history.

The next three sections outline the policy areas and discuss potential PRC countermeasures and US and allied responses. We then briefly consider the PRC's other options for waging economic warfare against the United States during a Taiwan crisis and discuss their implications for the Day One Plan. Finally, we discuss the severability of the three policy pillars.

POLICY 1: NATIONAL DECOUPLING

The first pillar of the Day One Plan involves the use of discriminatory trade policy—tariffs or quotas—to phase out trade with the PRC over a politically negotiated period of years. Washington would cite the national security exemption in Article XXI of the GATT Charter to justify these policies under WTO rules. During this process, some industrial policy may be necessary, particularly for critical products, as a safeguard against potential PRC export controls. Core allies would presumably follow suit.

It is impossible to establish in advance which states would comprise the Core. The most likely case is that it would include the non-EU G7—the United States, the UK, Japan, and Canada—as well as South Korea, Australia, New Zealand, and Taiwan. Support from EU member states, above all the remaining members of the G7, would be highly desirable. However, EU participation would be challenging and is not essential to decoupling. At minimum, a Core composed of the United States, Japan, the UK, Australia, and Canada would be sufficient. These nations represent 36% of global GDP. Which countries would be included and how ratcheting tariffs or quotas would be designed and sequenced are political questions that would be discovered only through negotiation.

It would not be advantageous to make membership status in the Core fixed and permanent, as not all members would support every policy. Some might want to participate in a joint industrial policy for critical products. Others may be capable of pursuing only their own. Some might impose tariffs on the PRC to ratchet at different rates, although they would have to align policies to prevent opportunities for arbitrage. In time, the Core may become a set of overlapping coalitions-of-the-willing. What would unite the Core would be a commitment to decoupling from the PRC in a gradual and market-driven manner that sustains the rules-based trading system.

As discussed in the first part of this essay, members of the Core may also broaden export controls on dual-use technologies to the PRC. These would be policies not of decoupling but of *technological dominance*. Therefore, the enforcement of export controls would be up to individual member states, not the ESCB. This report does not discuss export controls further. The rest of this section discusses how the Core could legally and operationally decouple from the PRC in noncritical goods.

LEGISLATIVE ACTIONS

All Core allies would need to revoke permanent normal trade relations (PNTR) with the PRC. This legal status provides trade partners with the same advantages offered to WTO members.[141] In the United States, revoking PNTR would require sixty votes in the Senate. This would be a significant political obstacle in normal circumstances but not in the break-glass scenario. To enhance credibility for scenarios in which the PRC tried to avoid firing the first shot, Congress might consider legislation that would automatically revoke PNTR if Congress or the president found that the PRC had begun a quarantine of Taiwan or imposed a blockade.[142]

In the United States, decoupling would be authorized legally through Section 232 of the Trade Expansion Act of 1962.[143] Under current law, the president has broad discretionary power to impose import restrictions if a Commerce Department investigation finds that certain imports threaten to impair US national security. Any department, agency head, or "interested party" can ask the Commerce Department to initiate an investigation, which can take up to 270 days. If the Commerce Department makes an affirmative finding, the president has an additional 90 days to impose whatever remedy s/he thinks is most appropriate. Before the Trump administration, Section 232 power was used sparingly.[144] Many US allies find it deeply concerning, since the Trump administration breached long-standing norms when it imposed Section 232 tariffs on steel imports from countries such as Canada, South Korea, and Japan in 2018. Still, the Trump administration proved its point: current US law recognizes a vaguely defined exception that allows the president to restrict trade on national security grounds.

In the Day One contingency, Congress would presumably want to amend Section 232 to take control of the avalanche decoupling process. The decision to trigger avalanche decoupling is too significant to give to a single person, unless Congress authorizes that person to decide. The current procedure is far too slow to be appropriate in a fast-moving Day One contingency. The Commerce Department lacks the legitimacy to make the determination that all trade with the PRC constitutes a national security threat, and pursuing full decoupling under Section 232 might face legal challenges. Furthermore, in the Day One context, Section 232, as currently written, would give the president too many powers and the wrong incentives to use them effectively. On the one hand, the crisis context would allow the president to justify shattering historic norms surrounding Section 232 and to use the power indiscriminately against US allies and trading partners, violating the spirit of trade agreements that Congress has ratified. On the other hand, the current language of Section 232 would give the president the power to modify, pause, or even reverse decoupling with the PRC if it ever became personally politically advantageous to do so. Since the United States holds presidential elections every four years, the US government could not commit credibly to ratcheting toward full decoupling under these conditions. If Washington could not make a credible commitment to see the avalanche decoupling through, the Core would be unlikely to follow.

Fortunately, once Congress revoked PNTR with the PRC, a few small amendments to Section 232 would suffice to trigger the avalanche while sustaining checks and balances between the legislative and executive branches' powers on trade policy. The amended

Section 232 text would give Congress the sole power to declare a foreign country a "systemic threat to national security" and create a mechanism for ending or phasing out trade with such countries over time. In other words, once Congress established a ratchet, the president would not be allowed to tamper with it without congressional approval. Congress might also consider restricting the president's future authority to use Section 232 against US treaty allies. Bipartisan groups in the House and Senate have already proposed legislation to this effect.[145] However, the president would retain the primary authority under Section 301 of the Trade Act of 1974. As a result, in practice, it would be up to the president to decide how to deal with third countries found to be illegally transshipping goods into the US market.[146]

DECOUPLING LEGALLY UNDER WTO RULES

The United States and the Core would decouple from the PRC in a manner consistent with WTO rules. There is no mechanism for expelling the PRC from the WTO, but the national security exemption permits member states to violate WTO rules in times of geopolitical crisis. The exemption in the WTO Articles of Agreement was established in Article XXI of the GATT Charter and was mirrored in the agreements on services (as Article XIV of GATS) and intellectual property (as Article 73 of TRIPS) that came with the creation of the WTO.[147] Its text is as follows:

> **Nothing in this Agreement shall be construed**
>
> (a) to require any contracting party to furnish any information the disclosure of which it considers contrary to its essential security interests; or
>
> (b) to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests
>
> > (i) relating to fissionable materials or the materials from which they are derived;
> >
> > (ii) relating to the traffic in arms, ammunition and implements of war and to such traffic in other goods and materials as is carried on directly or indirectly for the purpose of supplying a military establishment;
> >
> > (iii) taken in time of war or other emergency in international relations; or
>
> (c) to prevent any contracting party from taking any action in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security

On Day One, the Core would therefore declare that the PRC's decision to begin a Taiwan crisis represented a "systemic national security threat" as an attack on the entire rules-based system. This claim would justify any and all discriminatory policies that the United States might then impose on the PRC and other countries currently under international sanctions, including potentially Russia and Iran. Self-evidently, a PRC invasion of Taiwan would constitute a time of war under section (b)(i). Any attempt to blockade or quarantine Taiwan would constitute a similar “emergency in international relations,” given Taiwan’s importance in the global economy and Beijing’s repeated bilateral commitments to refrain from the use of force against Taiwan. Several recent examples highlight this precedent. Notably, in 2019, a WTO panel upheld Russia’s policy of denying transit to Ukrainian goods through the Black Sea, citing the national security exemption.[148] Similarly, the G7’s sanctions on Russia since 2022—including tariffs and market manipulations such as the oil price cap—are broadly accepted as justified under the national security exemption.

To strengthen the political legitimacy of the Core’s legal claim, Taiwan, a WTO member in its own right, could also bring suits against the PRC. Members of the WTO do not have to be states, only “governments acting on behalf of a separate customs territory.”[149] Taiwan acceded to the WTO in 2002, a month after the PRC, under the name “the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu.” Taiwan could challenge PRC aggression in the WTO in the event of a quarantine or blockade, even if there were no kinetic invasion.

Beijing would probably challenge the United States’ broad interpretation of the national security exemption and seek WTO arbitration.[150] However, even setting aside the strong US legal case and the current logjam in the WTO’s dispute settlement process, resolving this legal battle would take years, and neither side could be forced to abide by the ruling. Nor would the WTO have any authority to prevent the United States from intervening in currency markets, despite the enormous impact this might have on international trade.[151] Beijing’s complaints would therefore be mainly political theater, an attempt to persuade the Global South that Washington was to blame for undermining the global trading system.

Crucially, Washington would frame its invocation of the national security exemption as a defensive reaction to the PRC’s aggression, not as a pretext for undermining the WTO. The current US position is that national security interests are self-justifying—that is, they are what a state says they are, and they cannot be assessed by WTO jurists.[152] There is an argument for this position in principle. However, in the unique crisis context of Day One, it might be a mistake to continue to emphasize it. If other countries concluded that the United States was abandoning WTO principles altogether, they might cite the national security exemption to retaliate against the United States, and global trade could collapse as the world’s major economies spiraled into a multi-front trade war. The United States should therefore emphasize its commitment to WTO principles by continuing to abide by WTO rules and norms in its relations with nonrogue states as much as possible. This means that it would need to exercise restraint in using the national security exemption to justify trade action against other countries.

The United States would also need to make clear that while it considered the PRC to be a *systemic threat to the rules-based economic system*, it would not demand that other countries accept this designation or even condemn the PRC’s violent moves against Taiwan. Third countries would merely have to accept that the Core states were acting lawfully in imposing discriminatory trade policies against the PRC. The incentives for countries to take this position would be structured through the ESCB, as discussed below.

RATCHETING TARIFFS OR QUOTAS

To implement decoupling, the Core would impose ratcheting discriminatory policies upon trade with the PRC. The most obvious way to do so would be through a ratcheting tariff regime, although it could also be done through quotas that ratcheted downward. The speed of the ratchet would depend on the nature of the Day One crisis. In a wartime context, most US-domiciled multinational firms might withdraw from the PRC of their own accord, fearing legal or political retaliation. While avalanche decoupling may be triggered outside the context of a kinetic war as a response to a declared quarantine of Taiwan, it is also possible that the maritime trade routes connecting the PRC's industrialized coastal region to the global economy would be disrupted. It is therefore impossible to specify in advance where tariff or quota levels should be set on Day One or how quickly they should ratchet going forward. The design of the ratchet would be a political decision made on Day One.

There are several potential advantages to a ratcheting regime. Raising tariff levels gradually in exchange rate–adjusted terms would smooth out the disruption to global supply chains over time and minimize sticker shock for consumers. There would be no initial baseline. In other words, if a tariff were the chosen approach, it would begin at 0.0%. A ratcheting regime would also provide more clarity for financial markets and clearer signaling for industry than an ad hoc system in which political leaders had to keep agreeing on the optimal rate.

It is less important that the tariff or quota ratchet quickly than that it be difficult for politicians to interfere with the ratchet in the future. The goal of the ratcheting policy is to leverage private investment by persuading firms that full decoupling from the PRC is inevitable. If this inevitability can be established, capital markets will reward firms that act decisively to reshore their supply chains into safe countries while punishing those that do not.

ENFORCEMENT

As the Core countries ratcheted up trade barriers against PRC products, the incentives would grow for firms to re-export PRC products into the Core via third countries. This "leakage" problem is a perennial challenge for all tariff regimes. Since the Trump administration imposed tariffs on the PRC in 2018, there have been many well-documented examples of elaborate fraud networks for laundering PRC goods.[153] According to a study by *The Economist*, the value of made-in-PRC goods entering America via third countries to evade tariffs may have exceeded $100 billion in 2021 alone—more than total US imports from Japan or Germany in the same year.[154] Firms in Southeast Asia regularly repackage and re-export PRC intermediate goods without appropriately indicating their origins.[155] More recently, Central Asian countries with long land borders with Russia, such as Kyrgyzstan, have seen "imports" of manufactured goods soar several thousand percent as countries seek to evade sanctions on Russia.[156]

Executing avalanche decoupling will require a new approach to customs enforcement and border security. Since the negotiations for the 1993 Uruguay Round, the global trend in customs enforcement has been a shift in focus from physical border inspections toward "automation, risk management, and intelligence."[157] However, the current customs system is already beginning to come under strain. Fentanyl precursors continue to flow across borders, with devastating human costs. New regulations preventing the import of products made with forced labor and increasing interest in carbon border adjustment mechanisms (CBAMs) are also putting growing pressure on customs and border authorities.[158] To decouple from the PRC in any form, the Core would have to modernize their customs and border protection agencies and give them the resources necessary to succeed. Determining whether a product or its key components were substantially "Made in China" would be difficult, particularly as incentives to transship increase. Considerable progress has been made on standardizing nonpreferential rules of origin since the Uruguay Round's Agreement on Rules of Origin.[159] However, to accelerate decoupling, the Core might impose stricter origin requirements on particular goods and materials, in the manner of a preferential trade agreement. The details of these proposals can be negotiated in advance of Day One.

It would also be important to manage the flow of small parcels from the PRC into the Core. Under the de minimis rule, US Customs and Border Protection currently exempts import packages below $800 in value from typical customs inspections. The rise of e-commerce has made it easier to send parcels between customs regimes without proper inspections, and tariffs create incentives for buyers and sellers to use this approach. After the Trump tariffs were imposed, the number of packages entering the United States tariff free under the de minimis rule rose from 150 million in the 2016 fiscal year to over 1 billion in 2023.[160] Any process of trade decoupling would require reform to de minimis rules to close this loophole. There is already bipartisan support in Congress for de minimis reform.[161] Other Core countries would need to tighten their own de minimis rules.

Ultimately, minimizing transshipment would be the most challenging aspect of any decoupling strategy. No approach will be perfect, and there will be significant leakage, even in the best-case scenario. While perfection is not necessary to achieve broad decoupling over time, a generally effective customs regime is a precondition for avalanche decoupling. Further investment in US Customs and Border Protection and similar institutions in other Core countries would be a sensible preparatory step before any Day One crisis but would not be sufficient.

To achieve avalanche decoupling, the Core would need to incentivize third countries to honestly report when PRC products are transshipped through their domestic markets. This is where the ESCB comes in, as discussed below.

INDUSTRIAL POLICY

As discussed in the first part of this report, the Core allies would likely try to break their critical dependencies on the PRC in any Day One crisis, even outside break-glass scenarios. Actual or threatened PRC export controls would make it essential to develop alternative supplies for active pharmaceutical ingredients, for example. In the break-glass scenario, a larger basket of products would likely fall in this category. Industrial policy would not be appropriate for all goods, but it may be appropriate to invoke the Defense Production Act to ramp up supplies of a small number of essential products, as the Trump and Biden administrations did during the pandemic.[162]

In the break-glass scenario, the Core would have a common interest in using coordinated industrial policy to quickly reshore the most sensitive supply chains. These measures might be coordinated internationally by the US Departments of Treasury and Commerce and their allied equivalents, implemented according to domestic law, and made subject to regular review and renegotiation. To hedge against the risk of PRC trade retaliation, the group might also coordinate and finance the creation and maintenance of joint stockpiles. For critical products, Core countries would strive to build sufficient production capacity to fully substitute reliance on the PRC.

Under the Day One Plan, the United States would conceive of the Core, rather than the United States itself, as the home market. This would be important for reasons of both efficiency and political pragmatism, given the risks that some Core states might seek to use the process of decoupling to gain unfair competitive advantages over one another. Given the Core's fluid composition, formal dispute resolution mechanisms would not be possible. It is therefore essential that the bloc operate as much as possible through norms underpinned by US economic leadership, as well as economic expertise and empirical data. Inspired by the history of the GATT and Marshall Plan, Washington would therefore have to be prepared to stand back and allow other members of the Core to play leading roles in this process, both symbolically and substantively. Decisive US unilateral action would have triggered the process of avalanche decoupling. Once this process began, however, US restraint would be essential to bind the Core alliance together. The Core, after all, would advance US interests by implementing discriminatory policies against the PRC and sharing the fiscal burden of decoupling.

PRC COUNTERMEASURES

The most immediate PRC political response to these measures would be political and legal. Acting unilaterally or in a relatively small countercoalition, the PRC could block the IMF, World Bank, and WTO from achieving essential functions in line with US interests and then blame the United States for the resulting institutional dysfunction. Beijing could also organize a political campaign to rally third countries, private firms, and other actors against avalanche decoupling. This political grandstanding would have no immediate effect on the Core's ability to impose bilateral trade restrictions on PRC products, but it would create a political risk that major countries in the Global South might fall in line with this propaganda, blaming the West for the economic disruption of the Day One crisis and ultimately collaborating with the PRC to undermine the avalanche decoupling program. Managing perceptions in the developing world would be strategically critical to the long-term success of the Day One Plan and is one reason why the ESCB would play an essential role.

The PRC could also retaliate economically by dumping cheap products on global markets. As discussed in Part 2, the CNY would probably weaken after Day One, due to market forces. The US unilateral currency intervention described below would confirm and intensify this trend. The PRC could also increase subsidies to its manufacturing sector to give its exports an additional unfair advantage. The first-order effect would be an increase in PRC exports, once any physical risks to maritime transport within the First Island Chain abated. PRC products would therefore crowd out domestic production in markets that did not erect tariffs. The second-order effect, however, would be that industrialized and industrializing countries would feel pressure to put trade restrictions on cheap PRC products, lest their domestic industries be wiped out. In the medium term, the Core would exploit this trend to seek trade policy alignment with India, Brazil, and other industrialized and industrializing countries.

POLICY 1: CORE TAKEAWAYS

- On Day One, the United States and a small group of US allies ("the Core") would implement discriminatory bilateral trade policies against all goods coming from the PRC and other states labeled "systemic security threats."

- These tariffs or quotas would start at extremely low levels, leaving noncritical supply chains with the PRC largely open, but would ratchet over time, bringing total bilateral trade to zero over a politically negotiated period of years.

- Only the Core would decouple from the PRC. Third countries would be under no legal obligation or political pressure to change their trading relationships with the PRC in any way.

- The Core countries would present their actions as legal under WTO rules. They would argue that PRC actions had rendered further economic dependence on the PRC a national security threat to themselves while emphasizing they would exercise restraint in using the national security exemption in other contexts.

- The Core countries individually and collectively would need to develop a coordinated industrial policy for critical products, especially electronic components with dual-use functions that the PRC might cease to export in a crisis.

- The Core countries would need to develop joint stockpiles of key products for which they depend on the PRC, such as critical minerals and active pharmaceutical ingredients.

- The PRC's political protestations could do little directly to stop this decoupling process.

- Over the longer term, the greatest challenge would be how to prevent the systematic transshipment of (possibly mislabeled) PRC goods into the Core bloc via third countries. Leakage would increase as the RMB was increasingly devalued.

- Solving the leakage problem would require incentivizing third countries to build and use the customs administration capacity that they lack today. This is why the ESCB would be necessary for avalanche decoupling to succeed.

POLICY 2: PRESERVING DOLLAR HEGEMONY

Day One would be a pivotal moment for dollar hegemony. As established above, the immediate outbreak of a Taiwan crisis would likely see a flight to safety in dollar assets. However, the dollar's favorable position could crumble quickly if the United States abused sanctions and/or lost its political or military showdown with the PRC. The PRC is preparing to rapidly internationalize its currency in a crisis. Maintaining dollar hegemony regardless of the political outcome of a Taiwan crisis would be a critical goal. Since expelling the PRC from the dollar system would not be realistic or prudent, US policy should seek to *lock the PRC inside the dollar system while the avalanche decoupling proceeds*. This approach would minimize rogue states' ability to violate existing sanctions and export controls while degrading the PRC's terms of trade to erode its long-run competitiveness.

This section explains how the Treasury, with authorization from Congress, could accomplish these goals by executing a large-scale short trade against the CNY and HKD. If successful, the proposed operation might cause the rapid implosion of the PRC banking system on Day One. It would also very likely force Beijing to expend a large amount of its FX reserves to stave off a crisis while making a profit for the US taxpayer. However, US financial operations alone would have little long-term impact on the PRC economy. Even if the CNH lost much of its value, it would retain a fundamental value if it could be exchanged for PRC products. To prevent CNH and HKD exchange rates from rebounding later, the Treasury would need to continue currency market operations indefinitely, which could become expensive. To defray these costs and the risks of losing money on the trade, Washington would need a credible plan to achieve broad economic decoupling over time, eroding the fundamental value of the CNY by taking away the PRC's major export markets. If Washington succeeded in this long-term plan, the US taxpayer would eventually realize a large profit. If Washington failed to follow through on avalanche decoupling, the currency intervention could end up becoming an enormous liability for the US taxpayer. Currency intervention, therefore, would not be a standalone option for meaningful long-term economic punishment. It would be a down payment—a commitment to do "whatever it takes"—on a subsequent effort to see decoupling through.

TREASURY ACTION

In the context of large-scale Fed swap lines to provide bilateral dollar liquidity to third countries, the Treasury would intervene in currency markets on Day One against the CNH and HKD. The operation's proximate goals would be as follows:

- Break the pegs between the CNY and CNH, and between the HKD and USD.
- Drive down the HKD and CNH exchange rates as far as possible.
- Keep HKD and CNH weak and volatile for an indefinite period, raising transaction costs and exchange rate risk to disincentivize third parties from holding them.
- Force the PRC to spend its liquid FX reserves defending the exchange rate.

It is impossible to predict in advance exactly how far and fast the CNH and CNY might depreciate. As discussed in Part 2, the CNY exchange rate is protected by capital controls. If the capital control regime broke, a tsunami of capital could flow out of the PRC, causing a collapse of the banking system. This is not the base case, as PRC authorities would likely act decisively to tighten capital controls. Still, the fact that senior PRC policymakers and financial experts fear "currency sniping" suggests that they are not perfectly confident about how capital controls would hold up in a crisis.

The most likely scenario is that Beijing would abandon the CNH—and potentially the HKD peg as well—and return to its pre-2015 model of a single currency (CNY) behind capital controls. In this scenario, the PRC economy would continue normally, and Beijing would conserve its FX reserves for a rainy day. However, Beijing's trading partners would no longer be interested in taking payment in CNH. Beijing would have to be careful about offering swap lines of CNY to foreign partners, since the Treasury could potentially borrow CNY from them and sell it, driving down the onshore exchange rate. PRC firms would therefore have to conduct international trade in dollars or other FX using payment and clearing systems that they did not control.

The CNH market is also joined at the hip with the Hong Kong financial system, which presents an additional PRC vulnerability that Washington could exploit. Hong Kong has always been the main settlement hub for offshore transactions, with its banks handling 75% of CNH clearing. London comes in a distant second.[163] The Hong Kong Monetary Authority (HKMA) also serves as a vital provider of CNH liquidity. The HKD is pegged to the USD, and the HKMA intervenes in FX markets to keep the HKD in a band between 7.75 and 7.85.[164] The peg undergirds Hong Kong's financial system. If the peg collapsed, and Hong Kong's financial institutions became insolvent, the PRC would lose its most important clearing center for RMB transactions. A collapse of the Hong Kong banking system could also ripple through mainland capital markets, especially if margin calls forced Hong Kong banks to dump assets on the mainland. This presents a major vulnerability to exploitation. Beijing would probably intervene to preserve financial stability in Hong Kong.

If the US Treasury attacked the HKD, backstopping the HKD's peg to the US dollar could become another drain on Beijing's reserves. The HKMA holds FX reserves several times the size of the Hong Kong monetary base, which has enabled it to maintain the peg even in moments of great strain, such as the 2019 protests and 1997 Asian Financial Crisis.[165] However, in a Taiwan crisis, Hong Kong would face a grim combination of forces: existential risk to short- and long-term viability of its financial sector, forced selling of real estate, an exodus of foreign residents, and a collapse in its export facilitation sector. Foreign hedge funds have already eyed the peg for decades as a potential target for a speculative attack.[166] Given that the HKD is the world's ninth-most traded currency, the HKMA's reserves are small relative to the potential firepower that global capital markets could put behind a short trade. The PBoC and HKMA already have swap lines established, and these could be expanded in a crisis.[167] Nevertheless, depending on the extent of selling pressure, a simultaneous speculative attack on the HKD and CNH could force the PRC to bleed enormous quantities of reserves. If the HKD peg broke, capital would flood out of Hong Kong, the HKD would depreciate sharply, and international investors would be even less inclined to hold or take payment in CNH.[168]

Attacking the CNH and HKD at the same time would involve putting more US taxpayer money at risk and would cause far greater collateral damage to the global financial system, but it would further undermine the CNH capital market and increase the probability of a crisis in the PRC's domestic banking system. Washington should prepare in advance to do both, with the final decision resting with the president.

MECHANICS OF CURRENCY INTERVENTION

The US and its allies have various tools to attack the CNH that do not involve putting taxpayer dollars at risk. These include banking sanctions, fines, and taxes on CNH transfers. However, the most effective approach would be an open market operation to short the CNH.[169] The Treasury would borrow CNH at a fixed interest rate, then dump it on the open market. Also known as "short selling" or "going short," this trading strategy enables an investor to sell a financial asset (such as a stock or a currency) that it does not currently own, but which it hopes and expects will decrease in price. The goal of a short trade is to profit from a decline in the price of the asset by arranging to sell it when it is expensive and buy it back later for a lower price.

It is also possible to execute a short trade without physically exchanging currency. This can be done using a nondeliverable forward (NDF), an agreement between two parties to buy or sell an asset at a specific price on a future date. At the time of settlement, the parties determine the difference between the agreed-upon exchange rate (the contract rate) and the prevailing market exchange rate on the settlement date. When that date arrives, one party pays the other party the cash amount equivalent to this difference. If the price of the asset declines between when the NDF is opened and when it is settled, the short seller makes money. NDFs would be the simplest tools for the Treasury to short the CNH because they would not require the Treasury to take ownership of CNH or pay interest. However, it is not clear how many counterparties would be willing to offer NDFs to the Treasury, as opposed to lending their CNH for a profitable interest rate.

The Treasury's primary objective in a currency intervention would be to destroy the value of the CNH, not necessarily to make a profit. As a result, the operation would work slightly differently from a conventional short trade:

1. Congress would authorize the Treasury Department to use the Exchange Stabilization Fund (ESF)—its emergency reserve for FX intervention—to borrow and transact in CNH.[170] Congress has modified this authority before, most recently during the pandemic.
2. The Treasury would offer to borrow an infinite quantity of CNH from foreign central banks and institutional investors at the prevailing interest rate, plus a small premium to incentivize the transaction.[171] If desired, the Treasury could negotiate to make its interest payments in dollars.
3. The Treasury would also offer to take out as many NDFs as possible, betting that the value of the CNH would decline in the coming days, months, and years.

(*continued*)

4. Foreign investors, in response, would seek to borrow as much CNH as possible from PRC institutions at the PBoC's prevailing interest rate, since they could lend them on to the Treasury for a risk-free profit.
5. If Beijing wished to defend the CNH exchange rate, it would have to direct PRC banks to halt the issuance of new CNH loans offshore. It would also need to buy up CNH from the Treasury and other offshore investors using dollars or other FX from its reserves. Together, these actions would reduce the amount of CNH in circulation. Beijing could not return this CNH to circulation in the future without selling it, which would weaken the exchange rate in the process.
6. In light of the Treasury's actions, and Beijing's potential responses, third parties holding CNH would have to choose. If they expected the CNH to hold its value or appreciate—that is, if they expected the Treasury's short trade to fail—they should buy NDFs or lend their CNH to the Treasury, the world's safest borrower, for a "risk-free" profit. However, if they expected the CNH to depreciate—that is, if they expected the short trade to succeed—then the only rational decision would be to sell all their CNH before the price fell.
7. When the Treasury acquired the CNH, it would offer to sell it all on the open market at the current market price, going "short."
8. The Treasury would continue to borrow and sell CNH indefinitely until directed by Congress to stop.
9. If the short trade worked, and the value of the CNH fell significantly, the Treasury could negotiate with its creditors to repay its CNH loans in dollars instead, at a favorable exchange rate.
10. Insofar as the Treasury still needed to repay loans in CNH, its operations would need to become unpredictable. The Treasury could not buy back CNH to cover its short positions without causing the CNH to strengthen. Private investors would anticipate that the CNH would strengthen before the Treasury's larger CNH loans came due, as major repurchases would be necessary. Speculators might try to exploit this fact by attempting to hitch a ride on the CNH during periods of strengthening. The Treasury would therefore have to keep its schedule of CNH liabilities secret and buy and sell CNH in unpredictable quantities and at irregular intervals, perhaps in coordination with major US and allied banks.
11. Whenever the supply of CNH for sale exceeded the demand to buy CNH, the exchange rate would fall. If the exchange rate became highly volatile, the PRC's trading partners would be disincentivized to hold it, or even to accept payment in it, lest they find themselves unable to sell it to someone else later.

The CNH market is quite small, which makes it a relatively easy target for speculative attacks. As of July 2021, just $200 billion worth of CNH was deposited offshore. The derivatives market is even smaller and shallower, which would give speculators an additional tool to wreak havoc.[172] Anticipating this vulnerability, the PRC is trying to expand the market. Unfortunately for the PRC, allowing the CNH market to grow comes with a trade-off. The bigger and deeper the market gets, the more FX the PRC might have to spend to keep the exchange rate stable in a crisis. The smaller and shallower the CNH market, the less costly it would be to attack it.

PRC COUNTERMEASURES

Most of the PRC's options for retaliating against the currency war involve using its dollar reserves to persuade the market that it can remain in control of the exchange rate, overpowering or outlasting Treasury action. Beijing would have two basic strategies: increasing demand for CNH, CNY, and HKD and making the currency intervention more costly for the Treasury. Both strategies would have some downsides for the PRC.

The PRC has trillions of dollars of FX reserves that it could hypothetically use to support both exchange rates. The PRC's State Administration of Foreign Exchange (SAFE) held $3.2 trillion in FX reserves at the end of April 2023. It may also be able to mobilize up to $3 trillion more through the sovereign wealth fund and state banks, though it is not clear how much of these "leveraged" FX holdings are liquid.[173] The PBoC can also acquire dollars by selling CNH, thereby weakening the exchange rate, as it has done in the past.[174]

Still, the PRC would have to ration its FX reserves carefully. If Beijing spent too much of its reserves attempting to defend the currency but lost control of the exchange rate anyway, it might face a balance of payments crisis in the future if avalanche decoupling took place and its terms of trade became unfavorable. In any scenario, US pressure on CNH would force the PRC to adopt policies that would make its currency undesirable for use by third parties, including restricting convertibility and draining liquidity from the CNH capital market. The capital market for CNH is already underdeveloped, so the currency today is useful for buying the PRC's exports but little else. Countries exporting to the PRC would demand payment in dollars or other more stable currencies. Finally, the more carefully Beijing rationed its FX reserves, the less dollar aid it could provide to the rest of the world on Day One of a Taiwan crisis.

The PRC could also adopt policies to increase external demand for CNH and shrink the CNH money supply. Russia successfully deployed some of these policies when it rescued the ruble in March 2022. Thus, the PRC could execute the following measures:

- Instruct PRC state-owned banks and sovereign funds to buy CNH on the open market and hold it indefinitely.[175]

- Raise interest rates on CNH and CNY deposits to discourage bank withdrawals.

- Shut onshore exchanges and prohibit PRC financial institutions from helping foreigners liquidate assets onshore.

- Tighten capital controls, potentially including physical limits on outbound travel.

- Demand that foreign countries buy PRC goods pay in CNH.

Taken together, these measures would effectively reduce the money supply of CNH while encouraging market participants to buy or hold CNH, thereby pressuring the exchange rate to appreciate. Raising interest rates on CNH deposits would also increase the interest rate that the US Treasury had to pay on its CNH borrowings.

The challenge for Beijing is that efforts to shrink the CNH money supply would contradict efforts to expand trade in CNH. Once PRC banks and other entities had bought up CNH, they could not return it to circulation without selling or lending it, which would weaken the exchange rate. Moreover, if the PRC's export partners stopped paying in FX but Beijing had to continue paying for most of its imports in FX, the State Administration of Foreign Exchange (SAFE) could potentially drain its FX reserves by over $2 trillion per year. The PRC's imports in 2023 amounted to $2.56 trillion.

Another strategy would involve accepting a devaluation of the CNH and trying to stabilize the CNH/CNY exchange rate at some weaker level. There is no reason, in principle, for the CNH and CNY to be pegged 1:1. So long as they are freely convertible at some exchange rate—such as 2:1, or even 10:1—the PRC could maintain the purchasing power of the CNY while limiting the incentives for arbitrage. If the two exchange rates could be re-pegged at another level, third parties would once again have incentives to hold it, as CNH would be useful for buying the trillions of dollars of PRC exports that the world currently consumes every year. However, having abandoned the initial peg, the burden of proof would be on the PRC to persuade markets of the reliability of the new peg.

If the CNY and CNH exchange rates to the dollar were moving independently, the PRC's capital controls would come under extreme pressure. Today, PRC authorities currently allow regulated financial institutions to make 1:1 conversions of CNH to CNY under controlled conditions. This arrangement would become problematic if a peg could no longer be maintained because PRC entities could profit through arbitrage. Private PRC enterprises would seek excuses to buy dollars with CNY, perhaps under the pretext of buying foreign components; use those dollars to buy CNH; and then convert them into CNY for a profit.[176] PRC firms receiving payment from foreign customers might also have incentives to seek payment in dollars, hide those earnings overseas from their own authorities, and convert them later after the CNH had weakened further. These activities would be highly likely to cause the CNY to weaken, exacerbating pressure on capital controls and causing domestic inflation. In the long term, these potential risks would be highly problematic for the PRC. To prevent the PRC from re-pegging the CNH to the CNY in the future, the Treasury would simply double down on its short selling.

The following PRC counterstrategies would probably not work:

1. The PRC could ban conversion between CNH and dollars, requiring that all CNH transactions take place on CIPS. However, the Treasury could respond by selling CNH in exchange for euros, yen, or any other currency for which CNH conversion was not banned. If necessary, the Treasury could conduct its currency intervention through proxies.
2. The PRC could try to establish a cryptocurrency pegged to the dollar. However, the Treasury could simply short the cryptocurrency, draining FX reserves in the process.

3. The PRC could hypothetically create a blockchain-enabled e-CNH that automatically demonetized itself when taken off the CIPS platform. However, it is not clear whether such a solution is technically possible. Even if it were, foreign central banks and private actors might not want to hold a currency that the PRC government could demonetize at will.

SECOND- AND THIRD-ORDER ECONOMIC EFFECTS

Intervening in global currency markets is not without risk for the United States. The risks fall into two categories: fiscal losses, and effects on the monetary base that affect prices.

If the Treasury engaged in a large-scale short trade against the CNH and HKD, it would be making a bet that the value of these currencies would fall rather than rise. If the currency intervention turned out to be a self-fulfilling prophecy, the Treasury would make a profit that could be disbursed to taxpayers or used for other purposes, such as paying down the national debt. However, if the trade failed for any reason, and the CNH and HKD exchange rates to the dollar rose above the level at which the Treasury had shorted them, then the US taxpayer would face significant and theoretically unlimited fiscal liability. The Treasury would also lose money if the exchange rate held constant, because it would have to pay interest (possibly denominated in CNH) on the CNH that it borrowed. In a sense, the currency intervention could therefore be understood as a nonrefundable down payment on future trade decoupling. The United States would now have a powerful fiscal interest in eroding the long-term fundamental value of the PRC's currencies by destroying its terms of trade.

The risks to the currency intervention would come from independent market participants, not just PRC counter-intervention in the markets. The further the CNH exchange rate fell below its fundamental value, the more attractive it would be to speculators. No matter what the Treasury did, the value of the CNH would be unlikely to fall all the way to zero. Indeed, the exchange rate would probably continue to fluctuate wildly for as long as the Treasury's currency intervention lasted. CNH would have some value as long as PRC exporters were willing to accept it as payment.[177] CNH would also retain some value as a "war option."[178] Even if the PRC ran out of FX, it would still be able to purchase essential imports by issuing IOUs denominated in FX.[179] The US government would therefore have to show credibly that it could sustain the short trade for as long as necessary.

Importantly, the point of the currency intervention would not be to destroy the CNH altogether, but to render it a poor store of value. At any given market price and set of exchange rates, firms and countries prefer to be paid in a stable and secure currency rather than to receive the same amount in a devalued, highly volatile, or nonconvertible currency. This preference explains why all oil exporters today prefer to take payment in dollars rather than Bitcoin. Venezuela and Iran accept cryptocurrency for oil only because they are subject to dollar sanctions and are therefore forced to sell their oil at a discount.[180] The goal of the currency intervention would not be to shut down trade with the PRC. Indeed, the US government would encourage the PRC to continue to trade in dollars with the rest of the world by letting the PRC keep using the existing dollar payment networks: SWIFT and CHIPS. Rather, the goal would be to make it so that foreign countries and firms selling to the PRC preferred to take payment in dollars, euros, or other currencies—anything other than CNH. Major central banks and institutional investors would also reduce or even eliminate their allocations of CNH, further driving down the value. Insofar as Beijing wanted to pay for its imports in a currency that had only speculative value, it would have to pay a premium above the global market price.

In this context, currency intervention would be highly likely to succeed if—and only if—the Treasury enjoyed an ironclad and open-ended mandate from Congress. Congress can, in theory, authorize the Treasury to deploy an unlimited number of dollars for the purpose of shorting the CNH. On the other side of the trade, Beijing has and can theoretically acquire only a limited quantity of dollars to support the exchange rate by buying CNH and HKD. Thus, the goal of the operation would be to persuade both Beijing and the market that the CNH and HKD were indefensible.

The surest way for Congress to prove this commitment would be to give the Treasury unlimited authorization to deploy dollars for the currency intervention. Quite similar to European Central Bank president Mario Draghi's 2012 pledge to do "whatever it takes" to save the euro, such an action would send the message that the United States government was prepared to stake the credibility of its own currency on its ability to destroy the CNH while daring doubtful market participants to bet against it.

The effect of currency intervention on dollar price level is less clear, but it would not necessarily be inflationary. The Treasury would be deploying trillions of dollars to execute a financial operation, but it would not be spending them or injecting those dollars into the real economy in the manner of a fiscal stimulus. Shorting the CNH by borrowing it and selling it for dollars would reduce the dollar money supply. This, on its own, would cause the dollar to strengthen. The aggregate effect of the currency intervention on the dollar price level would depend largely on what happened to the value of the CNH and other peer currencies, which in turn would depend on how Beijing and financial markets responded to the Treasury's actions. If the currency intervention succeeded quickly, and Beijing allowed the CNH to collapse, the resulting impact on US prices would probably be mildly deflationary. If the currency intervention took longer to work because Beijing spent trillions of dollars buying CNH, the inflationary outlook would be uncertain for some time. It is possible that the dollar money supply could increase, with mildly inflationary results.

It would be the Federal Reserve's responsibility to manage the dollar money supply in light of the Treasury's currency intervention. The Fed maintains a balance sheet of roughly $8 trillion. Through the pandemic, it has asserted sweeping authority to expand or contract the balance sheet at will to maintain macroeconomic and financial stability. In any Taiwan crisis—with or without a currency intervention—the Fed would play a key role, intervening to maintain stable prices and support the banking system of the United States and friendly countries. If the dollar money supply abruptly expanded or contracted during the currency intervention, including through potential PRC fire sales of dollar assets, the Fed would have to act accordingly.

IMPLICATIONS

A successful currency intervention would incentivize capital outflows from the PRC, creating a large and enduring financial stability risk for Beijing to manage. Capital controls would be like a dam drained on the outside. If cracks ever opened in the dam, the CNY would sharply depreciate, and depositors would empty their onshore accounts, risking a financial crisis in the PRC. If the CNY depreciated, the PRC would experience inflation, since key imports such as energy are priced in dollars. Over the longer term, inflation may harm the legitimacy of the regime, as it did in the lead-up to the 1989 Tiananmen protests.[181]

The goal of currency intervention would be to force the PRC to settle most of its trade in FX using SWIFT or similar cross-border payment platforms that it does not control. The PRC's own CNH cross-border payment system (CIPS) would become virtually useless if foreign trading partners did not want to hold CNH or take payment in it, especially if Beijing could no longer safely issue CNY swap lines. The PRC could not build an alternative RMB trading system in the future without bringing the CNY and CNH back into alignment. The United States should not count on any particular outcome. However, all of the steps that Beijing would have to take would undermine the functionality of the CNH capital market, making it much more cumbersome for foreign entities to do business using CNH, and hamstringing Beijing's efforts to internationalize its currency quickly after Day One.

Steady and resolute US leadership in peacetime, undergirded by bipartisan consensus in Congress, will be essential for making the threat of currency intervention credible. Committing to a substantial program of emergency support and guaranteeing that all states will continue to be able to trade with the PRC in dollars would demonstrate the US commitment to supporting the global economy through the crisis. Simultaneously, the threat to do "whatever it takes" to destroy the CNH market would send a clear signal to the world that the US government was willing to take dramatic unilateral steps to preserve dollar hegemony and prevent Beijing from building a viable alternative system.

A weakening CNH by itself would not be all bad for Beijing. A weaker currency would not necessarily make the PRC's exports more competitive if these goods had to be shipped through a war zone, but in a quarantine scenario without kinetic conflict, or after a hypothetical war, a weak CNH would greatly boost the competitiveness of PRC exports. As discussed elsewhere in this report, this would pose a challenge for the US and its partners but also an opportunity.

POLICY 2: CORE TAKEAWAYS

- The Treasury would intervene in currency markets on Day One against the CNH and perhaps also the HKD, aiming to break the CNH/CNY peg and the HKD's peg to the dollar.

- The currency intervention would aim to keep CNH weak and volatile for an indefinite period, raising transaction costs and currency risk to disincentivize third parties from holding it.

- The strategic goal of the currency intervention would be to force the PRC to settle most of its trade in FX, using SWIFT or similar cross-border payment platforms that it does not control. Preserving dollar hegemony would allow the United States to enforce export controls on critical products and existing financial sanctions against Russia, North Korea, and Iran.

- To maintain capital controls, Beijing would be forced to spend its FX reserves in an attempt to stabilize the value of the CNH.

- If this attempt failed, Beijing would have to either abandon the CNH entirely or abandon the peg, putting further pressure on its capital controls.

POLICY 3: THE ECONOMIC SECURITY COOPERATION BOARD

On Day One, to persuade neutral countries to work with the United States rather than allowing private firms to actively undermine the decoupling process, the plan would have to be structured fundamentally and explicitly as a program of global economic recovery led by rules-based institutions. Otherwise, the avalanche decoupling strategy would lack political legitimacy and resilience.

Furthermore, to prevent a general turn to autarky, keep prices relatively stable, and provide countries with a clear incentive to enforce discriminatory policies enacted against the PRC and other rogue states, the United States would need to actively support global economic recovery through aid and investment. It would also need to limit the extent to which its own use of the national security exemption would give countries the green light to abandon the principles of the WTO altogether. As discussed in Part 1, the context of a strengthening dollar would make this particularly challenging. However, the United States would have a clear national interest in making such a commitment.

To achieve these goals and anchor the project of inclusive global economic recovery, the United States and its Core allies could establish an ESCB. They would vest the board with its own secretariat and a significant budget and incentivize as many countries as possible to join on Day One. The ESCB would not require potential members to decouple from the PRC or to oppose its actions against Taiwan. For non-Core members of the ESCB, membership would carry few political, legal, or financial obligations. Inspired by the Economic Cooperation Administration created as part of the Marshall Plan, the ESCB would have two primary mandates:

1. Provide dollar aid to member state governments and intervene as necessary to stabilize prices and support member states through the process of decoupling.
2. Support member states in accurately reporting when products or their component parts have been imported from states that one or more ESCB members deem a systemic national security threat and hold members accountable for acting as transshipment points for their products.

Both mandates are vital to the success of the Day One Plan, and when combined in a single agency, they would be mutually reinforcing. Aid would consist of financial, material, and technical support offered initially without conditions. By providing aid, the Core countries would be both showing economic leadership and demonstrating their commitment to sustaining rules-based global trade. Due to the incentives to transship, the Core would likely eventually need to put in place some punitive measures against third countries, because some countries would inevitably be tempted to serve as mass trafficking points for mislabeled PRC products. These challenges would need to be administered through an independent agency with sufficient legal legitimacy and power over purse strings to give all sides confidence that rules would be observed. By creating a clear framework by which discriminatory trade policy would be enforced, the United States would give confidence to private firms that decoupling would be possible within the context of the rules-based system, encouraging them to pull out of the PRC in the most efficient manner.

The Core would use the ESCB to provide financial support to countries that might play important roles in global supply chains during and after avalanche decoupling. Many of these countries would also face a severe economic shock resulting from the Day One crisis. Each country would face a unique set of challenges. Some countries would struggle to attract private investment during the crisis for geopolitical reasons that were out of their control. The ESCB would support US interests by enabling these states to remain relatively stable through avalanche decoupling.

Relatedly, by creating the ESCB, the United States would be sending a clear signal to global markets that its decoupling strategy would be targeted narrowly against the PRC and other rogue states and would not serve as a cover for a wider turn toward systemic protectionism. The ESCB would support the enforcement of discriminatory trade policies against nonmembers. If one member violated another member's discriminatory policies against a nonmember by failing to make basic efforts to prevent illegal transshipment, the ESCB would have the administrative power to determine that the transshipping state could be subject to discriminatory trade policies. In theory, two states within the ESCB could still use the national security exemption to implement discriminatory trade against each other. However, the ESCB would not be in the business of enforcing these policies. In practice, the ESCB would be intended to include as much of the global economy as possible. Its enforcement function would therefore be to support policies against rogue states, such as the PRC, Russia, Iran, and North Korea.

The ESCB would also support US interests by providing a framework for collective resilience against economic coercion by the PRC. In any Taiwan crisis scenario in which the US decides to decouple, Beijing may put considerable pressure on third states with export and import controls, offers of preferential loans or debt restructuring, and other economic instruments. The ESCB would give states the confidence and capacity to resist such efforts, although its power to do so would depend on how generously the Core was willing to fund it.

In short, the ESCB would not simply hand out aid but would play a vital role in shaping avalanche decoupling. It would establish and enforce the principle that states could protect their own economic security against systemic national security threats without abusing the national security exception. It would also ensure that the vast majority of states had a fair shot at gaining economic benefits from supply chain reshoring from the PRC.

HISTORICAL INSPIRATION: THE MARSHALL PLAN

The Marshall Plan (1948–52) provides a useful template for thinking through why American aid would be essential for institutionalizing the coalition. Under the plan, officially known as the European Recovery Program (ERP), the United States transferred $13.3 billion (around $173 billion in 2023 dollars) to Europe while encouraging the transition from wartime to peacetime economic structures. The Committee of European Economic Co-operation, tasked with representing the Western European negotiations, initially requested $29 billion in total aid over four years. Washington ended up appropriating less than half that amount, but the plan was still a success.

Recipient countries received Marshall aid on a roughly per capita basis. The major industrial countries received the largest shares of funding—26% to the UK, 18% to France, and 11% to West Germany. Altogether, seventeen European countries received benefits under the plan. US aid to Europe had previously been run through the UN on an ad hoc basis. The Marshall Plan funded aid for multiple years and backed it with administrative capacity, technical support, and a coherent agenda for encouraging European market integration.

Marshall funding and technical support gave Europeans the confidence to dismantle wartime controls on industrial production and allocation. Washington provided administrative and technical support through the Economic Cooperation Administration (ECA), which Congress established to administer the plan. The ECA was a fully US-run agency that had broad discretion to deploy Marshall funds, as well as "matching funds" that European states provided themselves. With only a small amount of aggregate spending relative to Europe's GDP, it improved productivity and established functional partnerships with industry and organized labor groups.[182]

The ECA was able to influence European policy for such a small sum because it gave recipient countries considerable agency. France poured Marshall funds into machinery and raw materials for manufacturing as part of Jean Monnet's "Plan for Modernization and Re-equipment."[183] France also maintained many state controls on the economy that left it "the most Eastern European" of all the Western European economies.[184] The ECA tolerated this, knowing that in the long term France was charting its own course within the Western coalition. Furthermore, France, Germany, and Italy all imposed tight national controls on agricultural production that contradicted Marshall's free-trade goals. Britain used most of its Marshall funding to pay down debt, bypassing the ECA entirely. "It was undesirable," the UK Cabinet Economic Policy Committee noted in January 1948, "that any opening should be given for excessive interference by United States representatives in our domestic affairs."[185]

The Marshall Plan's organizers emphasized practical areas of cooperation, including the regulation of trade and customs. One of the lesser-known outgrowths of the Marshall Plan was the Customs Co-operation Council, established in 1950 to encourage "the highest degree of harmony and uniformity in their customs systems and especially to study the problems inherent in the development and improvement of customs technique and customs legislation."[186] In 1994, the Customs Co-operation Council changed its name to the World Customs Organization, which still exists today to support member states in building customs capacity and standardizing customs procedures and nomenclature.[187]

All told, the Marshall Plan spent less than 3% of the recipient countries' combined national income during its active period while successfully achieving its geopolitical goal of building a coherent Western Europe opposed to Soviet influence.[188] The Soviets managed to leverage their military and political control over Eastern Bloc countries to make them reject the proffered US support. Crucially, however, former Axis countries and countries that remained neutral in the emerging Cold War were eligible for Marshall aid, not just former Allies. This decision proved farsighted, as it prevented neutral countries, such as Austria, from falling under Soviet influence at a time when communist parties were on the rise. The Marshall Plan also provided incentives to encourage the political cooperation that France saw as a prerequisite for lifting price controls, rationing, and production ceilings in occupied Germany. This decision enabled the reconstruction of West Germany as an anti-Communist bastion.

In the wake of a Taiwan crisis, different policies would be necessary. Far less US money would be required relative to the economic size of recipient countries, as the Core would not be in the business of rebuilding an entire continent ravaged by war. Still, two key elements of the Marshall Plan's success are worth highlighting:

- The explicit purpose of the Marshall Plan was to drive European economic recovery, not to punish the USSR or defeat communism. These were beneficial effects and central to the logic of the plan—but they were always implicit.
- In both design and implementation, the Marshall Plan gave recipient countries agency. While the long-term objective of the Marshall Plan was to drive European market integration and international trade, it accepted that in the short term, Western European states were going to want to pursue national development strategies at the expense of market efficiency, and it gave them considerable slack to do so. Implementation involved constant negotiation, and recipient governments did not always take the ECA's advice.

On Day One, the United States' efforts to preserve the rules-based economic system would be similarly framed not as "sanctions" or "economic warfare" but as economic leadership and recovery. Its objectives would be political as much as economic. To quote Secretary of State George Marshall, the United States would aim to restore the "confidence of people in the economic future of their own countries and of the [global] economy as a whole."[189]

STRUCTURE AND MEMBERSHIP

There is already precedent and momentum for multilateral policy coordination on economic statecraft. The G7 is currently coordinating sanctions against Russia through the G7 Enforcement Coordination Mechanism and smaller-scale cooperation efforts, such as the Russian Elites, Proxies, and Oligarchs (REPO) Task Force.[190] These ad hoc organizations were built out of the coalition to support the enforcement of specific sanctions.

The ESCB would be different. The ESCB would need to have a main secretariat located in a close US ally and global financial center, along with satellite offices across the globe that would be built over time. The institutional structure of the ESCB requires further research and analysis, but the essential principle should be that the ESCB would be operationally independent of the United States but not an exclusively legal institution in the manner of the WTO. One way to structure such a board would be to draw on the current structure of the IMF. For example, all member states might receive voting shares, weighted in accordance with their contributions to the annual budget, with the United States holding a de facto veto over key decisions as a result of the size of its initial commitment. Given that the Core allies would provide the overwhelming majority of the ESCB's operational funding, states that were committed to decoupling would, in practice, dominate the voting shares. If non-Core countries wanted operational influence over the ESCB, they would need to make corresponding financial contributions. Other structures could also be considered.

Membership would, in theory, be open to any country not considered by the United States a systemic security threat. Rules for accession would be agreed upon by the Core. The goal would be to begin with the biggest tent possible and sustain it over time. Neutral countries and countries that continued extensive trade with the PRC would be encouraged to join the ESCB on Day One in return for unconditional dollar aid.

The most important unanswerable membership question is whether or how EU member states might join the ESCB. Clearly, it would be preferable from a burden-sharing perspective if Europeans joined the Core and contributed as donors. However, the "EU 27" would likely be internally divided and might not unanimously support joining the Core. The European Single Market and Customs Union would make it impossible for some member states to join the Core while others stayed out.[191] Under European treaties, Brussels has primary responsibility for trade policy and trade sanctions, subject to the Council of Ministers, but member states enforce sanctions and trade policy under the supervision of the Commission.[192]

Every effort should be made in advance of Day One to persuade European nations to commit to joining the Core, but if this proves impossible, a natural compromise would be for Europe to stay out of the Core but participate in the ESCB. Brussels itself could become an active member of the ESCB and so possibly could individual EU member states, as membership of the ESCB would not require agreeing to a particular trade policy but the enforcement of the trade policy of other members.[193] In all break-glass political scenarios, close US allies in Europe would want to ensure continued US support for Ukraine and other related economic security priorities connected to the Russian threat. They would pressure Brussels to strengthen product identification requirements on products made with PRC components or re-exported via the PRC. Our base case is, therefore, that EU member states do not join the Core but need little incentive to participate in the ESCB.

Inspired by the Marshall Plan, the ESCB should distribute aid in tranches to member states, which could use the aid in consultation with ESCB advisors.[194] Before disbursing each subsequent tranche, ESCB administrators would assess both the use of the aid, the country's continued observance of WTO rules, and, as discussed below, its efforts to prevent transshipment. For political reasons, aid ought, therefore, be transmitted through the national governments of member states, not directly from the ESCB to businesses or multilateral or supranational institutions. The simplest form of aid would be direct dollar transfers. However, there may be circumstances in which the aid took the form of raw materials, as discussed below.

Given the political challenge of negotiating the ESCB's institutional design, the United States should hold consultations with key stakeholders and allied and partner governments in advance of Day One. No conclusive agreement is likely to be reached on draft articles of agreement in peacetime, but many foundational issues can be established by whichever states wish to be at the table during the consultations. Central bankers, international economists, trade lawyers, historians, and elected officials, among others, may participate in these preliminary discussions. Participants should bear in mind that the ESCB's raison d'être is not simply to enforce rules but also to sustain the political legitimacy of the rules-based trading system in the face of an all-out assault from a rogue PRC.

The agenda for the initial consultations should include the following points:

- What legal changes would be required in the key member states to enable the ESCB to operate?

- Beyond national aid, what power should the ESCB have to leverage its own funds for intervention in global commodities and financial markets?

- How would the staff be selected? Likely participants would include economists seconded from central banks and finance ministries, as well as academics, and lawyers nominated by national governments. It would probably be up to national governments to ensure that industrial and labor voices in their own countries were effectively represented.

The PRC should be aware of the existence of these negotiations but not necessarily of the substance. Public statements following consultations should emphasize consensus on the guiding principles of avalanche decoupling.

BUDGET

The size of the total budget is ultimately a political decision, based on how much Congress is prepared to spend relative to other priorities. Although the contribution of ESCB funding to global customs enforcement would be one of its most significant functions, the overwhelming majority of the budget would be dedicated to discretionary dollar aid. Therefore, there would be no funding level below which the ESCB would not work at all. The agency's political effectiveness at holding together the rules-based trading system would simply depend on how much money wealthier member states were willing to put into the pot. The greater and more stable the ESCB's funding, the stronger the incentives would be for third countries to cooperate with the Core and support the rules-based trading system. The amount of emergency funding required would also depend on the nature of the Day One crisis and the speed at which Congress decided that bilateral trade with the PRC must be phased out. To be blunt, the ESCB's budget would be a form of "political stimulus." The scale of the aid needed would reflect the scale of the challenge to the rules-based trading system, and the willingness of Congress to spend.

MANDATES

The ESCB would have two primary mandates, each defined and scoped in its articles of agreement.

Emergency Aid Distribution

The ESCB's mandate for aid would be to respond to the economic consequences of the Day One crisis itself. In the immediate aftermath of Day One, aid would likely consist of direct support to governments offered without conditions to allow them to respond effectively at the national level. ESCB member states could spend whatever aid they received however they saw fit, including on infrastructure spending, education, healthcare, or other programs. The ESCB would not seek to put its finger on the scale to direct the reshoring process but rather provide a sound financial and institutional background for the market to determine how supply chains moved.

Given that the Core's trade policies and the incentives to transship they inherently create would grow with time, economic aid would need to continue for a significant period of time. It might cover states victimized by PRC economic coercion or retaliation, as well as states facing economic crises resulting indirectly from a PRC economic slowdown or financial crisis associated with Core states' actions. Increasing amounts of funding would need to be given to states struggling to enforce customs rules effectively. As global supply chains would likely move in advance of ratcheting Core policies, this might mean continuing to provide aid to states experiencing rapid manufacturing-led growth and states that were continuing to rely on PRC products simultaneously. Levels of aid would then be reset—and likely substantially reduced—after the end of the next window.

As firms made decisions about how and where to reshore production, countries that failed to attract significant private investment would face an increasing incentive to transship, even with ESCB aid. Inevitably, some states would end up losing aid and significant access to the Core market under the ESCB's second mandate. Over time, some countries may end up as de facto members of the PRC's trading bloc. Still, all ESCB member states in good standing would enjoy ESCB collective insurance policies against PRC economic coercion. There would be a strategic, political, and economic benefit to keeping the ESCB a large tent—and giving states a reason to fear expulsion.

It is beyond the scope of this report to establish the formula by which the ESCB aid would be allocated. The formula would be the subject of political negotiation and might include metrics such as GDP per capita, population, state capacity, geographic proximity to and scale of trade with states designated by the United States systemic national security threats, and continued observance of WTO norms. As with current IMF staff, the ESCB administration would have to be empowered to guide each tranche of funding toward the states that most needed and deserved support.

Aid allocation would also need to deal with crisis disruptions to commodity prices, which are closely correlated with PRC demand. The PRC represents over 60% of global soybean imports, 71% of global iron ore imports, 43% of global copper imports, and so on.[195] Upon the outbreak of a Taiwan crisis, prices of key commodities might collapse. The oil market could also be severely impacted. The removal of some five million barrels per day of PRC demand—and potentially millions more in Japan and elsewhere in the Pacific region in some military contingencies—would create a sharp imbalance with global supply, leading to a collapse of global oil prices.[196] The OPEC+ oil cartel might slash production but volumes might fall so far and so quickly that prices became unstable. In some circumstances, it may be sensible for the ESCB to actively intervene to stabilize global commodity markets. How the ESCB could do this, if at all, would be a question for its charter that founding member states would have to negotiate.

Although facilitating decoupling would be one of the benefits of the funding, the ESCB should not seek to direct how supply chains move, or overweight a country's success in attracting manufacturing from the PRC when allocating funding. The ESCB aid process should not become a global scheme for "picking winners" or "friend shoring." This would undermine its objective of sustaining the rules-based trading system and would lead to enormous inefficiencies in global production.

The ESCB might also operate special programs for use as geopolitical "insurance policies" against PRC economic coercion. This might involve direct dollar aid to compensate victims of PRC aggression or the accumulation and maintenance of stockpiles of critical-use products, such as vaccines and active pharmaceutical ingredients. These activities could be structured separately from the regular schedule of aid distribution to support immediate support for countries victimized by the PRC. If the PRC engaged in the systemic dumping of manufactures on particular national markets, this fund might also be used to provide dollar aid to countries that erected their own retaliatory tariff regimes, covering the adjustment period.

Supporting the Enforcement of National Trade Policy against Nonmembers

The second half of the ESCB's mandate would be to support the enforcement of national trade policies toward nonmembers. The ESCB would be involved in cases in which one member imposed a discriminatory trade policy on a nonmember under the national security exemption, and another member was alleged to be engaged in illegal transshipping. In the late 1980s and early 1990s, the Uruguay Round established the Agreement on Rules of

Origin, which still functions as a global standard for trade policy. This regime aims to harmonize nonpreferential rules of origin and has been critical to facilitating global trade during the PRC's rise in the global trading system.[197] Avalanche decoupling would place the current customs regime under unprecedented stress. All ESCB members would have to follow the Core in taking a more active approach to customs enforcement, likely involving a greater role in border enforcement.

The role of the ESCB would be to support member states in monitoring flows of trade between members and other states, especially the PRC, and compile centralized reports documenting the volume and character of that trade. The ESCB would dispatch advisors to support members with weaker state capacity to digitize records, compile balance of payments and customs data, and if necessary build administrative and enforcement capacity to prevent cross-border smuggling and the mislabeling of products. It might encourage states to use its aid to build up these capacities while providing technical assistance. However, the ESCB would not force member states to accept help or adjust policies on specific issues. The ESCB would provide detailed and legitimate sources of data on the character of trade entering the rules-based trading system.

The details of how the ESCB would initially support customs enforcement are an open question that would have to be settled through political negotiation, in consultation with lawyers and other trade policy experts. The eventual process would need to balance building confidence in the rules-based system with sovereignty and capacity issues. In the ESCB's most extensive form, in the event that a Core country believed a foreign firm was violating the discriminatory trade policies discussed in policy pillar one, the Core country might require ESCB approval to implement the tariff or quota. As the ESCB would not function as a legal body but as an international agency, judgment would be relatively swift. Appeals would be possible to a higher body within the ESCB to remove the tariff. Only states, rather than individual firms, could appeal on the basis of specific evidence that an incorrect decision had been made. Appeals would likely run to the governing body of the agency in which donor nations (overwhelmingly from the Core) would constitute a clear majority, although there would also be representation given to the wider ESCB membership.

Example

Suppose that US Customs and Border Protection comes to suspect that a non-US company, Arbitrage Unlimited, is importing products made with PRC components and not declaring them as such. The US government would work with ESCB officials and those of Arbitrage Unlimited's home country, Neutralia, to confirm whether the components came from the PRC. If the ESCB and Neutralia's customs officials agreed, the US would be free to impose discriminatory policies against Arbitrage Unlimited's product, in line with Policy 1. If the US and Neutralia disagreed, then the ESCB might reach a decision on whether the part came from the PRC or not. In this approach, if the ESCB decided that there was insufficient evidence, the United States might be obliged to let the product through. If they decided there was sufficient evidence, Neutralia's opinion would be overruled, and the US *could act against Arbitrage Unlimited's products. If it disagreed with the ruling, Neutralia could then appeal to a higher function within the ESCB on Arbitrage Unlimited's behalf. Alternatively, the US would simply impose the tariff and the ESCB would only involve itself at the higher level, if Neutralia appealed against the decision. In any event, Neutralia's failure to enforce customs controls in one individual case would not automatically impact their standing in the ESCB but would be logged and registered.*

In another scenario, suppose that the ESCB, working with Neutralian customs officials, notices that Neutralia is importing large amounts of a component part via another company, China Traffickers Incorporated. It might support Neutralia in checking whether those components were ending up in Arbitrage Unlimited's final product and advise the United States to check the finished product. If it found proof independently that there was a link between China Traffickers Incorporated and Arbitrage Unlimited, it could itself recommend that the United States act against Arbitrage Unlimited's products and note that Neutralia had failed to adequately enforce customs procedures.

The ESCB would give confidence to third countries that discriminatory policies enforced against the PRC would not be used by the United States as a backdoor industrial strategy against third countries, leading to a race to the bottom that would undermine the rules-based trading system. By embedding itself in the development of enforcement capacity, the ESCB would restrain the use of the national security exemption. By definition, it could not support the enforcement of a discriminatory policy by one member state against another.

If the ESCB secretariat accumulated repeated evidence of a member state consistently failing to enforce rules of origin requirements, its first step would be to increase cooperation and to either provide additional aid for increasing customs enforcement capacity or to mandate a greater amount of existing aid to be used to strengthen enforcement. If this failed to have a meaningful effect on the number and scale of transshipment cases, there could be two enforcement mechanisms:

1. The ESCB could withhold aid tranches against countries that were failing to enforce rules of origin requirements, either permanently or until there was a meaningful improvement in customs enforcement.
2. If the governing body of the ESCB found that a member state had been systematically and consistently violating rules of origin requirements without taking reasonable steps to remedy the situation, it could declare it legitimate for other member states, including the Core, to impose discriminatory policies on it under the national security exemption.

The process for determining that a cutoff was justified would be rules based and subject to the governing board of the ESCB, perhaps similar to the operations of the IMF today. Withholding aid would itself be an effective response. (In fact, an emerging scholarly literature has found that withholding aid is a much more effective tool of economic statecraft than economic sanctions.[198]) The processes by which the ESCB decided how much aid to withhold and whether Core countries could legitimately impose discriminatory trade policies would be the responsibility of the ESCB director and secretariat, subject to appeal.

Core allies would be tempted to use ESCB data as a legal basis for enforcing unilateral export controls on dual-use products, but doing so would be a mistake. To protect its independence and legitimacy, the ESCB must be an independent body not associated in any way with dollar sanctions.

The ESCB would ensure that the avalanche decoupling took place according to the guiding principles outlined above, with all international aspects of the Day One Plan being based on incentives in the context of a broad program of economic recovery. The crucial point is to bind the enforcement of discriminatory trade policy into a wider program of economic leadership, conceived and executed as a response to any break-glass scenario aimed at preserving the rules-based trading system. Ultimately, enforcement of rules of origin for PRC or Russian goods entering the bloc would be the hardest part of the Day One Plan to implement. No system is going to be perfect, and the political complexity and administrative burden would stress the system over time. The states most at risk would be those with weak state capacity and land borders with the PRC and Russia. The ESCB would have to pay special attention to these countries, compensating them as part of its aid formula for the extra administrative burden that would be imposed upon them and in response to Russian and PRC retaliation. Some states would inevitably fall out of compliance and become subject to discriminatory national policies. Nevertheless, the planners of the system should aspire to build the largest possible coalition. All states that are not currently under US sanctions should receive invitations and initial bilateral support from the United States.

PRC COUNTERMEASURES

The obvious PRC response to the ESCB would be to offer its own program of economic aid to countries that refused to support US trade policy, backed by coercive threats. This might include aid, debt relief, market access, or the provision of goods at reduced prices, possibly offered under the banner of the Belt and Road Initiative.[199] In most break-glass scenarios, the PRC would also be facing a major economic crisis—compounded by a US currency intervention—that would limit its capacity to act. In this context, the PRC's economic offer would likely focus on the provision of cheap products rather than access to its market—which would come with some benefits to consumers but would further undermine domestic manufacturing in those states. If the CNY had become devalued as a currency, this outcome would be inevitable.

To accelerate this process, the PRC might seek to actively undermine or even collapse the WTO. The PRC could disrupt general business through dilatory procedural techniques by filing or by rallying a coalition to claim that the United States was destroying the WTO through the establishment of the ESCB. The PRC could not achieve any substantive relief through these efforts, as the United States has already arranged for a logjam in the WTO's Appellate Body. However, these efforts could advance the PRC's political goals: to persuade neutral countries that US action was undermining WTO rules and principles and that by joining the PRC in resistance, the ESCB could be torpedoed and US–PRC decoupling derailed. Once again, the Core and PRC would be competing for the support of the Global South, particularly countries that depend on cheap PRC-manufactured goods and countries in Asia that are embedded in complex value chains.

In many countries, customs officials would struggle to differentiate PRC from non-PRC products, and cross-border trafficking could become rampant. The states most vulnerable would be those that share long land borders with the PRC and are already closely integrated into the PRC economy, particularly those in Central and Southeast Asia. However, it would not be impossible, particularly for countries outside the PRC's immediate geographic neighborhood, to respond to such efforts with ESCB support.

Furthermore, policy could vary based on the products involved. For example, a country might wish to accept cheap PRC household appliances and conclude the burden of distinguishing between domestically produced appliances and PRC appliances was too high. This country might ultimately halt all exports of household appliances to the Core. However, if that country simultaneously had a thriving plastics industry, it might attempt to actively differentiate between different plastics products to retain access to Core markets. Alternatively, it might align with Core decoupling policies in that area to sustain its industry.

The PRC might later try to destabilize other established rules-based institutions, such as the IMF. Since the United States holds more than 15% of IMF voting shares, it can block the PRC from co-opting the institution for its own purposes. However, for the same reasons, the PRC and its rogue state partners could potentially attempt to assemble a counter-coalition to render the IMF incapable of issuing new emergency loans. In a post–Day One economic crisis, the United States might therefore lose its ability to use the IMF to channel emergency support to important countries in need. Without other forms of help, these countries would become more vulnerable to PRC economic coercion. Regardless of whether the United States adopts the Day One Plan, in break-glass Taiwan scenarios, it may become impossible to provide emergency lending to strategically important countries via the IMF. The ESCB offers one potential mechanism for providing emergency loans, although this would require an extension of its mandate beyond the scope discussed in this report. In the worst-case scenario, the United States and its Core allies would have to prepare to rescue key countries on the brink by providing bilateral support.

Over the longer term, if the PRC revealed itself to be an economic rogue actor, and the Day One Plan succeeded in diminishing the role of the PRC in the global economy, it might be possible to build support for formally expelling the PRC from the IMF and World Bank, although this would be an extremely tough ask. Such expulsions are not necessary for the functioning of the Day One Plan and should not be attempted unless the United States is extremely confident of success. Expulsion votes would present neutral states with the kind of binary choice that the Day One Plan generally seeks to avoid. However, in principle, it is possible to expel the PRC from both the IMF and the World Bank. The IMF's Articles of Agreement, Article XXVI, Section 3, Subsections 2(a)–(b), allow for suspension and expulsion of a member if it "fails to fulfill any of its obligations under this Agreement."[200] The rules require 70% of IMF voting power to suspend and 85% of the voting power to expel. Any state expelled from the IMF is automatically expelled from the International Bank for Reconstruction and Development, one of the two main institutions of the World Bank, within three months, unless three-fourths of the total voting power votes in favor of keeping them.[201] The International Development Association, the other major part of the World Bank, has its own expulsion process. This requires "a majority of the Governors"—in effect, a majority of member states—"exercising a majority of the total voting power" to vote for expulsion. The PRC controls just 5.92% of World Bank voting power, and its closest and most staunchly anti-American partners collectively control just a few percentage points more.[202]

Another potential pathway would be for the IMF to vote to transfer the PRC's rights back to the Republic of China (Taiwan) from the PRC.[203] Technically, the PRC never acceded to the IMF or World Bank, just as Taiwan was never expelled. Rather, the IMF executive board "decided that henceforth the People's Republic would represent China at the fund," with the executive board of the World Bank following suit.[204] By transferring the right to represent China back to Taiwan, the IMF and World Bank could potentially avoid having to use expulsion mechanisms that were not designed to be used for geopolitical reasons.

POLICY 3: CORE TAKEAWAYS

- The ESCB would provide a vehicle for Core economic leadership to preserve the rules-based trading system in post–Day One and provide an incentive structure to encourage honest reporting of goods and parts flowing directly from the PRC to the Core allies.
- The ESCB would not enforce policies against the PRC, and members would be free to continue to trade with the PRC if they wished.
- Rather, the ESCB would have two functions:
    - Provide aid to member states to support them through the economic consequences of the break-glass scenario.
    - Provide a multilateral framework for supporting member states' national policies toward nonmembers.
- ESCB aid would be delivered to member-state governments in tranches, and member states would be free to spend it according to their own objectives, in consultation with ESCB advisors.
- The ESCB would have its own secretariat, and rules-based process for adjudicating whether a country is acting as a transshipment point.
- If the ESCB found that a country had been misreporting exports of PRC goods, it could withhold aid or, ultimately, give Core countries the green light to extend the same trade restrictions they imposed on the PRC to the offending country.

- The PRC might retaliate by undermining the WTO, weaponizing import or export controls, dumping manufactured goods, or experimenting with other acts of economic warfare and political coercion.
- However, rogue PRC behavior would only demonstrate the value of ESCB membership, as the institution would provide members with insurance against PRC economic coercion.

BROADER ECONOMIC WARFARE SCENARIOS

In any break-glass scenario, the PRC would have prepared general economic actions designed to harm US interests, above and beyond countermeasures for aspects of US contingency planning communicated in advance. Most of these would take the form of the PRC manipulating access to its market through import and export controls, although it could also buy, sell, or seize strategic assets.

The danger for the PRC is that economic warfare would strengthen the incentives for states to work with the ESCB. The more economic disruption PRC retaliation caused, the more important the ESCB would become as an insurance policy for small states in particular.

The PRC could freeze or even seize foreign assets under its jurisdiction. Under the PRC's 2021 Anti-Foreign Sanctions Law, Beijing might seize assets of individuals or firms from countries participating in sanctions.[205] Even if the PRC did not freeze foreign-owned assets within its borders, it could prevent asset owners from liquidating them and withdrawing capital. However, the PRC would probably not turn to asset freezes unless the G7 countries froze PRC assets first. The PRC has a net foreign asset position of at least $2.8 trillion, so it stands to lose from a competitive asset freeze dynamic.[206] If the PRC seized foreign assets at scale, Core governments would probably need to provide support to companies with significant exposure. Asset freezes and seizures would be a risk in all break-glass scenarios.

The PRC could dump its holdings of US Treasury and agency bonds on the open market to drive up interest rates, but this risk is likely exaggerated.[207] The PRC held $782 billion of Treasuries in November 2023.[208] If the PRC abruptly liquidated this position, US government bond prices would fall, and yields would spike, possibly triggering a global financial panic. However, the Federal Reserve could, in principle, buy up the surplus Treasuries to stabilize the market, citing its existing Section 13(3) emergency authorities. There is precedent for such action: the Fed bought up over $1 trillion in Treasury securities between March and April 2020.[209] Even if Brad Setser's calculations are correct, and the PRC's true holdings of Treasuries, agencies, and other dollar assets are several times higher than reported, the Fed could, in principle, respond in the same way.[210] Moreover, the currency intervention would create a clear incentive for the PRC to hold rather than sell dollar assets, since if the CNY/CNH peg broke, the PRC would need FX to conduct its international trade. Prominent PRC scholars have acknowledged that a sudden sale of dollar assets would be a weak economic weapon, which helps to explain why SAFE's holdings of dollar assets declined by 40% between 2013 and 2023.[211]

The PRC might also respond to the Day One Plan by imposing export controls on strategic goods. Beijing has done this before, and the possibility of weaponized export controls is discussed openly in the PRC media. In 2010, it embargoed rare earth exports to Japan and Europe, leading to a WTO challenge. It has recently done the same for gallium and germanium, two important metals used in semiconductor production, and for drones produced by the PRC company DJI.[212] In a Taiwan crisis, the PRC could conceivably impose broader export controls on products such as rare earth alloys, active pharmaceutical ingredients, and intermediate electronic components. These measures would cause shortages and price spikes, contributing to inflation and lost economic activity. Aside from shortages and higher prices, PRC export controls on critical goods would also have political consequences around the world. Developed economies would buy up scarce supplies, causing shortages and a potentially political backlash in developing countries. The ESCB might maintain unity within the rules-based coalition by regulating hoarding and developing schemes for collective responses to PRC economic retaliation. Otherwise, member states might adopt autarkic trade policies, undermining the rules-based trading system over time.

However, export controls are a blunt instrument, and using them indiscriminately may not advance the PRC's strategic goals. Beijing has no visibility into where its exports go after they leave its borders. Lacking control of the global reserve currency, it also has limited "long-arm" capabilities to retaliate against re-exporting firms. Moreover, aggressive PRC export controls could be counterproductive to the goal of slowing down or reversing avalanche decoupling. The less foreign firms believed they could trust PRC supply chains, the faster they would try to reshore production out of the PRC. The United States and the Core would contrast the PRC's arbitrary and damaging export controls with their own programs of aid and support. Over time, markets would also adapt to PRC export controls. Rationing may be necessary in the short term while private industry developed substitutes, technological work-arounds, and alternative sources of supply.[213] In the medium to long term, Beijing's economic leverage would dissipate. This logic helps to explain why, in the gallium and germanium episodes, the PRC seemed most interested in making a propaganda point and chose not to maximally enforce its export controls after they were first announced.[214]

PRC import restrictions would probably be the PRC's most effective economic instrument for splitting the US-led coalition. The PRC has used import restrictions for geopolitical coercion in the past, often citing technical customs-related excuses.[215] In a break-glass conflict scenario, the PRC could cite national security as an excuse for sudden and arbitrary import restrictions. Since the WTO Appellate Body would remain logjammed, countries victimized by PRC import restrictions could suffer devastating consequences. The PRC could also arrange grassroots boycotts of products from ESCB member states. Exporters of finished goods, such as South Korea, Japan, and central and northern European countries, would be the most acutely vulnerable. Commodity exporters are in principle less vulnerable, but many are economically dependent on the PRC in other ways, including for tourism and debt financing.[216]

It is unclear how PRC import restrictions would affect victim countries, but the United States would have to prepare for the worst. History provides some encouraging evidence that PRC economic coercion might backfire. In 2015, before the PRC retaliated against South Korea in the THAAD dispute, only 37% of South Koreans reported a negative view of the PRC. Two years later, that number had risen to 61%, and it kept rising thereafter.[217] Similar trends occurred in Australia, Taiwan, and the Philippines. Still, in a conflict scenario, the PRC might apply import restrictions of a far greater scale, causing financial market reactions, mass lay-offs, and other negative effects. The PRC's goal in applying these punishments would be to elicit a change in political attitudes, persuading key stakeholders in these democracies that decoupling is too costly to execute.

The PRC import restriction problem requires an institutionalized and rules-based solution. The ESCB would serve as an instrument for collective resilience against the PRC's weaponized import controls, offering generous compensation to affected members. The ESCB could establish a special administration to assess economic damage caused by PRC economic warfare and disburse compensation to victimized governments.[218] The ESCB's program for compensation against PRC economic retaliation should take account of lost revenue from PRC tourism, which is an important source of economic activity and FX for many small countries in the PRC's neighborhood.[219]

Beijing could engage in barter trade and other unconventional deals to manage problems associated with its exchange rate. If the PRC's major trading partners did not want to accept CNH, and its FX reserves ran low, the PRC could issue IOUs denominated in FX. These IOUs would have some value as long as the PRC had enough FX reserves to make repayment plausible—and the potential capacity to earn hard currency in the future through exports. China has a history of using barter agreements to work around US trade restrictions.[220] In a Day One scenario, the PRC might use barter trade to acquire export-controlled products.

However, barter would not take place on terms favorable for the PRC, and it is not a scalable solution in the long run for a major trading economy. Under the Rubber-Rice Pact with Sri Lanka in the 1950s, the PRC paid a 40% premium over the prevailing market price for rubber and sold its rice for less than a third of market value.[221] Barter is also less workable as a system for manufactured products—which could not be re-exported at competitive prices under policy pillar one—than fungible products such as commodities. The existence of barter as a fallback option helps to illustrate why no amount of dollar sanctions could cut off the PRC entirely from global trade networks. However, if the Day One Plan succeeds in eroding the PRC's terms of trade over time, barter is not a pathway for the PRC to reverse this trend and reclaim its lost position in global value chains.

IMPLEMENTATION RISKS

This section discusses problems that could emerge if the policy areas above were implemented incompletely or not at all as a result of change or division in US domestic politics. These scenarios would mostly result from potential failures of bipartisanship in Congress.

Congress authorizes the tariffs and the industrial policy but not the currency intervention or ESCB.

In this scenario, Congress decides to stick to more familiar policy instruments on Day One, emphasizing decoupling into the Core market. Fewer allies would be likely to join the Core. In the medium to long run, trade tensions would result between the United States and its allies, which would have to be resolved bilaterally. The rules-based trading system would fray or break. Most problematically, PRC goods would leak into the US market. The EU and other major economies outside the Core might adopt their own industrial policies, citing the national security exemption. They might also impose trade restrictions on US products. After the crisis period passed, the CNH exchange rate would stabilize, and Beijing would continue to internationalize its currency in the context of a fractured global trading system, undermining US sanctions and export controls against rogue states.

Congress authorizes the tariffs and the currency intervention but not the ESCB.

At first, the CNH exchange rates would weaken sharply against the dollar, and the CNY would probably weaken as well, albeit more slowly. Many industrialized and industrializing economies would probably put up trade barriers against PRC products. However, as described in detail above, they would lack methods to prevent leakage of PRC goods and parts into their markets. These countries would either have to accept the leakage, defeating the purpose of decoupling, or retaliate against the third countries that were re-exporting the PRC goods. As with the scenario above, the rules-based global trading system would decay or collapse, and total global trade would probably decline. The United States might turn inward economically and geopolitically, and Beijing would seek new coalition partners. Of utmost concern in this context is that the currency intervention is a bet on the US ability to destroy the PRC's terms of trade over the longer term. If Beijing found new markets for its exports after Day One and continued to move up the manufacturing value chain, its currency would eventually appreciate, and the US taxpayer could take a major loss.

Congress authorizes the tariffs and ESCB but not the currency intervention.

The currency intervention is the most separable of the three pillars. The United States could probably achieve avalanche decoupling without it. However, avalanche decoupling might be more costly without it and would take place on less strategically favorable terms.

Without the currency intervention, Beijing would intensify its efforts to internationalize the CNH after Day One. After stabilizing its domestic financial system from the initial financial shock, Beijing would incentivize and pressure trading partners to pay for PRC imports in CNH, accept payment for exports in CNH, and hold CNH on their central bank balance sheets. Beijing would also continue to push indebted developing countries to roll over their debts to PRC banks from dollars to CNY, further locking them into Beijing's currency ecosystem. As discussed above, these steps would not replace the dollar's role, but they would accelerate the transition to a multi-currency system in which the threat of dollar sanctions is far less existential than it is today. In time, this trend would beget further geopolitical problems from Russia, Iran, and North Korea for the United States and its coalition.

If the CNY basically held its value after Day One, there would be less pressure on many industrialized and industrializing countries to erect trade restrictions on PRC products. This might reduce the size of the Core. The leakage problem would be less severe, but the process of Core decoupling would impose less economic pain on the PRC over the long term because the negative impact on the PRC's terms of trade would be much smaller.

Congress triggers the avalanche and then changes its mind.

During the decoupling window, events might change sentiments in Congress about the wisdom of ultimately reaching full decoupling from the PRC. As significant tariffs or quotas became felt, various stakeholders might call for slowing down the ratchet. Voters might dislike paying higher prices for non-PRC products. Most likely, businesses might ask for more time to finish supply chain reshoring. Financial markets might react negatively to the macroeconomic effects of decoupling. Core allies might slow their own ratchet regimes. US–PRC relations might stabilize. Any of these factors in combination might make it tempting to rethink the decision to decouple or, at least, slow the pace. A future Congress could modify or even remove the ratchet, although this would likely require strong bipartisan support.

In this scenario, the United States would probably end up with partial decoupling. Firms that had already begun to reshore production would likely continue to do so but at a slower pace. Once the precedent was set that the ratchet could be modified, full bilateral decoupling would become unlikely in the future unless Beijing aggressed against a US treaty ally. The ESCB would continue to operate, but Congress would likely restrict its further funding, causing it to fade in prominence over time. Without ongoing efforts to prevent leakage, PRC goods would find ways into the US market, and in time, the world economy might begin to reglobalize.

The challenge in this scenario would be unwinding the currency intervention at minimal loss to the US taxpayer. The Treasury would still be liable for any short positions it had taken out on the CNH and HKD in the early stages of the avalanche. If Congress altered the ratchet, the CNH and HKD exchange rates would rally hard versus the dollar, forcing the Treasury to realize a significant financial loss. This would be the termination fee for reversing decoupling.

The United States defunds or withdraws from the ESCB.

As discussed above, the creation of the ESCB would be possible only in a unique political moment in the United States. Once the immediate crisis had passed, some members of Congress might grow skeptical of the ESCB's value and call for defunding it or even withdrawing US participation. Opposition could also grow if a strong dollar continued to weigh on US exports. Threats to defund the ESCB, if voiced, would undermine the credibility of US leadership. If acted upon, they could badly hamstring the ESCB's ability to operate, as more than half of the board's operational funding would probably come from the United States.

Following a drawdown in US support for the ESCB, the other Core allies would have to decide the organization's future. Most likely, they would see it as in their interests to keep the ESCB alive and operating, albeit on a smaller scale, to maintain what they could of the rules-based trading system without strong US leadership. As these allies' proportional financial contributions increased, the institution would begin to focus more on their prerogatives, which may or may not overlap with US interests. Whether Japan and other major economies would keep the ESCB operational in the long term without US support would depend on the language of the organization's charter and the design of its voting rules. In any case, if Washington sharply cut its funding, ESCB monitoring of trade flows would probably weaken, and leakage would substantially increase.

Alternatively, if the United States withdrew, the ESCB might collapse altogether. In the absence of US leadership, other Core allies could halt their own decoupling programs. The PRC could intensify economic coercion, especially in the Indo-Pacific region and developing world. The WTO would likely remain dysfunctional, so countries victimized by PRC economic coercion would have to appeal bilaterally to the United States for help or submit to Beijing's demands. Assuming that the US bilateral decoupling continued, the leakage of PRC goods into the US market would increase rapidly. Washington could try to compensate with stricter customs inspections and bilateral threats to countries known for re-exporting PRC goods. Third countries would individually fear US retaliation but might recognize that the United States could not afford a trade war against the entire global economy at once. The risk would be that much of the global economy could organize against the Core, forcing the United States to choose between abandoning bilateral decoupling or decoupling from even more of the global economy.

PART 3: CORE TAKEAWAYS

- Conditional on a US decision on Day One that decoupling is necessary, partial implementation would be better than nothing. However, partial implementation would come at a far higher cost and bring far fewer benefits than full implementation.

- The key implementation risk is that the bipartisan US commitment to the ESCB could crumble after a Taiwan crisis is resolved and politics-as-usual returns.

- To establish the credibility of avalanche decoupling, Congress should consider authorizing several years of ESCB funding in advance and leaving it up to the president to disburse it in quarterly tranches.

PART 4: CONTRIBUTIONS TO DETERRENCE

The best deterrent is a credible plan for Day One. This section explains how the Day One Plan could strengthen deterrence against PRC aggression—if it is developed publicly and in advance, in a bipartisan fashion, and in consultation with allies and partners.

"INTEGRATED DETERRENCE" RECONSIDERED

The Biden administration claims that "integrated deterrence" is a central organizing principle of its foreign and defense policies. As the 2022 National Defense Strategy defines it, integrated deterrence means "working seamlessly across warfighting domains, theaters, the spectrum of conflict, all instruments of US national power, and our network of alliances and partnerships. Tailored to specific circumstances, it applies a coordinated, multifaceted approach to reducing competitors' perceptions of the net benefits of aggression relative to restraint."[222] As Defense Secretary Lloyd Austin has put it, "We'll use existing capabilities, and build new ones, and use all of them in networked ways—hand in hand with our allies and partners. . . . Deterrence still rests on the same logic—but it now spans multiple realms, all of which must be mastered to ensure our security."[223] Colin Kahl, former under secretary of defense for policy, has said that the concept of integrated deterrence "will inform almost everything that we do" going forward.[224]

Beijing understands that these are euphemisms for inventing new ways to punish it if it moves against Taiwan. According to Wang Shushen of the Taiwan Research Institute at the Chinese Academy of Social Sciences (CASS), integrated deterrence "can be regarded as the core concept of the current US strategy of 'deterrence' against China." Its goal is to "convince potential enemies that the costs of hostilities will outweigh the benefits."[225]

The US government needs "integrated" deterrence because conventional military deterrence is weakening. The PLA Navy now has approximately 350 surface ships and submarines compared to the US Navy's 293. The gap is set to widen rapidly in the coming decade, according to all realistic construction scenarios. The PLA is also rapidly improving in size and sophistication of its missile arsenal, anti-submarine warfare capability, and satellite communications infrastructure, all the while working systematically to plug the remaining capability gaps in its amphibious invasion force.[226] US deterrence policy in the Taiwan Strait has traditionally been based on the “strategy of denial”: the demonstration that Beijing could not win a kinetic war over Taiwan if the United States intervened. If CIA director William Burns is correct that Xi has asked the PLA for the capability to take Taiwan by 2027, then Xi is seeking to render the strategy of denial moot by 2027. This is why, even as the Defense Department strives to preserve the strategy of denial, it is also calling on other branches of the US government to develop a credible strategy of punishment.[227]

The heart of integrated deterrence, therefore, ought to be a credible political-economic plan for Day One that can operate independently of any military option. Such a strategy should protect fundamental US and allied interests in the process of imposing costs on the PRC.[228] The strategy would ideally be easy to trigger unilaterally, regardless of the political circumstances. However, this condition is not strictly necessary, as long as the political conditions would probably be met in crisis scenarios.

Integrated deterrence requires the ability to threaten deeper and longer-lasting economic punishment than financial sanctions, which failed to deter Russia from attacking Ukraine in 2014 and 2022. On January 31, 2022, President Joe Biden threatened “swift and severe” responses if Russia attacked Ukraine.[229] As several leading Russia experts predicted at the time, this threat was too vague to deter Vladimir Putin, who was strongly motivated to install a submissive government in Ukraine.[230] The Biden administration telegraphed that it would impose only such sanctions as could win widespread support from European allies and avoid increasing energy prices for Americans.[231] Ironically, after Putin invaded Ukraine, the G7 reached a consensus that would have been inconceivable before the invasion and gradually ratcheted up sanctions to target Russia’s oil and gas sector. At this point, however, sanctions were no longer relevant to deterrence. Their goal now was simply attrition: to starve the Russian war economy and undermine the Putin regime over the long term.[232] In the case of the PRC, integrated deterrence requires a credible plan to break the country’s system of political economy over the long term by destroying the country’s terms of trade and triggering the mass reshoring of supply chains.

The key is to communicate credibly to Beijing that if it moved against Taiwan by force, it would precipitate a crisis that would probably escalate in ways it could not control politically. As this crisis mounted, the US political system might eventually reach a bipartisan consensus that peacetime political considerations no longer held and that extreme measures were necessary. The PRC must be made to believe that if these costs were imposed, they would be sufficiently certain, acute, and lasting that they would outweigh the benefits of seizing Taiwan. Finally, it must be persuaded that it can avoid the punishment if it does not attack. If Beijing believes that avalanche decoupling will happen anyway, the threat has no deterrent value.

THE DAY ONE PLAN'S CONTRIBUTIONS

The Day One Plan, if developed, would strengthen integrated deterrence in several ways. First, the plan would undermine the PRC's efforts to erode dollar hegemony in peacetime. An explicit statement that firms could continue to trade with the PRC in dollars in noncritical goods, even in the most extreme break-glass scenarios, would undermine the PRC's efforts to internationalize the RMB. Simultaneously, the US government would make clear that Day One of a Taiwan crisis would see the rapid depreciation of the CNH, deterring third countries from holding too much of it.

Second, the plan would leverage market forces to deal a major financial blow to the PRC on Day One. If Washington credibly communicated the threat of currency intervention, market participants might try to get ahead of the US government by shorting the CNH and HKD whenever tensions arose in the Taiwan Strait. The PRC would therefore pay a price for fomenting brinkmanship crises merely to test US resolve. If the PRC moved on Taiwan anyway, market participants would effectively leverage the US Treasury's short trade against the CNH and HKD, multiplying the amount of FX that the PRC would have to spend to defend the exchange rate and protect its banks. Washington cannot guarantee these favorable effects, but signaling its resolve in advance could make these effects more likely.

Third, the plan would demonstrate Washington's ability to build a broad and inclusive coalition for its economic actions after Day One, isolating the PRC politically within the international community. This consideration might be more important for deterrence than any of the plan's economic impacts. Xi has tried to reduce the relative importance of economic growth to the CCP's legitimacy. However, he has also tried to make the PRC's supposed *status* in the international community—and his own personal standing on the world stage—an alternative source of legitimacy.[233] The US threat would be that on Day One of a Taiwan crisis, it might swiftly deprive him of both. By focusing on sustaining the rules-based system and leading the economic recovery from Day One, the Plan also makes it harder for Xi to argue that it is the United States that is seeking to undermine the rules-based system—a central aspect of the PRC's appeal to many countries, particularly in the Global South.[234]

Fourth, embracing the Day One Plan's guiding principles would strengthen US leverage and credibility in aligning the Core coalition behind a deterrence agenda in peacetime. Most US allies and partners privately hope that if the PRC moves against Taiwan by force, the economic fallout can be minimized. They also face political disincentives to negotiate about contingent punishment strategies in advance. However, a wide range of states are alarmed by the prospect of hard decoupling and would like the United States to come up with a less destructive alternative in the break-glass scenario. These countries understand that actions the PRC is currently threatening to take against Taiwan could bring about the break-glass political scenario in the United States and that in that scenario, they might require external support in the ensuing financial crisis. The plan, therefore, would make it harder for Xi to attempt to drive wedges between potential members of the Core that would, in turn, embolden him to act against Taiwan.

Consulting with allies publicly on the basis of the Day One guiding principles would soften some of the political challenges surrounding discussions of economic contingency planning with allies. Rooting the discussion in an analysis of the post–Day One financial crisis would also remind US allies and partners that this is a scenario in which the rules-based trading system would face an existential threat.

Fifth, the plan would threaten a devastating long-term impact on the PRC. Avalanche decoupling threatens to permanently withdraw manufacturing supply chains from a sector that currently employs roughly one hundred million people in the PRC and directly constitutes one-sixth of its GDP. The PRC already faces growing challenges from an aging population and mounting debt. The long-term impacts of avalanche decoupling could threaten the foundation of the PRC's economic prosperity and financial and social stability, placing greater stress on the CCP regime over time. The Day One Plan also emphasizes that the PRC could not win a long-term victory over Taiwan by absorbing short-term economic pain. On the contrary, economic pain would increase over time, regardless of the military or political outcome of a Taiwan conflict.

Sixth, the plan would provide an option for responding to a quarantine or blockade of Taiwan, or other scenarios short of direct US–PRC kinetic conflict. In principle, avalanche decoupling is an appropriate response to an attack on the rules-based economic system in the Indo-Pacific. The decision would be up to lawmakers at the time and would depend on the political context. Whatever the political context, having a viable option for avalanche decoupling on the shelf would bolster the confidence of US and allied forces if they chose to respond forcefully against a blockade or quarantine of Taiwan.

COMMUNICATING DETERRENCE

The Day One Plan will support deterrence insofar as it can be developed and made politically credible in public. The goal would be to align a range of relevant stakeholders across the Democratic and Republican parties and across the political systems of US allied and partner governments that if the United States does choose to decouple from the PRC, it would be prudent to do so according to the guiding principles of avalanche decoupling. This effort would involve both public and private diplomacy and policy coordination.

Xi Jinping must be made to understand the plan and fear that it will be carried out. It is therefore dependent on Congress. To be effective as a deterrent, Democrats and Republicans would need to embrace the Day One Plan as a nonpartisan framework for contingency planning. Allies and partners also play a critical role. The more detailed the public conversation over contingency planning, and the more consistently all sides emphasize the guiding principles of the Plan, the more credible the threat becomes.

Preparation for the Day One Plan has no direct relation to the "de-risking" of critical supply chains currently being pursued by the Biden administration and European and Asian allies, which is not directly related to deterrence.[235] De-risking and decoupling are completely different strategies. “De-risking” covers sensitive and strategic goods relevant to national security and other strategic areas. In principle, de-risking can accelerate even as total US–PRC trade in noncritical areas grows. De-risking is a sound strategy whether or not the PRC aggresses against Taiwan. The United States and allied countries are likely to continue de-risking in all scenarios, and the PRC knows this. The PRC is also pursuing its own policy of de-risking supply chains by investing in domestic high-tech innovation. Given that the logic for “de-risking” in peacetime is obvious, that it is legal under international law, and that the direction of policy is already clear, the threat of doing more de-risking in a crisis has little or no deterrent effect.

The fact that the Day One Plan for decoupling in noncritical trade could not plausibly be implemented in peacetime means that the United States and its partners can develop it in public without provoking the PRC. The ESCB could not be established without sixty votes in the US Senate to join a new multilateral treaty with power over some US trade policy, and to provide this institution with hundreds of billions of dollars of funding at a time. Such bipartisan consensus has no precedent in modern American political history, so the PRC would have no reason to worry about the Day One Plan being implemented unless its own actions brought that bipartisan consensus together. By focusing attention on the Day One Plan rather than the threats of dollar sanctions, Washington would therefore reassure the world that if the PRC refrained from using force against Taiwan, the rules-based trading system would hold.

PART 4: CORE TAKEAWAYS

- The US government’s concept of “integrated deterrence” has the right idea. It is unclear what combination of threats will deter Xi Jinping, so the United States must not hang deterrence on a single threat, especially as conventional “deterrence by denial” weakens.
- The as-yet-undeveloped arm of integrated deterrence should be a strategy of economic punishment that the United States could take independently of military action in Taiwan crisis scenarios.
- The existence of the Day One Plan strengthens integrated deterrence by showing that in the break-glass political scenario, Washington would have an option to trigger avalanche decoupling from the PRC in a manner that protected all its core economic interests and those of its allies and neutral nations.
- The Day One Plan provides the first incentive-based concept for how the United States could get neutral countries to cooperate in an economic plan that punished the PRC over the long term.
- The Day One Plan will contribute to deterrence insofar as Beijing is convinced that it would likely be a response to a move against Taiwan. It is therefore essential to communicate publicly that a range of US allies and partners are aligned with the guiding principles of the Day One Plan.

CONCLUSION

After the Cold War, as part of a broader push toward the creation of integrated global markets, the United States and its allies decided to welcome Russia and the PRC into the rules-based economic system established after World War II. This decision was a calculated bet that America's former rivals could be socialized through trade and engagement to eventually become responsible stakeholders who resolved differences through negotiation rather than violence. Vladimir Putin's decision to broaden his war of aggression against Ukraine in February 2022 proved that this bet had failed with respect to Russia.

Although the shock caused by the PRC's accession had profound consequences that were not fully confronted at the time, the bet has not failed yet.[236] The PRC produces affordable products for American consumers, holding down inflation, and sustains US employment by offering access to a large market for American technology, products, and services. Other countries, including close US allies, have derived even greater benefits from trade with the PRC. The PRC has violated WTO rules, eroded international norms, and revealed an aspiration to co-opt and, if necessary, replace key multilateral institutions. These malign activities and strategies require responses within the context of the rules-based system. If the WTO cannot effectively arbitrate and enforce PRC violations, such as when the PRC dumps subsidized products on its markets to gain strategic advantage or uses economic tools to coerce smaller countries, the correct responses are trade action, targeted and proportionate industrial policy, and multilateral cooperation to support the PRC's victims so that they do not have to capitulate to bullying. Still, expelling the PRC from the system is politically unimaginable as long as the PRC refrains from outright aggression.

"De-risking" of critical supply chains is fair play under the rules-based system and should be redoubled in peacetime.[237] Beijing often claims that de-risking is "decoupling in disguise."[238] This is propaganda—an attempt to deter the West from taking common-sense measures to protect its economic security by hinting that the PRC may misperceive them and attack Taiwan. WTO rules explicitly allow member states to adopt policies that preserve control over supply chains relevant to national security. Indeed, the PRC is pursuing its own strategy of de-risking in reverse. The United States and its allies should play to win this conventional, peacetime economic competition.

If the PRC moved against Taiwan by force, the situation would change fundamentally. Depending on the circumstances of Day One, the United States would have to reassess whether it could coexist with the PRC within the rules-based trading system and continue trading in noncritical goods over the long term. The rules-based trading system was not designed to contain a rogue state as economically powerful and sophisticated as the PRC. Even in the most extreme Taiwan crisis scenarios, the United States might decide that the PRC's actions were not sufficient to justify the economic disruption of attempting to decouple fully. It is not the purpose of this report to say where the United States should draw that line. Responsibility for that decision lies with the president and, ultimately, Congress. However, the United States' long-standing One China Policy—the political foundation of the US–PRC relationship—is guided by the Three Communiqués and Taiwan Relations Act, which call for cross-Strait tensions to be resolved by peaceful means. If the PRC moved against Taiwan by force, it would not only be abrogating the spirit of these agreements and undermining peace and stability in the region but also casting doubt on the credibility of its other past commitments, including raising the specter of further acts of economic coercion against key US allies in the region. This would be a historic rupture and cause for revisiting the fundamental assumptions of the US–PRC trading relationship.

The starting point of this report has therefore been to assume a break-glass scenario in which Congress decides that full decoupling is necessary. If the PRC moved against Taiwan by force and suffered no economic consequences, it might conclude that it could trample on existing economic rules and institutions on a far larger scale. It could ramp up state aid for strategic industries, continue its campaign of intellectual property theft, and use discriminatory trade policy to bully other countries to acquiesce. PRC economic coercion would become far more potent, as it would now be backed by the implicit threat of military force or coercion. Without a functional rules-based trading system to bind them together, the PRC's neighbors would have far less power to resist Beijing's dictates. US treaty allies—South Korea, Japan, Australia, and the Philippines—would become key targets for both economic and military coercion. Once the PRC pacified its neighborhood, it would become far more capable of using its coercive playbook in other regions as well.

From this perspective, the Day One strategy is a contingency plan of last resort to sustain the rules-based system through the process of decoupling, in light of the astonishing transformation the last thirty years of globalization has wrought. Decoupling is perfectly compatible with the rules-based system that emerged after World War II. By showing economic leadership, as it did in those early years after 1945, the United States could revitalize that system even as it gradually decouples from the PRC. To do so, however, it must recognize the consequences of the decision it took in the 1980s and 1990s to drive forward the most extensive increase in world trade in history in the context of a complex world system of sovereign nation-states.[239] The PRC may have been the biggest beneficiary of this process, but it was not the only one. The United States must therefore decouple in a way that recognizes the agency of third states that have also been transformed by the last thirty years of globalization and must also create a process that incentivizes them to work with the United States to sustain the rules-based system.

It is impossible to know in advance whether the United States would have the strategic interest, political will, or political capability to execute the Day One Plan. The bar is clearly high. However, the United States needs a plan to decouple in a way that preserves the rules-based trading system. Preserving that system is a key reason why Washington seeks to deter conflict in the first place.

The Day One Plan described in this report would commit the United States to preserving the rules-based trading system—even though the process of avalanche decoupling would inevitably transform the system through time. Through bilateral trade policy, the United States would completely decouple its trading relationship with the PRC over a period of years. It would do so legally under WTO rules, citing the national security exemption that began with Article XXI of the original GATT Charter. Like-minded allies and partners would do so in tandem, if they wished. As they decoupled, the Core allies would demonstrate their commitment to global macroeconomic stability by allowing all noncritical trade with the PRC to continue normally on Day One and giving private firms adequate time to reshore supply chains. They would further prove their commitment to the rules-based system, abiding by WTO rules and refraining from coercing other countries to impose their own trade restrictions on the PRC. Countries that wished to keep trading freely with the PRC under WTO rules could continue to do so indefinitely. Simultaneously, a US-led currency intervention would fatally undermine Beijing's RMB internationalization strategy and derail its efforts to build a broad geopolitical coalition.

To support the global economy through the consequences of Day One, including the United States' decision to decouple from the PRC, the Core allies would establish a new rules-based agency: the ESCB. The ESCB would have two objectives. First, it would give confidence to the global economy and encourage partnerships between the public and private sectors to respond dynamically to the economic consequences of Day One within the dollar system. Second, it would incentivize as many countries as possible to meet the minimum bar to allow the Core to continue to trade with them normally during decoupling. This minimum bar would be a full and accurate reporting of data on the re-export of PRC products. The ESCB would provide considerable aid to member states and help them build the customs enforcement administration to monitor the flow of PRC goods and components. If member states failed in their obligations or were caught cheating, the ESCB would investigate and adjudicate the trade disputes that would inevitably arise as a result. ESCB member states would be incentivized to participate by offering direct aid and ultimately retaining access to Core allies' markets as supply chains reshored from the PRC.

Implementing the Day One Plan in full would be possible only under unique political and geopolitical circumstances. Establishing the institution would require a bipartisan agreement in the US Senate, as well as significant and ongoing financial commitments from the United States and other Core allies to fund the ESCB. If the political winds subsequently shifted in the United States, the enterprise could collapse. Making the ESCB succeed would also require multilateral coordination between the Core allies, which would at minimum have to include Japan, the UK, Australia, and Canada.

As no one knows how the PRC might move against Taiwan, it is impossible to make predictive statements about the probability that the Day One Plan would be implemented in full. The purpose of the contingency planning would be to provide the people's representatives at the time with a meaningful choice—an option that involved neither economic capitulation to PRC aggression nor a desperate and devastating gamble with dollar sanctions.

Despite the challenges of implementation, it is strategically and politically advantageous for the US government and its allies and partners to develop the Day One Plan publicly and in advance:

1. Ruling out countrywide dollar sanctions on the PRC would reassure allies, demonstrate to the PRC an awareness of the current economic situation, and undermine its efforts to internationalize the RMB.
2. Public communication about the principles underlying the ESCB would reassure third countries that the US economic response on Day One of a Taiwan crisis would not impoverish them in the process of punishing the PRC or attempt to force a binary choice that in practice does not exist.
3. A credible threat of unilateral US currency intervention on Day One would undermine Beijing's strategy to internationalize the RMB in peacetime—and especially in the weeks and days preceding a crisis. Third parties would be less willing to hold the PRC's currency if they believed it could lose its value at any moment if the PRC aggressed against Taiwan.
4. A credible threat of unilateral US currency intervention on Day One would introduce a new reason for PRC planners to fear immediate financial meltdown if they use force against Taiwan.
5. If Day One arrives, and political and strategic considerations demand a decisive economic response, the guiding principles and policy approaches in this report would serve as a starting point. On the basis of whatever had been agreed upon in advance, the details could then be decided through political negotiations within and between the US executive and legislative branches and key allies and partners.

Developing the Day One Plan would also contribute to the US strategy of integrated deterrence in advance of a potential crisis. Even if the PRC concluded that the United States probably could not pull off the Day One Plan in the quarantine scenario, it would not be sure of this fact, because the PRC, too, is uncertain of how the US political context might change on Day One. The challenge is to demonstrate to the PRC that the United States understands the scale of the economic and political challenge that decoupling would pose and is not pinning its strategy solely on threats that, if executed, would devastate its own economy and those of its allies. Even if the PRC is not persuaded that an attack on Taiwan would inevitably trigger avalanche decoupling, public communication that the United States and its allies are devising a plan for gradual and orderly decoupling would force the PRC to reckon with the potential long-term costs of upending regional stability. It would become harder for Xi to persuade himself that the PRC's financial system could survive the shock of the Day One crisis or that the PRC could prevail in a long conflict simply by tolerating economic pain for longer than the United States could bear. The Day One Plan is the only economic option yet presented that shows how the PRC could potentially be made to suffer indefinitely escalating economic pain if it moved against Taiwan, regardless of the military outcome of the conflict.

It is in everyone's interest—including the PRC's—to find a solution to the Taiwan issue that maintains an honorable peace. Xi Jinping is clearly more determined than his predecessors to extinguish Taiwan as a free, liberal, and democratic society. However, if the United States keeps its resolve and strengthens its policy of integrated deterrence, it has a strong chance of preserving that honorable peace for another generation. It is in that spirit that we offer the Day One Plan: in the hope that by virtue of existing as an idea, it need never be made manifest.

RECOMMENDATIONS

Operationalizing the Day One Plan would pose enormous administrative challenges and demand up-front fiscal commitments, equivalent to reconstruction efforts after World War II. Planning and preparing for implementation in advance will require achieving a high level of alignment between the legislative and executive branches, and between the United States and close allies. This report has sketched out the basic principles that should guide the process. To translate these principles into an actionable policy agenda for the break-glass political scenario, a range of US federal government agencies and institutions would need to lead studies and planning in their own functional areas. Broadly, this would work in three stages.

In Stage 1, Congress and the executive branch should comprehensively investigate US economic vulnerabilities for Day One of a Taiwan crisis and determine the guiding principles that should shape US planning and action in a break-glass scenario. Congress must play a leading role in shaping the policy planning process. The executive branch can conduct its own reviews simultaneously with Congress' investigations, but the executive branch should not begin coordinated planning for implementation until Congress has achieved bipartisan consensus on the guiding principles. Stages 2 and 3 below assume that Congress achieves agreement around a version of the Day One Plan that is substantially similar to the one proposed in this report.

In Stage 2, Congress and the executive branch should work together to plan implementation. They should consider how responsibilities and resources would be divided across agencies in a break-glass scenario, determine which actions would be necessary and which would be optional, and assess US vulnerabilities. They may set up a coordination committee within the National Security Council. Regular consultations with allies will be essential.

In Stage 3, once Day One operational planning has advanced, Washington must communicate its contingency plan for the break-glass scenario publicly, consistently, and in tandem with allies and partners.

STAGE 1: CONSULTATION AND REVIEW

HOUSE SELECT COMMITTEE ON THE CCP (IF RENEWED IN 119TH CONGRESS)

- Produce a bipartisan, unclassified report establishing a list of consensus principles that should guide US economic leadership on Day One of a Taiwan crisis. These might include:
    - A commitment to aid and support third countries from the economic and financial consequences of any Taiwan crisis.
    - A commitment not to obstruct third countries from trading non-dual-use products with the PRC, provided they use dollars.
    - A commitment to sustaining inclusive and rules-based multilateral institutions in the event of a Taiwan crisis.
- Recommend how federal government agencies should divide responsibility on economic contingency planning for Day One scenarios.

HOUSE AND SENATE FINANCE COMMITTEES

- Hold classified and unclassified hearings to evaluate different approaches to economic deterrence, inviting expert testimony to investigate the financial costs, risks, and benefits of alternative Day One plans.
- Evaluate existing policy tools and potential new ones, including the proposals in this report.
- Take on responsibilities of the House Select Committee as outlined above, if the Select Committee is not renewed.

HOUSE AND SENATE FOREIGN RELATIONS COMMITTEES

- Hold classified and unclassified hearings to evaluate the political implications of possible Day One plans for key US trading partners and strategic countries and regions.

INTELLIGENCE COMMUNITY

- Produce a report assessing the potential impacts on the global financial and trading system of a kinetic war in the Taiwan Strait and the PRC's options for responding to currency intervention and economic sanctions of various degrees of severity.
    - Classified versions of this report should be cleared for sharing with US treaty allies and Taiwan.
    - Unclassified versions should be released to the public and presented by US diplomats to other governments.
- Produce shorter reports evaluating the potential effects on potential members of the Core alliance group for sharing with their governments.

NATIONAL ECONOMIC COUNCIL

- Evaluate in detail the costs and benefits of the Day One Plan and compare them to alternative approaches, presenting those findings to Congress.

TREASURY DEPARTMENT

- Produce a classified report for Congress and the president assessing the vulnerability of the CNH capital market and the PRC's capital control regime in general to large-scale and sustained currency intervention by the US government.

ALLIED NATIONS

- Produce reports investigating national vulnerabilities of US–PRC economic conflict for sharing with the United States government and assessing likely political reactions.
- Assess strategic options for responding to the economic shock on Day One of a Taiwan crisis, conditional on how the United States, the PRC, and financial markets might react.

STAGE 2: PLANNING IMPLEMENTATION

Assuming that Congress can reach bipartisan consensus around the guiding principles of the Day One Plan outlined in this report, the president should issue an executive order requesting an interagency review. The following sections describe specific recommended areas of focus for each agency.

TREASURY DEPARTMENT

- Produce a menu of tools for currency intervention that would be operationally possible if Congress revised relevant statutes.
- Working with USTR, draft articles of agreement for the ESCB, specifying mandate, budget, governance structure, and operational procedures.

STATE DEPARTMENT

- Consult with allied and neutral countries, both individually and in relevant regional groups, to inform them about the key findings of these reports.

US TRADE REPRESENTATIVE

- Consult with industry, labor groups, and foreign governments about the possibility of avalanche decoupling in a Taiwan crisis.
- Consult with industry, academic economists, and the Commerce Department to produce a report that develops several baseline scenarios for ratcheting discriminatory trade policies.
- Produce a classified report assessing how quickly supply chains for critical categories of goods could withdraw from the PRC under these scenarios, assuming no physical restrictions on trade.
- Collaborate with State, Treasury, and Commerce to consult with US treaty allies on this report to evaluate potential membership in the Core.

DEPARTMENT OF DEFENSE

- Develop a comprehensive list of dual-use technologies that should be export controlled to the PRC on Day One.

COMMERCE DEPARTMENT

- Consult with industry to produce a separate report on potential discriminatory trade policies (e.g., ratcheting tariffs) and attempt to deconflict using the Office of the US Trade Representative's version.

OFFICE OF MANAGEMENT AND BUDGET

- Review the capacity of federal agencies in the event of a Taiwan crisis and rank the shortfalls in order of urgency.
- Produce an annual classified report for Congress evaluating US institutional capacity and recommending budgeting adjustments on this basis.

NATIONAL SECURITY COUNCIL

- Evaluate the reports discussed above and compare them with the Day One Plan.
- Compile the United States' final economic contingency plan for Day One.
- Produce a classified memo for the House and Senate Finance and Armed Services Committees describing the plan and the legislative action required to enable it.

ALLIED NATIONS

- Investigate domestic administrative and legal changes that might be required in various contingencies.
- Commit, in principle, to joining a club of advanced economies to stabilize the global economy and financial system starting on Day One of the crisis, including through the provision of currency swaps, loans, and other support to developing countries.
- Consult multilaterally on the design of potential discriminatory policies in the event of a Day One crisis and potential PRC currency devaluation.
- Support the United States' administrative and diplomatic outreach to third countries in specific areas of diplomatic knowledge and expertise.

STAGE 3: COMMUNICATION

Members of Congress should circulate—but not pass—draft legislation that would authorize the Day One Plan in the break-glass scenario. This legislation should cover the following elements:

- Commit in principle to respond to break-glass provocations with avalanche decoupling, in accordance with the guiding principles discussed in this report.
- End PNTR with the PRC.

- Modify Section 232 of the Trade Expansion Act of 1962 to label the PRC a systemic national security threat and authorize phased decoupling through tariffs or quotas.

- Authorize the Treasury Department to conduct the currency intervention.

- Call for the creation of the ESCB, described along the lines presented in this report.

Further, the US government and the governments of allies and partners should publicly and repeatedly emphasize the following:

1. The United States and its allies are fully committed to the One China Policy, with an abiding interest in peace and stability in the Taiwan Strait.
2. If the PRC goes rogue, the United States has a viable plan to trigger avalanche decoupling on Day One while harnessing market forces to preserve dollar hegemony.
3. In this scenario, the United States would be prepared to exercise economic leadership. Washington and its Core allies would stabilize the global financial system and show the world that they had the confidence to achieve decoupling successfully.
4. Third countries could keep trading noncritical products with the PRC, but the United States would incentivize them to help enforce its anti-PRC trade policy.
5. The rules-based trading system would survive, but the PRC would lose its protection and privileges. Over time, the PRC would lose its most important external markets and face escalating domestic economic pressure.

To enhance the credibility of the threats, it is important that Democrats and Republicans describe them in a similar way. It is also important that US talking points about the Day One Plan align with those of allies and partners.

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117. Wang Fan 王帆, "Meiguo duihua zhanlüe: zhanlüe linjiedian yu xianzhixing jingzheng 美国对华战略: 战略临界点 与限制性竞争 [US strategy toward China: strategic tipping point and restrictive competition]," *Dangdaishijie yu shehuizhuyi* (2020): 142. Wang is the president of the China Foreign Affairs University's Institute of International Relations; Stephen A. Myrow, "China Finds It Can Live Without the U.S.," *Wall Street Journal*, September 3, 2019, https://www.wsj.com/articles/china-finds-it-can-live-without-the-u-s-11567551458.

118. Hu Xiaopeng 胡晓鹏 and Su Ning 苏宁, "Zhongmei jingji 'tuogou' de zhengce jieshi yiji dui liangan guanxi de yingxiang 中美经济"脱钩"的政策解析以及对两岸关系的影响 [An analysis of the Sino-US economic decoupling policies and their impact on the cross-straits relations]," *Taiwan Research Journal* 4 (2022): 30. Hu and Su are, respectively, deputy director and associate researcher at the Institute of World Economy, SASS.

119. For a few examples, see: Huang Zhiling, "Maoyimoca de quedingxing yu qianghua jinrongjichu de jiboxing fenxi 贸易摩擦的确定性与强化金融基础的紧迫性分析 [The analysis of the certainty of trade friction and the urgency of strengthening financial fundamentals]," *Quanqiuhua* 9 (2019): 38; Xu Shanda, "Renzhen yanjiu Meiguo ezhi Zhongguode mubiao he shoudian 认真研究美国遏制中国的目标和手段 [Careful study of US goals and means to contain China]," *Jingji daokan* 9 (2019): 28; Zhu Hongda 朱洪达, "Guojia anquanzhanlüe yu woguo jinronganquan 国家安全战略与我国金融安全 [National security strategy and China's financial security]," *Junshi jingji yanjiu* 7 (2011): 5–7; Niu Wenxin 钮文新, "Jinrongzhan shijian shilishi,

shixianshi, gengshiweilai 金融战史鉴是历史、是现实，更是未来 [Financial warfare history is history, reality, and the future]," *Zhongguo jingji zhoukan*, April 15, 2022, 42–43. Huang is the chief economist of China Construction Bank. Niu is an expert member of the State Council's Financial Stability Committee, among many other state and academic affiliations. Xu is former deputy director of the State Administration of Taxation. Zhu was the chief of logistics for the PLA Air Force and was a member of the 12th Chinese People's Political Consultative Conference until he was dismissed in March 2016 for unstated reasons.

120. Don Weinland, "China's Capital Flight Shows Up in Over-Invoicing of Imports," *Financial Times*, January 26, 2016, www.ft.com/content/2401aa36-c426-11e5-808f-8231cd71622e.

121. "Why More Chinese Tourism Means More Capital Flight," *The Economist*, February 16, 2023, https://www.economist.com/finance-and-economics/2023/02/16/why-more-chinese-tourism-means-more-capital-flight.

122. Gao Xingwei 高惺惟, "Zhongmei maoyi mocaxia renminbi guojihua zhanlüe yanjiu 中美贸易摩擦下人民币国际化战略研究 [Study on RMB internationalization strategy under China-US trade frictions]," *Jingji xuejia* 5 (2019): 66. Gao is an associate professor at the Economics Department of Central Party School. He is also a researcher at Renmin University's International Monetary Institute.

123. Gao, "Zhongmei maoyi mocaxia," 66.

124. See Raymond Yeung and Khoon Goh, "Petroyuan Will Not Bring About a Regime Shift Soon," *ANZ Research*, April 6, 2022, cited in Barry Eichengreen, "Sanctions, SWIFT, and China's Cross-Border Interbank Payments System," *CSIS Briefs*, May 2022, https://www.csis.org/analysis/sanctions-swift-and-chinas-cross-border-interbank-payments-system.

125. "Iran, Russia Link Banking Systems amid Western Sanction," *Reuters*, January 30, 2023, https://www.reuters.com/business/finance/iran-russia-link-banking-systems-amid-western-sanction-2023-01-30.

126. This agreement was significant, allowing over $2 billion of backlogged transactions to be settled. India and Russia had already agreed to settle payments through Russian-owned, rupee-denominated "Special Rupee Vostro Accounts" in Indian banks. However, Indian banks were afraid to operationalize these accounts for fear of Western sanctions. The currency of settlement was another and related contested issue. Russia also wanted to be paid in RMB or Emirati dirhams, which are pegged to the dollar. India did not want to use RMB, and the Emiratis were wary of Western sanctions. Ultimately, the Indian government decided that by accepting SPFS, it could restart trade and give cover to domestic banks to settle their trade with Russia in rubles. See "India Signs Deal to Adopt Moscow's SPFS System for Banking Payments to Russia: Report," *The Wire*, April 25, 2023, https://thewire.in/diplomacy/india-signs-deal-to-adopt-moscows-spfs-system-for-banking-payments-to-russia-report.

127. George Glover, "Russia Is Using China's Yuan to Settle 25% of Its Trade with the Rest of the World, Report Says," *Yahoo Finance*, September 28, 2023, https://ca.finance.yahoo.com/news/russia-using-chinas-yuan-settle-193805731.html.

128. Fanhua Zeng, Wei-Chiao Huang, and James Hueng, "On Chinese Government's Stock Market Rescue Efforts in 2015," *Modern Economy* 7, no. 4 (2016): 411–18.

129. Zhou Hanmin 周汉民 and Huang Hua 黄骅, "Meiguo duiwai jinrongzhicai de falifenxi 美国对外金融制裁的法理分析 [Legal analysis of American foreign financial sanctions]," *Haiguan yu jingmao yanjiu* 43, no. 1 (2022): 11.

130. Zongyuan Zoe Liu and Mihaela Papa, *Can BRICS De-dollarize the Global Financial System?* (Cambridge: Cambridge University Press, 2022).

131. Zhou and Huang, "Meiguo duiwai jinrongzhicai de falifenxi," 11.

132. China's foreign loans are generally denominated in CNY, not CNH. See Parks et al., *Belt and Road Reboot*, 78, 284.

133. Gordon, Mullen, and Sacks, *U.S.-Taiwan Relations*, 83.

134. Blackwill and Zelikow, *Strategy to Prevent War*, 35–37.

135. Blanchette and DiPippo, "'Reunification' with Taiwan."

136. For two books that explore these themes in compelling detail, see Nicholas Mulder, *The Economic Weapon: The Rise of Sanctions as a Tool of Modern War* (New Haven, CT: Yale University Press, 2022) and Lambert, *Planning Armageddon.* For reflections on how to address these challenges using existing policy tools, see Edward Fishman, "How to Fix America's Failing Sanctions Policy," *Lawfare*, June 4, 2020, https://www.lawfaremedia.org/article/how-fix-americas-failing-sanctions-policy.

137. Bromley and Freymann, "Malacca Myth."

138. Chong Ja Ian, "The Many 'One Chinas': Multiple Approaches to Taiwan and China," Carnegie Endowment for International Peace, February 9, 2023, https://carnegieendowment.org/2023/02/09/many-one-chinas-multiple-approaches-to-taiwan-and-china-pub-89003.

139. On March 2, 2022, 141 countries voted to condemn Russia's invasion of Ukraine; 7 voted against; and 32 abstained. "Aggression against Ukraine," United Nations, General Assembly, A/ES-11/L.1, March 1, 2022, https://undocs.org/en/A/ES-11/L.1.

140. "Atlantic Charter," Avalon Project, Yale Law School, accessed January 19, 2024, https://avalon.law.yale.edu/wwii/atlantic.asp. The insertion of the phrase "with due respect for existing obligations" was insisted on by Churchill to facilitate a more active Commonwealth trade policy.

141. Congress voted to grant China PNTR in 1999, paving the way for its accession to the WTO the following year.

142. Former vice president Mike Pence, Florida governor Ron DeSantis, former UN ambassador Nikki Haley, and Senator Bernie Sanders are among those who support repealing China's PNTR status. See Bryce Baschuk, "Why There Are Calls in US to Revoke China's Preferred Trade Status," *Washington Post*, August 22, 2023, https://www.washingtonpost.com/business/2023/08/22/what-is-china-s-permanent-normal-trade-relations-or-pntr-quicktake/94e900f6-4118-11ee-9677-53cc50eb3f77_story.html; Catholics 4Bernie, "Bernie Sanders: Repeal China's Trade Status (2/9/2005)," YouTube video, 5:32, August 24, 2015, https://www.youtube.com/watch?v=61Y_kNibQmM.

143. 19 U.S.C. §1862, as amended. See Rachel F. Fefer, "Section 232 of the Trade Expansion Act of 1962," Congressional Research Service *In Focus*, April 1, 2022.

144. Before Trump's presidency, the Commerce Department had conducted just twenty-six national security investigations under Section 232 since 1963, and no tariffs had been imposed under Section 232 since 1986.

145. Identical legislation was introduced in the Senate by senators Bob Corker and Pat Toomey and in the House by Rep. Mike Gallagher. To Amend the Trade Expansion Act of 1962 to Require Congressional Approval before the President Adjusts Imports That Are Determined to Threaten to Impair National Security, H.R. 6337, 115th Congress (2018). See "Senators Introduce Legislation to Require Congressional Approval of National Security-Designated Tariffs," Senate Foreign Relations Committee, June 6, 2018, https://www.foreign.senate.gov/press/rep/release/senators-introduce-legislation-to-require-congressional-approval-of-national-security-designated-tariffs.

146. Andres B. Schwarzenberg, "Section 301 of the Trade Act of 1974," Congressional Research Service *In Focus*, January 29, 2024.

147. See James Bacchus, "The Black Hole of National Security: Striking the Right Balance for the National Security Exception in International Trade," *Cato Policy Analysis* no. 936, November 9, 2022.

148. This ruling defined the national security exemption as relating to "armed conflict, or of latent armed conflict, or of heightened tension or crisis, or of general instability engulfing and surrounding a state, and not 'political and economic differences,'" See World Trade Organization, *Russia—Measures Concerning Traffic in Transit*, Report of the Panel, WT/DS512/R, April 5, 2019.

149. US Department of Commerce, "WTO: Multilateral Agreements On Trade In Goods - GATT 1947: Article XXXIII: Accession," International Trade Administration, Enforcement and Compliance, accessed May 28, 2024, https://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_005424.asp.

150. Legally speaking, the use of the national security exemption would only become relevant if China chose to challenge it.; Bacchus, "Black Hole," 3.

151. The WTO's lack of influence over monetary policy has in fact been one of its major weaknesses since its inception—as China is of course well aware. See Martin Daunton, "The Inconsistent Quartet: Free Trade Versus Competing Goals," in *China and the World Economy: Transition and Challenges*, ed. Jin Zhang and Zhang Laiming (London: Routledge, 2019), 61–82.

152. This position was taken by both the United States and Russia in the Traffic in Transit case, against the views of the European Union and others. World Trade Organization, *Traffic in Transit*, para. 7.104.

153. Hunter L. Clark and Anna Wong, "Did the US Bilateral Goods Deficit with China Increase or Decrease during the US-China Trade Conflict?," Board of Governors of the Federal Reserve System, June 21, 2021, https://www.federalreserve.gov/econres/notes/feds-notes/did-the-us-bilateral-goods-deficit-with-china-increase-or-decrease-during-the-us-china-trade-conflict-20210621.html.

154. "America's Tariff Wall on Chinese Imports Looks Increasingly like Swiss Cheese," *The Economist*, February 24, 2022, https://www.economist.com/finance-and-economics/americas-tariff-wall-on-chinese-imports-looks-increasingly-like-swiss-cheese/21807816.

155. Ana Swanson and Brad Plumer, "Chinese Solar Makers Evaded US Tariffs, Investigation Finds," *New York Times*, December 2, 2022, https://www.nytimes.com/2022/12/02/business/economy/chinese-solar-makers-tariffs.html.

156. Carl Schreck, Kubat Kasymbekov, Manas Qaiyrtaiuly, Riin Aljas, Kubatbek Aibashov, and Kyrylo Ovsyaniy, "Kyrgyz, Kazakh Companies Send Western Tech to Firms Linked to Kremlin War Machine," Radio Free Europe, June 22, 2023, https://www.rferl.org/a/kyrgyz-kazakh-firms-investigation-western-tech-russia-war-ukraine/32467795.html.

157. Pravin Gordhan, "Customs in the 21st Century," *World Customs Journal* 1, no. 1 (March 2007): 49–54. For a simple explanation of this process, see chapter 3 in Andrew Grainger, *Cross-border Logistics Operations: Effective Trade Facilitation and Border Management* (London: Kogan Page, 2021).

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159. See chapter 2 in Stefano Inama, *Rules of Origin in International Trade* (Cambridge: Cambridge University Press, 2022).

160. Jordyn Holman, "Where Textile Mills Thrived, Remnants Battle for Survival," *New York Times*, January 21, 2024, https://www.nytimes.com/2024/01/21/business/economy/textile-mills-carolina-trade-de-minimis.html.

161. "Blumenauer Slams De Minimis Loophole, Demands Congress Act," Blumenauer House, December 14, 2023, https://blumenauer.house.gov/media-center/press-releases/blumenauer-slams-de-minimis-loophole-demands-congress-act.

162. Anshu Siripurapu, "What Is the Defense Production Act?," Council on Foreign Relations, December 22, 2021.

163. London comes second, at 6%. See Leah Capili, Sarah L'Ortye, Laetitia Moncarz, Michael Moon, Sam Romilly, Astrid Thorsen, and Eric Yang, "Hong Kong, United Kingdom, Mainland China–Leading RMB Internationalisation" (Belgium: SWIFT, 2018), 8, https://ctmfile.com/assets/ugc/documents/swift_rmb_tracker_special_edition_january2018(1).pdf.

164. "How Does the LERS Work?," Hong Kong Monetary Authority, October 17, 2023, https://www.hkma.gov.hk/eng/key-functions/money/linked-exchange-rate-system/how-does-the-lers-work.

165. As of April 2023, the HKMA's total foreign currency reserve assets were $430.7 billion—over five times the currency in circulation, or about 41% of Hong Kong dollar M3.

166. Robin Harding, "Hong Kong's Dollar Peg Is on Increasingly Thin Ice," *Financial Times*, December 29, 2022, https://www.ft.com/content/a045f068-7639-4d75-ba71-63a1f62d6767.

167. "Enhanced Currency Swap Agreement between People's Bank of China and Hong Kong Monetary Authority," Hong Kong Monetary Authority, July 20, 2022, https://www.hkma.gov.hk/eng/news-and-media/press-releases/2022/07/20220704-5.

168. The Federal Reserve and allied central banks such as the Bank of England and Bank of Japan would have to rescue their own financial institutions from the general meltdown in Hong Kong. However, they could attach conditions—for example, a requirement to dump all RMB assets.

169. One is for Core states to place a heavy transaction tax on all settlements involving CNH, paid in dollars or local currency. This would include all attempts to use CNH to trade with China or to buy RMB on the open market. Even without an outright prohibition on trading CNH, the effect would be to significantly raise the transaction costs, which would rise in percentage terms as the currency depreciated, incentivizing private investors to sell CNH in advance. London, as the main CNH trading hub outside Hong Kong, would be the primary target of this measure, as would US multinationals trading offshore.

170. "31 U.S. Code § 5302—Stabilizing Exchange Rates and Arrangements," Cornell Law School Legal Information Institute, https://law.cornell.edu/uscode/text/31/5302.

171. The ESF allows the US government to influence currency exchange rates without printing money. As of December 2019, the ESF held assets worth $94 billion. The Federal Reserve also has the power to transact in currencies, using open market operations. The Fed in theory could "print" an unlimited number of dollars with which to short the CNH, pursuant to Section 14 of the Federal Reserve Act. However, the Fed is structured to be largely resistant to political influence, and currency intervention would be a geopolitical project outside the scope of its mandate. Involving the Fed in currency intervention would probably not be necessary or prudent. See Board of Governors of the Federal Reserve System, "Federal Reserve Act: Section 14. Open-Market Operations," US Federal Reserve, March 13, 2017, https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=10592&context=ypfs-documents.

172. Liu Yiye, Liyan Han, and You Wu, "Can Skewness Predict CNY-CNH Spread?," *Finance Research Letters* 46 (May 2022): 102392.

173. Zoe Zongyuan Liu, *Sovereign Funds: How the Chinese Communist Party Finances Its Global Ambitions* (Cambridge, MA: Harvard University Press, 2023), 190.

174. Bob Davis, "Brad Setser on the Myths and Realities of China's Financial Power," *The Wire China*, July 24, 2023, https://www.thewirechina.com/2023/07/23/brad-setser-on-the-myths-and-realities-of-chinas-financial-power.

175. There is precedent for this. During the stock market crash of July 2015, Beijing assembled a "national team" that bought over $144 billion in stocks to support prices. Importantly, PRC players in international financial markets are not necessarily profit oriented. See Liu, *Sovereign Funds*, 17.

176. Suppose that capital controls and government intervention cause the onshore exchange rate to stabilize at 10 to the dollar, while the offshore exchange rate falls to 20 to the dollar. Suppose also that Taoli, a PRC firm, produces widgets in China and sells them overseas for $1. If PRC entities are allowed to convert offshore back into CNY on a 1:1 basis, Taoli could receive $1 in payment for its exported widgets, convert them into 20 CNH, and then convert that into 20 CNY, which can theoretically be exchanged for $2 in the onshore market. If Taoli anticipated future CNH depreciation, it might prefer to take payment in FX, hold the cash offshore, and hope

to convert it back into CNH later for a profit. Meanwhile, Taoli would want to convert as much CNY into dollars at the onshore exchange rate as possible, so that it could repeat the arbitrage process. These examples illustrate the risk that China would face if it failed to enforce capital controls effectively, as well as the difficulty of managing the incentives of domestic actors.

177. PRC exporters might not want to accept payment in CNH if Beijing made it difficult or expensive to convert into the onshore equivalent, because these firms' foreign suppliers would not want to take payment in CNH.

178. Even if China temporarily allowed the onshore and offshore exchange rates to diverge and suspended 1:1 convertibility between them, it would still have a long-term interest in bringing the two currencies back into alignment in the long term and "reissuing" the CNH, if it were capable of doing so in the postwar era.

179. These IOUs would have some value as long as China had enough FX reserves to make repayment plausible and the potential capacity to earn hard currency in the future through exports. The more likely China appeared to favorable terms of trade in a postwar settlement, the closer to par these IOUs would be valued. Historically, investors have treated IOUs from belligerent states in wartime as a form of financial option. If the borrower wins the war, it can be expected that it will pay as much of its loans as possible, to stabilize the financial system for the postwar period. By contrast, if the borrower loses the war, its ability and willingness to pay wartime debt may fade, so bond prices might trend toward zero. Global investors therefore tend to be happy to hold debt of the side that they expect to win the war, though sentiment will turn in real time as the war plays out. While the fighting continues, this can be a bumpy ride. During World War I, the bond market saw twenty-two turning points of sentiment. The market ultimately determined that the Allies would win after the Central Powers' 1918 spring offensive failed. See Tobias A. Jopp, "Contemporaries' Opinions of the Allied and Central Powers' Performance during the First World War: Measuring Turning Points in Perception with Sovereign Debt Prices," *European Review of Economic History* 20, no. 2 (2016): 242–73.

180. Benham Gholipour, "Official Report: Iran Could Use Cryptocurrencies to Avoid Sanctions," *Iran Wire*, March 2, 2021, https://iranwire.com/en/features/69084.

181. Barry Naughton, "The Impact of the Tiananmen Crisis on China's Economic Transition," in *The Impact of China's 1989 Tiananmen Massacre* (London: Routledge, 2010), 166–90.

182. For labor in particular, see Michael J. Hogan, *The Marshall Plan: America, Britain, and the Reconstruction of Western Europe, 1947–1952* (Cambridge: Cambridge University Press, 2009). See also J. Bradford DeLong and Barry Eichengreen, "The Marshall Plan: History's Most Successful Structural Adjustment Program," National Bureau of Economic Research Working Paper no. 3899, November 1991.

183. Raw materials and machinery combined represented 67% of French Marshall Plan spending. See Hogan, *Marshall Plan*; DeLong and Eichengreen, "Marshall Plan"; Alan S. Milward, "Review of *The Marshall Plan Revisited: The European Recovery Program in Economic Perspective*, by Imanuel Wexler," *Journal of Modern History* 57, no. 2 (1985): 341–43.

184. Milward, "Review of *The Marshall Plan Revisited*" (Wexler).

185. British Library, IOR/L/E/8/6880.

186. "Convention Establishing a Customs Co-operation Council (CCC)," University of Oslo, https://www.jus.uio.no/english/services/library/treaties/09/9-04/wco_customs_council.html.

187. M. M. Parthiban, T. Samaya Murali, and G. Kanaga Subramanian, "World Customs Organization and Global Trade: Imprints and Future Paradigms," *World Customs Journal* 14, no. 2 (September 2020): 157–76.

188. DeLong and Eichengreen, "Marshall Plan"; William Hitchcock, "The Marshall Plan and the Creation of the West," in *The Cambridge History of the Cold War*, ed. Melvyn P. Leffler and Odd Arne Westad (Cambridge: Cambridge University Press, 2010), 154–74; Alan S. Milward, "Was the Marshall Plan Necessary?" (review of Hogan, *Marshall Plan*), *Diplomatic History* 13, no. 2 (Spring 1989): 231–53.

189. Hitchcock, “Marshall Plan.”

190. UK Government, “Global Advisory on Russian Sanctions Evasion Issued Jointly by the Multilateral REPO Task Force,” Gov.UK, March 9, 2023, https://www.gov.uk/government/publications/russian-elites-proxies-and-oligarchs-taskforce-statement-and-advisory/global-advisory-on-russian-sanctions-evasion-issued-jointly-by-the-multilateral-repo-task-force-accessible-version.

191. Federal Office for Economic Affairs and Export Control (Germany), “Foreign Trade: Export Control,” accessed May 28, 2024, https://www.bafa.de/EN/Foreign_Trade/Export_Control/export_control_node.html.

192. The relevant mechanism is the Common Foreign and Security Policy (CFSP). There are a few exceptions, which include export controls for dual-use technologies, but they do not cover the trade enforcement actions that would be required to join the Core.

193. This would require member states to gain over time the capacity to monitor transshipment risks through European frameworks.

194. DeLong and Eichengreen, “Marshall Plan”; Milward, “Was the Marshall Plan Necessary?”

195. “Soybean Exports from Brazil to China from 2015 to 2021,” Statista, 2021, https://www.statista.com/statistics/721425/value-soybean-exports-brazil-china.

196. Gabriel Collins, “A Maritime Oil Blockade Against China—Tactically Tempting but Strategically Flawed,” *Naval War College Review* 71, no. 2 (Spring 2018): 53.

197. For the history of this process, see Parthiban, Murali, and Subramanian, “World Customs Organization.”

198. Claas Mertens, “Carrots as Sticks: How Effective Are Foreign Aid Suspensions and Economic Sanctions?,” *International Studies Quarterly* 68, no. 2 (June 2024): sqae016.

199. Eyck Freymann, *One Belt One Road: Chinese Power Meets the World* (Cambridge, MA: Harvard University Press, 2021), 230–45.

200. International Monetary Fund, “Articles of Agreement of the International Monetary Fund,” accessed January 19, 2024, https://www.imf.org/external/pubs/ft/aa/index.htm.

201. The IBRD also has its own expulsion mechanism. World Bank, “IBRD Articles of Agreement: Article VI,” accessed February 5, 2024, https://www.worldbank.org/en/about/articles-of-agreement/ibrd-articles-of-agreement/article-VI.

202. For example: Russia (2.82%), Iran (1.26%), Venezuela (0.75%), Pakistan (0.50%), Belarus (0.19%), Cambodia (0.05%), and Laos (0.04%). World Bank, “International Bank for Reconstruction and Development Subscriptions and Voting Power of Member Countries,” accessed January 12, 2024, https://thedocs.worldbank.org/en/doc/a16374a6cee037e274c5e932bf9f88c6-0330032021/original/IBRDCountryVotingTable.pdf.

203. Bessma Momani, “China at the International Monetary Fund: Continued Engagement in Its Drive for Membership and Added Voice at the IMF Executive Board,” *Journal of Chinese Economics* 1, no. 1 (2013): 125–50.

204. Harold K. Jacobson and Michel Oksenberg, *China’s Participation in the IMF, the World Bank, and GATT: Toward a Global Economic Order* (Ann Arbor, MI: University of Michigan Press, 1990), 75–79; Oksenberg was involved in the negotiations as a senior advisor to President Carter.

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206. As of the end of 2022, it declares $2.8 trillion in FDI assets, $1 trillion in overseas portfolio assets, and $2.1 trillion in other investment assets. See State Administration of Foreign Exchange (SAFE), “SAFE Releases China’s International Investment Position as at the End of 2022,” March 31, 2023, https://www.safe.gov.cn/en/2023/0331/2063.html.

207. Brad Setser, "Power and Financial Interdependence," *IFRI Papers*, May 3, 2024.

208. US Treasury, "Table 5: Major Foreign Holders of Treasury Securities," accessed January 19, 2024, https://ticdata.treasury.gov/resource-center/data-chart-center/tic/Documents/slt_table5.html.

209. As of this writing, the Fed holds more than $4 trillion of Treasury securities on its balance sheet. Tim Sablik, "The Fed Is Shrinking Its Balance Sheet. What Does That Mean?," Federal Reserve Bank of Richmond, *Econ Focus*, Third Quarter 2022, https://www.richmondfed.org/publications/research/econ_focus/2022/q3_federal_reserve.

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211. US Treasury, "Table 5."

212. "China Gallium, Germanium Export Curbs Kick In; Wait for Permits Starts," *Reuters*, August 1, 2023, https://www.reuters.com/markets/commodities/chinas-controls-take-effect-wait-gallium-germanium-export-permits-begins-2023-08-01; Joe McDonald, "China Restricts Civilian Drone Exports, Citing Ukraine and Concern about Military Use," AP News, August 1, 2023, https://apnews.com/article/china-ukraine-russia-drone-export-dji-e6694b3209b4d8a93fd76cf29bd8a056.

213. The Fischer-Tropsch process to turn Ruhr coal into fuel oil, created in Nazi Germany, is the most famous example of this process. Adam Tooze and Jamie Martin, "The Economics of the War with Nazi Germany," in *The Cambridge History of the Second World War*, ed. Michael Geyer and Adam Tooze (Cambridge: Cambridge University Press, 2015), 47–48.

214. Rahul Rao, "No Signs Yet of Gallium or Germanium Shortage," *IEEE Spectrum*, October 10, 2023, https://spectrum.ieee.org/gallium-and-germanium.

215. In 2010, China restricted imports of Norwegian salmon after dissident Liu Xiaobo won the Nobel Peace Prize. In 2017, it arranged a "grassroots" boycott of South Korean products in retaliation for the government's decision to install the American THAAD missile defense system. Between 2017 and 2021, China took a variety of similar measures against Australia, targeting lobster, wine, and other goods. In 2021, it imposed a sudden ban on pineapples from Taiwan. See Justin Ng and Lei Dijie, trans., "The Sugar-Coated Poison of the Chinese Market: How Will Taiwanese Pineapples Fight against Their Fate?," *Baodaozhe* 報導者, March 1, 2021, https://www.twreporter.org/a/china-bans-taiwanese-pineapples-english.

216. If China kept import levels of commodities constant, it would not affect long-term price levels or the economies of affected countries if it shifted its imports from one supplier to another. The global market would simply rebalance. The shift in global oil and gas markets after Russia's invasion of Ukraine provides an analogy. As a result of sanctions, Russian oil and gas exports that once flowed to Europe began to flow to China, India, and other non-G7 countries instead. Suppliers that previously sold oil and gas to China, India, and others then had excess supply to sell to Europe. Lengthening supply routes added only marginally to the global price level.

217. By 2022, 80% of South Koreans had a negative opinion of China, the second-highest in all countries surveyed by Pew. Laura Silver, Christine Huang, and Laura Clancy, "How Global Public Opinion of China Has Shifted in the Xi Era," Pew Research Center, September 28, 2022, https://www.pewresearch.org/global/2022/09/28/how-global-public-opinion-of-china-has-shifted-in-the-xi-era.

218. Other analysts have developed this proposal. See, for example, Victor Cha, "Examining China's Coercive Economic Tactics," statement before the House Committee on Rules, Center for Strategic and International Studies, May 10, 2023, https://www.csis.org/analysis/examining-chinas-coercive-economic-tactics.

219. The Council on Foreign Relations report suggests creating an Indo-Pacific Economic Coalition (IPEC) with a common fund to make up for lost revenues. See Gordon, Mullen, and Sacks, *U.S.-Taiwan Relations*, 84.

220. Three years after the US government struck China off from the dollar financial system in 1949, China and Ceylon (later Sri Lanka) agreed to the so-called Rubber-Rice Pact. Ceylon agreed to import 270,000 metric tons of rice annually; China guaranteed to purchase 50,000 tons of rubber. The deal was renewed every five years for three decades. By the 1960s, China had become one of Ceylon's largest trade partners, even though no hard currency was exchanged. Sivananda Patnaik and Sanjeeb K. Haldar, "Sino-Sri Lanka Economic Relations: An Appraisal," *China Report* 16, no. 6 (1980): 19–31.

221. Saman Kelegama, "China–Sri Lanka Economic Relations: An Overview," *China Report* 50, no. 2 (2014): 132.

222. US Department of Defense, *2022 National Defense Strategy of the United States of America: Including the 2022 Nuclear Posture Review and the 2022 Missile Defense Review* (Washington, DC: US Department of Defense, 2022), 1.

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224. Jim Garamone, "Concept of Integrated Deterrence Will Be Key to National Defense Strategy, DOD Official Says," *DOD News*, December 8, 2021, https://www.defense.gov/News/News-Stories/Article/Article/2866963/concept-of-integrated-deterrence-will-be-key-to-national-defense-strategy-dod-o.

225. Wang, "Zhongmei jingzheng shijiaoxia."

226. Harry Du, "How Is China Modernizing Its Navy?," *China Power*, April 20, 2022, https://chinapower.csis.org/china-naval-modernization.

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228. Bromley and Freymann, "Malacca Myth"; Elbridge A. Colby, *The Strategy of Denial: American Defense in an Age of Great Power Conflict* (New Haven, CT: Yale University Press, 2021), 122–29.

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