The rivalry between the world’s principal global power, the United States, and its rising challenger, China, is now out in the open and is likely to deepen. Strategic competition has intensified in the past two years to cover trade, technology, naval activities in the South China Sea, and diplomacy. Domestic opinion in both countries have hardened, and there is little sign that differences would be mitigated soon. This has enormous strategic implications for all, including India. In order to grasp some of the politico-economic issues at stake, in this colloquium segment we carry two different perspectives on the emerging conflict from well-known and respected analysts. Both underline the gravity of the situation but take different tracks on the causes and consequences. Prasenjit Basu analyses the causes and argues that the crisis was inevitable given China’s self-serving and assertive policies, and that it opens up for other emerging economies, especially India, huge opportunities for expanding trade and other ties with the US. Pinaki Bhattacharya contends that a dangerous shadow is being cast on the global order by US President Trump’s brinkmanship and the threat of a ‘new Cold War’ that won’t benefit anyone.

- Editor, National Security
The US-China Economic Confrontation and India’s opportunity

Prasenjit K Basu*

The western world’s 25-year bet that engaging with the communist PRC would inevitably transform China into a free-market democracy is widely recognized to have failed (The Economist, 2018). The US-China trade conflict is one aspect of this reassessment, which began tentatively with anti-dumping actions by the Obama administration, but were escalated and widened by the Trump administration in 2018. Having abolished the implicit term limit that Deng Xiaoping had decreed for China's leaders (and written into the constitution of the PRC), Xi Jinping this March ensured that he would be "president for life". This implies that all China's challenges are now Xi's personal challenges. During his first term (March 2013-March 2018), Xi Jinping abandoned Deng's caution to "hide our capacities and bide our time...never claim leadership." The consequence was that China engaged in territorial conflicts with Japan, India (in Ladakh and via Bhutan in Doklam), Vietnam, the Philippines, and South Korea -- many of them US allies. Having thus revealed its aggressive intent, China now faces an inchoate coalition of Indo-Pacific democracies intent on countering China, led by the US -- which has officially deemed China a revisionist rival power (National Defense Strategy, 2018).

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China’s economic strategy and global impact

China’s economic transformation was spurred by a 33 per cent devaluation of the renminbi (RMB) on 1st January 1994 (from RMB 5.8 per USD to RMB 8.7 per USD), accompanied by a year of tight credit controls that broke the inflation-devaluation spirals that had plagued the renminbi between 1982 and 1993. During those 11 years, the RMB had fallen from RMB 2 per US$ to 5.8, accompanied by bouts of very high inflation and current account deficits. China does not have a floating exchange rate as most market economies have. In April 1994, Premier Zhu Rongji set the RMB at a fixed very competitive level of RMB 8.28 to a dollar and restricted inflation, moving China to seemingly permanent current account surpluses, until the switch to a small deficit in January-September 2018. This fixed rate was retained by Beijing for more than a decade, enabling it to become an exporting giant and leave behind competitors, after which it was allowed to appreciate somewhat under international pressure. It currently hovers around a still competitive and managed 6.92 RMB to a dollar to retain export competitiveness.

The eventual result of this super-competitive RMB was the Asian Financial Crisis (AFC) of 1997. This obliged the ASEAN economies and South Korea to concentrate on reforming and stabilizing their banks over the next 4-5 years, while the MNC-driven global supply chains that had been anchored in south-east Asia largely shifted to low-cost China, lured additionally by China’s entry into the WTO in 2001. The export-led bonanza, however, also set off a domestic credit boom in China – leading to a potentially even larger financial crisis there in 2003 than had occurred in ASEAN and Korea in 1997. In June 2003 (Kyne, 2003), the rating agency Standard & Poors estimated that China’s NPLs (non-performing loans in the banking system) were a monumental 50
per cent -- far higher than Malaysia, South Korea or Thailand at the height of their 1997-98 crisis.

While the AFC countries countered moral hazard via their market-based bank workouts, China’s 2003-06 bailout by the state allowed reckless lending to persist. Banks in Korea, Malaysia, Thailand and Indonesia were forced to sell their bad loans at steep discounts to face value, so that bank shareholders and managements bore most of the pain for the losses that had resulted from their past lending decisions. As a consequence, bank lending in the subsequent 20 years has been much more conservative in those economies. By contrast, China buried its 2003 banking crisis rather than confronting it. An astronomical 45% of all the loans on Chinese banks’ books were removed at face value – and parked in four “asset management companies”. Since bank managements faced none of the costs of their past lending decisions, they continued to lend recklessly in subsequent periods, helping to build up massive bubbles in industrial and real-estate capacity.

China has already undertaken the biggest monetary expansion in human history over the past 10 years. In August 2008 (the month before the onset of the GFC), China’s money supply was equivalent to US$6.56 trillion -- considerably smaller than US M2 money supply (US$7.75 trillion at the time). By September 2018, China’s M2 expanded to US$26.23 trillion – far larger than the current US M2 money supply of US$14.25 trillion. Over the past decade, China’s money supply has quadrupled, while US money supply has not quite doubled. This extraordinary monetary expansion in China had been preceded by rapid lending in 2004-07 that had already prompted concerns about severe industrial capacity in China. In March 2007, then-Premier Wen Jiabao said China’s economy was “unstable, unbalanced, uncoordinated and unsustainable”. 
The monetary surge has inflated industrial and property bubbles, and created a chronic problem of capital flight since 2014. The credit surge of the past 20 years and the resulting bubbles of industrial and real-estate capacity contribute to China’s financial fragility, which will be exacerbated as the economy slows in response to rising trade tensions with the US. Although China’s current account remained consistently in surplus between 1994 and 2017, its foreign exchange reserves peaked at US$3.99 trillion in June 2014 – and have shrunk to US$3.09 trillion by September 2018. Given the trade surplus throughout that period, a US$900 billion decline in foreign reserves suggests that China’s citizens have taken well over US$2 trillion out of China during those 51 months. Purchases of prime real-estate by Chinese citizens bearing suitcases filled with cash have begun an urban legend from London to San Francisco, Vancouver to Singapore, and many points in between.

US Vice President Mike Pence’s 4th October 2018 speech stopped short of declaring the start of a new Cold War. Pence accused China of meddling in US politics, attempting to compromise academic and cultural freedom even in the US, and using an "arsenal" of unfair trade including "tariffs, quotas, currency manipulation, forced technology transfer, intellectual property theft, and industrial subsidies". But he leavened those adversarial phrases with a reaffirmation of the One-China policy, and the soothing assertion that "competition does not always mean hostility" (White House, 2018).

**Trump’s Long Game**

What is clear, however, is that the Trump administration is playing the long game against China on trade and security. It recognizes that China is now a serious competitor and threat, with an approach to state power that is diametrically opposed to everything that the US stands for. The two clearest economic implications from this are: (a) that the US (and other western allies) will not accord China "market economy" status within the WTO, allowing the persistence of anti-dumping investigations of China by using third-party export prices (rather than simply comparing export prices with the domestic
cost of production); and (b) US protectionist steps will seek to disrupt and change the global manufacturing supply chains that are centred on China.

China’s "peaceful rise" since 1978 was facilitated by the US (and the other western powers), which midwifed communist China’s smooth entry into global markets, culminating in China’s membership of the WTO since 2001. So China’s non-market practices on currency policy (keeping the RMB pegged from 1994 to 2005 despite rising current account surpluses), industrial-export subsidies, the 2003-06 bank workout, and subsequent reckless lending were all excused as temporary aberrations. The West also averted its eyes while China broke its obligations under the Nuclear Non-Proliferation Treaty, supplying nuclear and missile technology to North Korea and Pakistan (thence to Libya, Syria and Iran through the "AQ Khan network"). The West quietly supported China-backed tyrants (like Cambodia’s Pol Pot and Zimbabwe’s Mugabe) because their opponents were potential Soviet allies -- and didn’t demand wholesale changes to those alignments over the quarter-century after the USSR’s demise. And the world largely accepted China's ahistorical claims that Tibet, East Turkestan, Inner Mongolia and Taiwan were all part of "One China".

As Xi Jinping engages Donald Trump in a tit-for-tat war of trade protectionism, the US is likely to ratchet up the pressure on all these fronts, moving from trade to the notion of "One China"(starting with an erosion of the idea that Taiwan is part of China), and issues of nuclear proliferation. On trade itself, the skewed nature of Sino-US trade (with just US$ 130bn worth of imports into China from the US in 2017, versus US$ 506bn of Chinese exports to the US) makes it futile for China to engage in a tit-for-tat tariff battle. Once China has imposed tariffs on US$ 130bn of imports from the US, there will be no more imports to hit -- while the US will still have ample ammunition for additional tariffs on imports from China. As of October 2018, the US has imposed tariffs on US$ 250 billion of its imports from China (less than half),...
while China has retaliated with tariffs on US$ 110bn of its imports from the US (leaving just US$ 20bn of annual imports untouched). While US consumers will suffer price increases in the short term, most imports from China can and will eventually be substituted by similar imports from elsewhere.

**Damage to China**

Disruptions to the China-centred supply-chain are likely to do permanent damage to China's export engine. As alternative suppliers successfully fill the breach, there will be little incentive to re-engage with China, especially with wages rising and the supply of labour beginning to run out (because China’s working-age population has been shrinking since 2013). Winners are likely to emerge in South-east Asia (Vietnam, Malaysia, Singapore, Thailand), Bangladesh and India -- which could all fill the void in the China-centred supply chains. More important, the sharp slowdown in China's domestic demand is already a major source of concern: FAI (fixed asset investment) was up just 5.4% YoY in January-September 2018, the slowest pace in 22 years. Much of that growth came in 1Q 2018 (+7.5% YoY), decelerating to 4.5% YoY growth in 2Q 2018 and 4.2% YoY in 3Q 2018. Retail sales have also decelerated sharply. The monetary easing is clearly aimed at countering this, but the depreciation of the RMB -- and the likely capital flight resulting from it -- will undermine the ability to provide a monetary stimulus.

China's main policy response has been to weaken the RMB, by easing monetary policy via a 250bp reduction in banks' RRR (required reserve ratio) over the past 5 months. Such a large decline in the RRR is aimed at bolstering the money multiplier, in order to spur faster M2 growth. But attempts to boost China’s money supply (i.e., debase the RMB), at a time when the US is raising interest rates, have inevitably resulted in accelerated depreciation of the RMB. In September 2018, China's foreign reserves declined by US$ 22.7bn to US$ 3.087tn, and its net capital and services/income outflows for September 2018
alone were US$ 54.4 billion. Capital controls (and FX intervention via forward rather than spot markets) have helped contain outflows to just about a third of what they were in August-October 2015. But we expect the downward pressure on the RMB to increase significantly in the current quarter and beyond.

China’s overcapacity in old industries (steel, cement, aluminium, chemicals) requires it to create its own demand, or generate it through BRI. In several key industries -- steel, aluminium, cement -- China now accounts for more than half of world production (see table below for 2016). China thus needs to create its own demand -- domestic Chinese demand is one factor, and a second is the Belt and Road Initiative (BRI) aimed at creating foreign demand for China’s overcapacity (largely through Chinese debt-financing of artificial foreign demand). Strong investment spending (including construction investment) is needed for China to sustain demand for the enormous overcapacity in steel, aluminium, cement and chemicals that China has built up. In Chemicals, China accounts for just over a third of world output, but its output and capacity have expanded very rapidly in the past decade, and marginal demand in that sector too comes mainly from China. Given that China is already facing a major challenge with capital flight, China can no longer afford the large capital outflows necessary to keep funding BRI spending with large amounts of its own lending. When Malaysia’s Mahathir referred to BRI as “new colonialism”, cautioning China against imposing “unequal treaties” on others, he was clearly speaking for many other BRI partner countries.

<table>
<thead>
<tr>
<th>2016 Production in key industries</th>
<th>China</th>
<th>World</th>
<th>2nd largest producer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steel (m tonnes)</td>
<td>808.4</td>
<td>1629.6</td>
<td>104.8 (Japan)</td>
</tr>
<tr>
<td>Aluminium (th tonnes)</td>
<td>31000</td>
<td>57600</td>
<td>3580 (Russia)</td>
</tr>
<tr>
<td>Cement (m tonnes)</td>
<td>2410</td>
<td>4200</td>
<td>290 (India)</td>
</tr>
<tr>
<td>Motor vehicles (th)</td>
<td>28,119</td>
<td>94,977</td>
<td>12,198 (USA)</td>
</tr>
<tr>
<td>Chemicals (€ bn)</td>
<td>1331</td>
<td>3360</td>
<td>528 (USA)</td>
</tr>
</tbody>
</table>

**Sources:** worldsteel.org, cefic.org, wikipedia
For the first time in 25 years, China is on course to post a current account deficit in 2018. China's trade surplus shrank to US$144.27bn in 1 half of 2018 (from US$187.77bn in 1 half of 2017). As a result, China's current account swung to a deficit of US$28.3 billion in 1st half of 2018 (from a surplus of US$68.27bn in 1st half of 2017). In recent quarters, a monthly trade surplus of US$ 32-35bn has been necessary to ensure a current account surplus -- so the smaller trade surplus of US$ 28bn in July, US$ 27.1bn in August 2018 and US$31bn in September are consistent with a current account deficit of US$ 6-10bn in 3rd Q 2018. Given the persistence of expansionary monetary policy, China's imports will remain robust and 2018 is likely to mark the first annual current account deficit for China in 25 years.

Ironically, in the year-to-date, China's global trade surplus was entirely accounted for by its bilateral surplus with the US. China’s Jan-Sep 2018 bilateral surplus with the US was US$225.8bn, up from US$196bn in Jan-Sep17; the surplus with the rest of the world was US$107bn in Jan-Sep17, falling to a deficit of US$0.7bn in Jan-Sep18. In August-September 2018, China’s exporters pre-shipped unusually large quantities to beat the imposition of the 10 percent US tariff on US$200bn of imports. When this is ratcheted up to 25 percent in January 2019, they will really begin to bite – with the prospect of a further widening of tariffs to another US$250bn of US imports from China. China has exhausted almost all its trade bullets against the US, but the US has only now begun to unload its bullets.

Protectionism helped China build up its internet behemoths -- Alibaba, Tencent and Baidu – which grew rapidly in response to China’s ban on Facebook, Twitter and Google. In turn, the Chinese trio are now major players in Private Equity globally as they compete with Japan's Softbank (among others) to seed the next “unicorns” of the technology sector. China’s credit surge has also helped build up world-leading capacity in areas like solar panels, robotics, and some areas of artificial intelligence. The “Made in China 2025” initiative (launched in 2015) is aimed at obliging the FDI-driven industries (particularly electronics, pharmaceuticals and vehicles) to raise Chinese-
domestic content to 40% by 2020 and 70% by 2025 – plans that the US is now determined to thwart.

India’s Opportunity

US tariffs are likely to induce foreign-invested companies to relocate from China. FDI-driven manufacturing in China increasingly focuses on serving China’s domestic demand, for instance in cars (including electric vehicles), for which China is the world’s largest market. But the vast majority of China’s exports are still accounted for by foreign-invested companies in electronics and semiconductors, textiles, garments, shoes, toys, car parts and pharmaceuticals. The supply chains anchored in China for all these products are likely to shift to other economies. Thus far, labour-intensive manufacturing has largely shifted to Vietnam and Bangladesh. In vehicle-parts and pharmaceuticals, relocation is likely to focus increasingly on India (and Thailand for car parts).

Vietnam has edged out India in the relocation stakes because of India’s inflexible labour market. There is much inertia in the process of relocation, with the size of China’s domestic market an additionally attractive factor. But a 10 percent tariff will be persuasive for export products, where competitive margins are thin, and a 25 percent for exports to the largest market will be compelling. The natural beneficiary of large-scale relocation of export-oriented manufacturing from China ought to be India. The faster-growing domestic market will be an additional factor helping India. But the main challenge in India remains the inflexible labour market, which has enabled Vietnam to be the biggest beneficiary of export relocation from China thus far. Samsung Electronics already employs 700,000 workers in Vietnam, its biggest manufacturing base outside Korea, and Yue Yuen (the world’s largest OEM manufacturer of athletic shoes) has also shifted much of its production from Dongguan (Guangdong) to Vietnam.
The ball is in India’s court to attract the massive relocation that could solve the long-term employment challenge. Cars, car-components and pharmaceuticals are areas where India has a critical mass already, and will naturally be able to attract substantial relocation. Electronics manufacturing has largely bypassed India in the past two decades, but there are encouraging signs (especially in smart-phone manufacturing): India’s electronics output is up 23.5% YoY in the first half of FY2018/19. Foxconn, the Taiwanese company that produces most of Apple’s OEM components in mainland China, has committed to establishing 12 manufacturing plants in India, but its progress has been slow. The labour-intensive complex (textiles, garments, shoes and toys) is one that India can yet aim to compete in. Average wages in most of north India are lower than Vietnam, and there is a vast army of underemployed youth that could be absorbed into these industries. Every successful industrializer in history (Britain, the US, Germany, Japan, Taiwan, South Korea, Malaysia, China) took its first step on the industrial ladder by producing labour-intensive products for the world market – thus absorbing excess labour from rural areas, and setting off successful urbanization. India’s demographic dividend would become a true bonanza if further labour-market reform were to attract the massive amounts of relocation of industry from China that are inevitable as China’s trade war with the US escalates. Given the US’ professed strategic commitment to deepening ties with India, this is a once-in-a generation chance for India to leapfrog to 10%-plus annual real GDP growth through a classic Asian export-oriented strategy.

References
Almost six months after the USA kicked off what is being called a “Trade War” with China, the set of import tariff imposed on Chinese imports by the Donald Trump Administration seem to have hurt the American economy as well. Measures that emanated from the White House have been variously called ‘destabilising,’ ‘ill-conceived,’ and even a drag on the global economy. The last description has in fact been voiced by the IMF that once used to be guided by the directions of the US Department of Treasury.

Clearly, the Trump Administration has failed to evolve a consensus on the methods of levelling the playing field on trade and commerce with China. However, despite the widespread opposition to many of Trump’s methods, one cannot obfuscate the fact that a meeting of minds exists in the USA over the challenges posed by China’s unrelenting economic rise, its trade policies and its technology acquisitions from American and European companies. Latest trade data shows a US $ 34.1 billion trade gap with China in September 2018, signifying a rise of nearly 20 per cent from a year ago in 2017. On top of that is the fact the US budget deficit is an ever-widening chasm, scheduled to rise to US $ 1 trillion by the time Trump comes up for re-election.

On the other hand, although extremely unlikely, if China as the largest holder US T-bills decides to move out of what can be called the ‘dollar trap,’
the American currency can go into a tailspin of the sort that could bruise the US economy – now being feted for having a good year in terms of growth figures. Such an extreme measure of course comes with a hefty price – it will bring China to its knees as well.

**Whither the dollar trap?**

But before one moves ahead with this narrative, let us examine what is being termed as the ‘dollar trap.’ As the global reserve currency the USD had muscled into the global coffers in the early 1970s when the world had transited from the gold standard. The biggest element that made the base for the American currency was not so much the strength of the American economy but trade in oil which the OPEC pegged on USD.

So, by the time of the early part of the first decade of the new millennium, when China became the largest holder of USD stock, a fear had emerged: what if the Beijing comrades decided to do a George Soros on the USD? The standard response to that idea from the US government then and till recently was China is a ‘responsible economic player’ and not a liberal billionaire dilletante-with-an-agenda like Soros. The run on the British Pound that Soros had engineered in the 1980s was naturally considered ‘irresponsible’ in the least.

But where is the trap? The American officials then had pointed out if the Chinese decide to dump the USD, it would at the very least hurt themselves as much as the US. For, a run on the dollar will seriously devalue the latter tranches of their large dollar reserve, thus causing their own economy a lot of pain. This could thus be dubbed the ‘dollar trap.’

Having said that, the weaponisation of these economic instruments in a ‘trade war’ of sorts is only limited by the American decision to not escalate the skirmish that has till now only been restricted to a ‘Tariff War.’ While the first phase of the Trump tariffs has affected goods worth about US $300 billion, the Chinese tariffs have been imposed on US goods worth about $200 billion. But these tariffs appear to be targeted politically unlike those imposed
by the US. For, Beijing chose those US items from its import basket which originate in Middle America, in other words Trump’s electoral base.

For the Chinese side the ‘tariff war’ was not happy augury. In fact, though China had been diversifying and expanding the market for its goods and services, the US turnaround may be giving Beijing similar feeling that we in India had encountered at the demise of the Soviet Union. For, the PRC for a long while had in the USA a dependable trading partner. In fact, like aid dependency, if one can think of China’s ‘trade dependency’ – as a result of its export-led economic transformation model established by Deng – the US became its primary benefactor. The Chinese elite know their ‘rise’ was facilitated by the US to a great length. Now that Washington has turned around, the evolving situation can cause turmoil, both externally and internally. That feeling is only limited by the nationalist desire to reclaim ‘greatness’ that they think China deserves.

Stemming from that is the effort to deny the US a victory. The most important element of punitive tariff hikes by China is yet to come; that will be on the American shale oil exports to China. While statistics show that most of American oil is imported by Canada – roughly 60 per cent of the total production – much of that is really the feed stock for the US-based refiners, who find the Canadian re-export route to be more cost effective. China imports about four per cent of that production. Considering that much of the shale oil is produced in the mid-western and mid-eastern states of the USA, Chinese hike in tariffs will hurt those areas the most.

Already the foreign direct investors of US-origin have begun complaining that they are bearing the brunt of the Trump tariffs, because they manufactured with Chinese labour what is exported to their land of origin. They are now being walled off from the market in the US. This is an influential section of the American population who can wield enormous and disproportionate influence on the public opinion of the country.
**Trump’s high risk gambit**

Trump’s autarkic view of the global connectivity of trade and commerce coupled with his newly acquired xenophobia can boomerang easily. If the better targeted Chinese tariffs begin to bite with some severity, the US President’s electoral base could shrink in no time. While it cannot be gainsaid whether the impending Congressional midterm polls will reflect the change in popular mood, course correction in its wake can be an immensely difficult imperative.

Any of these situations need not have come to such a pass had Trump been a lesser unilateralist. All the US government needed to do was to ensure some alliance building; its Western allies had been looking askance at the phenomenal Chinese growth for some time. Most worrisome for them were the gigantic projects such as the Belt and Road Initiative that the new economic giant had begun undertaking.

Also, the constant drumbeat of the Chinese media about these projects being better than the best – essentially geared towards shoring up the domestic nationalist base -- also irked many in the West. Chinese authorities were quick to catch this drift. Discrete words were thus put out that the homegrown media should tone down this rhetoric so that hackles don’t get raised too much, according to the Hong Kong-based *South China Morning Post* couple of months ago.

This message of restraint for the Chinese social and traditional media should have been read rightly in Washington. The Trump Administration should have been the first off the block in coaxing European allies to stand firm with the USA in punishing Chinese ‘unfair’ trade practices. But instead the government in Washington launched a ‘Tariff War’ with the European Union also, besides of course berating them about not doing enough for NATO. Thus, once the war was fully joined, we witness the weird coalition of the EU with Beijing – with Europe providing greater trade access to the Chinese.

In South East Asia the story is even more appalling for the US. Almost all the members of the ASEAN have China as their largest trading partner.
Plus, the growing military reach of the East Asian giant have them worried. In no circumstance can they afford to earn the pique of Beijing. Though there are report that some of the foreign direct investors are abandoning the lure of the Pearl River Delta and moving base to some of the ASEAN members such as Vietnam, these nations themselves do not like to appear that they are driving the capital flight away from China.

Thus, the time may have come for the American planners of this war to return to their drawing boards and take a long hard look at the pieces in play. While the US President Donald Trump considers himself to be the Negotiator-in-Chief, he needs to tone down his natural aggression and inject some pragmatism to the exercise. The last three rounds of trade talks with China did not even take off properly, because of Chinese recalcitrance. The time may be fast approaching for Trump to withdraw some of the ‘heavy artillery’ so to say, and instead sit at a table and talk.

The tensions on the economic front already appear to be spilling over into the realm of the military, and other equally dangerous arenas – like the South China Sea, for example. A foray close to Chinese Exclusive Economic Zone in the high seas by a US Seventh Fleet warship witnessed a chase by PLA-N destroyer. The world looked at the television picture of the engagement with rising consternation as the Chinese destroyer virtually grazed the American warship as it sought to actively guard the ‘Chinese waters.’ History will tell whether this was the first military engagement of the Second Cold War. For the rest of the global population seeking social and political equilibrium in these difficult times, where newer jobs hold out the only hope for economic well-being, this economic and military sabre-rattling is not a good tiding.