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UPDATE FOR CHINA/TAIWAN

SCENARIO ANALYSIS

Q1/2025

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BLUF:

- We update our scenario analysis surrounding the tail risk of a Taiwan Strait Crisis between Mainland China and Taiwan, China for Q1/2025.
- As previously forecast, scenario risk in Q4/2024 remained below historical averages as China waited for the results of the U.S. election and focused on its domestic economic problems.
- Now, rising China/Taiwan International Relations (IR) Risk and Taiwanese political polarization is starting to push this scenario risk back up.
- Scenario risk is forecast to increase steadily through Q1/2025 as U.S. President Donald Trump's foreign policy agenda threatens to isolate Taiwan militarily, initiate a new trade war with China, and increase regional instability.
- We use our contingency planning tool to simulate how different proposed U.S. tariffs against China and Taiwan affect scenario risk. A 10% tariff on Chinese goods leads to an estimated doubling in scenario risk as the opportunity costs to fighting dissipate. Trump's threat of a 60% tariff would push scenario risk much higher.

GeoQuant's systematic approach to **scenario analysis** monitors rare, but highly consequential, tail risk events. The aim is to provide a real-time, data-driven measure of event risk, changes in the underlying factors driving event risk, and forecast trends. This week we present our quarterly estimate surrounding the tail risk of a conflict between China and Taiwan.

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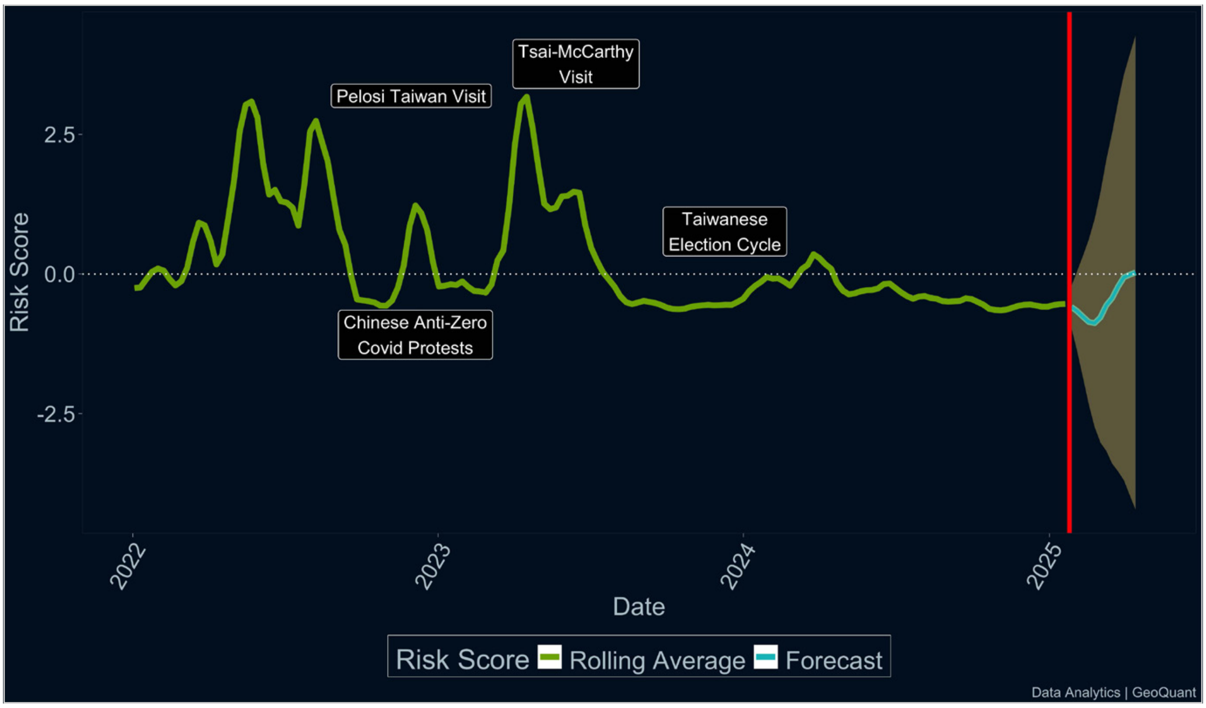
Current Trends and Forecasts

As previously forecast in October, scenario risk estimates remained low across Q4/2024 amid China's ongoing economic headwinds. The government's **suite of stimulus measures** coupled with looser PBOC monetary policy led to a decline in Policy Risk. However, Social Polarization Risk, which tracks social unrest and instability, continues to climb as **CPI barely rose 0.2%**, **youth unemployment remains high at 16.1%**, and rare **acts of overt dissent** – including mass stabbings and car-rammings – are up. In response, PBOC President Pan Gongsheng pledged in early January that China would focus on more **consumer-oriented reforms**, including **increasing resident income**. This is forecast to push Chinese political risk down through 1H/2025.

The scenario model forecast indicates that risk is near a low-point and will begin to steadily climb in Q1/2025 (Figure 1). This increase is driven by three factors: (1) falling Chinese Political Risk, (2) rising Taiwanese Political Risk, and (3) an increasingly hawkish U.S. foreign policy toward both China and Taiwan.

FIGURE 1. CURRENT SCENARIO RISK AND FORECAST



Source: GeoQuant

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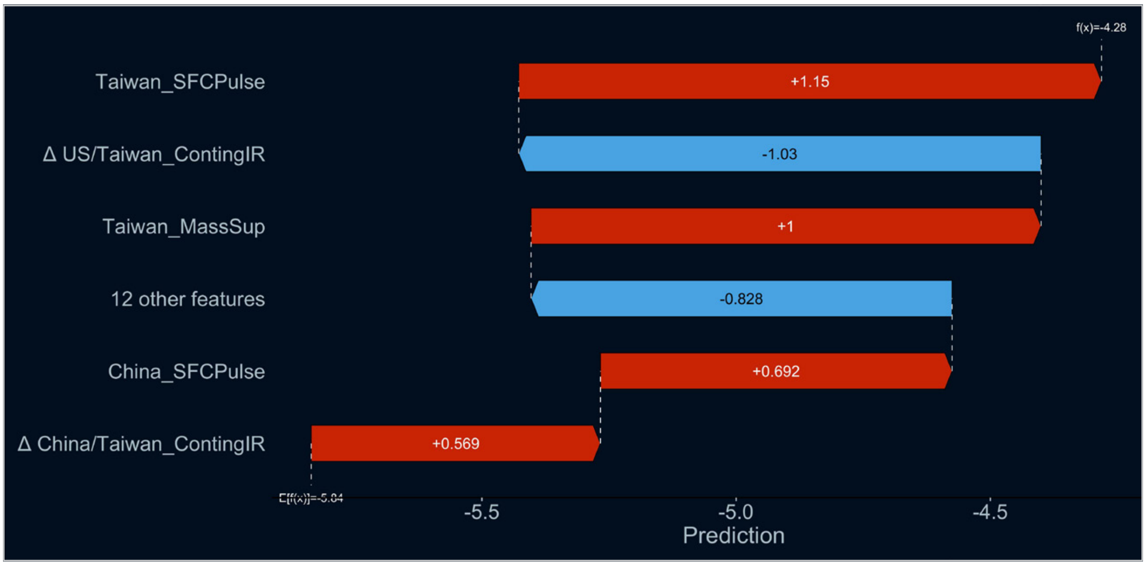
Biggest Movers

As part of our scenario framework, we monitor key risk inputs that help explain trends in the data. Figure 2 highlights the main drivers and restrainers for this week's risk estimate via a waterfall plot. We explain the relative stability, in this week's risk estimate relative to October when we published our last quarterly update.

FIGURE 2. TRACKING CHINA/TAIWAN ESCALATION PROSPECTS

Key Drivers and Restrainers Week of 27 January 2025



Benchmark Period: 21 Oct 2024
Source: GeoQuant

The bottom (right axis) of the waterfall plot shows the average risk estimate E(x) for a given benchmark period (e.g., data on 21 October 2024) and the top (left axis) of the waterfall plot shows the current estimate f(x) (27 January). From bottom to top, the key features driving scenario risk up from the baseline E(x) are in red; key features driving scenario risk down from the baseline are in blue.

The waterfall plot captures changes in scenario risk across Q4/2024 and early January. Relative to October, Figure 2 shows that rises and falls in different risk factors tended to offset each other but, on net, there has been a slight increase. While China's domestic political risk profile was counter balanced by falling Policy Risk and rising Social Risks, growing instability inside Taiwan combined with rising China-Taiwan cross-border tensions is starting to push risk higher. Specifically:

- **Falling U.S./Taiwan Contingent IR Risk:** Until Trump's inauguration and the new national budget passage, Taiwan's bilateral relations with the U.S. helped to constrain risk as the U.S. authorized USD 571.3 mn in security assistance for Taiwan.
- **Rising Contingent China/Taiwan IR Risk:** Bilateral relations risk rose through Q4/2024 as China continued to conduct "combat readiness patrols", sending planes into Taiwan's Airspace Defense Identification Zone (ADIZ). The large number of ADIZ violations, including a notable 204 times the first three weeks of January, dates back to U.S. Speaker Nancy Pelosi's visit in 2022. Scholars characterize the airspace incursions as part of a larger gray zone campaign to militarily coerce Taiwan toward unification short of outright war.
- **Rising Taiwan Mass Support Risk:** Mass Support Risk, which measures government popular approval, is up after the KMT-led legislature approved a 6.6% cut to the national budget including large cuts to the Ministry of Defense. The DPP, which controls the presidency, criticized the move as jeopardizing military readiness and called for a public recall against KMT legislators. These institutional divisions benefit China's long-term unification aims. China may indirectly use the political crisis to undermine the DPP or directly exploit the growing military gap between the countries, pushing scenario risk up.

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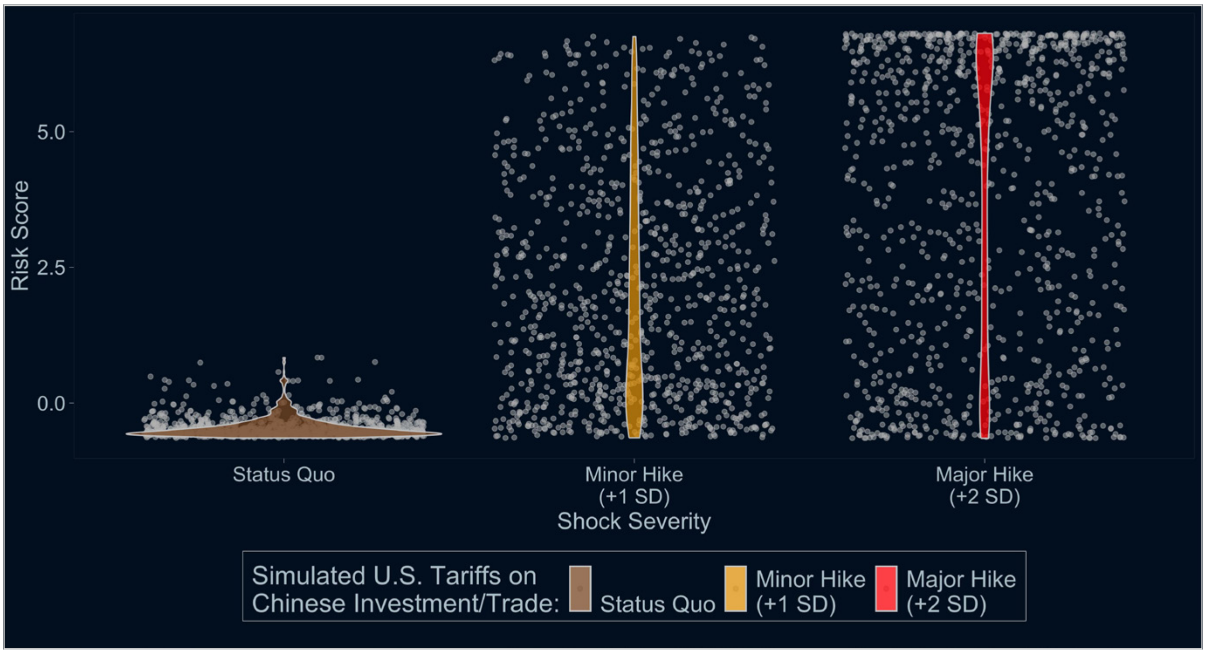
What to Watch For

While the scenario forecast for Q1/2025 predicts a rise in scenario risk, we are monitoring several events which could impact this trend:

- **How do Trump's tariffs affect China's economy?** U.S. President Trump has threatened blanket tariffs of up to 60% on Chinese exports and 20% on other countries exports. On February 1, he announced a 10% tariff on Chinese imports, similar to what the U.S. imposed during the first trade war. We simulate how much different proposed tariffs will affect the risk of a Taiwan Strait crisis based on their change to Investment/Trade Risk. During the first trade war, Chinese Investment/Trade Policy Risk grew by 1.3 points or approximately one standard deviation due to uncertainty over potential retaliatory steps. We assume conservatively that a higher tariff schedule will lead to at least a two standard deviation increase in Investment/Trade Risk. The simulation results show how differences in Investment/Trade Risk increase tail risk, holding all other factors at historical levels.
- Even a small 10% tariff hike doubles the average risk score from status quo levels (approximately zero) to 2.19; a more extreme tariff hike increases the estimated risk score to 3.66 standard deviations above normal. U.S. tariffs increase the scenario risk by (1) reducing China's opportunity costs to fighting (as the relative economic costs of war decreases) and (2) because they increase the probability of economic tensions between China and Taiwan due to relocation of multinationals out of China for tariff concerns. However, the simulations show there is low confidence in both of these estimates as the range of simulations span from little impact to the six-sigma range of outcomes. The uncertainty surrounding tariff policies is driven by two key factors: the ambiguous scope of potential tariff measures, given that Trump's actual trade policies toward China have been more conciliatory than his rhetoric suggests, and China's enhanced preparedness to respond to new tariffs compared to during previous trade disputes.

FIGURE 3.



Source: GeoQuant

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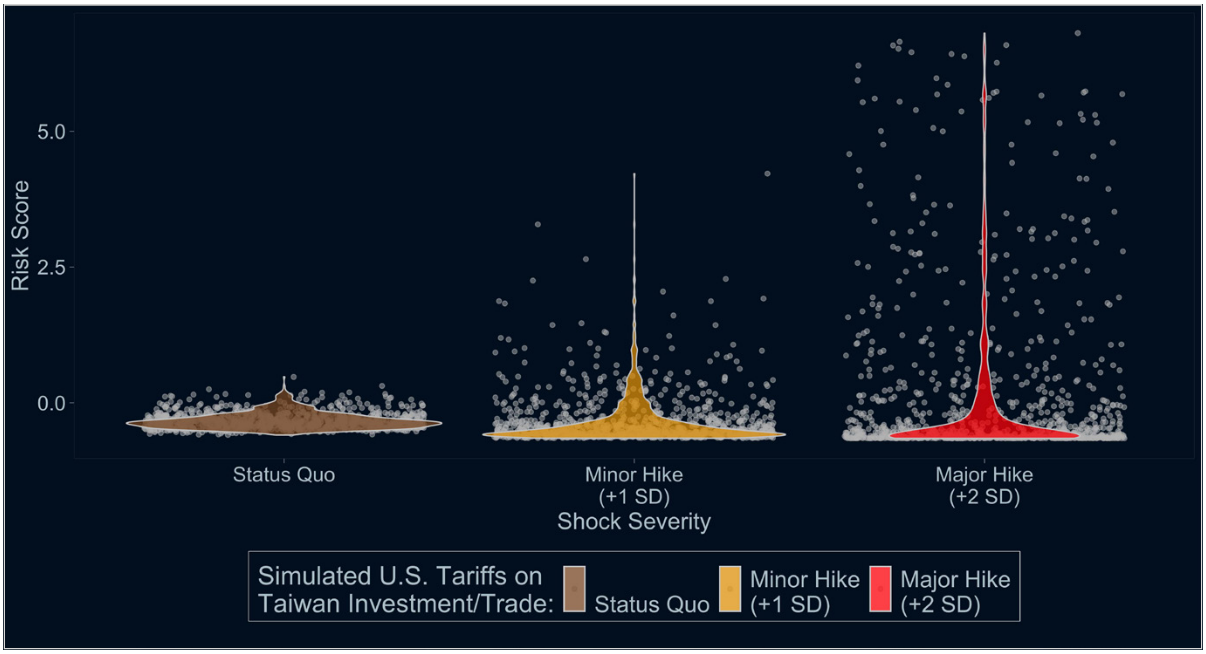
- **Does Taiwan's "Silicon Shield" deter China?** Conflict scholars have previously posited that Taiwan's central role in the semiconductor industry creates a "**Silicon Shield**", making it too valuable to attack and creating a key deterrent. DeepSeek's AI announcement might challenge Taiwan's strategic importance because it suggests chip demand may be lower than previously assumed. Trump's threat to **impose tariffs on semiconductors** or **scale back parts of the CHIPS Act**, which has induced Taiwanese chip creator TSMC to operate in the U.S., would increase Taiwan's Investment/Trade Risk. We conduct a similar exercise as before, simulating how the prospect of U.S. tariffs against Taiwan would impact a Taiwan Strait crisis, holding other factors constant. The results show with high confidence that small to even moderate changes in Taiwan's investment risk profile do not substantially increase the risk of war. Moving from benchmark to an extreme two standard deviation increase in risk has a negligible effect on the average tail risk z-score, which moves from 0 to 0.1 In other words, the "Silicon Shield" is not the main factor deterring China from military action and even threats to this shield would not substantially change the tail risk.

FIGURE 4.



Source: GeoQuant

Current scenario risk estimates of a Taiwan Strait Crisis are forecast to increase after a relatively quiet year. Rapidly changing threat environments and geopolitical shocks can increase risks. We will continue to monitor and update this scenario estimate as events unfold.

About GeoQuant

GeoQuant is an innovative AI-driven data and technology company, acquired by Fitch and now part of BMI, that is transforming the way the world's leading organizations are quantifying, integrating, and navigating political risk.

By fusing PhD-level political and computer science, GeoQuant generates high-frequency, quantitative measures of risk that are systematic, back-testable, and predictive.

The result is real-time updates for over 40 political risk indicators in more than 140 countries, and analytics that enable you to foresee risk trends and make proactive moves.

GeoQuant data, modelling and advisory services have been used to successfully inform the asset, risk and sovereign ESG strategies of leading institutional partners.

About BMI

In an uncertain macroeconomic environment, BMI's systematic, independent and data-driven market insights, analysis and forecasts enable you to recognize and assess risks and opportunities across 200+ markets and 20+ industries.

For over 40 years, we have provided impartial and transparent analytics, data and research across themes, countries and sectors, with deep insight into emerging markets. Our detailed intelligence is frequent, consistent and systematic, enabling you to easily make comparisons and interrogate data to support your strategic plans and investment decisions.

Learn more at **fitchsolutions.com/bmi**

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