

January 11, 2021

The U.S.-China Balance of Power: Part I

(Note: Due to Martin Luther King Jr. Day, our next WGR will be published on January 25.)

We've often written in these reports that one of the most important challenges of the 21st century will be the geopolitical tensions generated as China strengthens and comes into ever greater competition with the U.S., even as the U.S. wavers in its commitment to its traditional role as global hegemon. In early 2019, we introduced our readers to the concept of the "Thucydides Trap," which describes the heightened risk of war when a rising power comes into conflict with an incumbent hegemon (see our *WGRs* from [January 28](#) and [February 4](#), 2019).

Naturally, great-power warfare is a nasty business with plenty of potential ramifications for investors. Given the global scale of interests and the multiple dimensions on which the U.S. and China compete, even tensions short of combat could affect investors.

In order to stay on top of the evolving opportunities and risks, we continue to deepen our research into the U.S.-China competition. This multi-part report aims to assess the current balance of power between the two sides and what that implies for how the competition may play out in the coming years. In Part I, we provide a comprehensive overview of each side's key interests and goals, which will say a lot about how the two sides use their power over time. In two weeks, Part II will

provide a head-to-head comparison of U.S. and Chinese military power. In the following weeks, Part III will examine the relative economic power of the two sides, and Part IV will describe their relative diplomatic positions around the world. Finally, Part V will dive into the opportunities and threats for U.S. investors.

Chinese Interests and Goals

It's tempting to start this analysis by asking, "What does China want?" However, because of China's Communist, authoritarian political system, that's probably not the relevant question. Since Chinese policymaking is monopolized by President Xi Jinping and the Communist Party of China (CPC), it makes more sense to ask, what do *they* want? Of course, even Communist dictators need to be sensitive to the aspirations and desires of their ministers, their police and armed forces, and even their general citizenship. President Xi's success in concentrating power in himself has come in part from his ability to channel what many Chinese officials and citizens already wanted. All the same, Xi and his party dominate Chinese decision-making to such an extent that their interests and goals are the ones that really count.

China's Vital Interests. We define national "interests" as the set of circumstances and arrangements that benefit a nation so strongly that its leaders will work to establish or maintain them. We define "vital" interests as those circumstances and arrangements that are indispensable to a nation's independent survival. In our view, a list of China's vital national interests

compiled by President Xi and the CPC would look something like the following:

- ***Preserve China's political system.*** Despite Western expectations that China would democratize as it became more economically liberal and integrated into the world trade system, those expectations have not been fulfilled. As shown by the CPC's crackdown on democracy demonstrators at Tiananmen Square in 1989, the party is [only willing to liberalize to the extent that it can preserve its power and control over society](#). Not only do Xi and the CPC defend China's state-controlled system, but they actively promote it globally as a superior alternative to Western-style democracy and capitalism.
- ***Maintain territorial integrity and sovereignty.*** Like all national leaders, Xi and the CPC consider it essential to maintain government control over China's territory and prevent any breach of its borders by foreign powers. As we've discussed in the past, geography has left northwestern China exposed to invasion via the Central Asian Plain. More importantly, China's rise and future prospects are tied to its ability to trade from ports on its eastern and southern coastlines, so it must prioritize coastal defense. Finally, even though the ethnic Han constitute the vast majority of China's population, areas such as the [Xinjiang province in the northwest and Inner Mongolia in the north have significant populations of ethnic minorities agitating for greater autonomy or even independence](#).
- ***Retain access to the Asian shipping lanes.*** As mentioned above, China is a maritime trading nation, so besides protecting its seaports, it must also retain

access to the shipping lanes of the East China Sea, the South China Sea, and even the Straits of Malacca and the Indian Ocean for access to critical energy supplies.

China's Specific Goals. Of course, many other countries have vital interests similar to the list above. What makes a country's foreign policy truly unique is the set of goals and strategies it pursues in order to secure its interests. The goals being pursued by Xi and the CPC include the following:

- ***Maintain high, stable economic growth.*** Xi and the CPC believe rapid, stable economic growth that boosts living standards for the Chinese people is critical to legitimizing their rule over the country and staving off the kind of social unrest that could threaten their political standing. For example, one reason the government has recently [cracked down on domestic "fintech" firms](#) is that they pose a threat to the stability of China's financial markets. Just as important, Xi and the CPC know that China's heft in global trade gives it economic leverage over other countries. Of course, China's large, growing economy provides the resources needed to modernize and bulk up the People's Liberation Army (PLA), so it is also critical to maintaining the country's territorial integrity and freedom of navigation.
- ***Transform China into a world leader in critical scientific and technological capabilities.*** The [key technologies targeted under this goal](#) range from artificial intelligence (AI) and quantum computing to electric vehicles and hypersonic missiles. The goal therefore supports all the vital interests listed above. For example, ubiquitous video monitoring and facial recognition

technology already help the government keep close tabs on its citizens and undercut opposition to Xi and the CPC. Naturally, applying its scientific and technological expertise to the PLA would also support China's efforts to maintain territorial integrity and freedom of navigation. Although China has become infamous for the way it has used [industrial espionage](#) and various kinds of corporate extortion to misappropriate foreign scientific and technological secrets, it's important to remember that its goal is ultimately to build up its own indigenous innovation capabilities.

★ **[Modernize and expand the Chinese military to ensure it can fight and win in a conflict with the U.S.](#)** It is easy to think this goal is limited to building up those forces necessary to keep U.S. forces out of the “first island chain” running from Borneo through the Philippine and Japanese archipelagos to the Kuril islands. However, since Chinese trade is now global, the country is also developing important national interests well beyond China and its surrounding seas. That helps explain why China has [already established a naval base in the African nation of Djibouti and is expected to have a global “blue water navy” by 2030](#). It also explains why much of the infrastructure investment China has helped finance globally under its “Belt and Road Initiative” consists of ports and other facilities that could be used by the Chinese military in the future.

★ ***Regain “lost” Chinese territories and strengthen sovereignty over disputed areas.*** This goal is implied by Xi's rhetoric about the “China Dream” and reversing the “[Century of Humiliation](#),” when the country was invaded,

occupied, colonized, and influenced by foreign powers. Over time, it involves regaining control over Taiwan and Hong Kong, by force if necessary. In the near term, this goal is [already being accomplished by the construction of military bases on artificial islands in the South China Sea and the deployment of troops to occupy territory in the Himalayan mountains that both India and China claim](#). Achieving this goal would not only buttress China's territorial integrity, but by playing to the Chinese population's nationalist sentiments, it would also put Xi and the CPC in a stronger political position.

★ ***Build citizen loyalty and domestic political support.*** Obviously, achieving this goal would help ensure the survival of the current Communist regime. The overarching strategy for achieving it is to [play on nationalist sentiment by talking up the glories of Chinese civilization and the need to regain China's traditional hegemony over East Asia](#). The idea is to garner respect as one of the leading countries of the world and consign the Century of Humiliation to the history books. To achieve this goal, Xi and the CPC have focused heavily on [strengthening their domestic propaganda and political education programs](#). They also continue to closely censor the media and utilize ever more sophisticated methods to get their message out over the Internet.

★ ***Crush any domestic political opposition before it threatens the leadership.*** This goal recognizes that if political opposition is allowed to get a toehold, it can be difficult to eradicate. Xi and the CPC have therefore been increasingly [proactive in identifying potential political and ethnic-separatist opponents](#)

through high-tech surveillance and prosecuting them for corruption or other offenses.

🇺🇸 ***Soften potential opposition abroad.*** This goal is a corollary to crushing domestic political opposition, even if it is expressed largely as diplomatic and “soft power” initiatives. One manifestation of it is to [increase Chinese influence in international organizations like the United Nations Human Rights Council and the World Health Organization](#). By ensuring that Chinese nationals dominate the governing boards and executive bodies of these organizations, or by ensuring that China becomes the predominant source of their funding, Xi and the CPC hope they can veto any potential decisions they may take against China. This goal also includes subsidiary goals aimed at bolstering China’s image among foreign citizens through propaganda and the establishment of a global network of “Confucius Institutes” that promote Chinese culture around the world.

U.S. Interests and Goals

Assuming our readers are already familiar with the general contours of U.S. interests and goals, we won’t go into them in great detail. Still, it may be useful to highlight a few issues that affect U.S.-China relations. The first issue is simply how to define U.S. vital interests. Throughout the Cold War, successive U.S. administrations generally subscribed to some version of the vital interests laid out in a 1950 report from the National Security Council (NSC-68): ***“To preserve the United States as a free nation with our fundamental institutions and values intact.”*** [A more modern reformulation by the Heritage Foundation](#) goes into greater detail, listing vital U.S. national interests as: ***“1) Defense of the***

homeland; 2) Stability in regions critical to U.S. interests; 3) Preservation of freedom of movement within the global commons.”

At first glance, these formulations might seem to express nearly constant and eternal truths, but as we’ve written many times before, many Americans have begun to question whether stability abroad and defense of the sea lanes are really so important. Many Americans have become weary of the traditional U.S. role as global hegemon. As the U.S. looks more and more skeptically at the traditional formulations of its vital interests, its specific goals have also begun to change.

In a reasonably functioning democracy like the U.S., popular sentiment is expressed through the strategic goals of the administration. One important break from the traditional, post-World War II goals of the U.S. came with President Obama and his reluctant, “lead from behind” approach to U.S. foreign engagements. Of course, President Trump’s “America First” policy was an even more obvious break from the post-World War II policies. As we wrote in our [WGR from August 24, 2020](#), President-elect Joe Biden is an institutionalist, and his foreign policy will likely lie between the archetypes of Wilson and Jefferson, with a leaning toward the former. That means he would tend to intervene in foreign affairs with an eye toward morality and less toward commerce. Unlike the Trump administration, which is probably the most Jacksonian since Jackson himself, the Biden administration will likely be more concerned about the Uighurs in China than trade with China. And, being an institutionalist, Biden would probably try to rebuild the apparatus of government and improve alliances that have frayed over the past two decades (see our [WGR from December 14, 2020](#), which provides our geopolitical outlook for 2021).

Overlapping Interests, Growing Conflicts

From this listing of interests and goals, it is clear why tensions are increasing between the U.S. and China. As these two great powers come into conflict across numerous regional and global issues, the friction will generate heat like two metal plates grinding against each other. The danger is that another analogy may come into play: just as two tectonic plates grind against each other deep in the Earth’s crust, the building

tensions might eventually slip and create a global earthquake. In Part II later this month, we will begin to explore in greater detail exactly how this could occur, focusing on how the two sides stack up in terms of military power.

Patrick Fearon-Hernandez, CFA
January 11, 2021

Comparison of Vital National Interests and Major Administration Goals

	China	United States
<i>Vital National Interest #1</i>	<i>Preservation of political system</i>	<i>Defense of the homeland</i>
<i>Vital National Interest #2</i>	<i>Maintain territorial integrity and sovereignty</i>	<i>Stability in regions critical to U.S. interests</i>
<i>Vital National Interest #3</i>	<i>Continued access to Asian shipping lanes</i>	<i>Preservation of freedom of movement within the global commons</i>
<i>Goal 1</i>	<i>Maintain high, stable economic growth</i>	<i>Build up U.S. alliances to counter China, Russia, and other potential adversaries</i>
<i>Goal 2</i>	<i>Transform China into a world leader in critical scientific and technological capabilities</i>	<i>Rationalize U.S. military force posture/ continue "pivot to Asia"</i>
<i>Goal 3</i>	<i>Modernize and expand the Chinese military to ensure it can fight and win in a conflict with the U.S.</i>	<i>Bring Iran nuclear deal back into force</i>
<i>Goal 4</i>	<i>Regain "lost" Chinese territories and strengthen sovereignty over disputed areas</i>	<i>Stop Chinese trade and tech transfer abuses without trade war</i>
<i>Goal 5</i>	<i>Build citizen loyalty and domestic political support</i>	<i>Stop global human rights abuses like China's in Xinjiang, Hong Kong, etc.</i>
<i>Goal 6</i>	<i>Crush any domestic political opposition before it threatens the leadership</i>	<i>Promote international efforts to combat global warming</i>
<i>Goal 7</i>	<i>Soften potential opposition abroad</i>	

This report was prepared by Patrick Fearon-Hernandez of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence’s investment philosophy is based upon independent, fundamental research that integrates the firm’s evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, company-specific approach. The firm’s portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.