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How China Will Manage Its Evolving Geopolitical Bloc

In mid-2022, we published a report showing that as the United States begins to step back from its traditional role as the global hegemon, the world is fracturing into relatively separate geopolitical and economic blocs. Our study looked at almost 200 countries around the world and aimed to objectively predict which bloc each of those countries would end up in, i.e., the evolving U.S.-led bloc, the China-led bloc, the blocs that lean one way or the other, and a neutral bloc. The study predicted that this global fracturing would have major effects on the world's economy and financial markets, for example, by boosting commodity prices, inflation, and interest rates.

In this report, we deepen the analysis to examine how the U.S. and China will lead their respective blocs, and what that might mean for the global economy and financial markets. We pay especially close attention to the implications for the U.S. dollar and the Chinese yuan as well as the broader implications for investors.

The Evolving U.S.-led Bloc

Our study last year showed that the evolving U.S.-led bloc is likely to consist mostly of today's rich, industrialized democracies, along with a few closely aligned emerging markets. The bloc will likely include countries such as Germany, France, the U.K., Japan, Australia, Canada, and Mexico. This list would be familiar to anyone tracking the U.S.'s top trading partners as well as the sources and destinations of U.S. capital flows. More pertinent to this year's study, we anticipate that the way the U.S. will lead this bloc and the economic and financial characteristics of the bloc will also be quite familiar.

U.S. Leadership Style. To lead, manage, and control the countries in its bloc, the U.S. will likely use many of the same policy tools it has used to exercise global hegemony. After all, these tools are second nature to U.S. and allied policymakers, and they have proven to be generally effective with these countries since World War II. In this section, and in the following section on the China-led bloc, we categorize these order-building tools as "coercive," "consensual," or "legitimizing," following the formulation that Rush Doshi uses in *The Long Game*,[1] his recent analysis of how China is seeking to displace the U.S. as the leading country in the world. For the U.S., the two most important order-building tools have been:

- **Military Power.** Despite its military dominance since the end of WWII, the U.S. has refrained from using armed coercion to keep its own bloc in line. Along with its adherence to democratic and free-enterprise values, that fact alone has helped bolster the *legitimacy* of U.S. leadership. The U.S. has historically used its military to provide the public good of global security and has protected other countries from aggression and rebellion. It has used its navy and other

[1] Doshi, R. (2021). *The Long Game: China's Grand Strategy to Displace American Order*. New York, NY: Oxford University Press.

forces to protect the global sea lanes and other commercial trade routes. This further boosted U.S. legitimacy and secured a *consensus* supporting U.S. dominance as the "benevolent hegemon." We expect the U.S. will continue using its military in this way, at least for its own bloc, in the newly fractured world of the future.

- **The U.S. Dollar.** Since WWII, the U.S. dollar has been the economic glue binding nations around the world to the U.S. The dollar has sometimes been used for *coercion* when the U.S. imposed economic sanctions on rogue nations, but its main role has been to incentivize voluntary support for U.S. leadership. This was achieved by keeping the U.S. relatively open to other countries' exports and international capital flows, while accepting the resulting trade deficits despite the costs to U.S. workers. Since the trade deficits were politically viable before China's huge, low-cost industrial base entered the global economy, the U.S. might be able to use this tool again in the future to induce its bloc members to follow it. The question is whether today's populist politics will merely discourage or completely shut off this option. For example, the Biden administration initially sought to provide its 2022 green technology subsidies strictly to electric vehicles made in North America. Only after intense lobbying from the European Union did it offer concessions to make some of those subsidies available to vehicles from allied countries.

Economic and Financial Contours. If the U.S. leads its bloc as described above, the bloc's foreign currency market will probably continue to be dominated by the dollar, along with active roles for the euro, the pound, the yen, and today's other major currencies. Many trade flows within the U.S. bloc will be similar to those today, albeit with new and modified supply chains to replace semiconductors and other goods from China. The new supply chains will be less efficient and costlier than they would be with China, but the overall economic and financial contours of the bloc will probably be familiar to U.S. investors.

The Evolving China-led Bloc

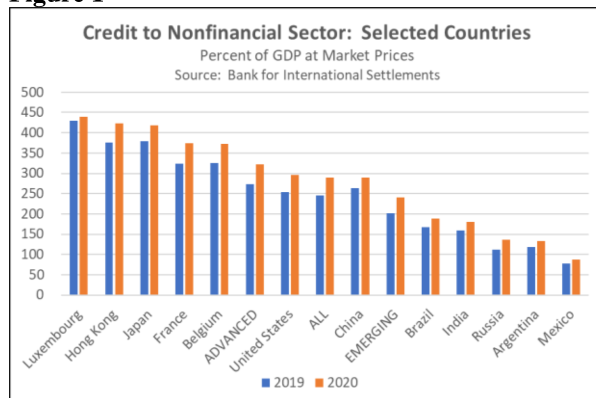
Our study last year showed that the China-led bloc will look quite different from the U.S.-led bloc. It will consist mostly of big, authoritarian, commodity-producing emerging markets such as Russia, Iran, and Iraq. That alone might suggest that China can't lead its bloc with the same tools that the U.S. has used. Just as important, the Communist Party of China (CPC) and the Chinese state probably have no desire to use U.S.-style policies of coercion, consensus-building, or legitimacy. We believe China will instead take an approach often seen in history, albeit in modern form. We think China will adopt a kind of neo-imperialist or neo-colonial leadership style that will produce a bloc economy and financial system based on the yuan and supportive of China's domestic economy.

Chinese Leadership Style. To manage the countries in its bloc, China currently doesn't have the same tools available as the U.S. Its communist, undemocratic, state-driven economy and its imperialist history don't lend it the same legitimacy that the U.S. has. Its military is still far from being able to project significant power globally, so it can't provide the public good of global security and protection for commercial flows. Its trade policies are mercantilist, i.e., focused on producing trade surpluses rather than deficits, while its currency still doesn't make the grade as a reserve currency. Therefore, we expect China will try to control its bloc

mostly via a kind of colonialism. This doesn't necessarily mean it will use military coercion and "gunboat diplomacy," as in 18th- and 19th-century colonialism. Its armed forces are still too weak for that. Rather, China will build a neo-colonial system based on its enormous economy.

- **Excess Capacity and Debt.** Chinese leaders need to control their bloc diplomatically and politically, if for no other reason than to win votes at the UN and other international organizations. They will also want to ensure that their bloc members are on China's side militarily, perhaps eventually hosting Chinese military bases and supporting China in times of conflict. Chinese leaders also need to manage China's vast excess industrial capacity and the debt built up during the recent decades of breakneck investment. As we have described previously, countries transitioning from a high-growth/low-cost phase to a low-growth/high-cost phase often have this challenge of excess capacity and high debts. China, with its very high debt for an emerging market, is a prime example of such a country (see Figure 1).

Figure 1



- **Available Resolution Strategies.** To resolve their excess capacity and debt problems, countries have historically had a number of options, including:
  - ***Allowing asset values to adjust rapidly*** via market forces, as the U.S. did during the Great Depression.
  - ***Allowing economic growth to stagnate***, as Japan did in the decades following the 1990 implosion of its "bubble economy."
  - ***Shifting production toward higher-value goods and services***, as Germany did in the decades following World War II.
  - ***Launching a war*** was seen, through much of history, as a way to use up excess resources or to suppress a rising adversary.
  - ***Establishing one or more colonies***, as Great Britain and other European countries did in the 18th and 19th centuries in order to have a captive market for their higher-value manufactured goods and to lock in low-cost supplies of basic resources.

- **The Attraction of Colonialism.** Many of the strategies China could use to resolve its excess capacity and debt would be risky. Big price adjustments via a depression or mere economic stagnation would strike at the core of the CPC's effort to build domestic political legitimacy via strong economic management. Decades of trying to shift China toward making more sophisticated, higher-value products via industrial espionage, intellectual property theft, and other hardball tactics have generated dangerous pushback from the U.S.-led bloc, including outright embargoes on some high-technology goods and services. Moreover, outright war is always risky. For China, we suppose colonialism will therefore be the most attractive strategy to build order within its bloc and resolve

its key excess capacity and debt problems.

- After all, China's huge economy, broad trade linkages, and capacity for foreign investment give it strong carrots and sticks, i.e., sources of *consensus* and *coercion*, to keep its bloc in line. The promise of being able to export to China or access its capital will be especially powerful.
- An example over the last decade was China's "Belt and Road Initiative," which has lent about $1 trillion to mostly less-developed countries around the world to help them build ports, railroads, and other infrastructure to facilitate their commodity exports.

Economic and Financial Contours. As noted above, the new Chinese colonialism won't necessarily look like the classic European variety, if only because China can and must rely to a greater extent on its unique economic tools. In the archetypical colonial structure, the mother country doesn't necessarily need to exercise complete control over its colonies, and we do not believe China will necessarily do so with the members of its bloc. What's important is that the mother country can use its colonies as both a captive market for its higher-value manufactured products and a secure source of basic commodities and factory inputs. Buying cheap inputs, turning them into high-value products, and then selling those products back to the colonies should theoretically give the mother country a trade surplus and the colony a trade deficit. The mother country's surpluses would then be channeled back into the colonies as investments in new mines, oil wells, farms, and the like. The currency used for all these transactions would be the mother country's currency. But is this what we observe in the evolving China-led bloc today? If not, what are the implications?

- **Deficits and Surpluses.** For this report, we conducted an in-depth analysis of China's trade relationships with the members of its projected bloc (using 2019 data, the last full year before the COVID-19 pandemic). Consistent with classic colonialism, many of the countries in the bloc had a trade deficit with China, including Pakistan, Nigeria, and Somalia (see Table 1 at the end of this document). On the other hand, we noted that big, low-cost crude oil producers such as Angola, Iraq, Russia, and Kuwait all had substantial trade surpluses with China. That makes sense, given that those countries provide a key, high-value resource but have relatively small populations and economies that can't absorb a lot of Chinese exports. We see a similar pattern in the China-leaning bloc (see Table 2). These surplus states present a dilemma for China.

- **Yuan and Petro-Yuan.** The major oil producers' big trade surpluses with China present challenges for Beijing. First, keeping in mind that oil is an essential resource, Chinese leaders will want the oil producers in their bloc to cooperate in denying supplies to the U.S. and its friends (the "weaponization" of commodities we have discussed elsewhere). Second, most oil today is traded in U.S. dollars, so buying these countries' oil would traditionally require China to hold big reserves of U.S. dollars, which the U.S. could essentially freeze as it did with Russia's reserves after its invasion of Ukraine. China has long had a goal of making its currency, the yuan, a global reserve currency like the dollar. It has made little headway in that regard. In the new China-led bloc,

however, Beijing will have a stronger incentive to insist that its oil purchases be at least made in "petro-yuan," as it already does with some of its purchases from Russia and Ukraine. Indeed, China will have a strong incentive to make the yuan or petro-yuan the reserve currency for its bloc. That process won't be quick or easy, but we think the result would be that the world ends up with a dual-reserve system, with the U.S.-led bloc relying mostly on the dollar and today's other major currencies, the China-led bloc relying on the yuan, and leaning or neutral countries using both.

Investment Ramifications

In summary, the issues is not just that the world is breaking up into at least two major geopolitical and economic blocs. Those blocs are also likely to differ radically in their internal relations, economic structures, financial systems, and currency regimes. This dual-system world will be reminiscent of the Cold War when the world was cleaved into a U.S. camp of mostly capitalist democracies and a Soviet camp composed largely of communist dictatorships. The evolving U.S.-led bloc will look and feel much like today's community of major democracies. It will be held together mostly by the "soft power" of U.S. legitimacy, the U.S. security umbrella, and the economic attractions of the U.S. dollar system. Its supply chains may be less internationalized and more resilient, and therefore costlier and less efficient, but the dollar will likely remain the bloc's top reserve currency. In contrast, the evolving China-led bloc will come to look like a community of commodity-producing dictatorships. Beijing will hold its bloc together by supporting and protecting the bloc's authoritarian leaders and promising its members access to China's vast economy and capital. Its members will gradually move away from using and holding the U.S. dollar in favor of the Chinese currency.

As this world evolves and the China-led bloc increasingly uses the yuan for its own internal trade, the ***U.S. dollar*** will likely roll over into a long-overdue downtrend. Even though the dollar will remain the key reserve currency for the U.S.-led bloc, the China-led bloc's shift toward the yuan will probably come disproportionately at the expense of the greenback. Global ***bonds*** are also likely to lose value and yields are likely to rise. With costlier production chains and a greater risk of supply disruptions, inflation and interest rates will likely be higher than in recent decades, not to mention the impact of reduced international capital flows. At the same time, U.S. investors will retain access to virtually all of today's universe of developed-market ***equities***, as well as the stocks of some closely allied emerging markets. Because of their costlier supply chains and higher interest rates, the underlying companies will probably face reduced profitability, but much of the resulting hit to valuations could be offset by investors shifting out of bonds. Finally, as we have argued before, ***commodity*** prices are likely to rise as basic goods like crude oil, natural gas, and cobalt are embargoed by their big producers in the China-led bloc. Despite the long-term trend of falling real commodity values, we continue to believe we may be entering a multi-year period of robust commodity prices.

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Table 1

Goods Trade With China, 2019: China Bloc Only

Sources: UN International Trade Centre, International Monetary Fund

Country	Total Goods Exports (Bil. $)	Goods Exports to China (Bil. $)	Goods Exports to China / Total	Goods Exports to China / GDP	Goods Balance With China, 2019 (Bil. $)
Pakistan	23.8	1.8	7.6%	0.7%	(14.4)
Nigeria	53.6	2.7	4.9%	0.6%	(14.0)
Liberia	2.0	0.1	5.6%	3.5%	(3.8)
Kazakhstan	57.7	9.3	16.0%	5.1%	(3.5)
Uzbekistan	14.3	2.2	15.2%	3.8%	(2.9)
Marshall Islands	1.3	0.0	3.6%	19.0%	(2.3)
Tajikistan	1.1	0.1	7.6%	1.0%	(1.5)
Somalia	0.4	0.0	4.5%	0.4%	(0.7)
Gambia	0.0	0.1	290.4%	3.9%	(0.4)
Maldives	0.2	0.0	21.3%	0.6%	(0.3)
Suriname	1.5	0.1	3.7%	1.4%	(0.2)
Timor-Leste	0.1	0.0	19.9%	1.5%	(0.1)
Sierra Leone	0.7	0.2	26.4%	4.7%	(0.1)
Mauritania	2.9	0.9	31.7%	12.1%	(0.1)
Niger	0.7	0.2	33.4%	1.7%	(0.1)
Burundi	0.2	0.0	7.2%	0.4%	(0.1)
Micronesia	0.1	0.0	8.8%	3.0%	(0.0)
Central African Rep.	0.1	0.0	42.4%	1.6%	0.0
Chad	1.3	0.4	33.4%	4.0%	0.2
Eritrea	0.5	0.2	42.1%	10.6%	0.2
Azerbaijan	19.6	0.9	4.4%	1.8%	0.2
Laos	5.8	2.2	37.2%	11.3%	0.4
Zimbabwe	4.3	1.0	22.8%	5.2%	0.6
Guinea	6.7	2.5	37.4%	18.2%	0.8
Equatorial Guinea	5.1	1.7	34.0%	14.6%	1.6
Papua New Guinea	11.8	3.1	26.0%	12.4%	2.3
Congo, Dem. Rep.	8.4	4.4	53.0%	8.9%	2.4
Venezuela	17.0	4.8	28.2%	7.5%	3.2
Iran	30.3	13.4	44.3%	2.3%	3.8
Gabon	7.3	4.6	63.2%	27.3%	4.2
Congo, Republic of	5.6	5.9	106.4%	47.3%	5.5
Turkmenistan	10.8	8.7	80.2%	19.2%	8.3
Kuwait	64.5	13.4	20.8%	9.9%	9.6
Russia	422.8	60.3	14.3%	3.5%	10.8
Iraq	91.0	23.8	26.1%	10.3%	14.3
Angola	34.8	23.3	66.9%	26.1%	21.3
	908.3	192.3	21.2%	4.7%	45.0

Table 2

Goods Trade With China, 2019: China-Leaning Bloc Only

Sources: UN International Trade Centre, International Monetary Fund

Country	Total Goods Exports (Bil. $)	Goods Exports to China (Bil. $)	Goods Exports to China / Total	Goods Exports to China / GDP	Goods Balance With China, 2019 (Bil. $)
India	323.3	18.0	5.6%	0.6%	(57.0)
Bangladesh	47.5	1.0	2.2%	0.3%	(16.3)
Cambodia	14.8	1.4	9.7%	5.4%	(6.6)
Kyrgyzstan	2.0	0.1	3.4%	0.8%	(6.2)
Myanmar	18.0	6.4	35.5%	9.3%	(5.9)
Algeria	36.8	1.1	3.1%	0.7%	(5.8)
Ukraine	49.9	4.5	9.0%	2.9%	(2.9)
Ghana	16.8	2.5	15.2%	3.8%	(2.4)
Djibouti	0.2	0.0	12.0%	0.6%	(2.2)
Togo	1.0	0.2	17.6%	3.3%	(2.0)
Sudan	4.1	0.7	18.0%	2.2%	(1.6)
Nepal	1.0	0.0	3.5%	0.1%	(1.4)
Mozambique	4.7	0.7	15.1%	4.7%	(1.2)
Belarus	33.0	0.9	2.8%	1.4%	(0.9)
Cameroon	5.7	1.0	17.9%	2.6%	(0.7)
Afghanistan	0.9	0.0	3.4%	0.2%	(0.6)
Bolivia	8.9	0.3	3.6%	0.8%	(0.5)
Mali	3.6	0.2	4.4%	0.9%	(0.3)
Brunei Darussalam	7.2	0.5	6.2%	3.4%	(0.2)
Comoros	0.0	0.0	0.1%	0.0%	(0.1)
Lesotho	0.6	0.0	4.8%	1.3%	(0.0)
Guinea-Bissau	0.3	0.0	3.4%	0.6%	(0.0)
Kiribati	0.1	0.0	2.0%	1.0%	(0.0)
Namibia	6.4	0.5	7.9%	4.1%	0.3
Armenia	2.6	0.5	20.6%	3.9%	0.3
Argentina	65.1	7.4	11.4%	1.7%	0.5
Libya	29.5	4.8	16.2%	12.0%	2.3
Zambia	7.0	3.3	47.4%	13.7%	2.3
Mongolia	7.6	6.3	82.2%	45.2%	4.4
South Africa	90.4	25.9	28.7%	7.4%	9.4
Saudi Arabia	251.8	54.3	21.5%	6.8%	30.3
Brazil	224.0	79.2	35.4%	4.3%	43.7
	1,264.7	221.9	17.5%	3.0%	(21.0)

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