Confluence Investment Management

Weekly Geopolitical Report

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

In Part II of this report, we provided a head-to-head comparison of U.S. and Chinese military power. Obviously, military power is the ultimate source of coercion that one country can use to influence others. During non-conflict times, however, countries tend to use less violent means of influence. One of the most important such peaceful sources of power is economic. This week, in Part III, we examine the relative economic power of the U.S. and China, mostly in terms of the leverage they gain from importing enormous amounts of goods and services from other countries and providing investment capital abroad. Next week, Part IV will describe the relative diplomatic positions of the two countries around the world. Finally, Part V will dive into the associated opportunities and threats for U.S. investors.

Chinese Economic Power

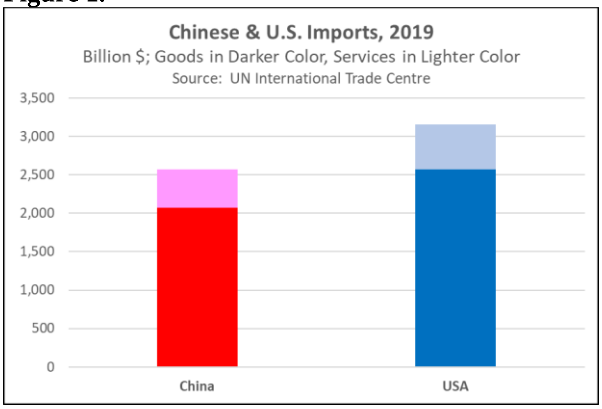
As we noted in Part II's discussion of the resource base available to China for its military forces, China is the world's most populous country and the largest economy. The United Nations Population Division estimates that China's population in 2020 stood at 1.4 billion people. Adjusting for the purchasing power of China's currency, the International Monetary Fund estimates that China's gross domestic product (GDP) had a value of $24.2 trillion last year versus U.S. GDP of $20.8 trillion. On an unadjusted basis, China's GDP only totals $14.9 trillion, but it is growing much faster than U.S. GDP. If the two countries' nominal, unadjusted GDP figures keep growing like they have over the last decade, this measure of Chinese GDP should surpass U.S. GDP as early as 2026.

Of course, the volume of GDP and its growth rate aren't the only factors determining a country's international economic power. The structure of the economy and its innovativeness are also key. On that score, China's large and varied land mass provides it with a range of natural resources. Its rapid economic development, forced or illicit technology transfers, and espionage over the years have also given it formidable technological resources. All the same, the factors that we focus on here are more related to China's economic relationships with other countries.

Trade in Goods and Services. On the way to becoming the world's largest economy, China also became the world's largest trading nation. The United Nations International Trade Centre estimates that by 2019 (the latest year for which detailed data is available), Chinese purchases of foreign goods had a value of $2.06 trillion, equal to 10.8% of all global imports and second only to the U.S. import bill of $2.6 trillion (13.5% of the global total). Because of China's continued rapid economic growth and the government's effort to stoke domestic demand, its purchases of foreign goods are growing very fast, and the country could overtake the U.S. as the world's top goods importer in a few years. Similarly, China is rapidly boosting its purchases of foreign services and will likely overtake the U.S. as the world's top service importer very soon.

However, because of limited data, this report does not examine services in detail.

Figure 1.



- ***China as a Major Market.*** In 2019, the typical country sent 12.8% of its total goods exports to China. However, some countries were much more dependent on China. Among major developed nations, Australia sent 43.9% of its goods exports to China. New Zealand and South Korea both sent at least 32.0%, and Japan sent 24.3%. Many less developed nations were even more reliant, sending at least half their exports to China. Another way to look at it is to compare a country's China-bound goods exports to its GDP. Globally, goods exports to China accounted for a weighted average of 2.8% of a country's GDP. For South Korea, they accounted for 10.5% of GDP. Even though the U.S. sends a bigger share of its exports to China than Germany does (7.5% versus 7.1%), Germany's greater reliance on trade means its China-bound exports accounted for a full 2.7% of its GDP in 2019, almost five times the U.S. share.

- ***China as a Source of Trade Surplus.*** In the U.S. view, China is an enormous mercantilist bully generating massive trade surpluses all over the world. But China's merchandise trade surplus of $429.6 billion in 2019 mostly reflected its extremely unbalanced trade with the U.S. Excluding China's $365.8 billion goods surplus with the U.S., it's easy to see why other countries are generally less concerned by their trade with China or see it as a blessing.

    - Almost one-third of all countries sell more goods to China than they buy from it, and one-half have either a merchandise trade surplus with China or an annual trade deficit smaller than $250 billion. Among those countries that sell more goods to China than they buy from it (including such U.S. allies as Japan, Germany, Australia, New Zealand, Peru, and Chile), the weighted average surplus amounts to 1.9% of GDP. One-half of all countries have either a merchandise trade surplus with China or a deficit smaller than 1.8% of their GDP.

    - China had an overall trade deficit in services of $217.5 billion in 2019, including a deficit of $181.1 billion with countries other than the U.S. That suggests the average country sells more in services to China that it buys. If detailed data were available, it wouldn't surprise us if more than half the countries on earth had an overall trade surplus (goods plus services) with China.

- ***China as a Fast-Growing Market.*** In a world where slower population growth, rising debt, and other factors are weighing on economic vitality, many countries see China's rapidly growing demand as a godsend. Since its entry into the World Trade Organization in 2001, the nominal dollar value of Chinese goods imports has increased at an astounding rate of 12.6% per year, while U.S. goods imports grew at a rate of just 4.6%. If those rates continue, China will overtake the U.S. as the world's top goods importer by 2022. Most countries' exports to China are growing faster than the rest of their exports (see summary table on page 6). Service exports to China are growing even more rapidly, at a rate of 13.1% since 2001.

Figure 2.

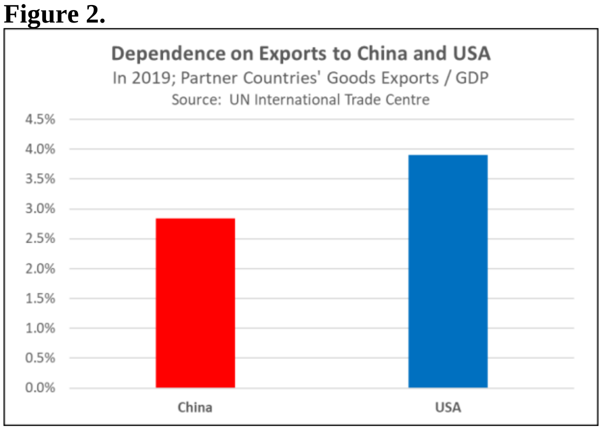
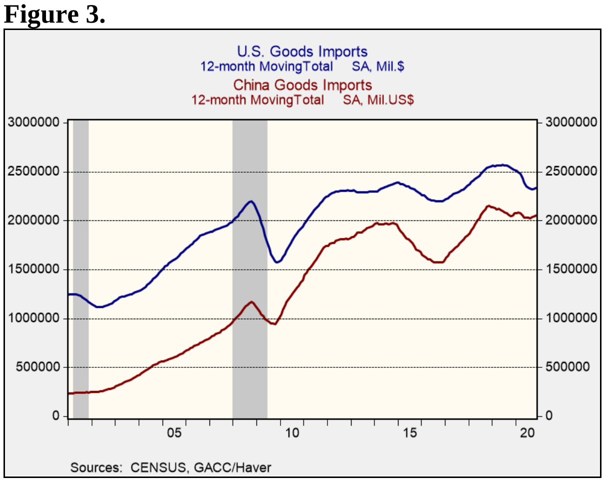


Figure 3.



Foreign Investment. Of course, trade in goods and services can't be the only measure of China's global economic heft. Just as important are the capital flows into and out of China. Detailed data on capital flows between China and other individual countries can be hard to find, but we can see the overall picture by looking at the official "capital account" and "financial account" data from China's State Administration for Foreign Exchange (SAFE). These are the flip side of China's "current account." They track all manner of capital flows into and out of the country, such as:

- ***Foreign Direct Investment.*** In economics, "foreign direct investment" (FDI) is when an entity in one country buys a controlling, long-term stake in a foreign enterprise. The purchaser can take total control of a firm's equity or establish it from the ground up, including buying its land, buildings, equipment, patents and other assets. FDI flows can be volatile, but according to the SAFE data, Chinese entities in the decade ended in 2019 spent an average of $113.7 billion per year buying such direct investments abroad, with the figure growing at an average annual rate of 8.3%. The biggest flows typically went to Japan, South Korea, and the U.S. Foreign entities spent an average of $229.9 billion per year on such investments in China. However, as the Chinese economy began to mature and growth prospects moderated, FDI into China grew at an annual rate of just 1.7% during the decade. It would not be surprising to see those trends continue, in which case China could soon become a net provider of FDI to the rest of the world. Over time, Chinese entities' growing control over foreign companies will give the country ever greater influence over economic, political, and social developments abroad.

- ***Foreign Portfolio Investment.*** Cross-border purchases of corporate stock, investment fund shares, and debt securities that don't amount to a controlling stake are considered "portfolio investments." In the decade ended in 2019, China's outward portfolio investment averaged a modest $43.8 billion per year, but the figure was growing at an average annual rate of

42.9%. Inbound portfolio investment was much stronger, at $74.0 billion per year, but it was only growing at an annual rate of 17.4%.

- ***Bank Deposits and Lending.*** China's outward bank deposits, lending, trade credit, and similar capital flows averaged about $176.0 billion per year over the last decade, far exceeding the average annual inflow of $50.6 billion in such transactions from other countries. Importantly, the Chinese government is explicitly planning to ramp up its lending abroad through programs like its "Belt and Road Initiative," which aims to provide over $1 trillion in loans to foreign countries for infrastructure development and other trade-related facilities over a decade. Not only does the sheer volume of the Belt and Road lending create a risk for the smaller, poorer economies that are one of its key targets, but evidence already suggests that Beijing is using it to create a "debt trap" for those countries that will eventually allow China to take control over the facilities or otherwise put pressure on them.

U.S. Economic Power

Consistent with our approach in Parts I and II of this report, we assume our readers are familiar with the contours of the U.S. economy, so we won't go into detail on it here. We instead simply provide a summary discussion of how the U.S. stacks up against China on the indicators described above.

Trade in Goods and Services. The U.S. currently absorbs more foreign country exports than China does. Indeed, as we have often discussed, one way a global hegemon like the U.S. gains its influence and binds other countries to it is to allow them to run large trade surpluses with the hegemon and accumulate its currency. If the hegemon's currency is a valuable, global reserve currency, the process gives the hegemon significant economic leverage, as we've seen with the U.S. for decades. Chinese imports are now growing much faster and will likely overtake U.S. imports in the coming years, but the influence that those imports give China would be constrained if the renminbi fails to become a valued reserve currency like the dollar.

- ***The U.S. as a Major Market.*** In 2019, the typical country sent 15.1% of its goods exports to the U.S., suggesting the U.S. has an even higher appetite for foreign goods than China does. However, this figure is distorted by the fact that Canada and Mexico each send about three-fourths of their goods exports to the U.S. Excluding Canada and Mexico, goods exports to the U.S. average only 10.6% of a country's total exports. Many countries are much more dependent on U.S. demand, especially large, developed countries like Japan and Israel. Even some less-developed countries like India and Vietnam sell more goods to the U.S. than they do to China. Globally, goods exports to the U.S. accounted for an average of 3.9% of a country's GDP. Excluding Canada and Mexico, goods exports to the U.S. averaged 2.9% of a country's GDP.

- ***The U.S. as a Source of Trade Surplus.*** The U.S. had an enormous merchandise trade deficit of $923.2 billion in 2019. About half the world's countries had a trade surplus in goods with the U.S., and many of those surpluses were extremely lopsided. China had a goods surplus with the U.S. of $365.8 billion in 2019, reflecting the fact that it sold 4.4 times as much merchandise to the U.S. than it bought from it. The ratio of exports to the U.S. versus imports from it was 6.9 times for Ireland, 2.9 times for Sweden, and 2.0 times for Japan. For all countries that have a trade surplus with the U.S., the average ratio is 1.9 times. Among the countries that sell more goods to the U.S. than they buy from it, the average surplus amounts to 2.3% of GDP. The U.S. had an overall services surplus of $287.5 billion in 2019, including a $36.4 billion surplus with China. The figures suggest the average country buys more in services from the U.S. than it sells to it.

- ***The U.S. as a Slow-Growing Market.*** Since 2001, U.S. goods imports have grown moderately, at an average annual rate of 4.6%. U.S. demand for foreign services has grown only moderately faster.

Foreign Investment. Foreign investment is one area where the U.S. still clearly surpasses China. That makes sense, since the mature U.S. economy is now growing much slower than it did in the past. With the opportunities created by globalization over the last several decades, companies have a strong incentive to invest in foreign business operations, portfolio stocks and bonds, and bank deposits and loans. Data from the U.S. Department of Commerce shows that FDI by U.S. entities averaged $298.8 billion per year in the decade ended 2019. In the same period, U.S. entities' foreign portfolio investments averaged $274.6 billion per year. U.S. credit extensions abroad were little changed over the 10 years ended in 2019. On average, they declined by about $8.8 billion per year, perhaps reflecting the decline in interest rates and the explosion of negative-yielding investments abroad. In addition, China's clear focus on foreign lending illustrates how the country's growing heft in credit, as with the Belt and Road Initiative, may be an unhealthy development for the global economy.

Figure 4.

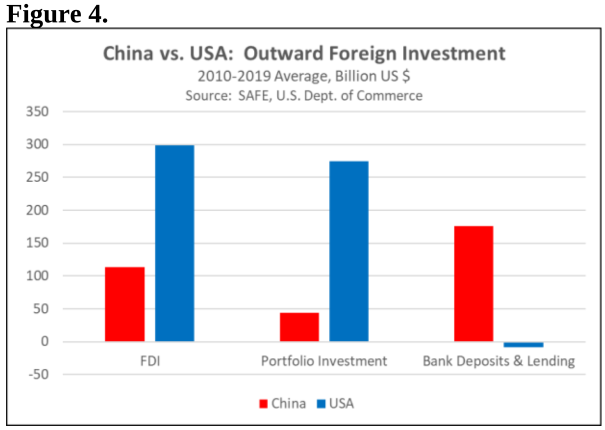
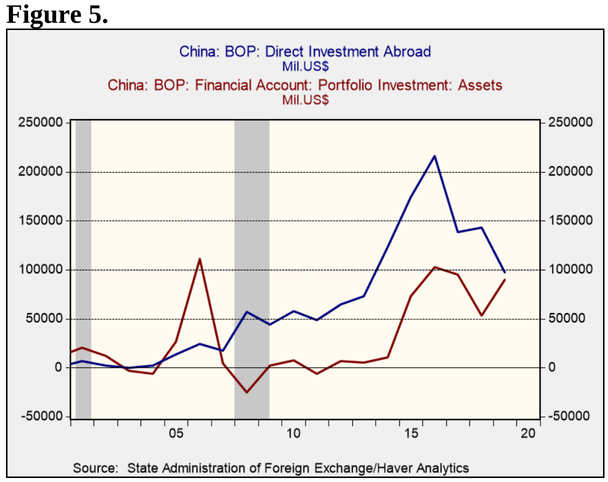


Figure 5.



Goods Exports to China, 2019: Selected Countries

Sources: UN International Trade Centre, International Monetary Fund

Country	GDP (Bil. $)	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. $)	Goods Balance With China/ GDP	China Goods Exports, Ave. Gr. 2009-2019	Non-China Goods Exports, Ave. Gr. 2009-2019
Mongolia	13.9	7.6	6.3	82.2%	45.2%	4.4	32.0%	16.7%	NA
Taiwan	610.7	329.5	172.8	52.4%	28.3%	117.7	19.3%	7.3%	2.9%
Angola	89.4	34.8	23.3	66.9%	26.1%	21.3	23.8%	4.7%	-7.8%
Oman	76.3	41.4	19.5	47.0%	25.5%	16.4	21.5%	13.7%	-0.1%
Malaysia	364.7	238.2	71.6	30.1%	19.6%	19.1	5.3%	8.3%	2.9%
Vietnam	329.5	264.6	64.1	24.2%	19.4%	(33.9)	-10.3%	29.7%	14.4%
Korea	1,646.7	542.3	173.6	32.0%	10.5%	62.6	3.8%	5.4%	3.5%
Iraq	230.1	91.0	23.8	26.1%	10.3%	14.3	6.2%	21.9%	NA
Kuwait	135.4	64.5	13.4	20.8%	9.9%	9.6	7.1%	14.4%	0.5%
Singapore	372.1	390.4	35.2	9.0%	9.5%	(19.7)	-5.3%	7.1%	3.4%
Chile	282.3	69.1	26.3	38.0%	9.3%	11.6	4.1%	7.5%	0.0%
Australia	1,387.1	272.6	119.6	43.9%	8.6%	71.5	5.2%	11.7%	2.9%
Thailand	543.6	245.4	46.1	18.8%	8.5%	0.5	0.1%	6.4%	4.6%
Venezuela	64.0	17.0	4.8	28.2%	7.5%	3.2	5.1%	1.0%	-13.6%
South Africa	351.4	90.4	25.9	28.7%	7.4%	9.4	2.7%	11.5%	3.6%
Saudi Arabia	793.0	251.8	54.3	21.5%	6.8%	30.3	3.8%	8.7%	1.6%
Peru	230.7	45.1	15.2	33.7%	6.6%	6.7	2.9%	13.4%	2.9%
New Zealand	205.2	38.2	12.5	32.7%	6.1%	6.8	3.3%	17.6%	1.4%
Philippines	376.8	70.3	20.2	28.7%	5.4%	(20.6)	-5.5%	5.4%	6.6%
Brazil	1,839.1	224.0	79.2	35.4%	4.3%	43.7	2.4%	10.8%	1.5%
Switzerland	704.8	314.1	27.4	8.7%	3.9%	22.9	3.2%	14.7%	5.6%
Russia	1,702.5	422.8	60.3	14.3%	3.5%	10.8	0.6%	11.0%	2.6%
Japan	5,079.9	705.8	171.5	24.3%	3.4%	28.3	0.6%	2.7%	1.7%
Indonesia	1,120.1	167.7	34.0	20.3%	3.0%	(11.7)	-1.0%	9.5%	2.7%
Germany	3,861.6	1,486.9	105.0	7.1%	2.7%	25.3	0.7%	6.5%	2.6%
Hong Kong	365.7	535.7	9.1	1.7%	2.5%	(270.6)	-74.0%	0.4%	5.1%
Iran	583.7	30.3	13.4	44.3%	2.3%	3.8	0.6%	0.1%	-12.5%
Canada	1,736.4	446.6	28.0	6.3%	1.6%	(8.8)	-0.5%	8.8%	3.3%
Israel	394.7	58.4	5.2	8.8%	1.3%	(4.4)	-1.1%	13.0%	1.4%
France	2,715.8	555.1	32.6	5.9%	1.2%	(0.5)	0.0%	9.6%	1.5%
Mexico	1,258.2	460.7	14.3	3.1%	1.1%	(32.0)	-2.5%	14.0%	7.1%
Italy	2,001.5	532.7	21.4	4.0%	1.1%	(12.0)	-0.6%	6.9%	2.6%
UK	2,830.8	468.3	23.8	5.1%	0.8%	(38.4)	-1.4%	11.7%	2.4%
Pakistan	276.1	23.8	1.8	7.6%	0.7%	(14.4)	-5.2%	3.7%	3.1%
India	2,868.9	323.3	18.0	5.6%	0.6%	(57.0)	-2.0%	2.7%	6.5%
Spain	1,394.3	337.2	8.6	2.6%	0.6%	(18.2)	-1.3%	7.2%	4.1%
USA	21,433.2	1,645.2	123.2	7.5%	0.6%	(295.3)	-1.4%	4.7%	4.5%
Turkey	760.9	171.1	3.5	2.0%	0.5%	(13.8)	-1.8%	7.2%	5.3%

Putting It All Together

Our analysis here shows that China and the U.S. spend a tremendous amount of money on other countries' goods and services. That gives them a lot of geopolitical leverage over those countries. The same can be said for their outward investment flows. Of course, other aspects of their economic activity also affect their power, even if we didn't focus on them here. For example, even though Chinese exporters compete with foreign firms around the world, they have also become critical sources of supply for a wide range of products. There are also other outward monetary flows we haven't addressed, such as the large and growing amount of repatriated profits from foreign firms' investments in China (averaging $257.0 billion per year over the last decade), and the investment of China's $3 trillion in foreign reserves. Furthermore, Chinese foreign aid or the share of other countries' public debt held by Chinese or U.S. investors are other areas that can affect power.

On balance, the outward financial flows from buying other countries' products and providing them with capital tell the same story: both China and the U.S. have enormous economic leverage over other countries, but while the U.S. is the bigger player right now, China is growing much faster, and that's giving it outsized influence on other countries desperate for new trade and investment opportunities. Next week, in Part IV of this report, we'll look at how China's rising military might and economic power are helping bolster its diplomatic heft and "soft power" globally.

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