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

As the U.S.-China rivalry intensifies in the 21st century, two questions arise. Which is stronger, the United States or China? Which country is better positioned to protect its interests and achieve its goals? To gauge the likely trajectory of their relationship in the coming years and assess the investment implications, Part I of this report discussed how the U.S. and China see their vital national interests and key goals. Part II offered a head-to-head comparison of the armed forces available to each side as they work to achieve their objectives. Part III compared the economic power of each country, and Part IV assessed their relative diplomatic influence. We complete the series this week with Part V, where we assess the overall balance of power between the U.S. and China and offer some thoughts on how their rivalry might develop over time. We conclude with a discussion of the associated opportunities and threats for U.S. investors, at least as long as President Biden is in power.

Which Is the Bigger Elephant?
We currently live in a bipolar world dominated by two "great powers." The U.S., the incumbent global hegemon, has dominated global affairs since World War II, while China, the upstart challenger, is only now reaping the full benefit of its economic reform and reopening programs launched in the 1970s. Either country could qualify as the "elephant in the room" for planet Earth. Indeed, our analysis here suggests that their overall power positions (the entirety of their military, economic, and diplomatic capabilities) have become much more closely matched than many people realize. However, what makes up their power may be different than many people perceive.

- We assess that the U.S. is still the stronger ***military power***, based largely on its strategic nuclear weapons, its ability to project power globally with its true blue-water navy and network of foreign allies and military bases, and its large, technologically advanced conventional forces. However, China has closed the gap considerably. It has now probably achieved parity in conventional forces within the waters near China, at least enough to inhibit the U.S. from interfering in a conflict centered on the Taiwan Straits, the East China Sea, or the South China Sea. China is also continuing to build its military power faster than the U.S., and it is working to develop its own global power projection capabilities, although that effort is still in its infancy.
- We also assess that the U.S. is still the stronger ***economic power***, since it remains the larger overall importer and outward investment provider. In fact, the willingness of the U.S. to run trade deficits and provide its partners with the world's most important reserve currency (the dollar) has been a source of hegemonic power for the U.S. since World War II. However, because of China's rapid economic growth in

recent decades, the country now rivals the U.S. as an importer of goods and services, as a provider of capital abroad (especially debt), and as an investment destination ostensibly offering attractive profits. China is a top export market and investment destination for many countries, including important U.S. allies in the Indo-Pacific region. China's relatively faster growth suggests that its economic power is nearly on par with the U.S. and could well surpass it soon.

- Finally, we judge that the U.S. is still by far the stronger ***diplomatic power***, based mostly on the stature it has built over the decades as a constant and reliable force for democracy, justice, freedom, and human rights. The U.S. reputation and leadership position have suffered in recent years as it began to pull back from its traditional role as a benevolent hegemon, loyal ally, and beacon of democracy and liberal economics. That's especially so in comparison with China's stable, rapid economic growth and development. However, China's growing authoritarianism and territorial aggression limit its appeal and diplomatic influence. In fact, a recent survey of leading academics, business leaders, and public policy experts from the Association of Southeast Asian Nations (ASEAN) shows the large majority are suspicious of China's growing influence and support greater U.S. influence in the region.

The Question of Strategy

In sum, the U.S. remains the world's strongest power, but China is nipping at its heels and threatens to overtake the U.S. in the coming years, at least in the Indo-Pacific region. As stated in the latest U.S. Defense Strategy, China under President Xi Jinping has become a "revisionist power" that seeks to transform the world's military, political, and economic environment to its advantage. China under Xi is much different than China under his predecessors, who seemed content to work within the global status quo and its U.S.-led, liberal system. Xi is pushing aggressively to marshal China's power toward "national rejuvenation" and to reclaim its historical position of dominance in world affairs, or at least in Asia.

The U.S.-China Balance of Power

Comprehensive Score Card, 2021

Power Dimension	Advantage
Military	
Resource Base	
Military-Age Population	China
Growth Rate	USA
Gross Domestic Product	China
Growth Rate	China
Foreign Military Bases	USA
Alliance Network	USA
Naval Forces	
Fixed-Wing Aircraft Carriers	USA
Other Major Surface Combatants	China
Submarines	USA
Coastal Patrol (Missile)	China
Amphibious Ships	China
Air Forces	
Fixed-Wing Aircraft	USA
Helicopters	USA
Strategic Rockets	USA
Tactical Rockets/Air Defense	China
Land Forces	
Active-Duty Personnel in Combat Units	China
Tanks	USA
Other Armored Vehicles	USA
Artillery Pieces	China
Economic	
Size / Openness of Import Market	USA
Growth Rate	China
Volume of Outward Investment (Direct + Portfolio)	USA
Growth Rate	China
Volume of Outward Investment (Loans)	China
Growth Rate	China
Reserve Status of Currency	USA
Attractiveness as an Investment Destination	China
Diplomatic	
Institutional Leadership	USA
Diplomatic Infrastructure & Operations	China
Political & Economic Attractiveness	USA
Cultural Attractiveness	USA

How the U.S.-China competition plays out will depend in large part on the strategy that the Biden administration and its successors adopt. So far, President Biden seems to be adopting a much broader strategy than the Trump administration. Biden has called for an "all of government" approach and has structured his National Security Council to prioritize the U.S.-China rivalry. He has signaled that he will work to rejuvenate U.S. alliances to better confront China, and his administration has already broadened U.S. demands on China to include human rights, rather than just the unilateral trade-focused demands of President Trump.

Going forward, Biden has indicated he will take a slow, methodical approach to developing his China policy, but initial signs suggest the policy could be tougher than many people realize and probably geared toward steering China back to its relatively benign path of the pre-Xi years. That approach has been advocated by a recent anonymous article seeking to set U.S. policy just as the famous "long telegram" of George Kennan did to promote Soviet containment during the Cold War.

Broad Implications

The most dangerous implication as China seeks to rejuvenate itself and seize power from the U.S. is that it increases the risk of war. Indeed, the U.S.-China relationship has been characterized as a classic example of the "Thucydides Trap," where an incumbent hegemon is challenged by a rising power.[1] Over the last five centuries, approximately three out of four such situations have led to major warfare. If the risk of combat between the U.S. and China is really 75%, it will take especially strong leadership and foresight for the two countries to avoid a devastating conflict.

To complicate matters, we have noted time and again that the U.S. has tired of its traditional role as global hegemon. Faced with the high cost of protecting its interests on a global basis and maintaining a globalized economy that exposes its workers to foreign competition, the U.S. has recently been pulling back from its active, Cold War-style engagement with the world. Even if the Biden administration currently looks like it will be tough on China, it's not clear whether that toughness will be sustained, especially by a post-Biden administration. In other words, it is not clear whether the U.S. will really rise to the Chinese challenge or hand over the keys to the aspiring hegemons in Beijing. Facing this complex, uncertain future, two questions are key:

What Are the Negative Outcomes if China "Wins"? With China seemingly dead set on becoming a rival power to the U.S., and with the U.S. now more reluctant to defend its hegemonic position, a key question is: what would happen if China effectively replaces the U.S. as the dominant power in either its own region or globally? This is where we circle back to our discussion of U.S. vital interests and goals in Part I of this report. If a country as large, aggressive, and authoritarian as China gains predominant power over the U.S. in the future, every vital U.S. national interest is put at risk:

- In order to advance its own goals or undermine the U.S., a dominant China could sever the transportation links between the U.S. and its key markets, suppliers, and allies in Asia or elsewhere. To pressure Taiwan toward reunification with the mainland, for example, it could impose a blockade on the island and cut U.S. access to the critical semiconductors and other electronic goods produced there. As more U.S. investors buy Chinese stocks and bonds, Beijing could also

[1] Allison, Graham. (2017). *Destined for War: Can America and China Escape Thucydides's Trap?* New York, NY: Houghton Mifflin Harcourt Publishing Company.

put pressure on them by freezing their accounts or initiating tax audits.

- China could pressure U.S. allies in Asia or other regions to reorient their political, diplomatic, economic, and military policies to the advantage of China, and to the disadvantage of the U.S. For example, it could offer additional trade and investment incentives (even beyond those in the Belt & Road Initiative or other current programs) to countries that support Chinese policies. It could also secretly provide large amounts of funding and cyber aid to political parties aiming to undermine pro-U.S. governments.

- Ultimately, China's predominance would call into question the U.S. ability to help defend its allies. In times of crisis, China could even threaten an attack on the U.S. homeland itself. The number of Chinese nuclear warheads remains much smaller than the U.S., but their increasing deployment on mobile launchers in deep underground tunnels and on submarines means many might be able to survive a U.S. first strike. As China becomes more powerful, it could also develop a larger network of foreign military bases that would put it in a better position to threaten U.S. territory.

All these potential actions would become available to Beijing as it seeks to not just rejuvenate China internally but also to transform the world political and economic system into one which is more conducive to Chinese-style communist authoritarianism. The result would be a weaker, more isolated U.S., whose security, prosperity, values, and social stability would be much more tenuous.

What Costs Would the U.S. Have to Pay to "Win"? The U.S. and its liberal democratic allies have only recently come to the realization that China poses a major threat to them. They are arguably still trying to understand the threat and what to do about it. There is little consensus on what a viable, peaceful coexistence with China might look like. In spite of the Biden administration's initial strong pushback against China, the U.S. still has no clear goal regarding what it wants from the U.S.-China relationship, and without that clear goal, its strategy for dealing with China is still in flux and the associated costs of the U.S. strategy remain unknown.

- As we have discussed previously, any U.S. or allied effort to counter Chinese aggression in the coming years by implementing a new "Cold War" would likely entail a wide range of social costs, from high defense budgets and more intrusive counterintelligence efforts to greater focus from policymakers that could take attention away from other domestic or international priorities.

- On the other hand, the net cost might be less than anticipated, given that a viable strategy to fend off Chinese competition might require the U.S. to embark on its own domestic rejuvenation with policies to boost public and private investment, accelerate the growth of productivity and output, and address the disparities in income and wealth that have created social and political tensions. As shown in this report, the U.S. also retains formidable assets in terms of its technological innovation, historically attractive culture, and "soft power," which could be leveraged relatively cheaply to better compete with China.

Ramifications for Investors

For investors, the evolving U.S.-China relationship, as reoriented under President Trump and as now being pushed further under President Biden, probably produces more risks than opportunities. For one thing, the turn against China by the U.S. foreign policy establishment is probably underestimated. It has now become accepted wisdom that the policy of accommodating China in hopes it will change has been a failure. On top of that, it's important to remember that the Biden foreign policy team consists largely of establishment traditionalists schooled on the U.S.-Soviet competition of the Cold War. With that background, they have the mindset and will to maintain a tough great-power competition with China. Many observers were probably expecting Biden to be soft on China, and for the relationship to become more stable and benign again. That would probably explain much of the run-up in Chinese equities in recent months. Those investors who participated in that run-up now may be in for a disappointment.

The Biden administration's more comprehensive approach to China could also mean that the potential conflict points with the country are broader than just the trade and technology issues that the Trump administration focused on. Since that could well lead to prolonged tariff, trade, technology, and military tensions, as well as further capital flow restrictions between the two countries, we see the following likely ramifications for investors:

Foreign Equities. We believe Chinese equities are particularly vulnerable to growing U.S.-China tensions. If the Biden administration continues to clamp down on investment in China, the country's equities could be driven significantly lower. Of course, worsening tensions could also scare investors away from those countries most dependent on trade with China. Taiwanese stocks might be especially vulnerable to being caught in the crossfire, perhaps even literally. In contrast, if the U.S. seeks to offer economic and security incentives to some countries in order to wean them away from China, those countries' stocks might benefit.

U.S. Equities. Greater power parity and increased friction could also hurt U.S. firms that depend heavily on trade or investment with China. Any firms with supply chains or interests straddling the two countries could face business disruptions and lose value. On the other hand, an increased U.S. commitment to defend itself could keep defense budgets high and help major defense firms. Firms currently benefiting from the Trump administration's anti-China trade policies could also benefit if the Biden administration keeps them in place.

U.S. Bonds. Although there has long been a fear that China could shift its investments away from the U.S. Treasury and corporate bond markets, the sheer volume of its holdings would make that challenging to pull off. Besides, in an environment where the Federal Reserve is intent on keeping U.S. interest rates low enough to boost the economy and support inflation, any major Chinese pullout would likely be met with increased bond buying by U.S. monetary authorities. To the extent that tensions threaten to turn into a military conflict, increased safe-haven buying would probably also support U.S. Treasury securities and other safer assets, such as German government bonds or the Swiss franc.

Commodities. If U.S.-China tensions escalate toward outright military conflict, we would expect to see a knee-jerk jump in crude oil prices, and many other commodity prices would likely be pushed higher as well. However, since China isn't a major energy exporter, oil prices might retreat fairly quickly. In fact, if the U.S. pushback against China remains far from military action and simply crimps Chinese economic activity, the resulting decline in global demand could actually take the wind out of global commodity prices.

As a final note, it's important to remember that the U.S.-China rivalry will probably play out over many years. Therefore, the investment opportunities and risks identified in this report may not become reality in the near term. Indeed, it would be difficult to predict exactly when there might be a new event that threatens military conflict or prompts a sharp increase in business for U.S. defense firms. Just as it can be costly for an investor to abandon a fast-rising stock market too early, it could be costly for investors to start investing for a U.S.-China conflict too soon. For now, the prudent strategy is probably to remain aware of the risks, monitor the situation closely, and be prepared to adjust portfolios as needed.

Patrick Fearon-Hernandez, CFA
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