Weekly Geopolitical Report

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The U.S.-China "Phase One" Trade Deal: Part II

In Part I of this report, we offered a detailed examination of "Phase One" of the recent trade agreement between the U.S. and China. This week, in Part II, we will examine the ramifications of the deal and conclude the report with market effects.

China appears to be the "loser" in this deal. Our careful reading of the report does support the notion that China gave up more than it got in this arrangement. All leaders of governments try to avoid looking weak; Chinese leaders especially worry about appearing fragile to avoid comparisons to the Opium War era. So, if this take is accurate, what led to this outcome?

1. ***China's economy is weaker than it looks.*** On the surface, China's economy is slowing but the weakness is far from catastrophic. However, there are growing worries about bad debt. China didn't allow debt default until 2014 and limited its use until 2018. Since then, there have been repeated reports of debt going bad. When a financial system doesn't allow firms or households to default on debt, banks are forced to constantly roll over dodgy loans, hoping something will happen in the future to improve credit quality. When China was growing at 8% per year, this "hope" was probably justifiable. However, as growth slows, the likelihood of a bad debt becoming good on its own declines. Chairman Xi may not have been able to tolerate further slowing and the potential for additional tariffs. Thus, he made an unfavorable deal and believes his media control will prevent the narrative of a bad deal from gaining traction. However, the fact that most U.S. tariffs remain in place makes it hard to argue that China managed to hold its own in this agreement.

2. ***The agreement will force reforms on China that Xi wanted to do anyway.*** China's economy is embarking on the difficult transition from being the world's "high-growth/low-cost" nation to a normal country. In the former phase, a nation grows mostly through investment. When the U.S. was evolving into the high-growth/low-cost nation, most of the investment capital was provided by Europe. China, the U.K., Japan and Germany, who have also enjoyed a turn at this stage, generated most of the investment capital internally by running large current account surpluses. History shows that the transition from high-growth/low-cost to being a normal developed nation is very difficult. At the end of the high-growth phase, a nation usually has excess productive capacity and, often, lots of bad debt.

   There have been four paths to adjust to this situation. The first is colonialization. Excess productive capacity is forced on the colonies. Britain used this path via its Commonwealth; Germany is currently using the Eurozone as a colonial area in a similar fashion. The second path is war. War either uses the excess capacity for military goods or finds it destroyed. War adjusted Germany and Japan's excesses in the first half of the 20th century. The third path, which is the least disruptive, is to advance up the manufacturing value chain. This allows the nation to transform its excess capacity. In the postwar world, Germany and Japan tried this method, with the former having more success. The fourth path is internal economic adjustment; assets must be written down to a level where the new buyer has a profitable enterprise. In the U.S., this adjustment was known as the Great Depression; in Japan, it has been three decades of stagnation.

China has taken steps to use two of the four; the "one belt, one road" project is a poorly veiled attempt at colonization. The projects it is funding are designed to use China's excess capacity to build infrastructure that will make regional economies dependent on China. The other is value-chain enhancement in the "China 2025" project, which is designed to make China a producer of advanced technology by the middle of this decade. Phase One may also facilitate a partial asset adjustment, which would follow the fourth path. We note that, in the agreement, China has agreed to open its financial system to U.S. firms. We suspect that China intends to rely on American banking expertise in dealing with distressed debt and likely hopes to attract U.S. investment. The trade deal's surprising concession on financial services may serve to support China's internal adjustment. Simply put, China will likely use three of the four methods of dealing with its transition, avoiding war as an adjustment option.

3. ***The adjustment process, described above, is fraught with political risk.*** The trade deal may help in managing that risk. Although nations like to rail against the IMF for their adjustment packages, in reality, leaders often use the outside pressure to make painful, but usually necessary, reforms. Chairman Xi has amassed significant political power. He has purged corruption (and potential rivals) and has extended his term in office in perpetuity, avoiding the "lame duck" problem of the second five-year term. Despite being arguably the most powerful leader in China since Mao, he isn't omnipotent. The transition discussed in point #2 is going to reduce the power and wealth of important members of China's Communist Party (CPC). It is quite possible Xi has decided that a trade deal to force some reforms on China dovetails with his own goals and carries the added bonus of not being internally generated. In other words, Xi can blame the U.S. for China's adjustment pains. Of course, the risk is that accepting the deal makes him look weak, but, given Xi's power, he can probably manage this risk.

4. ***This agreement may be designed for a short lifespan.*** Multi-lateral trade agreements usually have complicated arbitration systems. For example, NAFTA had an arbitration panel whose decisions were final. TPP and TTIP had similar bodies. The WTO has an appeal process that can adjudicate fault and proscribe remedies. The Phase One agreement does have a process for establishing the burden of proof (it's the accused party) and a system of regular negotiations. But, if an agreement cannot be reached over an issue, the final remedy is to exit the deal. Given President Trump's trade behavior,

exiting was always possible and thus the written agreement merely establishes a potential outcome. However, China may have also wanted this sort of exit provision. If Xi cannot manage domestic opinion or China reaches a point where it feels it no longer needs the deal, it can simply leave. Interestingly enough, it may give a future U.S. president a quick way to abandon the agreement and negotiate a new deal.

5. ***In this vein, businesses in both nations should avoid making long-term plans based on this agreement.*** In particular, farmers should exercise caution. Although the promised purchases by China would be historic, there is a chance the targets won't be met. The U.S. and China may be able to reach an accommodation, but there is no dispute mechanism to force compliance.

6. ***What's missing is also important.*** The agreement was called Phase One for a reason. A number of difficult issues were left unresolved, supposedly subject to Phase Two talks. China has already indicated it is in no rush to start the next round of negotiations. What's left to discuss? China's tendency to subsidize domestic businesses and national security remain the two major concerns. USTR Lighthizer has already signaled his tactics for addressing subsidies will be multi-lateral, not unilateral. He is working to change WTO rules on subsidies rather than deal with them in Phase Two negotiations. This may mean he doesn't think this issue can be effectively addressed by U.S. efforts alone, or he may believe that Phase Two talks may not occur so he needs to use another path to deal with this issue. The national security issues are tied closely to technology. We suspect the U.S. and China are on a path toward decoupling over technology. Therefore, there might not be much reason for Phase Two discussions to occur.

Decoupling may be necessary. Over the past seven centuries there have been a parade of hegemons. In most cases, they faced competition. In the late 1800s, Britain faced two rising powers, the U.S. and Germany. It made peace with the former, essentially ceding the Western Hemisphere to America. Although the U.S. had claimed regional hegemony with the Monroe Doctrine, the reality was that it couldn't really enforce the claim until the late 19th century. Britain effectively withdrew from its hegemon role in this part of the world because it wanted to focus on a more proximate threat, Germany.

The problem for Britain was that although Germany was a geopolitical rival, the economies of Germany and the U.K. were deeply entwined. In 1911, nearly half of German foreign trade was carried by foreign vessels, the vast majority being British.[1] In the same year, aggregate imports from the British Commonwealth to Germany represented 18.3% of Germany's total imports; exports from Germany to the Commonwealth represented 17.7% of the total.[2] Close economic relations between Germany and Britain complicated the march toward WWI. In fact, Norman Angell argued that war between industrial powers had become so costly that a conflict had become "irrational." Although WWI proved

[1] Crammond, Edgar. (1914). "The Economic Relations of the British and German Empires." *Journal of the Royal Statistical Society*, vol. 77, no. 8, pp. 777–824. *JSTOR*, www.jstor.org/stable/2340924. Accessed 22 Jan. 2020, p. 786.
[2] Ibid., p. 791

to be extraordinarily costly, it didn't prevent the parties from engaging in the conflict. There is evidence to suggest that none of the parties to WWI truly understood they would be fighting a multi-year industrial war.[3]

In the media, there have been discussions of a new "Cold War" with China. This could be true, insofar as the two sides will probably avoid a direct military confrontation. However, the danger with such characterizations is that it makes the narrative a repeat of the conflict with the Soviet Union after WWII. The basis of that policy for the U.S. was the containment of the Soviets, which was relatively cheap for the U.S. because we had few economic ties to the country. A better model for what the U.S. is facing with China is the British/German situation prior to WWI. The U.K. was the established power and Germany was the usurper. However, as we have noted above, the two economies were closely entwined, making the rising geopolitical tensions costly.

If the U.S. has decided that China is a geopolitical rival, then it would make sense for policymakers to decouple economically. In that way, the economic costs of an escalation of tensions would be reduced. That isn't to say that decoupling would be without costs, but it would give companies time to create supply redundancies and adjust to changes in demand for their products. A military conflict would require immediate decoupling which would be much more difficult. The first area of decoupling appears to be in technology. The technology sector includes numerous industrial groups; China and U.S. firms are deeply enmeshed so the costs of decoupling will be very high. It will likely create two separate technology systems that could lay the groundwork for a new bilateral geopolitical condition, a sort of G-2.

The current system of globalization, born in the early 1990s at the end of the Cold War, appears to be coming to a close. That system had two support systems. First, it relied on neoliberal economics, which fostered free trade and the free movement of capital and labor. Second, it was based on a single hegemon, which was willing to absorb a large trade deficit in order to supply the reserve currency to the world. The current practice of globalization has become untenable. In the developed world, the losers of this process, who bore the costs of adjustment, are no longer willing to absorb these costs any longer. The rise of populist movements in the developed world is a response to this anger. This means that free trade and immigration are under attack. In addition, the rise of China means the U.S. unipolar moment has come to a close. Under a single hegemon, the world could unify economically around the policies of the U.S. Going forward, nations will be forced to choose.

The Phase One trade agreement between the U.S. and China is the first clear signal of the reversal of the post-Cold War globalization. We still don't know for sure how it will evolve. It is possible that the U.S. and China don't have a complete break in terms of trade or that the break occurs over a long period. That is probably the most likely outcome. There is a chance that relations deteriorate rapidly but that isn't likely. Instead, we are seeing "peak globalization" with less globalization going forward. We

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[3] This was probably because the generals were fighting the wrong last war. They thought they were redoing the Franco-Prussian War of 1870, which was short. Instead, they re-fought the American Civil War, a war of attrition won by the side with the most resources. See: Clark, Christopher. (2012). *The Sleepwalkers: How Europe Went to War in 1914*. New York, NY: HarperCollins.

believe this is the framework for examining the Phase One agreement.

Ramifications

The current model of globalization brought the world remarkable efficiencies and persistently low inflation at the cost of higher inequality. As this model wanes, efficiencies will be lost and it would be reasonable to expect that inflation will rise.

The deglobalization trend will be bond bearish and gold bullish. Although rising inflation will tend to undermine equities as an asset class, that probably won't be the case for all stocks. Companies with sustainable market power can pass along price increases and maintain margins. Consumption of the bottom 80% of households in the U.S. should benefit as wages rise in a deglobalized world; firms that service this group should also benefit. Commodities, in general, tend to benefit from rising prices, especially if the central bank accommodates the price increases. The key unknown is the timing of these changes. If our assessment is correct, and the adjustment occurs slowly, then the changes discussed will take some time to occur. Nevertheless, by the end of the decade, we expect evidence of these trends will become clear.

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