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What to do with China: Part II

In Part I of this report, we laid out the two narratives that the U.S. and China are using to frame relations between the two countries. This week, we will summarize the two positions and examine the potential for war using the historical examples of British policy toward the U.S. and Germany, offering our take on which analogy fits best. There will be a discussion of current American views on hegemony as well. As always, we will conclude with market ramifications.

The Views in Conflict

From the U.S. perspective, China's historic economic expansion has come because it finally shunned Marxism and adopted capitalism. All that remains now for China to achieve its final leg of development is to become a multi-party democracy and give up the single-party rule of the CPC.

From the Chinese perspective, China's rise was due to the unity created by the wise rule of the CPC. Calls for democracy are nothing more than foreigners trying to create divisions within Chinese society for them to exploit and use, like the British did, to constrain and contain China's development.

Consequently, the general belief in the West that China was on the path to democracy was based on an ignorance of Chinese history. Although the CPC was generally giving more social freedom to Chinese citizens, the party was showing little evidence that it was willing to allow for multiple political parties. However, the

relationship with China produced many benefits to American consumers and the ability to ignore data that doesn't fit a narrative is almost impossible to overcome, so the West mostly ignored the lack of progress on democratization. In addition, Deng's foreign policy was to avoid threatening the West and his successors also adopted this stance. Thus, China's behavior was tolerated.

However, the 2008 Great Financial Crisis became something of a watershed moment. China tended to view this crisis as an indication that the U.S. is a fading superpower, offering an opening for the Middle Kingdom to expand. China intends to become a world leader and not on America's terms.¹

This shift was eventually recognized by the Obama administration. The "pivot to Asia" was designed to free up military and diplomatic resources from the Middle East to deploy in Asia. China wasn't fooled—it saw the pivot as an attempt to contain China's power projection. As we will discuss below, President Trump has continued and expanded this policy.

China as a Global Superpower

Although China may have global aspirations, it isn't at a point where it can actually accomplish that goal. China lacks the following elements:

Global navy: China is building a bigger navy but, currently, it only has two aircraft

¹http://cs.brown.edu/courses/csci1800/sources/2018_MayJune_ForeignAffairs_ChinasNewRevolution.pdf

carriers and they are both Cold War-era designs. Through its “belt and road” project, it is attempting to build bases in the South Pacific and Indian Ocean. However, under conditions of war, it isn’t obvious if they could be defended. If Iran blocked the Strait of Hormuz, it doesn’t appear China’s navy could reopen the Persian Gulf for shipping. China is probably two decades away from having a navy of that size.

Control over the first island chain: For China to project maritime power it needs to control the first island chain that surrounds its coast.



(Source: USNI)

The U.S. is allied with the nations from Japan to Indonesia, to a lesser or greater degree. To project power, China needs to control at least part of this island chain; otherwise, it would be easy to bottle up China’s navy.

There are parallels in U.S. history. For much of American history, the most pivotal city was New Orleans because if a foreign government held that city it would have gained effective control over the entire Mississippi River system. That river system is one of the most valuable geographic features of North America; because it is

easily navigable, it allows for shipping from the Ohio Valley and the Midwest. The U.S. engaged in two critical military operations to secure the mouth of the Mississippi, the 1814 Battle of New Orleans, where Andrew Jackson defeated the British even though the War of 1812 had ended, and the Spanish-American War in 1896, which secured Cuba. By holding New Orleans and gaining control of Cuba, the U.S. acquired effective control of the entire Caribbean, securing its southern border and creating conditions for cheap transportation from the U.S. interior to the rest of the world.

The means to provide a reserve currency: China’s capital account isn’t open and the country isn’t comfortable with running large trade deficits. Chinese authorities do not appear willing to allow the markets to determine its interest rates or exchange rates. It won’t allow the free flow of capital from outside its borders or the free flow of capital from inside China to outside China. Thus, foreigners will be unable to easily hold Chinese financial assets as reserves.

Friends: Although China does not have overt enemies, it does not have allies similar to what the U.S. has. It does not lead a bloc of nations committed to an idea. China’s culture is rather insular and doesn’t travel well outside of China.

If China is going to become a serious hegemonic competitor to the U.S., it needs to address these deficits. China could overcome these hurdles, but it is unlikely it will be able to do so without American cooperation. Or, the U.S. could take the opposite tack—viewing China as currently too weak to be a superpower and engaging in a war to ensure it never becomes one.

American Cooperation—A Historical Comparison

The chances of whether the U.S. and China go to war is a key focus of Allison's aforementioned book.² Not every hegemonic competition ends up in war. In my estimation, there are two historical parallels that resemble the current situation between the U.S. and China. At the turn of the last century, Britain, the established hegemon, faced two serious competitors, Germany and the U.S.

The American challenge: Teddy Roosevelt was determined to raise America's status in the world. The U.S. economy grew rapidly from the end of the Civil War to the early 1900s. In 1880, Britain's share of global manufacturing output was 23%. By 1914, Britain represented 13%, while the U.S. share was 32%.³ Britain had missed its chance to prevent the rise of the U.S. by not supporting the Confederacy. Although Britain did consider it, the political class found supporting slavery to be too distasteful and thus did not assist the South. During President Cleveland's second term, the British found themselves in a territorial dispute with Venezuela. The U.S. told Britain that it could not act against Venezuela without the U.S. playing the role of arbitrator as stated under the Monroe Doctrine. Britain's initial response was to reject America's "offer." However, Cleveland threatened war and the British decided to avail themselves of U.S. arbitration services.⁴

By the turn of the 20th century, Britain realized it could not defend its interests in most of the Western hemisphere. If the U.S.

was determined to invade Canada or British Honduras, there was little the U.K. could do to prevent such an outcome. As a result, British policy evolved to avoid war with America at all costs. "By the end of 1903... Britain had acquiesced to American supremacy in the Western Hemisphere from Venezuela to Alaska."⁵

Of course, there was another element to Britain's decision—the rise of Germany. In terms of economic competition, Germany was not as strong as the U.S. but it was much more proximate. In addition, Britain needed allies on the continent to constrain Germany's ascendancy. And so, British policy evolved to accommodate the U.S. while restraining Germany.

The German challenge: From its founding in 1870, Germany was destined to become an economic powerhouse. It sat on the Northern European Plain and had few barriers to transportation. In addition, it had access to the Baltic Sea. Unfortunately, the geographic characteristics that made it economically powerful also made it militarily vulnerable. There were no major land barriers to invasion from either the west or east, and its navy could be bottled up in the Baltic Sea. Therefore, Germany's growth alarmed its neighbors. Germany managed to avoid war under Bismarck, but when he faded from the scene lesser leaders were unable to avoid threatening European stability.

Britain became convinced that Germany's mere capacity to expand globally and undermine the British Empire was an unacceptable threat.⁶ To some extent, this attitude was born of fears that the U.K. was on a downhill path. Although the 19th century was dominated by Britain, there

² Allison, G. (2017). *Destined for War: Can America and China Escape Thucydides's Trap?* New York, NY: Houghton Mifflin Harcourt Publishing Company.

³ *Ibid.*, p. 195.

⁴ *Ibid.*, p. 195

⁵ *Ibid.*, p. 196

⁶ *Ibid.*, pp. 59-60

were deep fears that the 20th would not be so favorable.⁷ Simply put, Britain's lead in the world was shrinking and the country's leadership wasn't sure how to respond.

In response to the rise of Germany, Britain tightened its relations with France, its longtime rival. When Europe stumbled into war in 1914, Britain was aligned with France, France was tied to Russia, and Russia had treaties with nations in the Balkans. Meanwhile, Germany had a treaty with the Austro-Hungarian Empire. The tale of how the assassination of the crown prince of the Austro-Hungarian Empire by a Serbian radical spiraled into a catastrophic war is familiar. WWI was the beginning of the end for the British Empire.

Similarly, American policymakers are trying to decide how to deal with China. The country has become an economic powerhouse, but it has also become clear that its expected transition to democracy and political pluralism isn't likely to occur. At the same time, economic ties between China and the U.S. are deep. Not only do many American firms have supply chains that depend on China, but China's development was fostered, in part, by exporting to the U.S. A conflict seems unthinkable. However, similar thoughts were common during the last globalization cycle, which ended with WWI. Norman Angell argued that war between the Europeans was unlikely due to their close economic ties.⁸

Does either model offer a clue as to how the U.S. and China will proceed? Although there are other potential outcomes, we believe it is more likely that the U.S. will

treat China like the British treated Germany. There are three reasons for this position:

The U.S. has allies that will support China's containment. One of the reasons the U.S. effectively disarmed Japan was to prevent longstanding tensions between Japan and China from repeating the experiences of WWII. Japan has had hostile relations with China for centuries. In the absence of U.S. power, Japan and China would likely be at loggerheads; however, if the U.S. is aligned against China, then Japan would likely join the effort. Other nations in the region would like the U.S. to remain a balancing power. In the British/U.S. situation, the U.K. didn't have a powerful ally to contain U.S. ambitions but it had ample support to contain Germany. Therefore, allowing the U.S. to dominate its sphere was a more tenable outcome, while interfering with Germany's rise also made sense.

China isn't yet a global threat. China is becoming a very powerful nation, but it doesn't have a powerful enough navy to prevent an American naval blockade. Instead, China has concentrated on preventing the U.S. from interfering in its local aspirations. Specifically, China wants to have the ability to prevent the U.S. from defending Taiwan if the island ever declares its independence. At the same time, China can't threaten Hawaii. China's island-building gives it some power within the first island chain, but not undisputed control.

China's economy has vulnerabilities. Although China has made some progress in reducing its dependence on exports, it is still too dependent on investment and has not made the transition to a consumer-led economy. Other nations making this transition have suffered serious economic

⁷ Ibid., p. 60

⁸ Angell, N. (1910). *The Great Illusion: A Study of the Relation of Military Power to National Advantage*. London, United Kingdom: G.P. Putnam's Sons.

slumps; it isn't clear whether the CPC could survive such a depression.

In the case of Britain and the U.S., it had no choice but to give the U.S. supremacy in this sphere. The U.S. isn't compelled to do the same in China. If the U.S. is determined to remain the global superpower, it likely has the power to prevent China's ascendancy, although it will likely bring war.

What Happens Next?

The lack of compulsion doesn't mean the U.S. won't cede the Far East to China. The great unknown is whether the U.S. is adjusting its hegemonic role or abandoning it. As we noted last week, there is great disillusionment with the superpower role among Americans. If the U.S. is going to maintain the role, the majority of American citizens need to decide it is in their interest to do so. We suspect China's leadership has concluded that the U.S. is willingly abandoning the role. If so, then China rightly sees a power vacuum developing and is trying to fill it. At this point, we tend to agree with the idea that the U.S. will withdraw from the superpower role. But, that outcome isn't preordained. If the U.S. can make political accommodations to address inequality, then the political elites might be able to "sell" the public on American hegemony. There is time to work this issue out, but not an infinite amount.

American policy toward China is at a crossroads. If left alone, China will likely continue to expand its influence and could become dominant in its region, similar to how the U.S. dominated the Western Hemisphere in the early 20th century. The U.S. has the power to stop this development, but not without serious costs. Politically,

the U.S. is showing signs that it is tired of hegemony and thus may ignore the opportunity to contain China before it becomes too powerful.

At the same time, it does appear the U.S. has finally realized that the Washington Consensus is dead and that China is never going to evolve into a Western-style democracy. Thus, the realization that China is a threat has become widely adopted in U.S. foreign policy circles. What is unclear is exactly what to do about it. The odds of war are rising, but they are not yet at a level that requires immediate steps to respond.

Market Ramifications

The market ramifications of war are rather simple; it's usually inflationary and thus bad for both bonds and stocks. Over time, both tend to recover. Of course, war in the 21st century would be different. This issue would be a report all on its own.

In the short run, however, if U.S. relations with China become hostile, supply chains will need to adjust and global growth will likely slow. Some nations are especially set to benefit; Mexico could become a prime target for American foreign investment. Other Asian nations may be willing to side with the U.S. in return for economic support.

For 2019, our base case is that China and the U.S. will make a face-saving trade deal that won't resolve the underlying hegemonic issues. That outcome would support risk assets this year but the superpower issue will become a bigger problem in the future.

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