Confluence Investment Management

Weekly Geopolitical Report

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Emperor Xi: Part II

Last week, we discussed China's power structure and how the suspension of term limits changes recent precedents. We examined President Xi's actions in his first term to consolidate power and prepare for the next phase in China's adjustment. We concluded with the reasons for moving now and what it potentially signals about Xi's view of his power and political capital.

This week, we will continue this topic by analyzing China's challenges while shifting from the world's high growth/low cost producer to a slower growth, "normal" economy. We will show how these challenges fit into China's overall geopolitics and Xi's response to these constraints. From there, we will offer an analysis of America's policy toward China in the postwar era with specific discussion on the critical assumptions regarding democracy and markets that have clouded policymakers' expectations toward China. Finally, we will conclude with market ramifications.

China's Challenges

China is in the process of making the adjustment from being the world's high growth/low cost producer to a slower growth economy. Since the industrial revolution, the world has seen a number of nations make this transition. The British carried the high growth/low cost producer role from the onset of the industrial revolution in the early 1800s until around 1870. After 1870, the U.S. and Germany both played this role. Following WWII, Germany and Japan were high growth/low cost producers, with a parade of nations succeeding them in this position, including South Korea, Taiwan and, now, China.

In general, the high growth/low cost producer engages in a set of policies designed to boost the industrial capacity of the economy. This usually requires policies designed to increase saving. Saving can be domestic and/or foreign. The U.S. did attract a good deal of foreign saving from Britain after the Civil War but still exported saving (which is running a trade surplus). Most other nations followed a policy mix to generate most of the saving domestically. That required a specific policy mix that boosted domestic household saving. This was usually accomplished by an undervalued exchange rate, a weak or non-existent social safety net and low interest rates on retail bank deposits. All of these policies combine to curtail consumption. This saving funded domestic investment by allowing for low interest rate loans.

In the postwar period, with the U.S. providing the reserve currency and acting as importer of last resort, all of the high growth/low cost economies have been export promoters. They all built excess capacity to not only meet (admittedly constrained) domestic consumption but global consumption as well. In most cases, these nations have large rural populations that could migrate to cities and provide low-cost labor.

No nation that has accepted this role has maintained it indefinitely. Usually, three factors develop that undermine a country's ability to continue as the high growth/low cost producer. First, costs rise over time as the "Lewis tipping point" is reached. Named after the Nobel Laureate economist Arthur Lewis, this occurs when all the excess labor from the countryside is exhausted and wages begin to rise. This increases costs for the high growth/low cost producer and opens up the global economy to another competitor. Second, the country reaches sufficient size that the rest of the world finds it burdensome to continue to absorb the high growth/low cost producer's exports. Trade barriers are implemented which leaves the high growth/low cost producer with excessive productive capacity. Third, the accumulated debt that fostered industrialization becomes unsustainable and increases the odds of a debt crisis.

At this point, the high growth/low cost producer is faced with an economy with excess capacity, unsustainable debt and falling competitiveness. When other nations have faced this situation, there have been five responses. Only one is relatively painless.

Rapid asset value adjustment: The excessive debt is resolved by a crisis where the value of the debt (and the assets backing the debt) is aggressively adjusted downward to reflect lower values. This method was used by the U.S. in the 1930s. Although the collapse in asset values did lay the groundwork for rebuilding the economy in a manner different than being the high growth/low cost producer, it was extraordinarily painful and threatened U.S. social stability. It should be noted that no other nation has willingly followed this model since.

War: Often the established high growth/low cost producer sees a rising power as a threat. There is a temptation to maintain one's status by going to war with the emerging nation. If successful, the established high growth/low cost producer can continue in the role and use the excess capacity for the war effort. This response was common prior to the Cold War. Part of the reason for WWI was Britain's attempt to constrain the rise of Germany. Although the U.S. did not seek war in 1941, asset adjustment had not fully resolved excess capacity. This industrial capacity was used with great effect during WWII.

Colonization: The high growth/low cost producer needs a compliant nation to absorb its excess production. Colonies can serve this function as the colony is forced to buy the imports of the high growth/low cost producer. The British Commonwealth was a trade bloc of either former or current British colonies that settled trade in British pounds and partially fulfilled that role. Complete control isn't always necessary; having influence by differences in size or being the dominant member of a currency bloc can have a similar effect to direct colonization. Colonies work in this role but, over time, they tend to press for independence. In other words, colonization has not proven to be a permanent solution to adjustment but it can buy time for the high growth/low cost producer to change policy.

Value chain appreciation: The high growth/ low cost producer usually attains that status by making basic industrial materials. High value-added products are mostly produced in the more developed economies. If the high growth/low cost producer can transform its excess capacity from low valued-added products to higher value-added products, it can make the adjustment rather smoothly. This method tends to work better with smaller economies. Germany is a good example of an economy that moved from producing less sophisticated products during the 1950s to high value products by the 1980s.

Stagnation: If the excess capacity and coincident debt isn't adjusted and exports are curtailed, economic growth will tend to slow significantly. Under stagnation, the high growth/low cost producer slowly adjusts asset prices lower but attempts to do so gradually to avoid the problems associated with rapid asset value adjustment. The positive factor that supports this outcome is that the turmoil seen in the U.S. during the Great Depression is avoided. The bad news is that it can take years to fully adjust. Japan's slow growth since 1990 is an example of this response.

The Chinese leadership is fully aware of its position. Wen Jiabao, Hu Jintao's premier, described China's growth trajectory in 2007 as "unstable, unbalanced, uncoordinated and unsustainable."[1] Unfortunately, as the above five adjustment methods show, four are fraught with risk and one is probably not possible (or at least not the only path) for a nation as large as China. So, it appears the country is using more than one of the above adjustment methods. To fully appreciate these, an examination of China's geopolitics is informative.

China's Geopolitics

Although something of a simplification, China's geopolitics vacillates between two poles. One pole is when China engages with the world. This leads to economic growth and increased wealth at the expense of internal division. The coastal regions tend to prosper in this phase while the interior stagnates. Being open to the world can also bring foreign influences into China, causing further disarray. The other pole is to become insular. That leads to a poor but unified China.

In the years before Mao and the Communist Revolution, China had been forcibly opened to foreign influences, including partition and invasion. During parts of this period, the coastal regions grew faster than the interior. Mao opted to shift to the isolationist pole, effectively closing China to the outside world. Although the economy stagnated, China was unified.

Deng Xiaoping reversed Mao's policies. His position was that China was too poor to be sustainable and thus he was willing to live with internal divisions for the sake of growth. Deng also fostered something of a "wild west" mentality; high levels of corruption were generally overlooked if it supported economic activity. China's growth from 1978 was astounding. However, it came with the cost of environmental degradation, high levels of debt, rising income inequality and increasing social divisions.

So, China's geopolitics has led to a nation that is either poor, insular and unified or rich, engaged and divided. Of course, these are polar positions and it may be possible to combine parts of both. This is what we think Chairman Xi is trying to accomplish. In other words, Xi is trying to create a China that is rich, unified and engaged.

Xi's goals

Xi realizes he has to address the end of China's turn as the world's high growth/low cost producer. To make this work, he has two primary tasks. The first is to bring down debt. China's debt to GDP ratio is 260%, with most of it being private sector loans. This debt was fostered by Deng's model of development which rewarded

[1] http://www.scmp.com/week-asia/opinion/article/2085815/wen-and-now-chinas-economy-still-unsustainable

entrepreneurs with cheap, easy to access loans.

The first step is to stop debt from growing further. This is what is behind the recent actions against the life insurer Anbang. The CEO has been arrested and the company is being forced to begin liquidating its foreign holdings in a bid to lower its debt load. Other highly indebted Chinese conglomerates have also been targeted.

The second step is to recentralize the banking system. Under the Deng model, shadow banking was allowed. Regional lenders were also encouraged to boost loan growth to state and local governments. We look for Xi to recentralize the lending process into the large state-controlled banks. This process will allow Beijing to more easily control loan flows.

A potential third step could be to open the financial system to foreigners. We suspect that Westerners would be open to buying Chinese debt at good yields with a stable exchange rate. This would open another avenue of funding for loan restructuring. This action would be controversial. If the Chinese yuan is ever going to be a reserve currency, the free trade in Chinese debt is part of that process. On the other hand, opening China's financial markets to foreign flows could be destabilizing under certain conditions.

The fourth step would be to raise borrowing costs. This action is risky because it could increase the chances of bankruptcy as some firms won't be able to deal with the higher debt service costs. But, a higher return on saving is necessary to reduce further borrowing.

To address excess capacity, we expect two policy changes. First, some form of redistribution will be necessary. Part of the reason China has such high savings is due to the lack of a social safety net. Building a national retirement policy would make sense. Another possibility would be to privatize some of the state-owned enterprises and sell them at attractive prices to households. This action would shift wealth to households and likely create a wealth effect, boosting spending. And, if the fourth step above is implemented, we should see households benefit from a higher return on saving. All these actions should lift consumption and help absorb some of the capacity that is currently being used for exports.

Income redistribution will not be popular with the wealthy and the powerful members of the CPC who have benefited by participating in the growth during the high growth/low cost producer era. Purges directed by Xi in his first term are likely designed to quell dissent from the rich and powerful. Xi will also have to contain capital flight; if our analysis is correct, wealthy Chinese citizens are probably looking at some confiscation of wealth. This partially explains the capital flight observed in America's coastal urban centers. Thus, the purges were not only to reduce corruption but were, most likely, a way to signal to the wealthy that opposition is futile. Ending term limits simply solidifies that view.

The second policy change to absorb capacity would be to colonize the Far East. The "One Belt, One Road" project and the Asian Infrastructure Bank are two high-profile projects that would boost Chinese exports to nations that would find the projects irresistible. Expanding China's global footprint will also require a larger and more professional military and Xi has begun to improve the armed services on both fronts.

Although China's military would probably not be able to attack U.S. forces successfully in an offensive war, its military has improved in recent years and can likely increase the costs of operations around China. The ability to project power is required for China to expand its colonization. The military buildup will also absorb some of the excess capacity and provide employment.

There will also be an attempt to move up the value chain. The government's drive to boost artificial intelligence will be useful but will not, by itself, address the totality of change China needs to make. Still, the Made in China, 2025, a program to build China's technology sector, is yet another avenue to address the change away from being a high growth/low cost producer.

The challenges of addressing this shift should not be underestimated. The social disruption will be immense. Those who are wealthy will, at best, see their bank accounts lighten. If they resist, they could face imprisonment. The crackdown on the free flow of information is a clear signal that Xi wants to avoid any unified opposition. We suspect getting rid of term limits is part of that process. Those who stand to lose from restructuring might have thought they could simply "wait out" Xi's term. Now, barring his untimely demise, that seems less likely.

As a result, given the size of the task before the CPC, it appears the party elders have decided to risk another autocrat because they seem to have concluded that anyone with normal authority probably can't complete the job. It is a calculated risk on many fronts. Xi may fail. He may turn into a tyrant. But, it appears the elders saw the perceived failure of Hu Jintao's administration as an indication that a very strong leader is necessary.

The U.S. Response

American policy toward China has been built on a faulty assumption. The U.S. believes that once a nation adopts markets instead of a command economy, it will inevitably turn to democracy. This belief became a form of self-congratulations that led to the "Washington Consensus," which states there is only one viable organizing principle for government—open markets and democracy. Thus, the U.S. fostered China's development with the idea that, eventually, it would become like "us" and want to flourish in *Pax Americana*. That illusion should be fully shattered now. China has used the world America has created to build its own model of development that looks like something out of *Brave New World*.[2]

China doesn't intend to cooperate with America's postwar architecture; it intends to supplant it. Although China does aim to use markets (Marx doesn't guide the economy), the CPC plans to guide the market to reduce chaos and disturbances.

There is an obvious flaw in this plan. This sort of guidance tends to lead to stagnation. Radical ideas never come to fruition. However, before Americans become smug about how we, most certainly, avoided this flaw, there have been periods when we didn't. During the 1950s into the 1970s, technological change was often contained by government, unions and companies themselves to maintain stability and market power.[3] Although this model eventually failed due to inflation in the 1970s, it is still the period during which the American middle class grew and some view as the "golden age."

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[2] Huxley, A. (1932). *Brave New World*. New York, NY: Harper & Brothers Publishers.

[3] Galbraith, J. K. (1967). *The New Industrial State*. Boston, MA: Houghton Mifflin.

The U.S. Cold War policy of containment would probably not work against China. Its economy is too big and there is too much incentive for countries to participate in China's development. As a means of comparison, no nation teamed up with the U.S.S.R. for its robust economy—they did so because they either feared being invaded or needed raw materials. Although many Far East nations want to be protected by U.S. security, they are also drawn to China's economy. In addition, there is growing worry that the U.S. is abandoning its postwar role. If that's the case, China's neighbors may feel compelled to make peace with China and submit to its regional dominance.

The U.S. is facing a difficult choice. No one pines for a hot war with China. However, the costs of conflict won't fall over time; in other words, China will only become more powerful for the foreseeable future. If the U.S. decides it isn't interested in standing up to China's slow encroachment into the South China Sea and elsewhere, the other logical outcome is to acquiesce to China's regional hegemony. This isn't historically unprecedented. Britain decided it would allow the U.S. to dominate the Western Hemisphere in the late 1800s because (a) it wanted to focus on containing Germany, and (b) it wasn't sure it could defeat the U.S. and, even if it could, the costs would be prohibitive. Thus, Britannia reigned supreme…except where it didn't.

Our concern is that if the U.S. opts to allow regional hegemons to develop, the world will become much like it was prior to 1945; the Middle East, Europe and the Far East become conflict zones. That development is a potential risk.

But, the important point here is that China is trying to create an alternative to the Washington Consensus of free trade, open markets and democracy. Policymakers should no longer expect that China will eventually "fall in line" like the other nations that have benefited from American hegemony.

Ramifications

We see two significant market effects that could develop from Xi's China. First, the odds of conflict increase. Defense companies should benefit. Second, we expect more capital flight to develop. Wealthy Chinese citizens have even more incentive to move money overseas and create "escape pods." That should support U.S. real estate and other such assets.

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