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The Geopolitics of Taiwan: Part III

In [Part I](#) of this report, we covered the history of Taiwan along with current relations between the People's Republic of China (PRC) and the Republic of China (ROC), and discussed the end of strategic ambiguity. In [Part II](#), we analyzed the geopolitical importance of Taiwan and China's military options. In this final report of the three-part series, we will examine the importance of Xi Jinping's ascendancy to power and how he may react. Lastly, we will conclude with market ramifications.

The "Known/Unknowns": The Issue of Xi Jinping

After laying out several scenarios in Part II discussing actions that China might take, we determined the quarantine/blockade scenario had the greatest benefits compared to the risks. However, our assessment is from the perspective of an analyst, not from a leader. The calculus of a leader can be different based on the experience of that leader and the political conditions they operate within. In other words, our task now is to assess how Xi will behave in this situation. While we have no personal insight into General Secretary Xi's decision-making, we can observe his behavior and current circumstances to estimate the risks stemming from his actions.

After the Communist Revolution, Chairman Mao wielded extraordinary power, but he didn't always use it wisely. His Great Leap Forward (1958-62), the post-revolution second five-year plan, was designed to rapidly transform the economy from

agricultural to industrial. It was an unmitigated disaster. The policies of the change led to the Great Chinese Famine, during which anywhere from 15 million to 55 million Chinese starved to death, although estimates vary. As the disaster unfolded, Mao opened the Hundred Flowers Campaign, a program that allowed criticism of the party and the government. As written criticisms filtered into Beijing, the CPC was able to identify critics and eventually label them as enemies of the state. Often, these critics were intellectuals. In 1966, Mao set off the Cultural Revolution, an internal purge that created a cult of personality around Mao, which he initially used to remove his enemies and potential opponents. However, the program became difficult to control; cadres attacked CPC leaders, executing some, sending others into internal exile, and jailing others.¹ Although Mao tried to curtail the Cultural Revolution, it continued until his death in 1976.

Mao's successor, Deng Xiaoping, not only worked to end the cult of personality surrounding Mao, but he institutionalized the CPC and the government's leadership. General Secretaries could serve a five-year term with one re-election, but they would not serve more than two terms. The selection of the General Secretary would be from within the CPC leadership. Deng established a Standing Committee of the Politburo, an executive committee, that would report to the General Secretary. By

¹ Xi's father was among those attacked in the Cultural Revolution. He was a member of the Central Committee in the 1950s but was purged and imprisoned during the revolution.

institutionalizing China's leadership, Deng's goal was to prevent the rise of another Mao.

From 1976 to the present, the institutional structure has seen six transfers of power in party leadership. Like any political structure, there have been pluses and minuses. The primary benefit, the one we think Deng wanted, was to prevent another cult of personality, another Mao, from emerging. There was a degree of representation in the process of filling positions on the Standing Committee of the Politburo. Although the representation was mostly centered on elite interests, something akin to political "horse trading" occurred. The two primary groups, the rural/Communist Youth League and the urban/princelings,² would tend to be equally represented.

The downside, surprisingly enough, reflected problems often seen in democracies. The broader representation seemed to prevent the CPC from dealing with its significant problems. Pollution issues were unaddressed. The rural/urban income differences were not fixed. The rising level of debt continued. These problems were discussed at length, but little was done to address them.

President Xi has essentially reversed Deng's reforms. He is arguably the most powerful CPC leader since Mao. By refusing to accept term limits, he has become leader for life. This changes his perspective; he can't just allow a problem to be resolved by the next leader. He has circumvented the Standing Committee's structure by creating working groups that he leads. These groups set policy, rendering the normal apparatus of government moot.

² Children of party leaders.

Corruption had become endemic before Xi. To some extent, this may have been partly due to the elites divvying up the spoils of power. In his first five-year term, Xi implemented a massive anti-corruption campaign³ that not only curtailed corruption, but eliminated most of his contenders to power.⁴

Power is seductive. Leaders sometimes amass power simply to have and enjoy it. But it is also the case that leaders sometimes conclude they need a certain degree of control to accomplish their goals. Since his elevation in 2012, Xi has clearly expanded his power; it was unclear to us exactly what Xi intended to do, if anything, with all this authority.

China's challenges are daunting. The economy is overly dependent on investment and exports. This dependence on investment has created a massive debt overhang. The textbook response is to boost domestic consumption; however, that would require a massive realignment of the CPC (which has structured itself to the current economic model) just when the [population is peaking](#) and aging rapidly. Income and wealth disparities between the coastal provinces and the interior are sizable and threaten social stability. Relations with its most important export market, the U.S., have become increasingly hostile. It is arguable that the system Deng established was not addressing these matters (although we would also contend that Xi is mostly responsible for the decline in relations with the U.S.) and that a change was necessary.

Given the structure that Xi has created in light of China's challenges, how will this affect policy toward Taiwan? Here is our take:

³ See WGR, "[Xi's Purge](#)" (9/8/2014).

⁴ See WGR, "[The Purge of Bo](#)" (4/2/2012).

1. Institutional leadership is different than personified leadership. An institution will likely endure past the life of an individual. Because of this factor, institutions can be patient in dealing with major problems. People, on the other hand, have limited lifespans and thus tend to want to implement changes they believe are necessary while they are alive. Under Deng's political structure, China could wait to address difficult problems. Under Xi's model, patience is no longer a virtue and there is a premium on getting things done now.
 - a. Nowhere else is this more evident than the situation with Hong Kong. In 2047, China would get full control. Xi was not willing to wait that long. It is possible that Xi saw Hong Kong as a separatist threat, but time was clearly on the side of Beijing. Xi decided to absorb Hong Kong anyway.
 - b. It is not evident that time is on Xi's side when it comes to annexing Taiwan. Over the past two decades, citizens of Taiwan are seeing themselves as less Chinese. If Xi lacked patience with Hong Kong, when time was on his side, Taiwan must be a key worry.
2. China has been getting away with encroaching behavior for the past two decades. It has steadily militarized the South China Sea and abrogated the Hong Kong treaty without serious cost. History would suggest that the U.S. and its allies won't expend blood and treasury to protect Taiwan.
3. The Marxist in Xi believes in historical determinism. Marxists believe that the internal tensions within capitalism will doom it over time. Although the need to press the issue is an internal

contradiction in Marxism,⁵ Xi likely views himself as a historical figure who will unveil the decline of the U.S. and the emergence of China as a historical power.

4. [China's foreign policy apparatus appears to view the U.S. as a declining power.](#)

The political and social divisions are seen as a sign of decay. It is reasonable to believe that Xi accepts this premise.

- a. The Trump administration's "America First" policy was seen as benefiting China. Unwinding the post-WWII alliance system creates opportunities for China to project power.
- b. President Biden's attempt to rebuild alliances is an unwelcome development, one China would like to discourage.

It appears to us that Xi's views of the growing Taiwanese identity, the perceived weakness of the U.S., and China's past success in projecting power mean the chances of him acting against Taiwan are elevated. As we detailed above, the more reasonable approach would be a quarantine/blockade, which would prove that China controls Taiwan without an overt military challenge. In addition, an island-confiscating attack would be consistent with China's behavior in the South China Sea. If we were still using Deng's governance model, we would have much greater confidence that the riskiest path, an island invasion, is highly unlikely. However, we cannot rule out the possibility that Xi attempts a full military solution to Taiwan.

Our position is that an invasion would be a mistake. The U.S. can appear dead set against military involvement until provoked. [Foreign nations tend to misunderstand the](#)

⁵ After all, if capitalism is going to collapse anyway, why work to hasten its doom?

[Jacksonian element of American foreign policy](#). As the Axis powers discovered in WWII, the U.S. was determined to stay out of the war until attacked. Sentiment can turn quickly. Because the U.S. doesn't face a serious near-abroad threat, Americans can allow themselves to be divided. [But that isn't necessarily a sign of weakness or a signal of terminal decline](#). It is worth noting that, in China's historical experience, internal divisions tend to end dynasties. Therefore, there is a deep-seated fear in China of political, religious, and social divisions. This fear explains why China so strongly resists the Dalai Lama, cracked down on the Uighurs, and absorbed Hong Kong. The U.S., being a multicultural, multi-religious, and multiethnic society, is very familiar with divisions. That doesn't mean they are always easy to manage, but it also doesn't mean they are a signal of devolution. The current divisions in China are likely just a phase or cycle; if so, a wager from Xi to attack Taiwan looks less reasonable. However, the decision to take action against Taiwan would likely be based on what we consider to be an incorrect perception of the U.S. If America views Taiwan as worth going to war over, China might find itself in a fight that it isn't prepared to undertake.

Ramifications

In geopolitics, assessing the “when” of an event is much harder than the “if.” If China really believes that Taiwan rightfully belongs to it, at some point, it will do something to exercise that control. But that action could occur today, or years from now. We feel reasonably confident that Beijing will, at some point, take aggressive steps to control Taiwan. What we have attempted to determine in this report's analysis is whether the “when” is close to occurring.

The aggression we are seeing on the [Indian/China frontier](#), the decision to end Hong Kong's separate legal and political systems, and the persistent pressure in the South China Sea all suggest that China is becoming confident in its ability to project power. Last year, we wrote a report on what might be driving China's behavior.⁶ Increasingly, it appears that China is an impetuous power that believes it is in the ascendancy. Perhaps even more worrisome is that, in Xi's China, dissenting voices to this narrative are no longer in existence.

What does this mean for markets? Globalization, as it has been practiced for the past four decades but especially in the last three decades, is in deep trouble. In the West, debt levels, high degrees of inequality, and sluggish economic growth have led to a populist revolt. One of the “enemies” of the populists is globalization. However, inflection points usually require an event, a catalyst, that makes it abundantly clear that what preceded is no longer. A Chinese seizure of Taiwan could be just that trigger.

If this event occurs, as during the Cold War, nations will be pressed to choose which orbit they will occupy. Will they join the U.S. or China? Most nations have tried to avoid this choice because they want the security of the U.S. and the economic benefits of China. That outcome will probably not be available. The breakdown of globalization will likely boost inflation by reducing efficiency. It will likely lift labor over capital as the former will face less competition and the latter will face higher costs. Higher inflation is a serious problem for debt markets and elements of the equity markets. It is bullish for commodities.

⁶ See *WGRs*, “Rethinking China: [Part I](#)” (7/27/2020) and “[Part II](#)” (8/3/2020).

Timing such events is impossible, but, as we detailed in this report, conditions are such that China could take an aggressive step toward Taiwan. We would be surprised if it happens this year. But by 2030, the odds of

a PRC attempt to take Taiwan are quite likely.

Bill O’Grady
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