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Why China and India Are Fighting

In a bizarre confrontation last month, Chinese and Indian soldiers [fought a pitched battle in near total darkness high up in the Himalayan mountains](#). If that wasn't strange enough, the weapons used were merely fists, stones, police batons, and wooden clubs wrapped in barbed wire or studded with nails. At least 20 of the Indian soldiers died, many after falling down steep mountain ravines or freezing to death in the cold. An unknown number of Chinese troops also died. In spite of the primitive weapons used and the relatively small number of casualties, the skirmish created a major crisis and risk of war between Asia's two nuclear behemoths.

In this report, we explain how the confrontation came about and why it was waged in such a primitive way. More importantly, we examine the tensions building between China and India and how the skirmish could cause them to spiral out of control. We also outline how things could develop from here and the likely ramifications for investors.

Geography and History

Although China and India are both ancient civilizations, their 2,500-mile border has never actually been well-marked and agreed upon. Until at least the mid-1800s, the difficult, mountainous terrain (see Figure 1) and sparse population tended to discourage efforts to delineate the frontier with any precision. As the British pushed their Indian colony into the area, they began to recognize

borders laid out by surveyor W. H. Johnson in the western Ladakh region and Foreign Secretary Henry McMahon in the eastern region of Arunachal Pradesh.

Figure 1.



*China-India border terrain, Ladakh region.
(Source: Taiwan News)*

After India broke free from British rule in 1947 and China achieved its independence in 1949, both countries rejected many of the border lines drawn by the British. For example, in the western part of the frontier, the Chinese government took control of the Aksai Chin area, south of the Johnson Line, by building a road through it to connect its provinces of Tibet and Xinjiang. In the east, India rejected the McMahon Line because it lay south of the highest peaks in the Himalayas, which India traditionally considered to be its northern border. At the same time, China wanted the border to be south of the McMahon Line so as to include an area it considered to be South Tibet. China therefore now controls the Aksai Chin area that India covets, while at the eastern end of the border, India holds parts of Arunachal Pradesh that China wants. The

border also includes other, smaller areas of disputed ownership (see Figure 2).

Figure 2.



Disputed territories on the China-India border.
(Source: The Heritage Foundation)

The War of 1962

When India and China emerged as independent states in the late 1940s, they initially prioritized cordial relations over their differing border claims. Over time, however, the differing border claims began to chafe on the countries. The tensions broke out into outright enmity in 1959, when Indian Prime Minister Jawaharlal Nehru granted asylum to the Dalai Lama, the Tibetan religious leader who had fled Lhasa after a failed uprising against Chinese rule. That decision helped convince the Chinese that India sought to undermine Beijing's control of Tibet. Aggressive troop buildups and probing into the disputed areas by both countries led to intensifying skirmishes and dozens of casualties on each side.

Chinese leaders were determined to block any Indian attempt to reoccupy the areas where People's Liberation Army troops had moved in. They also wanted to undermine Nehru for his perceived designs on Tibet and punish the Soviet Union for supporting India over China. They also may have feared a Soviet-U.S.-India encirclement and

isolation of China. On the October 20, 1962, Chinese forces launched a surprise attack against the unprepared Indian forces. The main attack came in the eastern sector in Arunachal Pradesh, while a secondary attack was launched in the western area of Aksai Chin. In each theater, Chinese forces routed the underprepared Indian troops and quickly occupied all areas claimed by China.

Having achieved his objectives, Chinese Premier Zhou Enlai declared a unilateral ceasefire starting on the November 21, 1962. Under the declaration, Chinese troops in the western sector pulled back 12 miles from their "line of actual control" (LAC), and their counterparts in the central and eastern areas pulled back north of the McMahon Line. To this day, the LAC is used to refer to the actual effective border between China and India, even though actual sovereignty over the areas is still not formalized by treaty. The LAC was merely accepted in a bilateral agreement in 1993.

Since the end of the 1962 war, Chinese and Indian forces [have periodically increased and decreased their presence and probing activities along the LAC, often producing skirmishes](#). Prior to this year, the last fights that resulted in fatalities were in 1975, but there were also significant nonlethal skirmishes in 1987 and 2017. In order to keep such fights from escalating into a hot war, the two sides have agreed that troops patrolling the territory will generally not carry firearms. Therefore, when patrols have clashed in recent years, the fights only involved insults, shouts, and fistfights.

The Current Crisis

The crisis that began in early May can ultimately be traced to the heightened nationalism of Chinese President Xi Jinping and Indian Prime Minister Narendra Modi. Both leaders want to assert their country's

sovereignty to the fullest extent possible. Xi's efforts to assert control in Hong Kong, Taiwan, and the South China Sea are well known, but the current crisis could mean Xi is looking for territorial expansion in the Himalayas as well. As evidence of that, the *Global Times*, a Chinese Communist Party publication that often echoes Xi's hard line, [recently asserted that the Galwan Valley area where the skirmishes took place is in Chinese territory, even though China had never claimed the area previously](#).

Meanwhile, Modi has been asserting India's control over the autonomous territory of Jammu and Kashmir, which straddles the Ladakh region just opposite Aksai Chin (see our [WGR from September 9, 2019](#)).

Broader international relationships have fed into the confrontation as well. For example, [India's warming ties with the U.S. probably provided Xi with further reason to take a tougher stance on the area](#). With India chairing the World Health Organization's executive council for the next two years, Xi probably wanted to send a warning to India that it shouldn't support President Trump's call to investigate China's role in the COVID-19 pandemic. Xi probably also wanted to warn India away from giving Taiwan observer status at the WHO.

In any case, both China and India have been ramping up their road building and other infrastructure development along the border in recent years, prompting fears on each side that their adversary was preparing to seize control of disputed areas (see Figure 3). India's ill-timed decision to postpone a major military exercise in the area probably also tempted Xi to seize the moment and probe more aggressively into the area.

Against this backdrop, [the proximate cause of the current crisis can be traced to troop incursions](#). Indian sources insist that the

conflict was started when Chinese troops entered a disputed area in the Galwan Valley and set up camps around Pangong Lake. India has traditionally considered that area to be its territory, so it sent troops to push the Chinese back. On the other hand, Chinese officials [have blamed Indian troops for entering areas traditionally controlled by Beijing](#). Whichever side was to blame, when the opposing troops met, the result was a series of shouting matches and fistfights that extended throughout May. As the skirmishes continued and intensified, both China and India began to rush reinforcements and heavy military equipment to staging points close to the fighting. The scuffles worsened even though high-level military officers from each side were meeting frequently and agreed to disengage. In fact, the fight that turned lethal came after high-level military officials struck a deal to disengage, suggesting they lost control over their units.

Figure 3.



Indian military vehicles on the China-India border.
(Source: GlobalNews.ca)

Aftermath

We suspect that both Xi and Modi would prefer to contain the confrontation and keep it from escalating out of control. After all, gaining control over more territory in the barren, resource-poor Himalayas is probably a fairly low priority for Xi. Faced with even modest pushback from India, he would probably prefer to quietly let things calm down so he can focus his energies on higher

priorities like Hong Kong, Taiwan, the South China Sea, the fallout from the COVID-19 pandemic, and the all-important relationship with the U.S. Even if Xi wants to [punish India for its warming ties with the U.S.](#), India's willingness to push back might convince Xi to bide his time while further developing Chinese military capabilities. On the Indian side, Modi likewise probably sees little to gain from a military conflict with China in the area, especially since his budding alliance with the U.S. still has much further to develop and the pandemic is presenting him with enough domestic challenges.

Chinese state media accounts of the fatal fight have been circumspect. For example, their accounts of the battle have refrained from reporting the number of Chinese casualties. That probably reflects an effort by Xi to keep the fight from generating popular nationalist anger. Strong popular anger could box Xi into a corner and force him to react more aggressively than he would prefer. Ominously, however, [some Chinese officials and many Chinese social media users have criticized India's role in the confrontation much more strongly than state media](#). Some retired military officers [have called for Chinese troops on the border to be given authority to respond to Indian incursions independently and aggressively](#). That highlights the difficulty Xi could have in containing sentiment.

The problem is especially difficult because Indian media sources have aggressively criticized the Chinese. [Sensationalist reporting in the Indian press has helped fuel outpourings of indignation and rage, and many Indians have called for revenge or boycotts against Chinese imports](#). The strong Indian reaction apparently prompted Prime Minister Modi [to vow in a televised speech that India would give China a](#)

[“befitting reply” if China tried to worsen the situation](#). At the end of June, the Modi government said [dozens of Chinese mobile apps, including the widely used TikTok and WeChat, would no longer be allowed in the Indian market](#). Officials said the move was to prevent the apps from being used to undermine Indian defenses and send a message to China. The Modi government [has also been slow-walking approvals for Chinese imports](#).

In early July, after weeks of high-level military and diplomatic talks between India and China, [the two sides finally struck an agreement to de-escalate and started to pull their troops back from the disputed border areas](#). Under the deal, a phased pullback from the disputed areas would create a buffer zone wide enough to prevent the two sides' troops from being able to see each other. To further cut the risk of accidental confrontations, the deal also restricted night patrols by both sides.

Going forward, we believe China and India will take steps to keep the crisis contained and reestablish some semblance of order along the border, even if residual tensions remain. As discussed above, it is doubtful that either Xi or Modi would be willing to risk an all-out military confrontation for the gains they might achieve in the area. That's especially true because any military conflict between the two rivals could potentially lead to nuclear exchanges. Still, the apparent failures of command and control over lower-level troops in the area should serve as a reminder that events can spin out of control despite the top leaders' preferences. As long as the two sides disagree on where their border actually lies, seek to leverage nationalism to shore up their domestic political position, and face imperfect control over their forces, the China-India border will

remain a potential source of instability and a risk for investors.

Ramifications

Despite how devastating a China-India war could be if the current crisis gets out of hand, it appears that global financial markets have been little affected by the fighting so far. Nevertheless, it is important to keep in mind how markets would likely react if the current fistfights and clubbing matches spark an all-out shooting war. In that event, the most direct impact would likely be a sharp decline in the value of Indian equities and a somewhat smaller decline in Chinese equities (due to China's larger, stronger, and more diverse economy). Global equities would likely suffer as well, especially if the conflict worsened enough to threaten nuclear exchanges or a longer-lasting negative impact on global geopolitics and economic relationships.

Likewise, most global commodity prices would probably also be driven down on the prospect that the fighting could damage the Chinese and Indian economies and sap their demand. Given that both countries are major importers of energy products, crude oil prices could be severely impacted, but there would probably also be significant price declines for industrial commodities like copper. With a short conflict, prices could potentially rebound quickly. A longer, more damaging conflict would have the potential to weigh on commodity prices for a much longer period.

The only major commodities that might benefit from a shooting war would be gold and other precious metals, which are traditionally considered safe havens in times of geopolitical conflict. The impetus to precious metals would add to the current tailwind those metals are enjoying from the extremely loose monetary and fiscal policies put into place in the developed countries in response to the COVID-19 pandemic.

Finally, a worsening conflict between China and India would likely spark a rush to buy U.S. Treasury obligations and other sovereign debt that traditionally serves as a safe haven. However, we note that prices for such debt have already been driven up strongly in response to the pandemic and the resulting asset purchases by the major central banks. Those price hikes have already helped push the yield on many sovereign assets into negative territory (though not U.S. Treasuries, so far). This behavior suggests that in the event of a destabilizing war between China and India, precious metals could end up as the safe haven of choice and sovereign debt may not be bid up as much as it otherwise would have been.

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