Weekly
Geopolitical Report
By Bill O'Grady

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Rethinking China: Part I

President and General Secretary Xi Jingping has changed the course of Chinese governance. Deng Xiaoping Peng created a collective leadership model to prevent the rise of another Mao. Leaders were carefully selected and surrounded by leading figures of the various factions of the Communist Party of China (CPC). Term limits were put in place to restrict a President/General Secretary to two five-year terms. Deng established a structure of government which was somewhat decentralized. Cults of personality were discouraged.

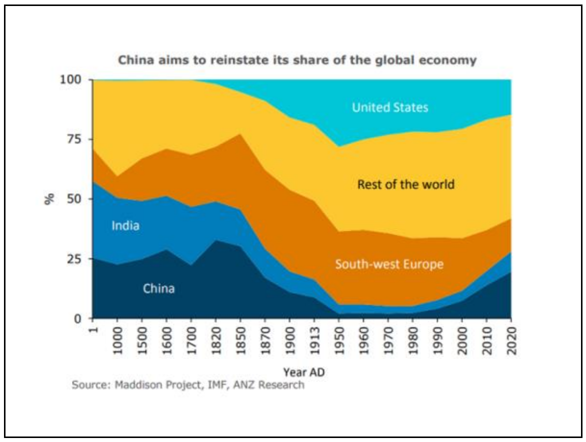
Xi Jinping has reversed these measures. He has ended the restrictions on term limits. The Standing Committee of the Politburo is mostly composed of allies. Instead of using the structure of government that diffused power, Xi has created a series of informal committees that actually execute policy; this gives him nearly complete control of the government. "Xi Jinping thought" is now discussed in party and academic circles; although no one has bound them into a little red book, it would not be a surprise if that were to occur.

Xi is also changing China's foreign policy. Under Deng, foreign policy was all about "hide your ambitions and disguise your claws." Under Xi, foreign policy has been more assertive. However, over the past 18 months, we have seen aggressive and, perhaps more importantly, widespread actions. China seems to be willing to create tensions across a broad spectrum, which does appear to be a new development.

There are two broad themes to this report. In Part I, we will frame China's situation using Japan as an analog. In Part II, we will continue the analog, discuss recent Chinese aggression and offer a detailed analysis of the potential motivations of Chinese and U.S. policymakers. As always, we will conclude the discussion with potential market ramifications.

China's Problem

China has become a major economic power.



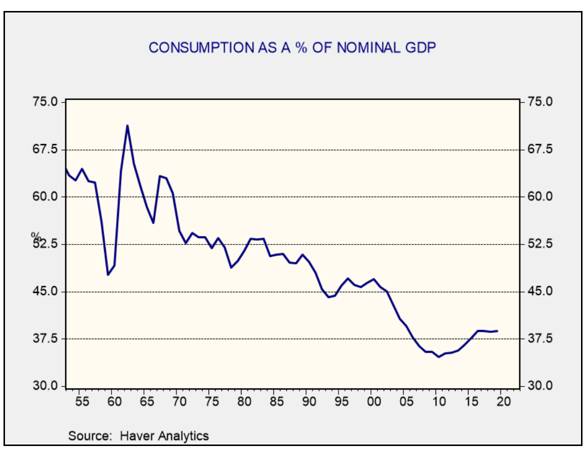
(Source: Australian Broadcasting Corp. News)

As the chart shows, China held a large share of the world economy for centuries, only to see its economic rankings fall from 1850 into 1980. This period of decline was triggered by the Opium Wars with Britain, the first in 1839-42 and the second (which included France) in 1856-60. These wars coincided with the Taiping Rebellion (1850-64) and the Dungan Revolt (1862-77). These were key events during the "century of humiliation," which ran from 1839 to 1949. This humiliation was due to foreign powers seizing control of large parts of China and was facilitated by internal dissention.

The CPC dates the communist takeover of China as the end of the humiliation. But, the impact of this "humiliation" continues to affect Chinese policy. The two lessons learned are that foreigners are a threat and internal dissent leads to collapse and chaos. Mao Zedong resolved the humiliation by isolating China from the world, removing foreign influences. He was also intolerant of internal dissent. As the above chart shows, this isolation policy led to a long period of economic stagnation. Deng wanted to revitalize the economy by re-engaging with the world but maintained the goal of unity by controlling internal dissention. Although there was hope among some that the opening of the economy would coincide with a political opening as well, this idea was quashed at the Tiananmen Square event in 1989.

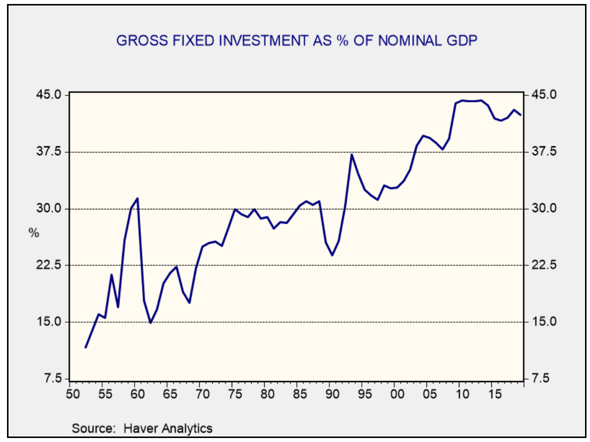
Starting in the late 1970s, the Chinese economy began to grow rapidly. Deng's policy of allowing markets to operate was a clear success. China followed the development model of export promotion; this model suppresses domestic consumption to fund investment and utilizes foreign consumption to provide a reliable outlet for goods produced.

The following charts illustrate this policy mix. First, China's consumption.

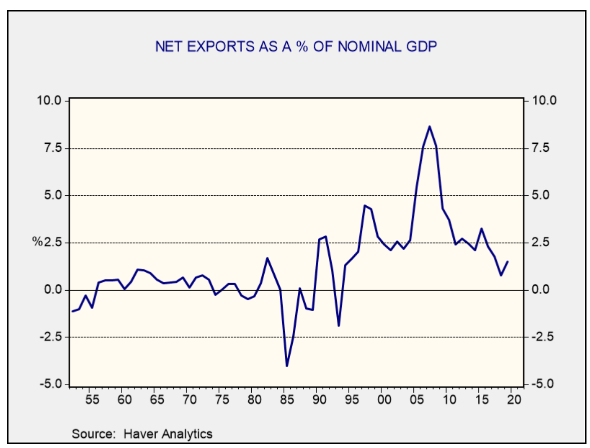


Consumption [is usually about 60% of GDP in developing countries](). China's consumption is unusually low for a developing country.

Second, China's investment.



Constraining consumption allowed for the rapid increase in investment. In the early stages of development, this investment supported economic development. However, by the turn of the century, China's productive capacity was outpacing its restrained consumption by a significant amount. This led to a measurable rise in net exports.



As China's economy integrated into the global economy, it became the world's high growth/low cost producer (HG/LC). Since the industrial revolution, we have seen a series of such countries. They often, but not always, become challengers to the established hegemon. Britain was the first HG/LC, followed by the U.S. and Germany. Although the U.S. threatened Britain obliquely in the early 20th century,[1] Germany was a more obvious and nearby competitor. The inability to resolve this tension resulted in WWI.

Japan industrialized in the first half of the last century but was not a threat to the British order until after WWI. Tokyo had sided with the Allies in WWI but was disappointed with the Versailles Treaty, which did not treat Japan as an equal. Japan became an empire in the first four decades of the 20th century, winning wars against Russia and China. Imperial Japan bears some similarities to China, which we will detail below.

After WWII, the U.S. created a global order for the non-communist world. It provided security for the previous combatants as well as the reserve currency, which fostered global trade. Both Japan and Germany (along with Western Europe) took advantage of the U.S. structure to recover from the devastation of WWII. By relying on the U.S. consumer and access to the American financial system, both Germany and Japan recovered through export promotion. This model became problematic as both nations reached sufficient size; America tired of the import competition with Germany and Japan. Germany resolved this problem by essentially "colonizing" the Eurozone. Japan never resolved the issue and has experienced economic stagnation since 1990.

Other smaller nations developed via export promotion, including Taiwan[2] and South Korea. Neither of these nations grew to a size where they became political problems for Washington.

Japan: A Cautionary Tale for China

Japan's imperial policies of the 1930s and export promotion of the 1980s led to American policy actions focused on restraining Tokyo. In the 1930s, the U.S. became alarmed by Japan's aggressive actions in the Far East, an area of U.S. interest. In the 1980s, the policy of suppressing consumption to generate trade surpluses adversely affected the U.S. labor market and distorted American financial markets. In other words, the desire to accumulate dollar reserves becomes difficult to manage once a country reaches sufficient size.

Japan, given its geography, was dependent on open sea lanes. In the 1930s, in response to its continued expansion in China, the U.S. decided to embargo oil supplies. Japan was building an empire, in part, due to its desire to secure sea lanes. Once the embargo was announced, Tokyo had to either acquiesce to U.S. demands to end its invasion of China or retaliate against the measure. It decided to attack Pearl Harbor; although history makes it clear this was a bad decision, at the time all of Japan's alternatives were unattractive.

Japan faced a similar situation in the 1980s. Its economy had thrived via export promotion to the point where it was having an adverse effect on the U.S. industrial base. Although Japan wasn't the only reason for the development of the rust belt (it is one of the downsides of providing the global

[1] The U.S. made it clear it was enforcing the Monroe Doctrine and suggested it could conquer Canada as well. The British quietly deferred to U.S. power.

[2] Technically, Taiwan is not a nation, but part of China. It is separate enough from the mainland government to act like a sovereign nation, much to the chagrin of Beijing.

reserve currency), it was arguably the most visible. The popularity of Japanese automobiles and the high-profile purchases of prized U.S. real estate led the Reagan administration to react against Japan. Because Japan was completely dependent on the U.S. for regional security, a "Pearl Harbor" response was unavailable. Thus, Tokyo was forced to accept a series of "voluntary" export restrictions on cars. Perhaps most importantly, at the Plaza Accord Japan agreed to allow the yen to appreciate. The strengthening yen not only weakened its export competitiveness, but it led to falling inflation. The decline in inflation reduced nominal interest rates, triggering a bout of borrowing. It was this borrowing that caused a real estate bubble in Japan (after all, land in Japan is quite limited) which spilled over into foreign investment as well.

In the early 1990s, the bubble burst; real estate prices and the Japanese equity market declined. Japan had a massive debt overhang that needed to be addressed. Its choices were stark—either endure a 1930s-style debt/deflation, where the private sector debt is rapidly written down, or attempt to write off the debt slowly over time. Simply put, the choices were a depression or years of stagnation. Japan chose the latter.

Part II

Next week, we will complete this analogy, examine China's recent aggressions and discuss potential motivations of Beijing and Washington. We will conclude with market ramifications.

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