PENDAL

Emerging Markets spotlight

The US hegemon versus the Chinese challenger: echoes of history

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AS ONE of the first countries to recover from the social and economic effects of coronavirus (and assuming that there is no second wave), China's prospects in the second half of 2020 and beyond will be substantially determined by two drivers: Chinese economic policy while the rest of the world struggles and American policy towards China.

With regard to domestic economic policy, we have long highlighted that, as a country with capital controls and a financial system funded in its own currency, China enjoys a very powerful set of tools with which to manage its economy.

These come, of course, with various institutional constraints, including a hawkish central bank with a great sensitivity to consumer price inflation and the sensitivity to currency volatility of both domestic savers and key trading partners. More on this later.

This is a time for countries with inherent strengths in State capacity to limit the damage the coronavirus response has wrought on economies and societies. The Chinese government has been moving to provide the fiscal and monetary support that is needed. We will provide more comment on this in a future note.

The other big determinant for China will be its relationship with the US, or to say it like it is, the great power struggle between the existing hegemon and its challenger.

Great powers in the modern era compete in a variety of arenas and with a variety of methods.

While much is made of the parallels with the Cold War (and we do note these), in many ways the US-China struggle more closely resembles the rise of a unified Germany in the early 20th century, and its competition with incumbent hegemon Great Britain.

In this note we explore the current tension and what it might mean for markets.

The final argument of kings

Direct military competition is the most basic form of geopolitical rivalry. (Cannons were, in Louis XIV's view, "the final argument of kings".)

US-Chinese military competition has been building for the past 20 years, accentuated by the cross-currents of China's territorial disputes with its neighbours. Beijing had previously been cautious in these matters, but as its military strength has hugely overtaken its neighbours', China has deployed hard power in the region.

Naval and other manoeuvres designed to intimidate US allies Japan and Taiwan – as well as ongoing border clashes with India and developing claims on the South China Sea – are all a challenge to the willingness and ability of the US to protect its position in the region.

American response to this challenge has been mixed.

An administration elected with a mandate to reduce US involvement overseas is in disagreement with a security establishment convinced of the need to assertively strengthen American military capability and reassure concerned allies.

These kind of minor conflicts were seen in both the German-British tension and during the Cold War – although in the latter through allies and proxies rather than directly between US and Soviet forces.

The market impact of military competition is hard to analyse. It is essentially binary. Tensions have a very limited effect on markets and superpower military conflict is unpriceable.

An end to death by China

A second area of competition is supply chains.

A key plank of the Trump administration's economic policy, substantially driven by presidential adviser Peter Navarro author of '*Death By China*', has been the view that the two economies have become too interconnected, at the cost of supply chain risk, loss of American jobs and weaker national security.

China's heavily State-driven economy and its aggressive acquisition of research and technology has amplified these concerns. The coronavirus pandemic and shortages of critical medical equipment and supplies outside China has exacerbated this.

The US is now planning to promote domestic production of products such as pharmaceuticals and semiconductors. Wider national industrial planning is under consideration.

This tension between economic gains from specialisation and trade versus the security of domestic supply – particularly in the context of an increasingly powerful autocracy with a State-managed economy challenging an established democracy with a free-market economy – is far more similar to the British-German competition than the Cold War.

German Chancellor Otto von Bismarck was critical of Great Britain's free-market system. He promoted protectionism, managed economic development and created domestic cartels tasked with serving the national economy.

German banks (similar to Chinese banks today) were tasked with organising and financing these cartels, as well as financing strategic infrastructure. As in the Chinese-US relationship, Germany's coordinated and protected economy allowed the country to become highly competitive, even in British markets. Similarly, restrictions and tariffs were seen in the UK as they are now appearing in the US.

The severing of trade links will be an economic negative for all countries where it happens.

The great thrust of global growth in the emerging world and low inflation in the developed world has been off the back of globalisation. De-globalisation could put this all into reverse. This is possibly accentuated beyond the US-China relationship with American unhappiness at other trade partners such as the EU, Japan and South Korea. Other manifestations such as Brexit are also appearing.

De-globalisation and the consequences for Emerging Markets

This seems to offer a negative outlook for emerging markets, including the three largest – China, South Korea and Taiwan. However, there will be three substantial constraints on the unwind.

Firstly, economic logic will not go away while labour costs remain so different between rich and poor countries.

Secondly, in areas with highly specialised products and strong network effects, it will be very difficult to replace existing production. (This is particularly true of electronics – consider the underwhelming result of Hon Hai's plans to relocate some production to the US).

Thirdly, trade between developing countries continues to grow rapidly and can to some degree offset declining exports to the US.

Technological double standards

A third area of competition is access to technology – particularly new areas such as semiconductors, artificial intelligence and 5G wireless technology.

Scale, government support and subsidies have allowed Chinese companies – particularly the equipment supplier Huawei – to supply digital infrastructure quicker and cheaper than American or European competitors.

Security concerns, and probably fears about competitive positions, prompted the US to push back hard, restricting the supply of components to Huawei and compromising its ability to sell equipment in the US and allied countries.

This is likely to lead to the development of a two-world environment in communications equipment, in which some countries adopt Chinese standards and equipment and others US standards and American and European equipment.

To see how this would work, consider the online world in which Western apps and services are mostly useless in China, while Chinese apps and services are mostly irrelevant elsewhere.

Again, this pattern is very much seen in the German-British competition. Parallels in the radio transmission industry are very clear. Britain sought to constrain domestic and allied users to the British-backed Marconi standard, while the German government sought to create a rival, forcibly merging German firms into a State champion Telefunken, which the government then sought to promote internationally.

The success of both US and Chinese online companies suggests a two-world outcome is not a barrier to spectacular stock performance in both halves.

However, hardware is a far more competitive and mature industry and the loss of large potentially accessible markets must be negative. Although this is likely to play out at firm and industry level rather than at the national economy level.

The significance of soft power

Finally, we turn to two related soft power areas: institutions and culture.

The ability to influence outcomes partly sits in institutions, both domestic and multinational.

One of the main domestic institutions is the US financial system – the dollar payments system and access to US stock markets for Chinese companies.

This is a key area of conflict at present, with expectation that the US will require Chinese companies to delist from US equity markets. Even excluding ADR names this is about US$1 trillion of market capitalisation trading about US$10 billion per day.

China has access to a liquid, international stock market in Hong Kong, so this will not necessarily affect investors. But it will certainly lead to substantial change in the shareholder base of these companies, which may well create opportunity for investors with access to both markets.

This pattern of constraint to the financial system – the incumbent great power requiring the challenger to innovate and restructure – is also seen in the British-German relationship. Germany developed its own trade finance system to circumvent the effective British monopoly on trade finance bills.

Internationally, the China-US struggle has played out in various multilateral institutions, recently including the UN Security Council and World Health Organization. The US has suspended funding to the WHO because of alleged Chinese influence on the organisation's coronavirus clinical findings. Maritime and aviation law are also areas of disagreement, while at the UN Security Council the status of both Hong Kong and Taiwan are in dispute.

There are broad global struggles between the US and China in cultural areas such as film and television. US studios seeking to sell in both markets avoid the "three Ts" – Taiwan, Tibet and Tiananmen.

In sport the sometimes outspoken views of US and European sport stars run into Chinese resistance to criticism. This has recently been a problem in American basketball for the Houston Rockets and the NBA league organisation itself.

Universities and academia are another sensitive area. The presence on campuses of China's well-funded and state-backed Confucius Institutes is causing some concerns about freedom of speech and thought.

These soft-power conflicts do resemble the Cold War more – for example the tit-for-tat boycotts at the 1980 Moscow Olympics and the 1984 Los Angeles Olympics.

These are likely to play out at firm and industry level, creating significant risks that must be managed by companies seeking to distribute films, games or sport in both countries. This is as true of Western companies such as Disney as it is of Chinese companies such as Tencent.

Different future outcomes demand country-led analysis

The China-US competition has a long way to go.

Competition for military edge, trade and supply chain networks, technological access and for financial, institutional and cultural supremacy will be part of Asian and global geopolitics for years to come.

Given that the competition between the United States and China will endure, companies and investors will need to find ways to navigate this reality.

The fact that the German-British struggle ended in combat and the Cold War did not means that a wide range of outcomes are possible.

But we feel monitoring this from a top-down, country-level perspective can provide clues to the twists and turns as they emerge.

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