Capital Dialectics
ECONOMICS | FINANCE | GEOPOLITICS

Investing and cold war 2

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SUMMARY

- The days when US political and economic hegemony went unchallenged are over. The neo-liberal "Washington consensus" has broken down too. In a time of great power rivalry, the "politics" has been put back into political economy.

- China's rapid growth in economic, political, and military power combined with an assertive foreign policy, is uprooting the international order in the Indo-Pacific and beyond. The "logic of strategy" dictates that a new cold war is upon us.

- The economic inter-dependency implied by "Chimerica" no longer holds true. While non-trivial, the economic linkages between the United States and China are currently not so deep as to impose a prohibitive cost on antagonistic foreign policy. Both powers are pursuing a policy of immunizing themselves from the economic impact of the other's action, while weaponizing the linkages and economic policy for national advantage. A bifurcation of the world economy is the result.

- The legal and regulatory framework for investment in China is likely to become less benign and reputational risk is rising. Risk mitigation is called for wherever possible.

- As Bytedance, HSBC and others have found, navigating Cold War 2 will be difficult for companies and managers of capital. Jurisdiction risk drives a wedge between the cost of capital for domestic and foreign investors while the diversification benefits of cross-border investment last only as long as the inter-linkages remain small.

INTRODUCTION

In our introduction to Capital Dialectics we identify the Nine Fault Lines, the policies around which we believe will dictate asset price performance over the coming decades. The disintegration of the "unipolar" world is one of the most important of them. This paper explores the extent to which the international economy is becoming politicized, and economic policy is being subjugated to political considerations. Whether the potential loss of economic welfare is worth it, depends entirely on one's perspective and this paper does not seek to justify or vilify recent events, but purely to observe, analyse and draw conclusions that are hopefully of use to people who are charged with running companies and capital at a time of Great Power Rivalry.

This report is in three sections: "The end of Pax Americana?" looks at the breakdown of the Unipolar world; the rise of China's economic, military and political power, and seeks to establish that we are in a new Cold War between the United States; Indo-pacific powers and China. Furthermore, this conflict is likely to be long lasting and directly impact to some extent or other the whole world, not just the chief belligerents.

Part 2, "The economic dimension to rivalry: war by other means.", lays out the contours of the economic statecraft between the two sides; their respective strengths and weaknesses and analyses the pre-existing economic linkages. "Chimerica" is no longer a binding constraint on action and if the US or regional powers can build an alliance to resist China's power projection, its chances of success are dramatically increased.

Part 3 looks at the conflict from the perspective of what it means for portfolio investment through the prism of the likely evolution of the regulatory and legal environment; the reputational risk of investing in China; the likely winners and losers from the bifurcation of the global economy; and the potential for investments in China to yield superior risk adjusted returns or diversification benefits in a Cold War environment, with elevated jurisdictional risk and diverging costs of capital.

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THE END OF PAX AMERICANA?

From a unipolar to a multipolar world

The age of uncontested US hegemony has ended

A defining feature of the period following the fall of the Berlin wall and the collapse of the Soviet Union was the irrelevance of great power rivalry and the undisputed hegemony of the United States. When exactly that epoch ended is debatable, but it is evident from current events that it has. While the United States remains the preeminent military force in the world and the largest economy in nominal terms, its suzerainty no longer goes unchallenged.

The EU has been forging its own path

The European Union, although lacking a military command structure, is forging its own path in international relations and, where its interests' conflict with those of the United States it appears prepared to act accordingly. This has been evident in industrial policy (Airbus for example); energy security (Nordstream 2); and in its relations with Ukraine, Belarus, and Turkey.

Russian capacities have been rebuilt

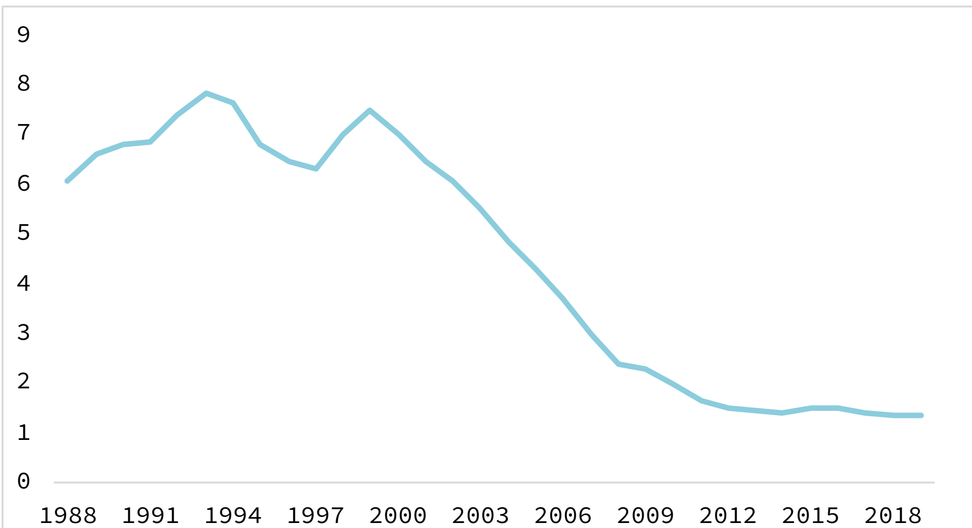
While Russia suffered an economic contraction in the aftermath of the Soviet Unions' collapse, which diminished its military power and its ability to project its influence, the period of high oil prices from 2000 through to 2014 has enabled Russia to rebuild her capabilities.

But China's economic rise has produced the most dramatic redistribution of national power

China's explosive economic growth has, however, produced the most dramatic redistribution of national power. When the Soviet Union collapsed at the end of 1991, the Russian economy, in nominal GDP terms, was USD520bn; China's was USD380bn and that of the United States was USD6,156bn. The United States in other words had an economy nearly 12 times as large as Russia's; 16 times the size of China's and nearly 7 x Russia and China combined. This was the order of magnitude of American economic superiority that gave rise to, and sustained, the "unipolar" world of the 1990s and early 2000s.

The US had an economy 7x larger than Russia and China combined, its now scarcely 1.5x larger

Chart: US GDP as a multiple of China and Russia combined (x)



SOURCE: World Bank

Fast forward three decades and the situation is unrecognizable from that of the early 1990s. China's sheer geographical size and her gargantuan population always meant that a modicum of economic efficiency would produce an economy of considerable size on a global scale, as of course had been the case for much of history.

National rivalry never went away...but none cared much...now they should

International rivalry did not disappear during the era of a unipolar world- far from it. However, the unchallenged economic and military superiority of the United States diminished its visibility; its impact on capital markets and the behaviour of investors and corporates. We have now entered an era in which great powers contest each other's international policy, compete for influence and resources, and seek to enhance their national power to maintain or gain an advantage over each other in a more obvious and impactful way.

Are we in a new Cold War? Does it matter?

Investors have been slow to grasp the true nature of the change in international relations

The importance that someone attaches to the breakdown of US/China relations can perhaps be gauged by the lexicon they use. Since most financial related commentators on China have a vested interest in playing down the seriousness of the current situation, it is perhaps not surprising that the language has lagged the reality of developments.

Economic relations between super-powers rarely comply to neo-liberal economic principles)

"Trade spat" implies a narrow, ephemeral, and probably futile interruption to "normal economic relations". In truth, I would suggest, the tariffs were not really about trade nor are they likely to pass quickly. If or when they do, it will most likely be replaced by sharper instruments of geo-economic policy rather than marking a return to "normality". Economic engagement between global super-power rivals has precedent (UK-USA; Dutch Republic – UK), but it is not normal for economic relations to go uninterrupted while global hegemony potentially passes from one power to another. Nor is it normal for economic relations to be divorced from politics, in a way that the neo-liberal consensus of the past few decades has tried to engineer through organizations such as the WTO.

We are witnessing a clash of systems: power rivalry with an ideological dimension

"Trade War" captures more of the gravity and the sense of rivalry but it over emphasises trade in what is a broader economic conflict. 'Clash of systems" is accurate in that the US market-driven economic system has not been replicated in China; in fact, since the GFC, China has back peddled on market reforms. The interaction between a statist, nationalist, mercantilist China and a market orientated United States was always in danger of producing unintended and debilitating consequences. Nor have western political systems been adopted either. What is lacking from "Clash of systems" is the national power rivalry. If one side changed its system, but not its ambition, would the confrontation go away? It might become less intense and international relations might more resemble the period during which power was passed from the UK to America, but I would suggest the side with the upper hand would perhaps be compliant and the aspirant side less so.

Lose -lose policies are war like not trade like

We now appear to have arrived at a juncture where rivalry is giving way to action, including actions aimed at relative rather than absolute gain. While economists, focused on economic welfare, talk of win-win situations, national power is far more of a relative phenomenon where "wins" involve costs but impose greater costs on an enemy.

Although there are differences between the Soviet/ anti-Communist rivalry of the post WW2 period and today's Sino/US-led rivalry, "Cold War" seems to be the appropriate phrase to use: Not as a point of semantics, but because it most closely captures the reality:

Cold War seems the appropriate terminology for these five reasons

1) A desire for national power to facilitate economic and national security even at the expense of some prosperity.

2) That national power is being measured increasingly in a relative sense not an absolute sense and therefore lose-lose policies may make sense.

3) There is an increasing military dimension to the conflict, with both sides expending resources on establishing the legitimacy of their goals and the illegitimacy of their opponent's.

4) Third countries are being brought into the contest, either because their interests are aligned with one side or the other, or because they are being forced to choose sides.

5) There is a clear clash of ideological, economic and value systems.

The differences between Soviet/US-led rivalry and Sino/US-led rivalry might suggest a potentially longer and all encompassing struggle

There are differences between the nature of the rivalry between the United States and China now and the rivalry between the States and the Soviet Union, apart of course from the obvious one of geography.

1) Soviet power stemmed not only from Russia but from the Russian empire- the other soviet states but also her ideological allies and satellite countries that combined to form the Soviet bloc.

2) Soviet power was never backed by the economic might of an order of magnitude comparable to the political and military power she wielded. Nor did the Soviet Union succeed in using its political and military power to achieve economic success sufficient to support its national power. The chosen political ideology was an obstacle to economic success and therefore retaining national power.

3) Although there was a limited quantity of economic interaction between the Soviet bloc and her allies with the anti-Soviet alliance, it was never particularly meaningful. Each side, probably rightly, assumed that economic independence was required to sustain their power and that economic interdependencies would be weaponized by their opponents.

In contrast,

1) China's national power does not stem from alliances or an ideological following among other countries. China's economic rise has dragged, and may well continue to drag, other countries into her sphere of influence, either by accident or design, but China's hegemony derives from its own size and economic might.

2) China's economic rise has led its growth in geopolitical influence and largely determines it. The economic power came first, and is being transformed into military and political power. Assuming the economic model is sound, which remains to be seen given that it was partly facilitated by the outside world, this makes the national power potentially longer lasting. Furthermore, China is perhaps transitioning to a stage in which the newfound geo-political and military power can be used to perpetuate and enhance the economic power, thus reaching a point where each becomes reinforcing.

3) China's economic rise has arguably been driven by a deep level of economic engagement with countries that are actual or potential geo-political rivals both within the Indo-Pacific and beyond. China's ability to disentangle itself successfully from this economic dependency, or alternatively use them to her advantage, is a key question going forward.

China's national rejuvenation

China sees its natural place as being at the heart of the Indo-pacific: a regional if not global hegemon

All countries have a creation myth and a national story: China and the United States are not exceptions. From the perspective of making sense of China's current foreign policy, and at the risk of over-simplification, there are perhaps two elements to China's story that are of particular relevance. The first is the belief in the centrality of the "Middle Kingdom" to global affairs. China has a right to global hegemony: the Middle Kingdom is also a Celestial Empire and its leader has a mandate from heaven. Second is the belief that a brief (within the context of the world's most ancient civilization) interruption to this hegemony was caused by internal weakness and wicked foreign exploitation. "National Rejuvenation", therefore can be interpreted, through the prism of China's history, to imply the restoration of China to global centrality and rectifying the injustices of the unequal treaties. As Xi Jinping has put it "Achieving the rejuvenation is the dream of the Chinese people."

This requires territorial settlement; technological leadership; military power and a leading role in global governance

In practical terms, what does China's rejuvenation actually mean?

1) Territorial integrity: Most countries would claim that their territorial integrity is sacrosanct. The problems arise because of disputes as to which territory exactly one is talking about. Leaving Taiwan aside China has territorial disputes with: Russia, Japan, India, Nepal, Bhutan, Tibet (under occupation), Malaysia, Indonesia, Vietnam, the Philippines and Brunei. China's territorial expanse has altered dramatically over time, with the modern borders being established, China would argue, when the country was at the nadir of its power and therefore unable to establish in law what it considers to be its rightful claims. "China's" borders have expanded and shrunk over the centuries to a degree that leaves plenty of subjectivity as to where they should settle. A satisfactory settlement of territorial and maritime disputes is a core part of rejuvenation.

2) Technological leadership: A lesson to be drawn from the "Century of humiliation" is that technological backwardness leaves a country exposed to foreign influence and potential dominance. China's industrial policy and its much talked about industrial espionage and forced technology transfers are driven by the perceived need for the nation to achieve technological leadership. Made in China 2025 was a manifestation of such policy: self-sufficiency in key advanced technologies along with global leadership in them is central to rejuvenation.

3) Military Power commensurate with being a global hegemon: Driven by unsettled territorial disputes, a thirst for resources (food, ores, fuel and water) and facilitated by technological leadership, a military capability to match China's centrality to the Indo-Pacific and the world beyond is a core goal of the "Chinese dream".

4) Rediscovering China's place in the world: At its most rudimentary level this implies a say in the management of the global commons and the multilateral institutions that oversee international relations, that is commensurate with China's standing in the world. Thus, China can be expected to rigorously pursue power within organizations ranging from the Word health Organization to the United Nations to the World Trade Organization and to mould them to its national interests. Where such pursuits are thwarted, China has shown it is ready to establish alternative institutions, such as the AIIB.

The logic of strategy and a region-wide reaction

As China's power has grown, it naturally induces a reaction from her neighbours and other powers keen to maintain independence

Writing in 2011, Edward Luttwak described the prospect of China emerging as the world's predominant power as "the least likely of outcomes". His argument was that "the logic of strategy" dictates that in a world of nation states, each protective of their own autonomy, China's rise can continue unchallenged only for as long as it is not perceived as a threat. In the years since Luttwak made the argument, China, having reached a level of national power that holds out the prospect of regional domination, and having started to assert its claims to regional centrality, is now inducing reactions to its rise.

Chinese diplomacy, until recently, postponed this reaction

That China has managed to travel the road from economic irrelevance to being the second largest economy in the world, without eliciting a cohesive and concerted response from other powers in the Indo-pacific until now, is testimony to the diplomatic skill of the last generation of Chinese foreign policy practitioners. At the heart of this diplomacy was a view that China should down-play its power, appear unthreatening and create economic inter-dependencies that would raise the cost of any action to curtail it's rise or resist it's power projection.

Greater Chinese assertiveness in recent years has brought issues to the fore

In recent years, starting perhaps after the Global Financial Crisis under Hu, but with renewed vigour since Xi Jinping took over the leadership, China has become more assertive in its diplomacy, and in pursuing its "rejuvenation" through ostentatious displays of its military power. Territorial claims are being enforced where possible in a de facto sense even when international arbitration has ruled against them. The militarization of the South and East China Seas, hydro-carbon exploration and fishing in disputed waters are all on-going examples of this new assertive expansionism.

In the same way- China's assertiveness pre-dates Xi, America's pivot to Asia pre-dates Trump

China's rising power, when accompanied by assertiveness, has induced a reaction from her Indo-Pacific neighbours. While Donald Trump's tariff escalation, that began in July 2018, is often thought of as marking a turning point in US-China relations, a change in US attitudes, if not necessarily matched by action, had begun long before that. The Obama administration's "Pivot to Asia" strategy, showed at least recognition that the greatest threat to American hegemony, security, values and prosperity now emanated from China. The negotiations around the Trans-Pacific Partnership (TPP), which morphed into the Comprehensive and Progressive Trans-Pacific Partnership when the US withdrew its support, and the revival of the defunct Quadrilateral Security Dialogue in 2017 are perhaps more valid indicators of the start of regional alignment aimed at containing China's ambitions. The important point of comparison between the two organizations, is perhaps that, with or without US involvement, countries in the Indo-pacific are seeking closer co-operation with one another to resist China's assertiveness.

The cold war is regional or global and likely long lasting

If the "logic of strategy" is correct – that China's rise will elicit a response from neighbours and concerned parties to try to curtail it – then investors face a very different landscape in Asia-Pacific than in the past. Not only is this simply not a US-China relations issue, it appears that there is an inevitability about the frictions in the Indo -Pacific based on the intrinsic nature of international relations. That mean the tension is likely more permanent than temporary. A change of President in the United States will make little or no difference to strategy, but may alter the tactics and tone.

THE ECONOMIC DIMENSION TO RIVALRY: WAR BY OTHER MEANS.

Geoeconomics

Keeping the war cold means a greater role for geopolitically orientated economic policy

In the nuclear age, great powers have had to emphasise alternative fields for conflict, other than all out military confrontation. The old Cold War was, of course, punctuated by proxy, and sometimes high intensity hot war, but Mutually Assured Destruction (MAD) kept the war between the two main belligerents cold.

Given that economic power is to a large extent the substructure of national power, it is unsurprising that foreign policy practitioners aim to utilise economic policy to project power and undermine an opponent's ability to project power. Geoeconomics is the use of economic policy to achieve or further geopolitical aims.

Good geo-economic policy is not necessarily good, neo-liberal economic policy

There is an obvious potential for tension between geo-economic policy and sound international economic policy, which is aimed at maximising economic welfare. Trump's 2018 tariffs are a good example, where a relatively small amount of US economic welfare was sacrificed to inflict a potentially larger loss of economic welfare on China. In a cold war, geo-economic policy becomes about relative winners and losers not win-win situations. A failure to view the tariffs through the prism of geo-economics led to criticisms of the tariff policy based on their economic merit (or lack of it) missing the point that it was the potential asymmetry of the impact that was important and perceived economic security the objective.

Maximizing profits can conflict with geo-political goals and often does

CEOs, Investors, and analysts tend to look at situations from a profit maximization perspective. Long time investors in Asia are well aware that profit maximization is not always the aim of companies. The financial community must now grasp the fact that maximizing economic welfare will not always be the aim of international economic policy either.

The geoeconomics tool Kit & endowments

Geoeconomics firmly puts the "politics" back in "international political economy" and can encompass every aspect of the economy

The tool kit available to geo-economic policy makers is extensive. Blackwell and Harris in 'War by Other Means' identify 7 broad categories: trade policy; investment policy; economic sanctions; cyber; economic assistance; financial and monetary policy and natural resource policy. Important sub-sectors would include specific technology policy and strategic industrial policy.

While the range of potential geo-economic tools is theoretically available to all, clearly their efficacy and importance depend very much on the economic endowments of both the instigator and the target of geo-economic policy. An embargo on hydrocarbon exports to a country blessed with a surplus of oil is unlikely to have much impact. Denying a large adversary access to a small consumer market might make a point, but its impact will be small and maybe even self-defeating. It should also be evident that, in the absence of an overwhelming endowment differential between two powers, alliances, leading to multilateral action, stands a higher chance of success.

Geo-economic endowments: China vs US

China has made great progress in the last 40 years, but suffers from some serious geo-economic weaknesses... its totalitarian nature is a source of strength in conflict.

On a stand-alone basis China suffers from a number of geo-economic weaknesses, while it has tried hard and successfully to manufacture some strong endowments from a hopelessly unfavourable position 40 years ago.

1) China does not enjoy a high level of food security and famine and food scarcity have played a major role in the downfall of dynasties throughout its history. Key suppliers of imported food include the United States, Canada and Australia – leading liberal democracies and members of the five eyes security alliance. In 2003, China was a modest net exporter of food by value to the tune of USD6bn. In 2017 China was a net importer of food to the tune of USD45bn. Food security is a factor behind China's global fishing fleet; the nine-dash line and her maritime claims; as well as the BRI in Africa. It has become topical again following the severe flooding this year; the long-term environmental degradation

industrialization has caused; the paucity of clean water; and the "clean plate campaign".

2) China is not self-sufficient in energy. Despite the hype about renewables and the commitment to the 20% threshold by 2030, 70% of China's oil is imported and the country relies heavily on imported coal despite having large domestic reserves, which still accounts for 60% of energy consumption. Geopolitical considerations can account for some of China's commitment to renewables but for now, energy security remains a key driver of foreign policy and energy security is dependent on imports.

3) China's economy is still more heavily dependent on external demand than other similarly sized economies such as the United States and the EU, although this is less true than it was in the past. This creates a vulnerability in terms of market access and the potential detrimental impact on employment.

4) Furthermore, despite rapid and spectacular progress, outside of 5G, there are few products that cannot and are not made by alternative suppliers. China's value proposition in several industries, such as transportation equipment, is however, a core geo-economic strength with costs associated to anyone denied access to it.

5) From a geo-economic perspective, power can come from a monopoly supply position. China has grown its share of world manufacturing value added from 6% in 2000 to about 25% now. This presents China with economic power, but China is dependent on importing the raw materials. Rare earth is a good exampole of China's monopoly power. The assembly business is movable over time, albeit there is cost to be incurred.

6) Perhaps China's greatest geo-economic endowment comes from the Party-State's ability to command resources through its monopolistic control of savings and capital allocation, its control of SOEs, and apparent buy-in to the program of national economic improvement. The flip side of that line of argument is of course, that a liberal economic structure has, and continues to, produce meaningfully higher per capita output. One system produces a better result but is harder to mould into national power projection: the other worse results, but is easier to purloin for

geopolitical ends.

On a stand-alone basis, the United States enjoys a number of geo-economic endowments that would appear to grant it a stronger hand in an economic contest but it has left itself more vulnerable than in the past by ignoring some of the implications of globalization:

1) The United States enjoys a high degree of food security to the extent it is a large net exporter of food. Furthermore, those exports are less dependent on China buying than some interpretations of the fallout from the tariff war have suggested. As global commodities, prices adjust, and displaced bilateral flows get redirected.

2) The United States trades in oil and energy and on a net level is more or less self-sufficient. In addition, the US enjoys access to energy from close security allies (Canada and Mexico for example). Furthermore, the US has the potential to dramatically improve energy efficiency that could produce self sufficiency at a lower cost than it currently pays.

3) The US enjoys a technological lead in many areas that are crucial to the functioning of a modern economy and in some cases such as semiconductors is a monopoly supplier in critical niche areas. This produces geo-economic power.

4) American dominance of the international payments and settlement system combined with the role of the US dollar in global trade and investment, gives the United States both leverage over other economies in their international transactions and an "exorbitant advantage" in terms of seigniorage.

5) As the largest import market, America has clout among those countries that wish to export to it. In contrast, while China is a big importer, a large part of imports is for re-export, or non-discretionary. US imports are largely discretionary.

How do alliances change the picture?

The US alliance net-work gives it a potential large advantage over China

While US economy no longer dwarfs China's as it did 30 years ago, one of the United States' key advantages over China is its network of long-standing security alliances, both within the Indo-Pacific and beyond. While, these have been largely military in nature, as geo-economics plays a greater role in geopolitical affairs, investors should be prepared for these alliance networks to take on a more economic dimension.

China's economic rise has brought some countries inextricably into its sphere of influence

China, on the other hand, has few allies of any economic importance but it has worked hard to bring countries under its influence by concentrating economic resources in countries a) that can help increase its economic security, through the provision of the food and raw materials that China needs and b) where a small amount of money goes along way and the economic-power relationship is extremely asymmetric. Angola's oil exports for example and Laos and Cambodia as FDI destinations.

While the Trump administration has tested some alleigences

It is probably fair to say that during the Trump presidency, the resilience of the US alliance network has been tested. A less assertive stance from China during this time might have paid long term dividends for China by further weakening the alliances. Equally, the US withdrawal from CPTPP, may well be viewed as a strategics mis-step by the United States. Nevertheless, despite the rise of China economically, and the more diffuse nature of economic activity throughout the world, there is still an overwhelming economic arithmetic in favour of liberal democracies and US security allies.

An alliance of the US, USMCA, QUAD and Five eye countries accounts for 43% of world GDP

The US accounted for 24% of global GDP in 2019 to China's 16%, which leaves 60% of economic activity in third countries. Mexico and Canada, as members of USMCA (new NAFTA), are so intertwined with the US that they could not afford to be alienated from it economically, and they account for a further 3% of world GDP. Japan, Australia and India, (that together with United States makes up the Quadrilateral Security dialogue (QUAD)), account for a further 13% of world GDP; with the two remaining "5 eye" countries, the UK and New Zealand, accounting for a further 3%. At 43% of world GDP, this collection of countries presents a formidable economic, political, technologically advanced, and military bloc.

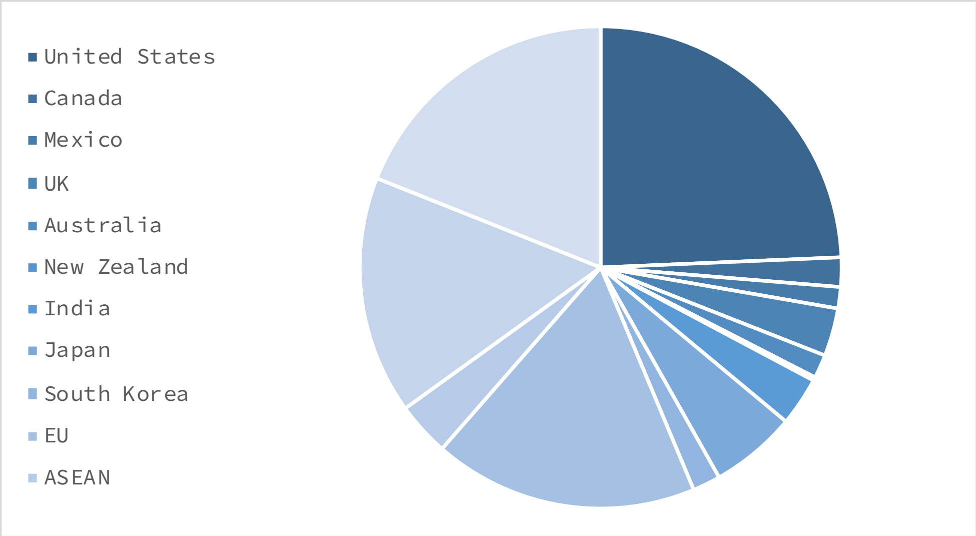
If the EU wee to join forces with a US-Led alliance, allies would command 61% of the global economy

The EU has demonstrated its willingness to stand up for its own interests in recent years, even in the face of US opposition. Furthermore, the Trump presidency has tested and strained US-EU relations. Nevertheless, there is an increasingly apparent commonality of interests between the EU and the US when it comes to China. The EU-China trade is dominated by Germany, with exports from the rest of the EU accounting for just 1% of the remainders GDP. Made in China 2025, is a clear indication that China intends to achieve self-sufficiency in areas that traditionally Germany has been a key exporter and there is an increasing exasperation in Europe at the asymmetry of the relationship and the un-level playing field. In 2019, the EU accounted for a further 18% of world GDP, taking the potential size of a "grand alliance" to 61% of the global economy. Close American allies in Latin America, the middle East and elsewhere would add a few percentage points to the total.

China is unlikely to be able to form an alliance commanding much more than 20% of the world economy

On the other hand, China's potential allies largely boil down to two groups of countries: 1) Those currently sanctioned by the United States such as North Korea, Cuba, Iran and Venezuela and 2) Those countries whose economies are so intertwined with China's that saying "no" to anything – even if they wanted to - will impose a devastating economic cost that outweighs any other national consideration such as sovereignty. This could include countries such as Pakistan, Laos, Cambodia, Angola and Mongolia. With China accounting for 16% of the world economy, and a few economically small allies, even including Russia, it is hard to envisage China corralling much more than 20% of the global economy under its umbrella.

Russia, which accounts for less than 2% of world GDP, but has considerable military capability and its own sphere of influence in the Eurasia land mass, while sanctioned by the US and Europe, has territorial disputes with China and of course regional hegemonic ambitions of its own. Its support for China should not be taken for granted and would not be unequivocal but a military alliance could impose a big cost on a US-Led alliance in terms of the need for greater defence expenditure.



The problem with alliances

Although there is abroad commonalty of interest among a range of countries, the objectives, structure and policies of such an alliance may be hotly contested

Although there maybe a broad commonality of economic and security interests that bind a majority of the world's economic might together in an alliance, there are a number of very fundamental issues to overcome.

1) An agreed Strategic objective: What is it? At one end of the spectrum might be regime change, at another economic independence in specific strategic industries. There is obviously a myriad of possible objectives in-between.

2) A structure: An Indo-Pacific NATO or a more values driven economic union with a military dimension. How all-encompassing would such an alliance be?

3) Actions: At one end of the spectrum this could simply be to agree a limited range of actions – such as not having Huawei in 5G networks or denying China dual use technology– that all can agree on. Or, at the other end of the range of possibilities, a move to de-couple economies completely.

There may well be an asymmetric cost burden relative to perceived benefit

Whatever shape an alliance might take, there are clear problems even assuming that an objective, structure and plan of action could be agreed. Different potential members of a coalition of the willing have very different levels and types of economic inter-dependence with China: 38% of Australian exports are to China; the UK has USD-600bn of cross-border lending to China and Hong Kong for example. They also have very different perception of the degree of threat that China poses to their national interest, nor is there much correlation between the two. If economic dis-engagement results in costs, then a country's willingness to bear the cost will depend on the level of perceived threat. This is the obvious Achilles heal in such an alliance, but that does not mean it will not happen: it is already taking shape.

Does "Chimerica" make divorce too expensive?

Is economic divorce too expensive? Security invariably trumps prosperity

The most often cited argument against the kind of bifurcation in the world economy that this paper argues is happening in front of our eyes, is that it is simply too expensive. The US and China economies are simply too inter-dependent – "Chimerica" as it has been called – for de-coupling to happen. This consensus, in my opinion, does not stand up to scrutiny and is thus a dangerous, potential costly, assumption to hold when managing capital. As John Mearsheimer put it " Security invariably trumps prosperity".

The raw data does not tell the whole story but...

The raw data pertaining to the economic relationship between the United States and China does not tell the whole story. In some ways it understates the true linkages, because of third country participation in a complex web of interaction. Equally, the data treats a dollar invested in one place equally to one invested in the other, whereas the utility of each maybe very different.
Nevertheless, the raw data is what we must work with – at least as a starting point, and although the numbers are big in absolute terms, they are not so intimidating when taken in a global context.

Trade in Goods & Services

US exports to China are less than 1% of GDP and less than 7% of total exports

Bilateral trade between the United States and China was stagnating before the trade war, shrank after the tariffs were implemented, and obviously COVID now distorts the data in a way that makes the impact of the geopolitical influence hard to measure. Nevertheless, in 2018 goods exports to China totalled just USD120bn and fell in 2019 to USD106bn. US goods exports to China represent just 6.4% of total goods exports and are equivalent to just 0.5% of US GDP. Service exports to China at about USD56bn, again are under 7% of total service exports. Together, Goods and services exports to China account for just 0.8% of US GDP down from 1% pre-tariffs.

China's exports to the US are more important, but down from 4% of GDP to 3.4%

Chinese exports to the United States are of course much larger, both in absolute terms and relative to China's GDP. From an annual peak of USD540bn in 2018, goods exports fell to USD472bn in 2019- a 12.5% or USD68bn fall. Service exports to the US are small at sub-USD20bn. The goods and services total exports from China to the United States accounted for 3.4% of China's GDP in 2019 down from 4.2% two years earlier – not exactly a huge number albeit 4.5x as significant as the flow the other way. Furthermore, China's goods exports to the US contain perhaps 20% foreign value added in them, not captured in the bilateral numbers.

US-China bilateral trade accounts for just 3.5% of total global trade

In a global context, large as the bilateral trade relationship is, it still only accounts for about 3.5% of total global trade, and the evidence from the post tariff escalation period suggests that much of the lost bilateral trade was simply diverted to other countries. US-China trade is smaller than UK-EU trade for example, and smaller than EU-US trade,

Foreign Direct Investment

Chinese FDI into the US, accounts for just 0.3% of the US total capital stock

The United States has a total domestic capital stock of some USD60 trillion. At market value, foreigners have an FDI stock of over USD8 trillion in the United States. The USTR estimate the Chinese stock of FDI in the US at just USD40bn in 2017. This is understated because much Chinese FDI is routed through the BVI and other third countries. The US-China investment project estimates the total at USD-154bn. The larger number equates to just 0.3% of the domestic capital stock in the United States and just 2% of that owned by foreigners. The raw numbers though do not tell the whole story. Much of this FDI is in trophy assets and has fled the reach of the CCP, much of remainder has been aimed at purchasing intellectual property. Whatever the motivation the numbers are negligible and hardly suggest an economic system joined at the hip.

US FDI is China is equally small numerically, although more significant in terms of the positive externalities it has created

The stock of US FDI in China is estimated at USD108bn in 2017 by the USTR. The US-China investment project put the number at USD260bn. Bearing in mind China is now a USD13 trillion economy with gross fixed capital formation running at 35%+ of GDP, the stock of US FDI is equal to about 5% of one years' flow of domestic investment. China's capital stock is now over USD100 trillion, making the US owned portion a rounding error. Again, the raw data is perhaps deceptive. China has benefited from technology transfer; transference of management skills and the multiplier effect of US MNE investment in the past, but the statistics speak for themselves in terms of the negligible size of the stock of FDI relative to the respective capital stocks.

MNE activity

US Multi-National Enterprises have been at the forefront of globalization over much of the past 50 years. They have built considerable overseas operations and have been, to a large extent, the first movers in the creation of Global Value Chains. Chinese companies' overseas activities have been far more muted, but since the GFC thee has been a concerted "going out" policy aimed at internationalizing the activities of Chinese companies, particularly State-Owned Enterprises (SOEs).

The BEA produce survey-based data on the activities of foreign affiliates of US based companies and US affiliates of foreign based companies. Because the survey was expanded in 2014, long term time series data needs to be treated with caution.

Although US MNE's generate USD390bn of sales in China, they make just USD30bn of profits and most value is added by Chinese or third countries companies

In 2018, US MNE's operating in China through majority owned Chinese affiliates: employed 1.7m workers, paying USD32bn in wages (USD18K each or an 80% premium to per capita GDP). They generated about USD390bn of sales, adding USD77bn of value added in China. The profits they generated amounted to USD30bn. Very little, about USD20bn was imported from the US by way of supplies to these affiliates and very little, USD 20bn, was re-exported back to the US.

China accounts for about 7% of US MNE overseas operations and 2% of their total operations

It is therefore basically, a 'made in China for sale in China' business model. Putting those numbers in context, the USD30bn of profits made by these affiliates in China (plus USD9bn made in Hong Kong), represents about 7% of the total overseas profits generated by the MNE and less than 2% of their total profits when one includes domestic operations too. The USD77bn of value creation, compares to a total overseas value-added number of US1.5 trillion. Which ever metric one uses, China and Hong Kong combined, account for about 7% of overseas operations and 2% of total operations.

The US operations of China-based companies are even smaller. Sales of USD65bn with value added of USD14bn make them irrelevant, in terms of dollar size, based on the BEA data, to both the US economy and China. The relevance to China may well be through the intellectual property acquired rather than any profitability of revenue expectations.

Portfolio Investment and Financial flows

When it comes to bilateral portfolio flows, accurate data is hard to come by, given the scope for intermediaries to obscure the true source of funds. Each superpowers' international investment position and international transactions report, however, reveal a number of important trends and insights.

China owns about 4% of the US treasury market, a number that has not grown since 2011)

At the heart of the concept of "Chimerica" – the idea that the two economies are too interconnected for there to be a separation - is the vendor financing loop created by Chinese net exports of goods to America being funded by China's purchases of US debt. What is telling is that China's holdings of US treasuries peaked in 2014 at USD1.25 trillion and has since fallen to USD1.1 trillion – all the while, the bilateral trade deficit, and indeed the US's overall deficit, has continued to be high. In the last 3 years alone, the bilateral deficit in goods & services has amounted to over USD1 trillion and yet China's holdings of treasuries have fallen slightly and are smaller now than they were in 2011. China now owns about 4% of the US treasury market. The financing of US trade deficits by Chinese purchases in the treasury market is well and truly over and has been for about a decade.

Americans own about USD225bn of mainland financial assets

As things currently stand US ownership of portfolio investments in mainland China are extremely small in the big scale of things. Total foreign ownership of mainland equities and bonds, according to the PBOC, while having grown very rapidly (5x) since 2013, now stands at RMB4.2 trillion or USD610bn, with the US treasury putting the US portion at USD225bn. For context, the combined value of mainland China's bond and equity market is about USD23 trillion so Americans own about 1% of it. The US equity market alone is USD36 trillion. Adding the USD182bn of exposure the United States has to Hong Kong, does little to alter the arithmetic given the overall scale of international portfolio flows – the US owns about USD13 trillion of foreign equity and debt in total.

Including indirect methods of ownership and off-shore listings, it is possible that the US has about USD1 trillion of exposure.

These numbers do probably understate the true exposure because some investment into China and Hong Kong will be indirect through off-shore centres such as the Cayman Islands. In addition, there is the issue of US listed China equities, in part owned by US entities but also third parties. There are more than 200 such listed companies with a market capitalisation of about USD1.8 trillion. The Free float is small relative to the market capitalization however and suggests maybe a further USD300bn of equity should be added to aggregate US exposure to China.

Despite the complications of an accurate calculation, it does appear that, while non-trivial, the inter-connectedness between the two economies via portfolio flows is not yet at a level that presents an insurmountable obstacle to geo-political action as things currently stand.

While portfolio flows have the potential to be weaponized as an instrument of geo-economic policy, the bilateral position between the United States and China is one in which the stock of respective portfolio investment is very small in the context of overall stocks, but that China has a US treasury market investment about 2x larger than the US private sector has invested in mainland capital markets but possibly of an equal order of magnitude when indirect portfolio investments in China are taken into account.

Taking these four measures of direct economic inter-linkages together, for two economies that comprise a combined 40% of world GDP in nominal dollar terms, the scale of dependence is remarkably small.

Taken together the interlinkages are small and do not pose a barrier to foreign policy action... if anything, the asymmetry currently encourages US action

Economic divorce or de-coupling or even a scaling back will inevitably carry a cost in terms of economic welfare. All foreign policy tools tend to carry costs. However, it could be argued that the statistical measures of inter-dependence suggest it is not an unbearable cost and does not pose a barrier to the operation of foreign economic policy and attempts by each power to influence the others behaviour. If anything the asymmetry of the relationship probably encourages US action, because it will have a relatively larger impact on China.

The battle ground and objectives

Both China and the US are heavy users of economic statecraft

Both China and the United States, have made frequent use of economic state craft in recent decades. If geo-economics is the use of economic instruments and policy to endeavour to achieve geopolitical ends, then the US's precipitation of China's accession to WTO, through granting Permanent Normal Trade Relations (PNTR), was arguably a geo-economic policy: the idea being to make China a "responsible global stakeholder." It is debatable if it has worked. Similarly, China's drive for self-sufficiency in technology, for example, can be seen as a defensive measure to immunize itself from the ability of others to weaponize this dependency to their advantage and limit China's military capability.

There are four areas of relevance to investors where this geo-economic rivalry is likely to play out: Trade, investment, technology, and the international financial system.

The cold war means trade, investment, technology and global financial system will become increasingly political and weaponized

Trade

Trade and National power have always been linked albeit mercantilists and free traders had different approaches

It is probably wrong to think of the 2018 tariffs imposed by the Trump administration as the start of a "trade war" in anything other than the narrowest of terms. As far as trade is concerned, the laissez-faire approach adopted by previous US administrations, was an attempt to influence China's behaviour. In addition, rightly or wrongly, it was often viewed as the best way to maximize US economic growth and efficiency and hence indirectly national power. Equally, the mercantilist approach of China to trade was also an instrument of economic statecraft, designed to enhance China's national power capabilities. Trade and national power have always been inter-linked, the difference between mercantilist and free-traders has largely been one of approach not objectives.

Trade has been the most prominent driver of the rise of China's national power

China's export orientated growth from the mid-1990s through to 2008, resulted in a rapid enhancement of the country's industrial capabilities; its technological know-how; employment and living standards (and hence buy-in into the regime); and its foreign exchange earning capabilities that in turn could be put to use in other areas. By acquiring such a large proportion of world manufacturing, China became a monopsony buyer of many commodities and a near-monopoly supplier in many manufactured goods, bringing with it, considerable economic leverage. Trade has, therefore, been the preeminent driver of China's increase in national power in recent decades.

China's success along with the distributive impact of globalization have combined to call into question the neo-liberal economic consensus

A growing perception that US policy has failed, and China's has succeeded was behind the US-driven change of direction. The belief that "free trade" is the "normal state of affairs", has been nurtured by the exceptionalism of the post cold-war period and the ascendency of neo-liberal economic theory. The co-existence of rapid economic growth with high levels of underemployment; the Global Financial Crisis; the distributive impact of globalization and the clear asymmetry in global trade patterns have combined to serve up a severe challenge to neo-liberal hegemony.

The political and geo-political implications of trade policy will perhaps receive more attention than the economic implications going forward

When it comes to trade policy, the belief that there is a coincidence of interests between those of the private sector and the nation is under scrutiny. Classical liberal economists were among the most ardent believers in the view that national security could conflict with commercial activity and that the former was a higher priority. Resilience and robustness in supply chains have started to take priority over efficiency and scale – a phenomena that has been accelerated by COVID – but was catalysed by the realization that even the industrial-military complex was heavily dependent on goods supplied by China.

For the United States, I would suggest the yard sticks for measuring the success or otherwise of geo-economic policy pertaining to trade are fourfold: a) the speed and degree to which trade is diverted

Trade policy will become more about cost-benefit analysis and the externalities of trade, not welfare maximization. From a US perspective it is about de-Sinification at the lowest possible cost

away from China; b) the size of the net welfare losses (gains) from the re-orientation of trade patterns (including the retaliation from China) and any on-shoring. c) the comparison of those gains or losses relative to those incurred by China's through the loss of that economic activity. And most importantly, d) the comparable cost of attaining the same geo-political goal – degrees of security of supply and independence of action– by other means. The last one of course is probably unmeasurable. In other words, it is a cost benefit analysis including the externalities of trade, not purely an economic welfare analysis.

For China, trade is becoming more about expanding its sphere of influence to increase economic security

From China's perspective the key variables pertaining to their trade policy are a) the degree to which they hold on to leverage over global supply chains. b) the degree to which redistributed trade pattern induce or reduce potential compliance from smaller regional economies and c) their ability to secure supplies from friendly or compliant nations of the key economic inputs that they lack themselves and the welfare losses incurred by potentially having to opt for a second best supplier.

Investment

Foreign ownership of mainland Chinese assets has risen dramatically from low levels. By encouraging foreign investment China has the potential to impose a big cost on any action taken against its interests

China's mainland capital markets were largely closed to foreigners prior to 2012. As noted above, in recent years there has been dramatic growth from a low base, of foreign involvement in China's capital markets. As things stand, the current level of US ownership probably does not present a barrier to foreign policy action as the cost China could impose is limited. The sensible course of action from a Chinese perspective is to induce a level of non-controlling foreign ownership in its domestic capital markets, that substantially raises the cost to a rival power of pursuing a policy counter to China's interests.

Foreign investment also produced foreign exchange with which to pursue geo-political ambitions in Eurasia and beyond

This growth, driven by policy moves by China to open its markets, has coincided with the shrinking of China's current account surplus as a proportion of GDP, and with the "going out" policy of encouraging China's SOEs to internationalize their businesses. "Going out" is a part of the Belt and Road Initiative and has geo-economic overtones. All these trends, that impact the balance of payments have taken place against the back-drop of the USD 1trillion drop in, and subsequent stagnation of China's foreign exchange reserves.

The following sequencing of events may help clarify China's policy on inbound foreign portfolio investment from a geo-economic perspective.

- The GFC marked the peak of China's export orientation towards the United States and other Western Developed markets. The focus moved towards smaller developing markets, with both greater growth potential and an asymmetric balance of power. As an earner of foreign exchange US and EU exports remain very important but their propensity to grow is limited by both political and economic considerations. Consequently, the current account is no longer going to provide meaningful growth in hard currency inflows, at least until the developed markets become significant drivers of exports.

- The "going out" policy, leading SOEs to acquire about USD1 trillion of overseas assets, combined with other BRI related projects fulfils an important geo-political objective of widening China's sphere of influence, particularly when combined with China's new export focus. These policies also, however, put pressure on the balance of payments through capital outflows.

- These twin pressures, combined with the capital flight from China, in part driven by Xi's tightening of control over the party, manifested themselves in the big drawdown in foreign exchange reserves, potentially threatening the exchange rate and economic stability. The severity of the clampdown on capital flight can be explained by its potentially significant impact on China both domestically and its on its geopolitical ambition.

- What was needed was a large source of foreign exchange (until such time as the RMB is widely accepted abroad), to finance overseas expansion by the SOEs, while maintaining reserve levels and currency stability. The obvious source was foreign inbound portfolio investment.

- While take up by foreigners of Chinese financial assets was muted to start with, fortunately, benchmarking is a great driver of ‘blind" or index linked capital. Hence, whether under pressure or not, the inclusion of China's mainland markets in various benchmark indices, has been and, if unconstrained will remain, a big driver of capital towards China thus ensuring it can recycle its foreign exchange inflows in the ways the regime perceives to be most important and beneficial to China's national power.

· Importantly, encouraging rival powers to hold a proportion of their savings in Chinese assets has created a foreign interest group heavily vested in preserving the dividend and coupon flow from these assets. The power to stop the income flow rests with the Party-State.

Policy makers can use their control over the value of foreign investments, to buy acquiescence

In between the extremes of "national treatment" - whereby a foreign investment is treated identically to a domestic one – and outright confiscation, there is a myriad of actions that can be taken by policy makers to denigrate the value of a foreign investment. Actions can be official or unofficial; explicit or covert; threatened or actual. The impact is to control the value and use variations in the value as leverage to buy acquiescence.

The obvious policy reaction by China's geo-political rivals is to prevent such investment

Ironically, having lobbied so hard for the opening up of China, it is most likely to be foreign powers that try to curtail or discourage and potentially even prohibit, the inflow of portfolio and direct investment into China. Of all the many divisions in liberal democracies, it is perhaps that between those with a vested interest in accessing China's markets and those with an interest in containing China that is among the most important. The obvious policy choice for the US or other potential geo-political rivals to China, is to discourage or prohibit such investment so as to deny China this leverage.

Technology

Technological rivalry could lead to a resurgence of industrial policy in countries where is has lapsed

The competition for leadership in technology is a key element of the rivalry between the United States, its allies, and China. Chinese leadership in crucial 5G technology, has probably acted as a catalyst for action and an increased focus on geo-economic policy in the United States. For its part, China has been keen to wean itself off dependency on US technology for many years, if not decades. Made in China 2025 was an expression of that wish and the latest iteration of long term economic planning will most likely re-emphasise the point. A re-appraisal of the role of industrial policy is ongoing in major economies across the world.

Technology plays a part in most aspects of national power: military, propaganda, and economic (through productivity). There is also an inherent friction between the desire to have a technological standard widely adopted in order to maximize the economic value of it, and the potential national interest to maintain exclusive use of leading edge technology that bring some sort of advantage.

There is a conflict between profit maximization by companies, and the national priority to lead in technology

Broadly speaking, in the past 30 years, with a few exceptions, technology companies have operated in an environment where establishing standards and maximizing the economic value of a piece of technology through its export to whoever would and could pay was the normal practice. This is perhaps why the reaction to policy towards Huawei, ZTE and SMIC has been so shocking to many in the capital market. In an era of cold war type power rivalry, national interest (or policy makers perception of it) will likely find greater expression in policy than profit maximization.

Semiconductors are in the front line, export controls will likely broaden

The export restrictions pertaining to the semiconductor industry are a case in point. From a pure short term economic stand-point they are an own goal it could be argued. From a geo-political perspective, the outcome may look very different. In a Cold War scenario, the value of intellectual property pertaining to weaponized technology may well fall, because it cannot be exploited in a profit maximizing way. Equally, as the rivalry becomes more blatant and open, industrial espionage will likely increase, and the whole legal defence of intellectual property become less relevant as countries will resort to, or step-up, efforts to close the technology gap by nefarious means.

Maintaining exclusive use of and exploiting intellectual property will become more difficult

The Financial system

The new cold war will likely manifest itself in the sphere of the financial system (having treated portfolio investment separately) in three areas: 1) the battle for seigniorage, as China tries to internationalize the RMB to capture some of the United States "exorbitant privilege". 2) the international operations of commercial banks. And 3) the international payments and messaging systems associated with the international trade and investment.

Reserve currency status, seigniorage and the dollar standard.

Seigniorage accrues to the state through the issuance of currency. Currency debasement and international conflict run hand-in-hand

The US dollar's dominance in international reserves and transactions has been a source of national power: China is challenging dollar suprememcy

through history. The advantage of being the issuer of a global currency is that you can issue more currency than would otherwise be the case, to satisfy international demand, without debasing the value through inflation. Official holdings of US Treasuries for example, total in the region of USD7 trillion and it is estimated that up to USD1 trillion of US Dollar notes also circulate outside the US.

The dollar standard has been a pillar of the international order since the collapse of Breton woods and the move off the gold standard. China's intention to compete with the dollar as an international reserve currency is no secret – and nor need it be. It is a legitimate goal of any state to encourage the international use of its currency. Indeed, there are some in America who believe that a more multi-polar system currency system would be to the benefit of the US economy, by facilitating a more competitive exchange rate.

There is a tension between the economic benefits of the digital Yuan and the increased power that accrues to China through its adoption

The national power that will accrue to China if it successfully achieves its objectives, however, would be substantial and that is why it is likely to meet with considerable resistance. Countries in the region, all of whom have close economic relations to China, are potentially going to face a choice between sound economics and sound geo-politics. The economic benefits of the digital Yuan for example, to the tourism industry or for cross-border transactions, will have to be weighed against the leverage and increased resources that will give to China to cement regional economic and military hegemony.

Cross-border lending

Does power rest with the debtor or the creditor?

The increase in cross-border lending has been a defining trend of the globalization of the past 40 years. Form a geo-economic perspective two sayings about banking ring true: 1) "giving the money away is the easy bit: getting back is the hard part of banking" 2) "If you owe the bank a small amount of money you have a problem: if you owe the bank a large amount of money, the bank has a problem". From the perspective of economic statecraft, it is perhaps the case that the promise of bank lending, gives the lender leverage but once the loans are in place the borrower has the leverage: the ability to inflict damage through default.

The internationalization of the banking system, even in "normal times" has been a key source of contagion, spreading economic woes from one region to another. Western banks have enjoyed unprecedented policy support in recent decades compared to the past, with losses being socialized as a point of policy, much to the chagrin of other interest groups, formalizing a policy that systemically important banks are simply too big to be allowed to fail.

Banks will likely find themselves increasingly in the crossfire of geopolitical policy

In an age in which economic inter-dependencies are likely to be closely scrutinized by policy makers, and subject to sanction and weaponization, banks may well increasingly find themselves caught in crossfire of geopolitical rivalry. China's international lending has largely been done by policy banks under state control anyway. These banks are instruments of Government policy. Western and Japanese banks involved in international lending are responsible to shareholders, but may find that freedom of action is curtailed by their reliance on central banks for support to times of crisis.

THE IMPLICATIONS FOR INVESTORS

If, as this report so far has tried to establish a) we are now in an environment like the Cold War. b) The current environment is here to stay and will likely intensify and c) The international economic policy environment will become highly politicized, then what are the implications for investors and for capital markets?

The impact, opportunities and risks, this change of environment entails can be divided into four parts:

- **A changing legal and regulatory environment will likely impact scope of action for activity for investors, a possible complete reversal of the existing trend.**

- **Changing perceptions that pose a reputational risk.**

- **Policy direction will impact core capital market fundamental drivers such as growth and inflation. Within markets there will be relative winners and losers.**

- **Risk, returns and diversification benefits: Given that China is in no way capital constrained, is there evidence that real dol-**

lar based returns should be higher enough to compensate for jurisdictional risk?

The regualatory and legal environment pertaining to China is already changing fast.

A changing legal and regulatory environment.

The two key questions for foreign investors into China are surely: What will be permissible by one's home jurisdiction going forward and how might rules and regulations in China change in way that impacts my investment?

The liberalization of China's capital markets to foreign investors has been a slow and ongoing process that has received renewed vigour as the balance of payments has come under pressure. Foreign appetite for the assets has been driven by a number of factors but index-benchmarking is certainly one.

At the same time, the number of pieces of proposed legislation in the United States aimed at in some way having an impact on China has risen exponentially. The "Entity list" is expanding. Export prohibitions are being extended. Sanctions against named individuals are in place. Prohibitions on investment in China by some state pension funds have been passed. A timeframe has been set for the de-listing of Chinese companies from US exchanges that do not meet Public Companies Accounting Oversight Board (PCAOB) criteria pertaining to record inspection.

It seems unlikely that the legal environment for US investment into China is likely to become more favourable and out-right prohibition is quite possible. It could well be that a further catalyst is needed for such a move, but in a regional where events are moving fast, who can tell when such a catalyst could come about? It is a risk that few are thinking about.

Furthermore, secondary sanctions have played an increasingly important part in trying to improve the efficacy of economic statecraft. This means that it will be increasingly difficult for non-American companies or individuals to avoid compliance with US instigated sanctions. More than that, recent calls for the EU and US to adopt a joint approach to China seem to be gaining momentum among officials, not just commentators. The prospect of a unified front putting in place legal restrictions on companies' abilities to operate in China, including in the investment sphere is rising fast.

Given that is not in the national interests of any country to have a meaningful part of its national savings invested with a belligerent, it would seem common sense to assume that at the least:

1) Pressure will be brought to bear to limit China's weighting in benchmarks.

2) Pools of money directly controlled by the State, will be unlikely to be allowed to continue to invest in China.

3) Investment law will become increasing conflated with geo-political issues, and prone to economic sanction.

4) SOEs are more vulnerable than private companies although the demarcation line is blurred.

Reputational Risk: Can capital remain amoral?

ESG is symptomatic of the already existing trend to politicize capital

In recent years there has been a trend to conflate social and political values with commercial activity. The politicization of capital is not just about domestic, progressive values and the environment. The "s" is ESG – social responsibility – and human rights still have the ability to motivate consumers and complicity in their abuse, real or perceived, has the potential to be very damaging and bring commercially damaging opprobrium.

Mainstream financial media now reference China's Xinjiang policies as genocide

Mainstream, even neo-liberal leaning economic focused publications, such as the FT and the Economist, are starting to report intensively on China's human rights track record – particularly pertaining to Xinjiang. This is a marked departure from the relatively low level of interest shown by such publications in say, human organ harvesting or the persecution of the Falun Gong.

The sheer weight of legislation pertaining to China's behaviour towards its minority populations is overwhelming. A search of "trackgov.us" using the word "Uygur" reveals no less than 26 pieces of legislation that have been introduced into this congress. Legisla-

The weight of legislation pertaining to China and human rights is mounting and spreading to other jurisdictions

tion condemning human rights abuses and recognizing (calling out) China's treatment of minorities as genocide are pending. It is hard to believe that against such a backdrop, Companies with investments in China are going to escape severe scrutiny in coming years.

Fund managers, banks and other companies doing business in China should be aware of and plan for a potential popular backlash against their activities. Any brand conscious, consumer facing company needs to be able to answer such questions as "How has the genocide in Xinjiang altered your investment approach to China?

The scope for China operations to cause severe reputational damage is rising

Whatever one's own views about the politicization of investing, mitigation of any reputational risk that arises from investing in China seems a sensible course of action. Bifurcating Chinese operations from other business lines, both legally and from a branding perspective, and avoiding investments in SOEs and companies connected to the CCP would seem to be the minimal necessary action to take for those worried about changing perceptions towards China.

As China has become more autarkic since 2007, the impact of de-coupling will not be as pronounced in some areas as it would have been

Core capital market drivers.

As China has become more autarkic since the GFC, the impact of a de-coupling from the global economy now will be less than would have been the case a decade ago, never the less there will likely be an impact of inflation, growth and profitability.

Inflation & growth

De-coupling in isolation will likely be modestly inflationary

The period from the 1991 recession onwards has been typified by the struggle of central banks to sustain aggregate demand in the west at sufficiently high enough levels to absorb the increased supply of goods coming from the perennial current account surplus countries. China has not been alone in exporting deflation; Japan, in the past, and Germany more recently, have been large contributors to this trend.

In the period from 2001 through to about 2014, however, China was the big swing factor – exporting deflation through a current account

And lead to economic welfare losses

surplus that peaked at 10% of GDP. A policy driven attempt to secure supply chains through diversification away from China, could well prove somewhat inflationary for tradable goods, if and when, demand conditions return towards pre-COVID norms.

The tension between geo-economic policy and economic policy, implies that there will be a loss of economic welfare as politics takes the upper hand in policy making. Quantifying the costs from a deterioration in trade is hard: the political nature of the tariffs has impeded objectivity; most studies on the impact of the 2018 tariffs conflate industry specific tariffs that were applied to multiple countries, with the China specific tariffs, furthermore the impact of COVID obscures the impact of the tariffs in recent data, which is when producer welfare gains to the United States might have been expected to materialise.

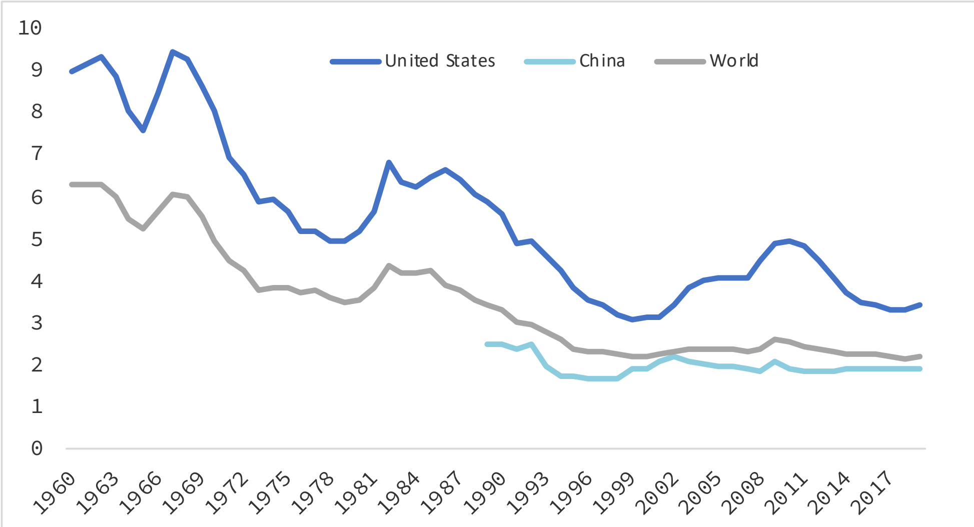
Most studies put the welfare losses (deadweight loss net of tariff collection) of the 2018 tariffs in the range of USD18bn to USD20bn per year to the US economy before taking into consideration any producer surplus gains from onshoring. It is probably fair to assume that the welfare losses to China are higher, given the greater dependency on exports and the asymmetric nature of the trade relationship. Nevertheless, the overall costs to each economy appear to be small in comparison to the size of GDP and represent a hit of maybe 0.3% of GDP to the United States and up to 1% for China. The gains have been made by third countries.

Defence expenditure could prove highly inflationary as in the past.

The bigger impact on inflation and growth may well come from the indirect impact of de-coupling. The increase in defence expenditure associated with Cold War 2, may have a similar impact as the Vietnam war did on US finances. Military expenditure has dropped by about 4 percentage points of GDP from the 1960 to now and is starting to creep up again, even in official numbers. A return to 1960s highs would entail about a USD3.5 trillion rise. In the United States, military expenditure was running at about 9% of GDP in the 1960s vs 3.5% now. In China the percentage of GDP officially spent on the military has been fairly constant at about 2% but obviously a rapidly rising GDP has change the nominal number dramatically. There is the further issue of PPP adjusting the China spend to reflect the efficiency of the military spending and of course the issue of domestic security spending, which is not included in the dataset but enhances China's military power.

Given the fiscal pressures in each country, any meaningful increase in military expenditure is likely to require central bank funding, with the potential knock-on impact into inflation.

Chart: Military expenditure as % of GDP: World, China and United States.



Source: World Bank

Indirect impacts on corporate profitability could be meaningfully larger than the direct impact

Profitability

While the likely direct impact on goods inflation and growth from a de-coupling of bilateral trade might appear modest, the impact on labour pricing and corporate profitability could be meaningfully larger. The biggest impact of China's rise in manufacturing has been to suppress the pricing power of labour globally, as a working age population of 600 million, which rose to 1 billion over twenty years, entered the global trading system and a price level back in 2000, of one-thirtieth of US levels. With per capita GDP still only one-sixth of that in the US, China's work force still has a deflationary impact on global wage levels and hence an enhancing impact on profitability and returns to capital. Exploiting this wage arbitrage was a business model in its own right for companies such as Li and Fung and US retailers such as Walmart. Trade diversion, onshoring and a renewed emphasis on supply chain resilience, combined with increasing awareness of carbon intensity in supply chains, is likely to be supportive of wages in higher cost economies. Hence, while US companies have limited direct profitability stemming from China, the indirect impact from a de-coupling could be very damaging to long term profit growth as bargaining power moves back in favour of labour.

Exchange rates

A successful US led geo-economic policy towards China will likely elongate the US dollar standard.

Is a bifurcation of the global economy dollar bullish or bearish? There is a good argument that, as China's economic rise manifests itself in greater assertiveness in the economic sphere, the RMB will at least in part replace the US dollar as an international currency. Indeed, that has been a modest trend of late, and there is an expectation that the digital Yuan could accelerate this process, particularly within the Indo-Pacific region. To achieve this, however, requires the Chinese monetary authorities to relinquish control over the capital account of the balance of payments and history suggests this is a big ask. Capital account liberalisation has taken the form of permissiveness under state control rather than a wholesale removal of state control. It is highly questionable as to whether the CCP is prepared sacrifice its control over the capital allocation process sufficiently to facilitate the wide adoption of the RMB outside of China. The more plausible and potentially achievable goal is to replace the dollar as far as possible with its bilateral trading partners-about 20% of global trade.

Equally, if the up-shot of the new cold war is to bring a number of other countries closer to the United States, both militarily and in terms of their economic connectedness, this period of economic conflict could well be associated with a strengthening of the Dollar Standard. One consequence could well be that a greater share of the economic costs are shared among Asian countries such as Japan, Australia and India and that Europe picks up the financial burden of its own defence. The assumption that the dollar is in a terminal decline in terms of its global position, is perhaps a mis-guided one and to the extent it is reflected in current exchange rates, a potential driver of dollar strength. The reassertion of hegemony by a US led coalition is more likely to elongate the dollar's role in the world economy.

The relocation of China's export orientated manufacturing could be among the biggest trends of the next decade

Relative winners and losers

At the country level, there are a number of contenders to at least partially replace China as manufacturing centres to service the US market. If current trends continue, up for grabs is about USD400bn of domestic value added that China exports to the United States, but potentially far more than that, if other countries, particularly the EU seek to diversify their supply chain as in fact Japan is already attempting.

The relocation of USD 2 trillion of manufacturing activity could have a transformative impact on some frontier and emerging markets

China has a 25% market share in global manufacturing value added, about 1.5x its share of global GDP. Just under half this domestic valued added is exported, about USD2 trillion. The relocation of such a dramatic proportion of world manufacturing activity will take time, but could have a transformative impact on less developed countries that are creating manufacturing proficiency.

Emerging and frontier markets stand to benefit from rapid growth in manufacturing

Mexico has seen exports and income levels stagnate over the past 20 years as China came to dominate in manufacturing and the period of great power rivalry presents an opportunity to regain the initiative. Within Asia, Vietnam is emerging as the destination of choice for low end manufacturing moving out of China. Perhaps the biggest impact of this redistribution of global manufacturing could be felt in sub-Saharan Africa, where cost competitiveness and demographics provide a strong tail wind and where momentum is building. Ethiopia, Cameroon and the Democratic Republic of Congo stand out as demonstrating strong existing momentum in manufacturing growth in Africa: Bangladesh, Myanmar and Vietnam in Asia. India, has the existing scale and domestic market size to capture market share rapidly if policy execution is improved. The potential boon to frontier markets from a restructuring of trade patterns is a subject we will explore in the future, but the table below shows 5-year compound annual growth rates for selected frontier/emerging economies in manufacturing value added. While the aspirant countries currently account for just 17% of China MVA, on current growth rates with a modest augmentation from geo-economic policy, they could account for close to 40% of China size by 2030 and have surpassed China by this metric by 2040.

Emerging manufacturing centres

Country Name	2013	2018	2013 /18 Cagr
Ethiopia	1,764,026,832.73	4,910,894,738.05	23%
Bangladesh	24,661,459,165.33	49,212,333,209.63	15%
Congo, Dem. Rep.	5,027,855,019.42	8,663,842,913.40	11%
Vietnam	22,832,775,310.87	39,225,645,461.36	11%
Cambodia	2,358,904,039.78	4,017,337,623.17	11%
Myanmar	12,003,268,250.56	18,859,448,804.23	9%
Cameroon	4,851,720,876.06	7,180,349,502.61	8%
India	283,206,246,517.88	395,688,247,275.27	7%
Bahrain	4,821,462,765.96	6,660,691,489.36	7%
Bolivia	3,043,801,302.46	4,167,012,445.73	6%
Saudi Arabia	74,152,352,986.67	100,748,315,733.33	6%
Bosnia and Herzegovina	1,988,203,787.93	2,669,339,770.67	6%
Guatemala	7,640,205,427.15	10,219,209,756.36	6%
Lao PDR	1,007,375,184.98	1,338,046,766.71	6%
Dominican Republic	9,146,371,307.23	12,093,709,822.26	6%
Sub Total	458,506,028,775.00	665,654,425,312.14	8%
China	2,935,340,069,079.05	3,868,458,282,950.42	6%
Other as % of China	16%	17.2%	

Source: World Bank

Manufacturing migrating away from China poses a big risk to China's economy

According to the World Bank, almost 95% of China's USD2.5 trillion of merchandized exports are in manufacturing. Allowing for 20% foreign value added in those exports, means that the domestic value added of China's manufacturing exports amounted to USD1.8 trillion out of the total USD3.9 trillion of manufacturing value added or 46%. Manufacturing in turn accounted for 30% of GDP. The EU and the United States alone make up 40% of the total exports. Other treaty allies such as Japan and South Korea also feature high on the list of China's export customers. This is the potential hit to China from an alliance led de-coupling and re-orientation of supply chains.

At the corporate level too there will be winners and losers from the displacement of Cold War 2

At the company level too, there will be a wide range of potential outcomes. Companies whose business models have been structured around China-centric globalization are finding their business models strategically challenged. Surprisingly, some of these appear to be in the process of doubling down on such a strategy. This is particularly true in the financial sector where credit rating agencies, investment banks, money centre banks and asset managers are responding to China's inducement of market opening by committing new capital and expertise to build China parts of their business. Time will tell is this is a sensible hedging strategy or a strategic mistake.

HSBC epitomizes the class of MNE with geo-politically challenged corporate strategies

HSBC perhaps epitomises the "foot in each camp" strategy, becoming the world's local bank and ignoring the geo-political ramifications of such a strategy, imbued with the experiences of the hyper globalization of the 1990-2009 period, an exceptional rather than normal time in my view. Its share price is currently below its 1998 Asian crisis low and it is probably the case that the China / Hong Kong business and the remainder would carry a higher valuation if separated from each other, reflecting the new (or emerging) reality of the bifurcated global economy. Ironically of course, HSBC and Standard Chartered Bank, are well placed to profit from the relocation out of China of manufacturing if they re-oriented their priorities.

Jurisdictional risk vs diversification benefits and returns.

As jurisdictional risk rises, investors can no longer assume they enjoy support form their host or from their own Government

In an era in which economic interconnectedness is viewed with suspicion, through the prism of the potential geopolitical leverage it may produce, investors can no longer assume that their own Government will be supportive of their actions and defend their rights – even if they could. Nor can they assume that the host country will act in a way that continues to encourage the in- bound flow of investment, unless of course they see it as enhancing their national power. The key questions should be; Who is this investment benefiting? What externalities is it creating? Who would rather it did not happen and what can they do about it that could harm the profitability?

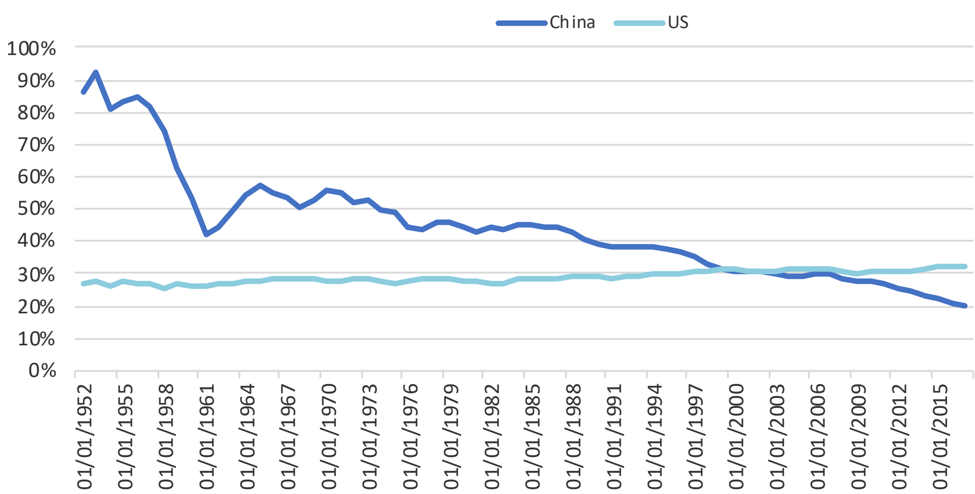
De-coupling might enhance the diversification benefits of investment in China

Market-driven International investment has been about two things: the hunt for higher returns than those available in the domestic market and the search for portfolio efficiency through diversification benefits. In the case of China, the diversification benefits are likely to stem from two factors: the sense that economic growth and therefore the drivers of asset price performance are increasingly endogenous as China de-couples from the global economy and secondly, the fact that foreign ownership is relatively low, particularly in the case of the mainland markets.

In aggregate is their a compelling case that Capital invested in China will produce superior returns?

In the case of return enhancement, optically, nominal fixed income returns in China may look relatively attractive. Adjusting for jurisdictional risk, and the fact that the real effective exchange rate is at a high, the case may be less compelling. Perhaps the key macro question that should be asked is this: If China has enjoyed the highest sustained investment rates that the modern world has ever seen over the past 40 years, and domestic savings have exceeded domestic investment in all but a handful of those years, and the efficiency of the investment – its ability to generate growth measured by say Total Factor Productivity or Incremental Capital Output Ratios – is declining, what are the chances of investments in China producing superior returns in aggregate?

Falling Returns on Investment in China GDP/Capital stock



Source: Penn World Tables

Diversification benefits could fall if foreigners become more heavily invested

All this is not to say that there will not be some spectacularly good investments to be made in China, but the macro headwinds are extremely strong. The sustainability of any diversification benefits are questionable. Returns are largely dependent on a continuation of foreign inflows into the market. As foreign ownership rises, cross-correlations with other asset classes will likely rise as it is the financial interconnectedness that gives rise to higher correlations.

Jurisdiction risk drivers a wedge between the cost of capital for locals vs foreigners...does RMB upside compensate for jurisdictional risk?

Finally, jurisdiction risk has the effect of raising the cost of capital for foreign investors relative to locals. Given, China's relatively closed outbound capital account, and the huge pool of savings trapped in the country, if locals face a lower cost of capital, assets will be priced accordingly. By definition, therefore foreigners will be buying assets that do not meet their risk adjusted return threshold, unless they believe that the currency strength of the RMB will be sufficient to compensate for the jurisdictional risk they are running.

CONCLUSIONS

The new cold war environment means that the "politics" has very much been put back into "international political economy". This will entail economic costs and will be a drag on fundamental drivers of capital market returns such as profitability, growth, and inflation. The re-ordering of trade patterns presents an opportunity for some frontier markets. The bifurcation of the global economy, and the growing level of policy interference, means business models orientated around a smooth China-US economic relationship look severely challenged. Jurisdictional risk has raised the cost of capital for Chinese companies operating overseas and foreign companies operating in China, probably to an extent that means all but the most profitable will retreat. The potential for policy coordination among likeminded nations, means that the risks to investors will be spread beyond just the United States and China.

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