Gavekal Research

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Learning To Live With US-China Strategic Rivalry

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Agenda

- **China's domestic position is strong:**
  - Politics: post NPC, Xi is firmly in charge, with no term limits and with an institutional agenda to strengthen the Party's control over governance
  - Economy: stable growth in 2018, led by a strong construction cycle; financial risk looks more contained
  - Key policies: Made In China 2025 (industrial/technological upgrading); Belt and Road (international grand strategy)
- **The rivalry with the US is rapidly becoming more intense:**
  - Consensus is growing in Washington that the US is in a race with China for technological leadership; economic cold war is the answer
  - "Trade warriors" in US administration also want China to dismantle its industrial policy system
  - Section 301 sanctions are probably just the beginning

China: resilient and self-confident

It's now Xi's China until further notice

- Xi Jinping now dominates China's political system:
  - At 2017 Party Congress, stacked the Politburo with his followers
  - At 2018 NPC, abolished term limits, so can stay in power past 2022
  - Key aides: VP Wang Qishan, Liu He, financial and economic czar
  - Xi controls the Party , and the Party controls government
- Xi's agenda less personal than institutional: to create a governance system that will outlast him and push China to great-power status before 2050. This means:
  - Increased central control of local government through Party discipline
  - Stronger party-state management of the economy; markets are a tool of the state not an independent force
  - Ambitious industrial policy: "Made in China 2025"
  - Continued assertive yet pragmatic foreign policy: "Belt and Road"

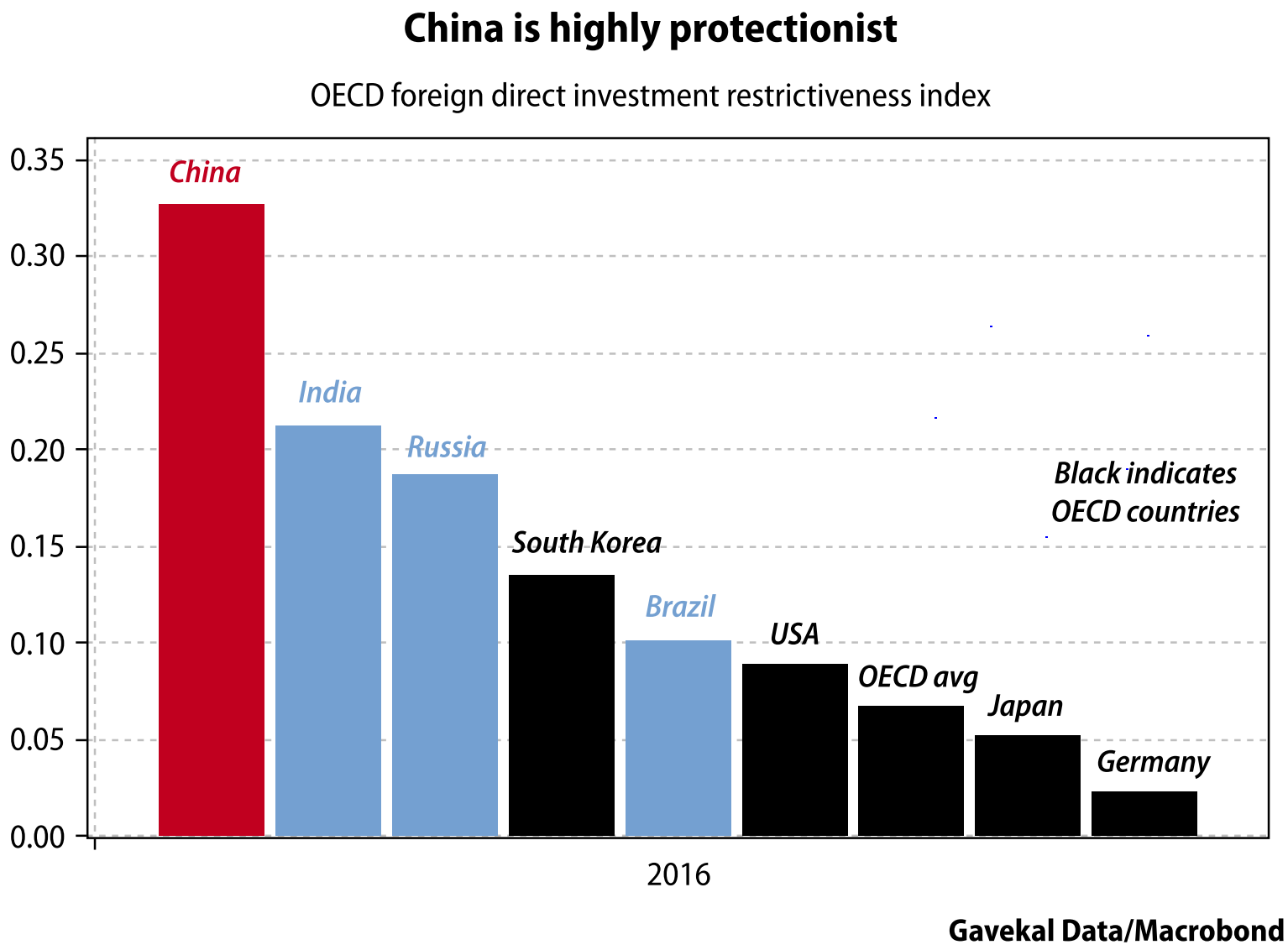
The economy under Xi

- Economy:
  - Escape from the 2015 trough depended on both credit/housing stimulus and surprisingly successful supply-side constraint.
  - Recovery survived a strong financial crackdown and credit slowdown in 2017.
  - Growth, industrial production, construction and capex look roughly stable in 2018; supply-side policy means moderate inflation can continue; policy emphasis on financial de-risking and pollution control will act as a brake. Risks are on the upside.
- Finance:
  - "De-leveraging" goals: reduce corporate debt/equity ratios and intra-financial system leverage, stabilize gross debt/GDP.
  - Financial crackdown targets interbank borrowing and speculative finance; credit to the real economy is actually stable/accelerating.
  - Destruction of leveraged asset traders (Anbang, HNA, Wanda) is probably a positive development.

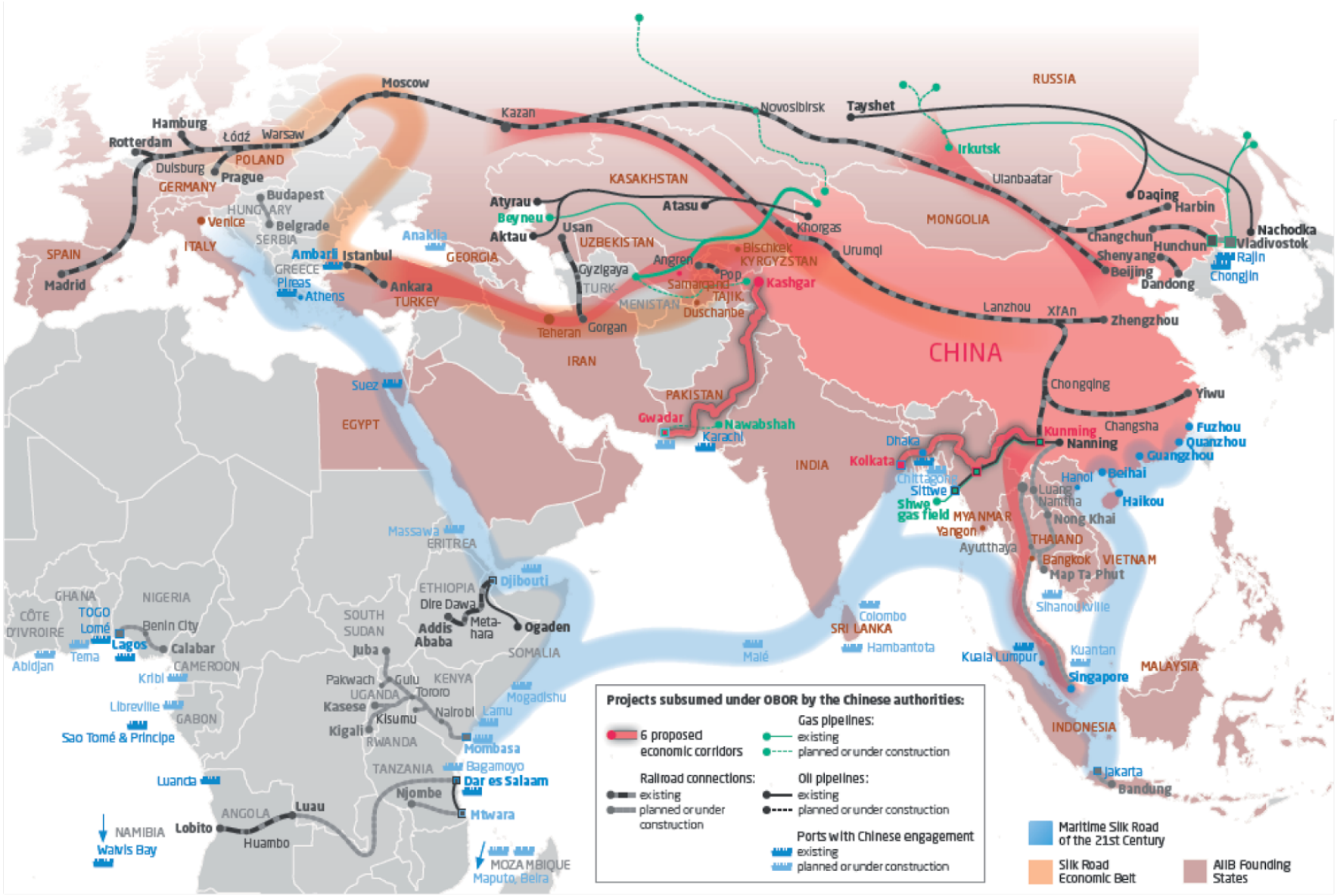
Industry/technology: China has huge and well-financed ambitions

- Made in China 2025: a broad industrial policy with many goals:
  - Improve manufacturing productivity by better use of IT
  - Develop capacity/leadership in many tech-intensive sectors (AI, robotics, new-energy vehicles, semiconductors, etc.)
  - Import substitution: 70% domestic self-sufficiency in "basic core components and important basic materials" by 2025
- Massive funding:
  - US$232bn spent on R&D in 2016, with nearly 80% by companies
  - Government venture funds: US$328bn in capital (1/3 for ICs)
  - Private funds: US$100bn in venture capital; US$1.2trn in private equity
- Central Commission for Integrated Military and Civilian Development (founded in 2017) raises fears that much Chinese tech development—especially AI—will turn to military use.

Ambitions are combined with extreme protectionism

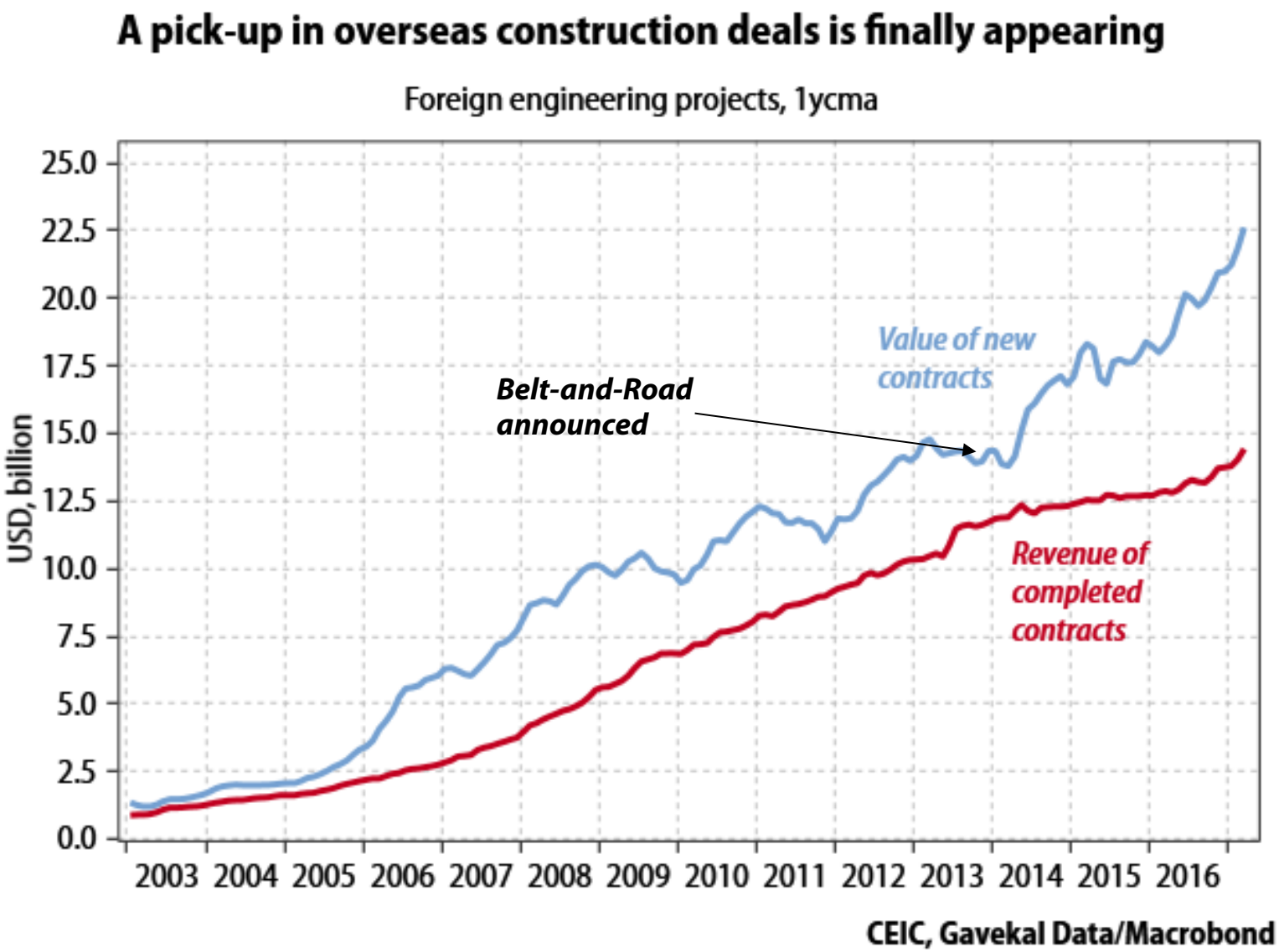


Belt and Road Initiative: A grand strategy for Eurasian integration



Source: Mercator Institute for China Studies

BRI built on past trends; unclear how much new investment it creates



China's construction and engineering firms steadily increased their international presence for a decade before the Belt and Road Initiative was formally announced.

After the BRI announcement, there was a surge in new contracts, but actual engineering revenues flat-lined. This suggests that political incentives to sign new deals were greater than the number of bankable projects.

But revenue growth began to pick up in 2016, when 61 Belt-and-Road countries generated construction revenues of US$76bn (vs contracts of US$126bn).

Making sense of the Belt and Road

- BRI is not just a laundry list of infrastructure projects.
- It is a "grand strategy" for a) promoting economic integration (first regionally then globally) through physical connectivity, and b) gradually extending China's economic and political influence.
- It is an alternative to the US-led model of economic integration via trade and investment agreements. With the US withdrawal from TPP, BRI is "the only game in town."
- A new twist: the "China Option": China encouraging other countries to adopt its infrastructure-driven growth model.
- In the short run, BRI creates an "infrastructure arms race" with Japan, especially in Southeast Asia.
- The long-term question is whether the competing Chinese and American visions of economic integration will co-exist or conflict.

The US-China rivalry

Trade war – or economic cold war against China?

- After a year of dithering, Trump unleashed steel and aluminum tariffs—mainly hurting allies, not China.
- Next, two scenarios:
  1. Broad trade war on all fronts (e.g. Nafta is torpedoed)
  2. Future trade actions will more tightly target China
- Power in the administration is held by an alliance of two groups:
  - **Trade warriors** (e.g. USTR Lighthizer; trade advisor Navarro)
  - **National security hawks** (e.g. Defense Sec Mattis; CIA chief Pompeo)
- Trade warriors / security hawks don't agree on everything, but could agree on a strategy of technological "cold war" against China, with the aim of constraining its rise and denying it technology.

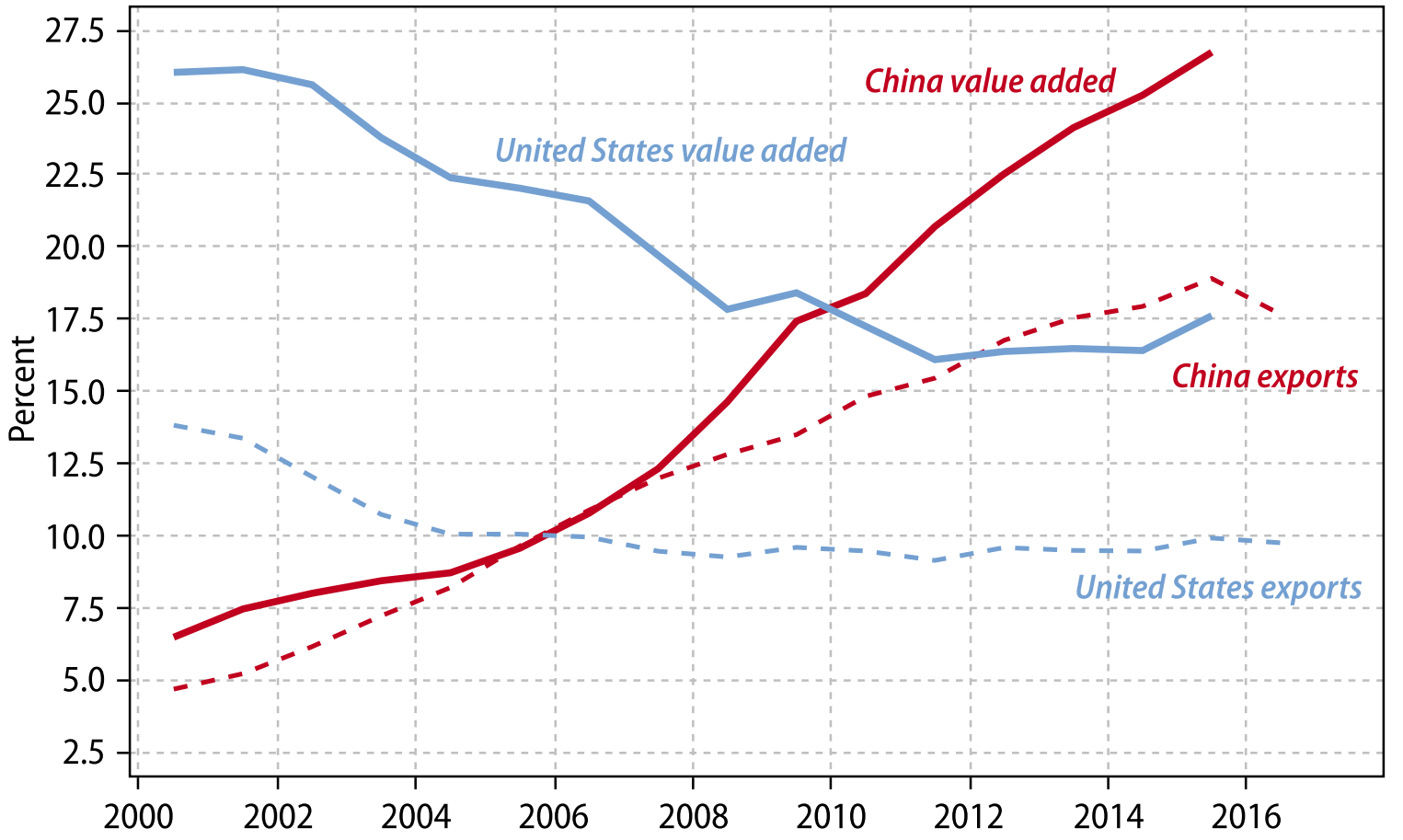
The US anti-China agenda

- China has been defined as a "strategic competitor" (National Security Strategy, National Defense Strategy; IPR Report)
- Demand that China cut its surplus with the US by US$100bn
- Next: Section 301 sanctions (tariffs, quotas, investment curbs)
- Other measures under consideration:
  - More blocks under CFIUS; legislation to broaden CFIUS mandate
  - Restrictions on Chinese SOE and tech-related investments in US
  - Limits on Chinese students/workers in US in tech fields
  - Tighter export controls
- Key point: this is <u>not</u> a transactional approach aiming for better access for beef, financial services etc. The strategic aims are:
  - (Trade warriors): Get China to dismantle its industrial policy system
  - (Security hawks): Win a race for technological supremacy by denying access to US technology assets

US talks deficits, but really worries about manufacturing/tech mojo

China has surpassed the US as the world's biggest manufacturer

China and United States share of global manufacturing value added and exports, %



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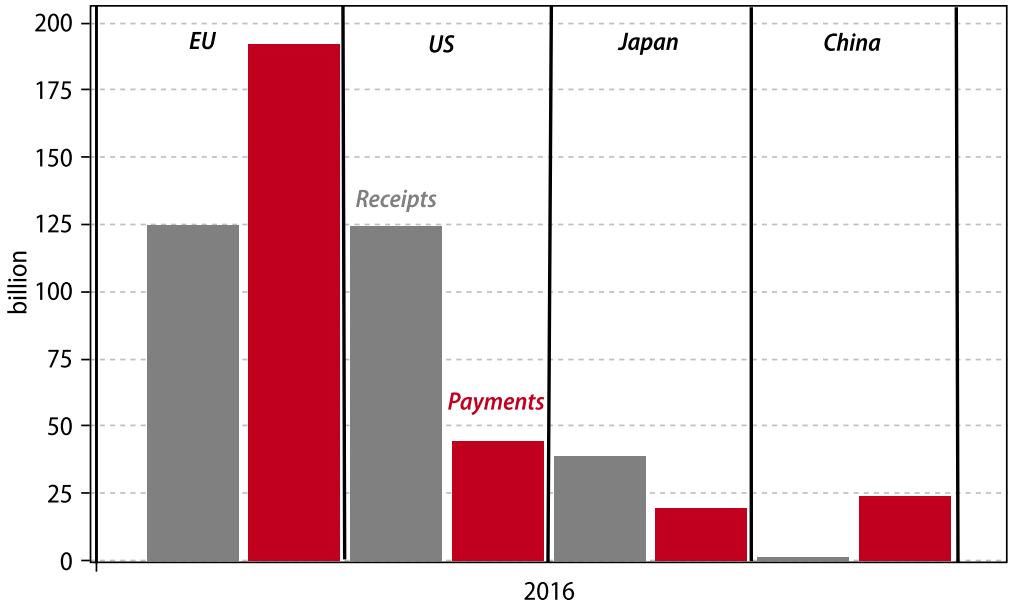
Reality: China is still in technological catch-up mode

China buys far more IPR than it sells

International IPR licensing charges, receipts and payments, 2016 (US$bn)



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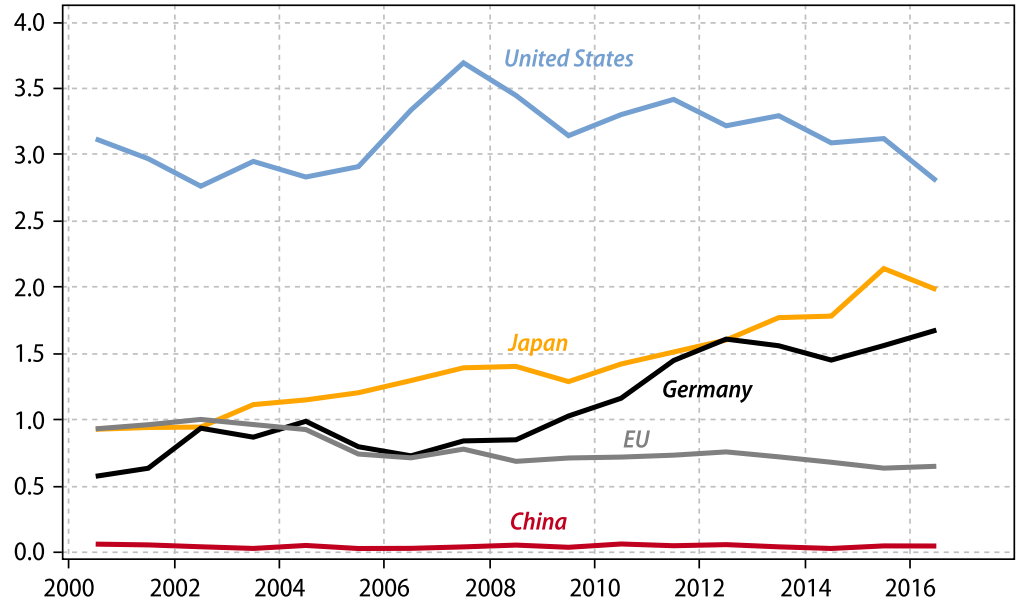
China is not obviously closing the technological gap

International IPR licensing charges, ratio of receipts to payments



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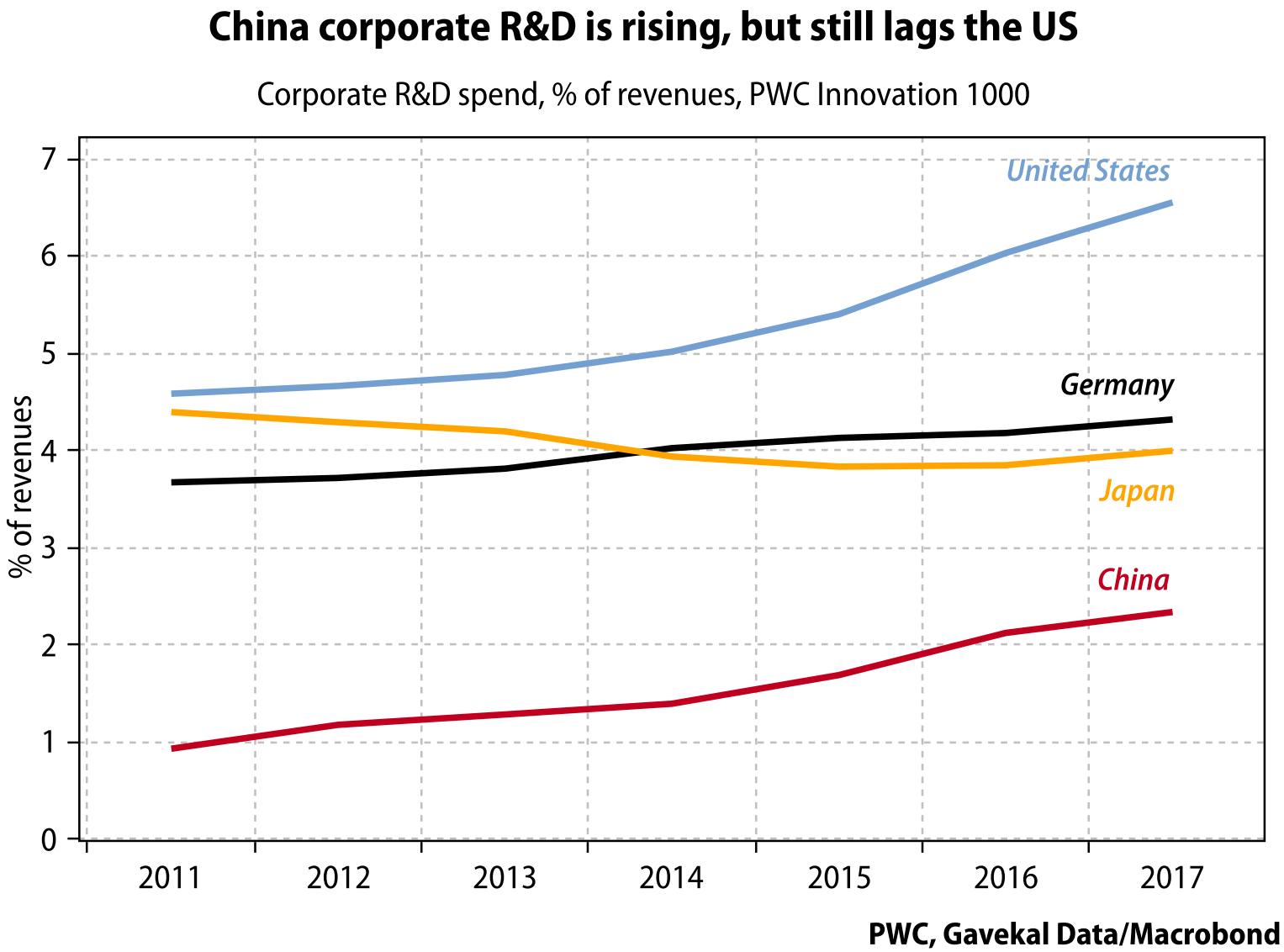
Chinese firms are making impressive progress in many sectors, and should not be underrated as international competitors. But data suggests that as a whole, China is still far from the global technological leading edge.

One test is international IPR licensing fees. The strong US technology sector runs a big royalty surplus each year, earning US$125bn and paying out US$44bn. China earned just US$1.2bn in 2016, while paying out US$24bn.

On average, US firms earn three dollars of IPR royalties for every dollar they pay. Japanese and German firms have steadily strengthened and earn two dollars for every dollar they pay out.

Chinese firms earn just a nickel for every dollar they pay—a ratio one-sixtieth that of the US. And the ratio has not improved over the past 17 years. On this measure at least, China is not yet a true contender for tech leadership.

Chinese companies ramp up R&D spending, from a low base



Foreign firms still dominate China's high-tech exports

Domestic company share of high-tech exports, %

	2005	2012	2015
All products	**8**	**12**	**19**
Medical equipment	14	34	41
Telecoms equipment	11	26	26
Electronic appliances	7	6	16
Semiconductors	14	13	14
Integrated circuits	2	5	12
Computers	1	1	3

Source: China High-Tech Yearbook 2016; Kennedy, The Fat Tech Dragon (CSIS, 2017)

What are the impacts?

- US will continue to ramp up actions against China; investment flows will be at least a big a target as trade.
- China's initial reaction will be to play it cool, responding with WTO suits against "illegal" US actions, and tit-for-tat tariffs on specific products.
- Impact of a 25% US tariff on US$100bn of Chinese exports: lost of about 0.3pp of Chinese GDP. This is material but manageable; and can be offset by infrastructure stimulus.
- Closing off of US markets and technology will cause China to double down on its tech-intensive industrial policy.
- Chinese investment capital, blocked in the US, could flow elsewhere.
- Worst case: broad-brush US trade war slows down global GDP growth.

Contact and disclaimer

Thank you!

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