PALOS

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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The China Question: An Economic Cold?

On the third of May, the S&P 500 peaked at 2946. Since then, it has registered a decline of 160 points (5.5%). Contrary to past market weakness, the dollar has traded defensively, consumer sentiment has continued to be upbeat, the recession risk has remained stable, and the estimates for Q2 growth were lowered but positive for period under review.

It follows that market sentiment has been mainly affected by worsening global trade tensions between the two largest economies. Linking Huawei to a trade deal is creating even more suspicions that the US is trying to cut short the global clout of China before it gets too big to compromise, or just too late. The sheer contemplation that we might fall in the "Thucydides Trap" is chipping away at investors' faith that the temperature will cool down. The ''Thucydides Trap" is named after the Greek historian who chronicled how Sparta's fear of a rising Athens made war between the two inevitable. Graham Allison in his famously acclaimed book—Destined for War: Can America and China Escape Thucydides's Trap—examined 16 earlier rivalries between an emerging and an established power and found that 12 of them led to war. Although one may not prescribe to Karl Marx's notion that history is deterministic, one could say that there is a 75% chance that the trap is happening. Examples of such conflict being avoided are rare. Given that both sides believe that they have legitimate reasons to pursue their objectives, an escalation of geopolitical tensions, as it pertains to the economics of technology, seems unavoidable.

On the one hand, the progress that China has made in the application of technology in building massive infrastructure programs like the "Belt and Road Initiative", in boosting its military advancement, and prowess is viewed by the National Security Agency as a competitive threat. On the other hand, the Americans have insisted that China reaps big benefits from the globalization of the investment and trading systems and has had a free ride on its rules. Meanwhile, the Chinese are suspicious that the U.S.'s real intention is to ensure their dominance of the A.I., 5G, and IOT space.

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In this limited respect, the trade issues could be resolved. As a matter of fact, it has been reported by all the trade negotiators that a deal was almost completed a month ago. Unfortunately, it did not transpire. New dynamics have entered the space. Now, the negotiations may spill over into a perpetual stalemate, perhaps animosity, over technology.

Andy Browne, editorial director of the Bloomberg New Economy, reminded his audience that the U.S. has a long history of not wanting to be eclipsed in science and technology—think of the long struggle against the Soviet Union and the short struggle with Japan. I'm not sure where lies the "Chinese Sputnik". Was it in 2010, when Chinese hackers forced Google to leave China? Or, in 2014 when President Xi Jinping declared that China would pursue homegrown core technology, squeezing IBM, Microsoft, Cisco, HP and others out of their markets and stressing the need for secure and controllable technology in critical areas? In 2015, when the Chinese cyber-authorities banned Facebook, Twitter, YouTube and Instagram altogether in the name of "Internet Sovereignty" along with NYT, WSJ and the WP. What about the time when the Chinese military stole the plans for Lockheed Martin's F-35 stealth fighter and made their own carbon copy, avoiding all the R&D costs—NYT. In 2016, when President Xi launched a whole-of-government effort to pursue high-tech autarky under the symbol "Made in China 2025". This initiative which targets up to 90% of market share in advanced industries, is a program that strikes at just about every U.S. technology company operating in China.

There you have it—-a ferocious pushback by the U.S. that has the support of both the Democrats and Republicans. China assails the resistance as "McCarthyism in high-tech fields" and urges a "people war" and a "Long March". Thus, technology supply chains are already exiting China. According to U.S. Census, year-to-date data for January to March 2019 shows that U.S. imports of Chinese advanced information and communications products decreased $10.0 billion versus 2018. As mentioned in last week's commentary, some form of peaceful co-existence will likely be implemented until companies operating in China have fully adjusted their supply arrangements. It will take time. In nominal terms, Sino-American trade totals $750 billion. Plus, the process could balkanize the world economy into two incompatible economic blocs, forcing foreign countries to pick a side. Using a wrecking ball is not the way to settle this impasse. Trump must get off his high horse and stop his juvenile use of Twitter. Meanwhile, Xi needs to realize that China can longer enjoy the trading privileges that it acquired in 2001 for joining the WTO. The days when trading with China was all about simple consumer products are over. We are in new era of science where an amount of trust under a set of rules is needed, because technology like 5G is very expensive, and can be easily embedded in a country but difficult to replace once implemented.

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This a pivotal moment for them because everything is now coming to a head. Game theory teaches that “winner takes all” brings about serious unresolvable conflicts; however, also teaches us that constructively managed cooperation under healthy competition makes only winners. The latter begs the question as to whether all this fuss is about national security and trade secrets, or about dominance in the technology sector. If it’s strictly about the former, it would be internationally resolvable. Advanced countries, God willing, could prevent foreign technology companies from being Trojan horses by introducing good security practices such as forcing them to obey patent laws, to test equipment in domestic labs, to list their stocks on international stock exchanges, and to share ownership with the importing countries in the form of subsidiaries or joint partnerships. Such measures would give assurance to national security concerns and submit them to standards of transparency. If it's about the latter, a full-scale cold war could erupt, triggering a de-globalization of trade and in turn making a win-win deal impossible. The “Thucydides Trap” would put the entire world in peril.

Whatever happens, the Sino-American differences will surely replace the Middle East as the most important geopolitical issue of the next decade. Given the growing size and sophistication of China’s domestic market, it’s likely that China, even on its own, will end up with many leading technology companies. China has already joined the ranks of the technologically advanced countries--Turbines, Smartphones, PC’s, Semiconductor Fabs, Chip Designs, Electric Cars...

I can only trust that reason will prevail and that the negotiators will succumb to the “better angels of their nature”. There can only be one good solution in the offing—-the acceptance of a peaceful coexistence between two rivalries. That could turn out to be good thing, because it would promote competition, innovation, and productivity.

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