

China-U.S. rivalry equals a reconfigured global supply chain

Tensions between China and the United States run much deeper than a conventional trade dispute. Rather, they are competing over which country will dominate tomorrow's technologies and become the world's preeminent geopolitical power.

Indeed, their rivalry has no precedent in post-war history. The United States had relatively few economic ties with the Soviet Union, so their geopolitical struggle seldom spilled over into trade. Where Germany and Japan are concerned, the impact of trade disputes has been limited by the fact that both these countries are U.S. military allies and democracies. In stark contrast, America increasingly views China as an authoritarian geopolitical rival intent on reducing its global geopolitical and economic influence. It is also a contest between two very different economic models: one, market-oriented, and the other, state-driven.

The mounting tension between the two countries was brought into sharp focus in early October in a hard-hitting speech by U.S. Vice-President Mike Pence highly critical of China.¹ He outlined a series of Chinese offences, including forcing U.S. companies to surrender technology in return for market access, launching cyber-attacks on U.S. companies and government agencies, and oppressing its own citizens.

To quote Pence: "Beijing now requires many American businesses to hand over their trade secrets as the cost of doing business in China. It also coordinates and sponsors the acquisition of American firms to gain ownership of their creations. Worst of all, Chinese security agencies have masterminded the wholesale theft of American technology - including cutting-edge military blueprints." **While such criticism has no doubt been delivered to Chinese officials before in private, this was the first time it was voiced in such a public and direct manner.**

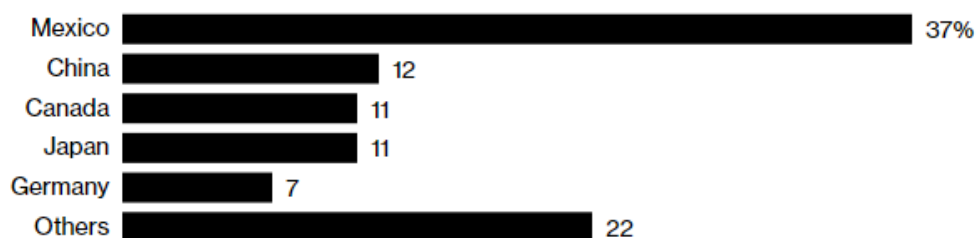
The United States-Mexico-Canada Trade Agreement targets China

The geopolitical rivalry between the two has also manifested itself in the United States-Mexico-Canada Trade Agreement. Indeed, preventing Chinese companies from gaining further market share in North America, particularly in the auto sector, is an implicit objective of the new deal:

- The new rule requiring automakers to increase the North American content of their vehicles from 62.5% to 75% in order to retain duty-free status takes direct aim at Chinese auto-part makers.
- The revamped trade deal also includes a provision that requires members to give notification of any trade negotiations with a "non-market economy." The clause in theory allows Washington to walk away from the new trade agreement. **Whether the threat of American withdrawal is serious or not, the mere risk could dissuade Mexico and Canada from pursuing tighter economic ties with China.** The United States will likely try to insert a similar clause in future trade deals with other countries.

America's Car Parts Suppliers

Of the \$149 billion the U.S. imported last year, China was the No. 2 supplier



Source: U.S. Commerce Department

Source: "Trump's Trade War with China May Hit Parts of Your Car First," Bloomberg, September 3, 2018

- The United States has also forced Canada to pledge that it would not be used as a backdoor for Chinese steel and other low-cost steel producers to enter the United States. To this effect, Canada recently unveiled new quotas and tariffs on certain steel products.

¹ "Vice President Mike Pence's Remarks on the Administration's Policy Towards China," Hudson Institute, October 4, 2018

Strong U.S. bipartisan and public support for tougher stance on China

There is another factor fueling trade tensions between the United States and China. While many U.S. law-makers have been critical of tariffs imposed on the European Union and other countries, the vast majority of Democrats and Republicans feel that a tougher line needs to be taken against China. **The Democratic U.S. Senate Minority Leader Chuck Schumer recently stated that one of the only Trump policies he supports is the administration’s tougher approach on China.**

Even more importantly, under the Foreign Investment Risk Review Modernization Act passed by the U.S. government last August with strong bipartisan support, the U.S. Committee on Foreign Investment will be able, as of November 10, to review a much wider array of deals. These will include joint ventures and smaller investments by foreigners in American businesses that produce technology deemed to be of critical importance. Previously, the committee was entitled to examine only transactions aimed at taking over or gaining a controlling stake in American companies.

The American public also feels China has engaged in unfair trade practices

Americans' Views of Fairness of Trade Policies Vary Widely by Country

For the following countries, please tell me if you believe each has a fair trade policy or an unfair trade policy with the United States.

	Fair %	Unfair %	Don't know/ No opinion %
Canada	65	24	10
European Union	56	29	15
Japan	55	33	12
Mexico	44	46	11
China	30	62	9

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Further, about one in five members of the American Chamber of Commerce in China has admitted to being pressured to transfer technology. Among these companies, 44% in the aerospace sector and 41% in the chemicals sector have reported significant pressure. **Given the long-held reluctance among western companies to criticize China for fear of retaliation, it is safe to assume that the real figure is higher.**

The gradual partial unwinding of supply chains between two countries

The driving force behind this gradual unwinding is the desire of both countries to become less reliant on the other. Indeed, the main goal of Made in China 2025 is to shift Chinese consumption of high-tech products away from foreign manufacturers, specifically American ones, to domestic companies. **As for the United States, its tighter rules on Chinese investments in U.S. companies and screening of supply chains for national security vulnerabilities is an attempt to at least partially disentangle itself economically from China.**

Over the longer term, U.S. firms will relocate some of their supply chains to the United States and/or low-cost countries such as Vietnam, Malaysia, Mexico, and Thailand.

But moving a supply chain out of China is easier said than done, especially in the short term.

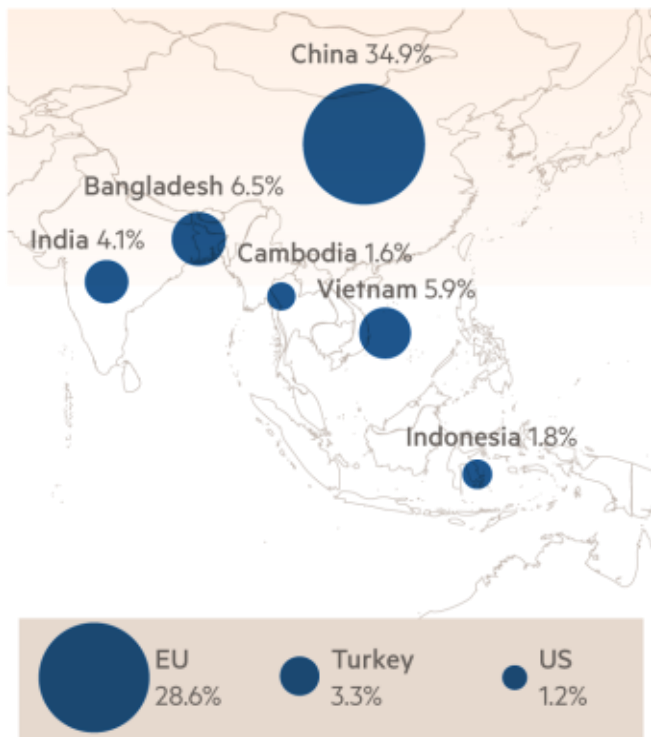
This is because while labour costs have gone up, China still retains many advantages. These include well-developed infrastructure/logistics, skilled labour, and access to a huge internal market.

All of these attributes have made China the centre of the technology sector’s global supply chain. While U.S., Korean, Taiwanese and Japanese companies remain leaders in designing semiconductor chips and other IT hardware, much of the work of installing these components into products, such as motherboards and iPhones, is done in China. In all, Chinese factories install two-fifths of the world’s semiconductors.²

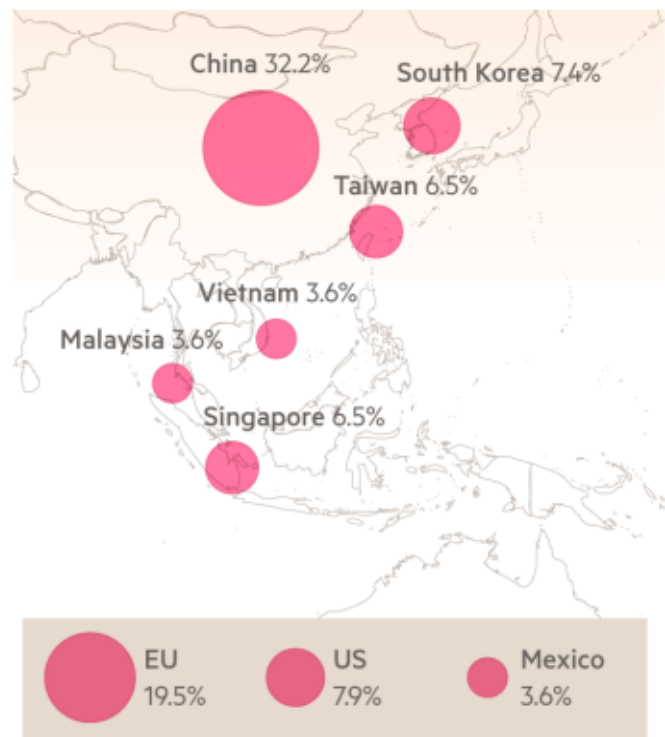
Top exporters in the global supply chain

Share in world exports in:

Clothing, 2017



Office and telecom equipment, 2017



Source: World Trade Organization
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Source: “US-China trade war prompts rethink on supply chains,” Financial Times, September 3, 2018

Despite the challenges involved, some companies have managed to reduce their exposure to China.

Concerns that their supply chains had become overly reliant on China prompted certain Japanese and Korean companies to shift some of their operations out of China to Southeast Asia. One of the factors behind this move is China’s habit of punishing them when geopolitical tensions flare up with their home countries. For example, last year the Chinese government organized a boycott of South Korean products to punish the South Korean government for deploying an American missile-defence system. Although the system was intended to protect against an attack from North Korea, China said it could also be used to threaten China’s defences.

² “China’s grip on electronics manufacturing will be hard to break,” The Economist, October 11, 2018

Samsung, the world’s leading smartphone manufacturer, is one company that has managed to reorient its supply chain away from China. Since 2009, it has shifted most of its production to Vietnam. As a result, Vietnam has become the biggest exporter of such devices after China. Samsung employs more than 100,000 people in Vietnam and accounted for about one-quarter of the country’s total export revenue last year.³



The Economist

Adidas, the shoemaker, is another case in point. In 2017, about 19% of its footwear was produced in China, down from 30% in 2012. Over the same period, its footwear production went from 31% to 44% in Vietnam.⁴ Even though China is trying to move up the value chain, it is still heavily reliant on the production of cheap goods to employ its vast population of low-skilled workers. Though China has made impressive progress in reducing poverty, the World Bank estimated in 2017 that nearly 500 million Chinese still earned less than \$5.50 per day.

Is a united front forming against China?

China’s nightmare scenario is that the United States, the EU and Japan form an alliance to combat its trade practices. Not long ago, China was relieved when the United States undertook trade actions simultaneously against several countries, as opposed to only targeting China. **But now that trade deals have been struck with Canada, Mexico and South Korea and that negotiations have begun with Japan and the EU, the risk of an alliance forming against China has resurfaced.**

³ “Why Samsung of South Korea is the biggest firm in Vietnam,” The Economist, April 2018

⁴ “Adidas sees ongoing sourcing shift from China to Vietnam,” Reuters, May 9, 2018

In fact, the EU and Japan recently joined forces with the United States to launch a WTO complaint against China's forced technology transfers. EU Trade Commissioner Cecilia Malmstrom recently said: "There's no secret that we think China is a big sinner here."

Signs China and the United States are headed for a long drawn-out geopolitical tug-of-war

- In a recent widely publicized report, the Pentagon found that "China represent[ed] a significant and growing risk to the supply of materials deemed strategic and critical to U.S. national security," including a "growing number of both widely used and specialized metals, alloys and other materials."⁵
- In late September, a Chinese warship came within 45 yards of a U.S. warship performing a Freedom of Navigation Operation near the Spratly Islands, a group of islands in the South China Sea that China and other countries claim as their own. The manoeuvre by the Chinese navy was perceived as much more aggressive than usual.
- An October report by Bloomberg alleged that China's People's Liberation Army inserted tiny espionage chips into the motherboards of servers when they were being assembled in China in order to spy on U.S. corporations and government agencies. China has denied this accusation, and responded by stating Edward Snowden revealed in 2013 how America's National Security Agency used hidden vulnerabilities in IT products to spy on China and other countries.
- In early October, the Congress approved the Build Act, a US\$60-billion development program intended to finance projects all over the world. The goal is to compete with China's One Belt One Road infrastructure plan. Growing concerns that China's infrastructure plan is leaving some countries overburdened with debt has afforded the United States an opening to promote its development plan.
- On October 10, it was announced that a Chinese intelligence official had been extradited to the United States to face espionage charges after being arrested in Belgium. The United States wanted to send a signal that it would henceforth respond more vigorously to corporate espionage.
- In addition to imposing countervailing tariffs on U.S. imports, China has responded to U.S. moves by cutting its own tariffs on numerous non-US goods in an attempt to steer the Chinese from U.S. products.

Conclusion

Growing tensions between the United States and China are being driven by two narratives. On the one hand, the United States feels that China's ultimate aim is to replace it as Asia's preeminent geopolitical power by any means necessary. On the other, China feels that America's actions are not only meant to gain increased market access, but also to constrain China's rise as a global power. Both views have an element of truth.

The situation has provided both countries with an incentive to reduce their reliance on the other's supply chains. Over the long term, companies may need to set up two supply chains, one with access to the United States, the other with access to China. This will mean higher logistic costs for many companies.

The situation will also accelerate the emergence of two major economic systems: One embracing a more state-driven model that tolerates little political dissent, and the other advocating a more free-market and democratic model. The one perceived to deliver the best results will increasingly be emulated by other countries, particularly in the developing world.

This growing geopolitical rivalry will also likely impact co-operation in other areas. Indeed, there are already signs that China has relaxed enforcement of sanctions against North Korea. Also, China's pledge not to ramp up purchases of Iranian oil after U.S. sanctions have been imposed could be reversed.

⁵ "Assessing and Strengthening the Manufacturing and Defense Industrial Base and Supply Chain Resiliency of the United States," U.S. Department of Defense, September 2018

Geopolitical Briefing

While we do feel that armed conflict between China and the United States remains highly unlikely, history shows that in periods when an established global power is challenged by a rising power, geopolitical tensions tend to rise significantly (see chart below). Current tensions are amplified by the fact that never before in history has a nation emerged as quickly as China.

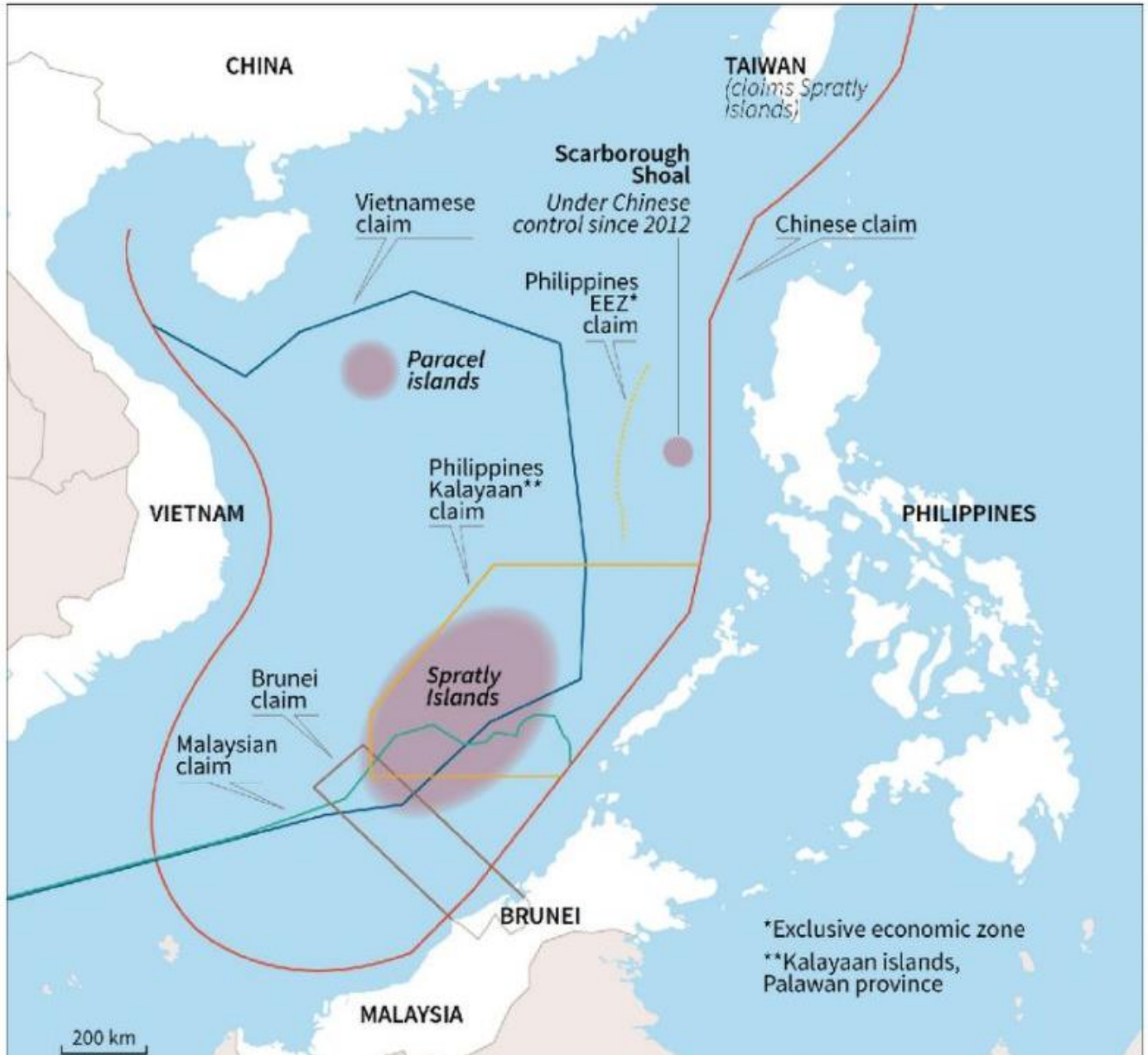
Inevitable tensions between rising and established global powers

	Period		Ruling Power	Rising Power		Result
1	First half of 16th century		France	Hapsburgs		War
2	16th–17th centuries		Hapsburgs	Ottoman Empire		War
3	17th century		Hapsburgs	Sweden		War
4	17th century		Dutch Republic	England		War
5	Late 17th–early 18th centuries		France	Great Britain		War
6	Late 18th–early 19th centuries		United Kingdom	France		War
7	Mid-19th century		United Kingdom, France	Russia		War
8	19th century		France	Germany		War
9	Late 19th–early 20th centuries		Russia, China	Japan		War
10	Early 20th century		United Kingdom	United States		No war
11	Early 20th century		Russia, U.K., France	Germany		War
12	Mid-20th century		Soviet Union, U.K., France	Germany		War
13	Mid-20th century		United States	Japan		War
14	1970s–1980s		Soviet Union	Japan		No war
15	1940s–1980s		United States	Soviet Union		No war
16	1990s–present		United Kingdom, France	Germany		No war

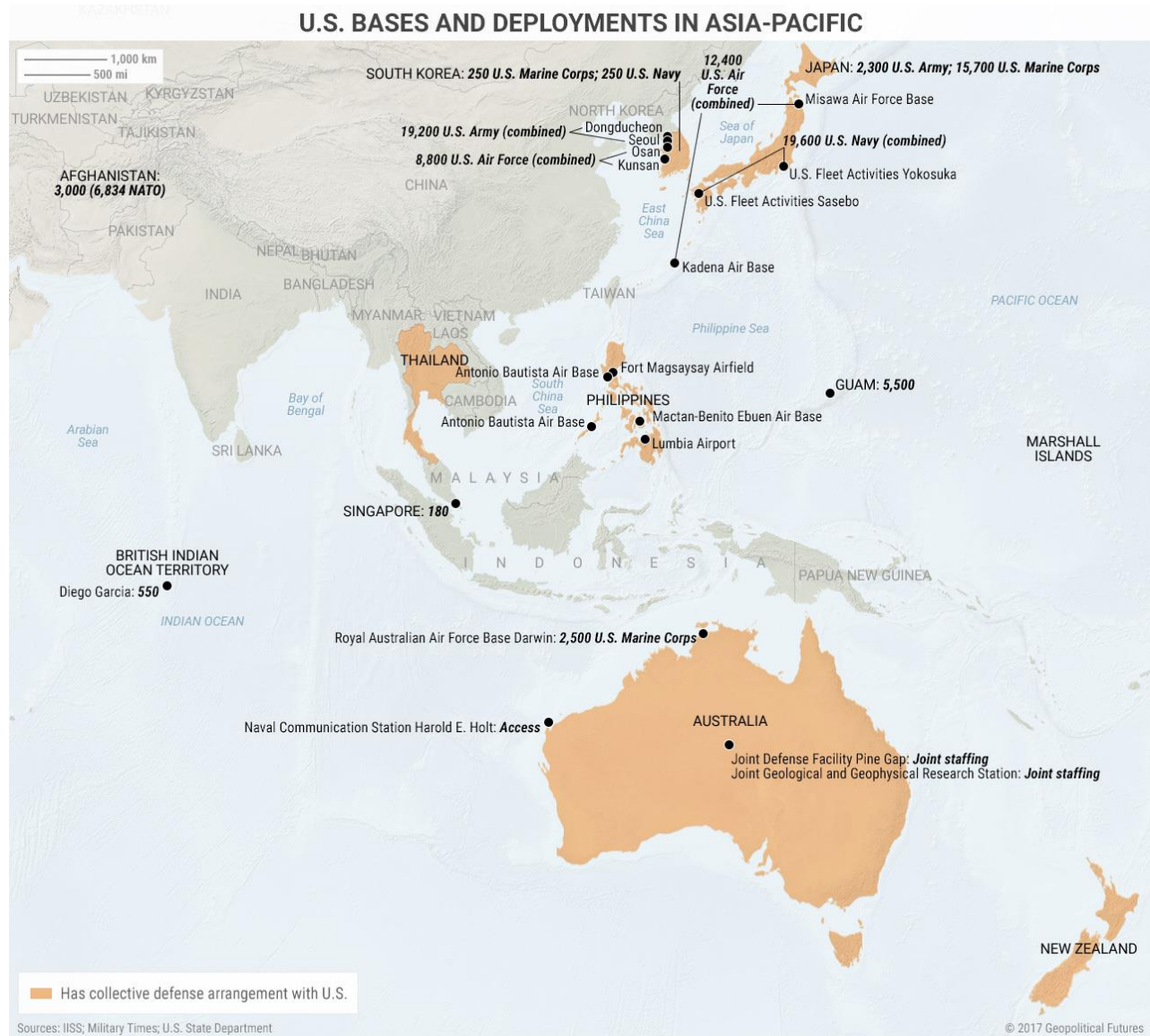
Source: Harvard Belfer Center(Graham Allison), 2015

As the maps below illustrate China and the United States are locked in competition for influence in Asia. They also raise two questions: 1) Should China's sphere of influence in Asia at least be partially recognized by the United States? 2) How would the United States react to this many foreign military bases near its homeland?

Disputed claims in the South China Sea



Source: South China Sea: Facts about Asia's maritime flashpoint, AFP, June 2016



Source: Geopolitical Futures, 2017

In this global environment, investors must do more than simply analyze a country's - or a company's - fundamentals. In assessing a country, they must also look at any ongoing or potential future tensions with trading partners, since such conflicts can significantly impede access to key markets. Similarly, when assessing a company's prospects, investors must focus on the country that the company considers its home base, and determine if that country's relations with its main trading partners are strained in a way that might impact its bottom line.

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