

Three Focal Points for the U.S.-China Relationship

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- The recent U.S.-China summit kicked off with U.S.-China relations at a low point. The ongoing shift in U.S. policy towards China—hastened under the Trump administration with the support of both political parties—was long in the making and effectively ended the U.S. doctrine of strategic engagement that facilitated China’s global rise during the preceding four decades.
- With this context, we touch upon three focal points—investment, technology, and national security—that will likely define the U.S.-China relationship in the years to come.
- While the diplomatic tone may moderate and the two sides may find common ground in areas of mutual interest, we do not anticipate any fundamental changes in the U.S. stance towards China.
- Furthermore, China’s response to the increasingly fraught relationship remains an open question and a key underappreciated risk within financial markets.

Setting the Stage

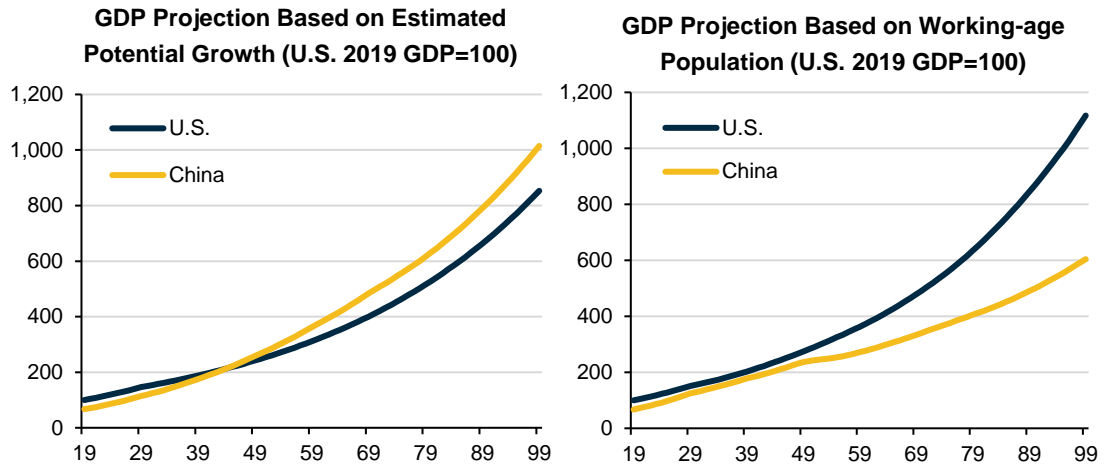
At its most fundamental level, the new, more confrontational relationship between the U.S. and China reflects growing concerns about the latter’s seemingly unstoppable ascent as an economic superpower during the “Chinese Century,” to use a consensus phrase among geopolitical analysts. However, these concerns require some perspective in terms of the current positioning of the two countries.

Yes, China is the world’s second largest economy with significant catch-up potential remaining. Yet, its working-age population is already declining, and productivity gains are increasingly hard to come by.

Figure 1 illustrates the issue: while a straightforward projection of the past GDP growth trend would indeed place China at the top of global economies over the current century (as shown in the left panel), correcting for projected working age population growth and extrapolating productivity growth trends flips the projection in favor of the U.S. More than anything, we believe this dynamic—particularly along the critical nexus of technology and productivity—will set the stage on which the longer-term global rivalry will evolve.

Figure 1: Productivity and Population Will Determine China’s Long-term Economic Prospects

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Source: PGIM Fixed Income as of March 2021

China’s rising military assertiveness combined with its globally expanding diplomatic and economic clout under Xi Jinping as General Secretary of the CCP has raised U.S. concerns about a potential irreversible shift in the balance of power between the two countries. Against this background, the Biden administration has initiated a strategic review of the entire set of U.S. policies and measures towards China. While it is too early to know the outcome of the review, recent statements from President Biden and senior administration officials signal a recalibration, rather than a fundamental change, in U.S. policy.

This will likely dash Beijing’s hopes for a return to the pre-Trump status quo, which, in turn, may prompt China to stay the course with its more assertive global stance.

While perceptions that China’s trade practices economically harm the U.S. and its workers continue to grab the attention of policymakers and the press, the future of the relationship increasingly revolves around three key topics. They include China’s widespread use of its trade and economic ties as leverage to advance its strategic goals; its efforts to assume a dominant technological role; and national security issues, such as the growing geopolitical tension in the South and East China Seas, China’s heightened presence in Hong Kong, and its moves to suppress domestic opposition, including ethnic and religious minorities.

The following provides some perspective on how each issue may evolve going forward.

China’s Leverage of its Economic Power. The fate of the so-called “Phase 1” trade deal continues to draw media attention as China’s imports from the U.S. remain woefully short of targets (Figure 2). However, purchases have recently accelerated, particularly of agricultural goods, and both sides have expressed an interest in maintaining the arrangement.

Yet, solely focusing on trade misses a bigger issue. China may be tempted to use its market size as leverage considering that the sales of U.S. companies and their affiliates in China far outweigh the value of imports from the U.S. (Figure 3). In a not-too-subtle way, [the agreement on the China-EU investment treaty](#) flags potential risks to U.S. corporations doing business in China in the event that their market access is deemed unnecessary and is subsequently restricted or revoked.

Technology is a foremost issue in the U.S.-China relationship—China sees a critical need for technology-led productivity enhancements, while the U.S. is unwilling to relinquish its sizable technological edge to a strategic competitor.

Figure 2: Phase-1 Trade Deal Remains Off Target

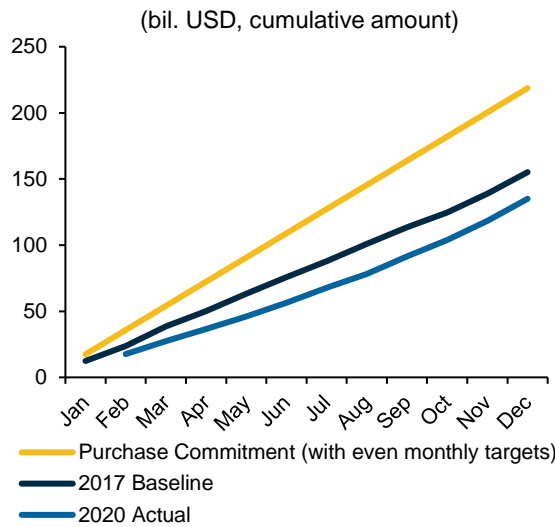


Figure 3: Yet, the Fixation on Trade Far Misses the Point

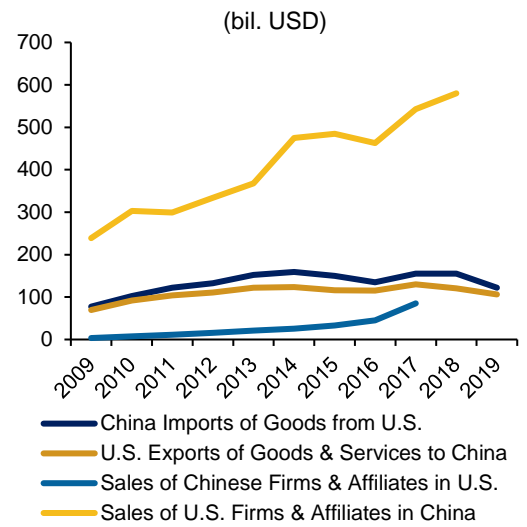


Figure 2 Source: PGIM Fixed Income, China Customs, and IMF Staff Calculations. Figure 3 Source: Haver Analytics, CEIC, and IMF Staff Calculations. Note: The annual target for 2020 is \$219 billion, assuming China keeps its imports of other U.S. goods that are not covered by the “Phase 1” agreement at the 2017 level of \$47 billion.

Technological Competition. Technology is a foremost issue in the U.S.-China relationship—China sees a critical need for technology-led productivity enhancements, while the U.S. is unwilling to relinquish its sizable technological edge to a strategic competitor. The national security dimension of the technology sector makes any material easing of trade restrictions unlikely with the Biden administration already indicating that it expects to keep the bulk of existing restrictions in place. For its part, China has publicly aired the prospect of banning rare-earth exports for U.S. defense uses and has continued to press for the adoption of its 5G technology in allied countries.

As a result, bifurcated global platforms will likely emerge for 5G and other emerging technologies, such as artificial intelligence. This may pose some hurdles for China, which has recently stumbled in converging to global technology standards, including those for microchips and aircraft engines, despite significant investments. Furthermore, the International Monetary Fund has recently estimated that China’s substantial productivity gap (70% below the global frontier) has deteriorated in key sectors as the renewed focus on the state-led economic model has stifled innovation. In terms of a potential retaliation, experience suggests that a rare earth ban would be unlikely to cause lasting harm as alternative supplies would be forthcoming, albeit at potentially higher costs.

National Security and Geopolitical Risks. The Biden administration has highlighted the importance of working with like-minded allies to address China-related challenges, which is a point not lost on Beijing. Success, however, is far from assured. China wields hefty economic and political influence over U.S. allies in Asia and in Europe, and it will likely continue trying to peel more of them away from the U.S. Few U.S. allies would want to alienate China by

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openly supporting an anti-China coalition for fear of a retaliation by Beijing. Thus, no matter how well-designed the new U.S. strategy towards China may be, the Biden administration will face significant implementation hurdles. This does not mean that the two sides won't be able to reach out and develop constructive relations on "win-win" topics, such as climate change.

Historians have highlighted the risk of the so-called "Thucydides' Trap" where the mismanaged rivalry between an existing and newly ascendant power can lead to armed conflict. That is not our base case. Yet, the concept clearly maps out an extreme tail event. The most immediate risk however likely stems from U.S. efforts to sway the balance of power in the Asia-Pacific region even more strongly in its favor by restoring and rebuilding ties with regional allies. Combined with the U.S. drive to re-invigorate the West's value-based democratic model in juxtaposition to China's communist-party led model, the shift in the U.S. and allied military posture in the Asia Pacific region presents a threat to regional stability.

These issues are most clearly interlinked when it comes to Taiwan. China's threat to reunify with Taiwan is real and credible. Beijing has increased its military presence across from the Taiwan Strait and carried out military drills that simulate an invasion of Taiwan on nearby islands. And more recently, the Chinese military has ratcheted up the incursions of the island's airspace in a show of force to the Biden administration. Biden's response has been to reaffirm the United States' "rock-solid" commitment to Taiwan.

Such unequivocal support for Taiwan will almost certainly continue as the U.S. is legally obligated to enhance the island's defensive capabilities. To the extent that Taiwan does not push for outright independence from China, the risk of a U.S.-China military confrontation over the island remains low.

However, in a scenario where the economic and military gap between the U.S. and China remains, the West's largely rhetorical reaction to China's accelerated integration of Hong Kong could embolden China to be more assertive towards Taiwan. It's a risk the markets have essentially overlooked to this point.

Conclusion

While the Biden Administration offers the prospect of a fresh start to U.S.-China relations, we continue to see three contentious points that will likely set the tone between the world's two largest economies.

Beyond the fate of trade deal phases, China can exert significant economic leverage via the market access it provides to U.S. companies and affiliates. We also expect something of a technological "arms race" between the countries, likely resulting in competing platforms across a range of cutting-edge technologies. Furthermore, the geopolitical risks between the countries cannot be overlooked: China will likely attempt to bolster its relationships with U.S. allies while continuing to take a hard line towards Taiwan.

Although the two sides may find more common ground on less contentious topics, these three points will likely cast a chill over the relationship and pose attendant investment risks going forward.

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