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The US-China relationship has become hostile

~ Implications for the economy and investments

A fundamental shift has occurred in the US stance regarding China. The Trump administration will probably rapidly take actions one after another to contain China for two reasons, First, the United States has reached a critical point where it is no longer possible to allow China to continue pursuing its salami-slice strategy. Basically, this strategy entails using a series of actions that have become effectively a fait accompli for enlarging its sphere of influence and control. Second, President Trump views measures for attacking China as one of the keys to his hope for a second term. Initiatives include the formation of diplomatic alliances and diplomatic sanctions like closing China's US consulates. Furthermore, at this stage, even some type of limited military action is conceivable, perhaps involving one of China's artificial islands in the South China Sea.

US-China tension is increasing rapidly. Investors need to be even more vigilant regarding the short-term outlook. When it finally becomes clear that China is unable to withstand US actions, investors will probably have an excellent opportunity to go bottom fishing. This opportunity may appear before the November US presidential election.

US-China decoupling is already starting. The US objective is to weaken the Chinese economy by building a global supply chain over time that excludes China. About three years from now, companies and investors will probably have to choose either the United States or China as an ally, thereby repudiating the other country.

(1) The Trump administration has switched from a defensive (sanctions in response to cheating) to an offensive (change China's Communist Party) stance

The US posture regarding China has shifted 180 degrees from defense to offense. Until now, there were only passive US demands for China to end improper and illegal activities. From now on, though, the ultimate US objective is to change China's Communist Party. This requires an active stance that includes the consideration of every possible action, including the use of military force. The rapidity of US actions may increase and the Trump administration may not be concerned very much about the associated cost and side effects any more.

We have seen a dramatic shift in the Trump administration's stance since the middle of June. The US position regarding China was entirely defensive until the enactment of the Hong Kong national security law. On June 13, US Secretary of State Mike Pompeo proclaimed that "Beijing's claims to offshore resources across most of the South China Sea are completely unlawful." This was a fundamental shift from the prior consistent US policy of neutrality concerning border disputes.

About the same time as this statement, many high-ranking Trump administration officials were giving speeches in which China's Communist Party was regarded as an enemy. In a speech on June 24, national security adviser Robert O'Brien said that exposing the beliefs and conspiracy of the totalitarian Chinese Communist Party would be good for the wellbeing of people worldwide. In a speech on July 7, FBI Director Christopher Wray warned that the Chinese Communist Party has used influence over democratic countries, a network of secret information, large-scale cyberattacks and other actions to inflict enormous damage involving

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the US economy and national security. In a speech on July 16, Attorney General William Barr said the United States response to the global ambitions of the Chinese Communist Party may prove to be the most important issue for the world in the 21st century.

Hostility subsequently escalated to the July 22 order to close the Chinese consulate in Houston and the July 23 speech by Secretary of State Pompeo at the Richard Nixon Presidential Library and Museum in California. “Xi Jinping is a true believer in a bankrupt, totalitarian ideology. It is this ideology that informs his decades long desire for global hegemony of Chinese communism,” said Mr. Pompeo. He went on to declare that the traditional approach to US engagement with China has failed. Mr. Pompeo therefore proclaimed at President Nixon’s birthplace the end of a China policy that started almost 50 years ago with President Nixon’s historic trip to China in 1972. For changing China’s behavior, Mr. Pompeo said, “Maybe it’s time for a new grouping of like-minded nations, a new alliance of democracies.” He believes that if the free world does not change, Communist China will surely change us. “If we do not act now, ultimately the Chinese Communist Party will erode our freedoms and subvert the rules-based order that our societies have worked so hard to build.”

(2) The US may establish a new long-term China strategy and even take extreme steps like military action

In a Wall Street Journal op-ed, foreign affairs and policy expert Walter Russell Meade said that Beijing’s neocommunist (so-called “digital Leninism”) is far more dangerous than Lenin’s model of communism. He believes the United States must not allow neocommunist to control the world. He also thinks that we should regard the Trump administration’s actions as demonstrating the resolve to create a strategy for blocking China’s ambitions. If the Chinese Communist Party should be targeted as something to be changed (in effect, an enemy), then no excuses are needed for action. Any type of initiative should be on the table.

Extreme possibility 1 – A long-term US strategy for bringing down the Chinese Communist Party

If this actually happens, this view that is currently only an unlikely outcome could very well end up being right on target. In a Fox News interview on July 20, former White House chief strategist Steve Bannon said that President Trump has an integrated war plan for dealing with the Chinese Communist Party. Mr. Bannon believes the first step is confrontation and the second step is to take down the party.

Extreme possibility 2 – Limited military action, such as an attack on an artificial island in the South China Sea

On the Gendai Business website, journalist Daisuke Kondo on July 21 said that President Trump may decide to attack one of the South China Sea islands that China has constructed. There are virtually no Chinese civilians on these islands and the Permanent Court of Arbitration says the islands are illegal. Furthermore, attacking the islands is unlikely to spark an all-out war with China because the islands are about 1,000 kilometers from mainland China. The Trump administration would probably increase its approval rating by telling the American people that they had destroyed structures created by the evil China.

China’s hopeless position regarding the South China Sea and East China Sea

For China, the South China Sea is a region of life-and-death importance. George Friedman, one of the leading US strategists, says that China depends on shipping routes along its east coast, which faces the South China Sea and East China Sea. He calls this China’s “hopeless vulnerability” (“Who Rules the Western Pacific?”, Sankei Shimbun, July 24).

The Chinese government would probably be shocked to see the United States demonstrate its control of the South China Sea, which China is attempting to convert into its own territory. In addition, a US action of this nature would force people worldwide to respect the power and resolve of the United States, which many people have despised because of the US stance of abandoning its role as the world’s policeman.

More military actions by the United States

In July, the United States held two exercises in the South China Sea led by the aircraft carriers Nimitz and Ronald Reagan. Between July 19 and 23, joint naval military exercises took place with Japan and Australia. In addition, the United States is clearly demonstrating its support for Taiwan. This includes supplying F-16 fighters in 2019 as well as mines and Patriot surface-to-air missiles. Moreover, Taiwan was invited to participate in RIMPAC (Rim of the Pacific Exercise) while China was left out.

President Trump views measures to contain China as key to winning a second term

Why has US policy changed direction now? First, China's arrogance has reached the point where it can no longer be tolerated. Britain is angry about the Hong Kong national security law. India is angry about China's border incursions. Australia is angry about China's initial concealment of the COVID-19 outbreak and so called Invisible Invasion which is the title of best seller book describing Chinese irresistible influence in Australia. As a result, the timing is perfect for the formation of an alliance to contain China. Second, President Trump has positioned China initiatives at the center of his campaign for reelection. There will probably be even more actions for holding down China and altering public opinion. Donald Trump and Joe Biden are likely to compete in order to show who is better at standing up to China. This will probably be detrimental to the Biden campaign.

(3) China is focused solely on economic stimulus measures and an asset bubble and must therefore simply ignore US verbal attacks

The United States has stepped up criticism of the entire Chinese system rather than only specific aspects of China's activities. China has no effective way to respond to this criticism. At the June 17 meeting between top US and Chinese diplomats in Hawaii, China offered compromises aimed at reducing tension between the two countries. However, the United States completely rejected China's offers.

China can probably maintain its economic supremacy for a while by using economic stimulus measures and encouraging the formation of an asset bubble. COVID-19 has given China many advantages. Most significantly, China has staged a V-shaped economic recovery as the first country in the world to bring the COVID-19 outbreak under control. The Chinese economy is currently performing very well. The current account balance, which has been China's Achilles' heel, has improved greatly. The trade surplus increased as exports in the second quarter of 2020 returned to about the same level as one year earlier while imports decreased. Overseas travel from China, the largest negative component of the current account balance, has plummeted. The result is an upturn in China's current account surplus as well as the growth of dollar reserves. At first glance, China does not appear to have any weaknesses.

Criticism of President Xi within China is unlikely to increase

There is no chance of US criticism bringing about political change in China, such as the fall of President Xi. One reason is that the older people in power are weakened by bribes and other improper behavior. Another reason is the president's establishment of complete one-man rule by using digital technology for checking and censoring information and a system for the oversight of what people say and do. A third reason the backing of public opinion due to patriotic lessons at school and the control of mass media. In addition, the president is protected by his control over the military.

Waiting for starvation tactics to weaken the Chinese economy

At this point, the only course of action for the United States is to remove obstacles standing in the way of its goals and then wait for the Chinese economy to weaken. Secretary of State Mike Pompeo believes that containment measures, which were effective against the Soviet Union, will not work with China. The reason is China's critical role in the global economy. Consequently, China will still have the ability for the time being to fuel its economy by increasing credit and public-sector expenditures.

After the COVID-19 crisis ends, we can expect to see an uninterrupted and prolonged period of rising stock prices and economic growth even if stock prices plunge briefly in response to the limited use of military force.

- ✓ The next Strategy Bulletin will follow up on this bulletin by examining the US-China conflict with respect to China's Achilles' heel and US strategies.

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