The cost of dominance

84 – 22 March 2021

Key points

- The high-level meeting between US and Chinese officials last week was acrimonious. The real issue is dominance. Old cold war concepts are en vogue again. There are crucial limits to those historical precedents, but the macroeconomic ramifications of a "superpower clash" are significant.

Beyond the immediate challenge of the pandemic, the US-China relationship is the main source of global instability. On this front, the newsflow is not encouraging. The meeting in Anchorage between the US Secretary of State and National Security Advisor with their Chinese counterparts did not start well. Antony Blinken raised the human rights issues in Hong Kong, Tibet and Xinjiang, as well as Beijing attitude to Taiwan. The Chinese side accused the US of condescension, questioned Washington's own record on human rights, but the key statement by Yang Jiechi was that "the US does not have the qualification to say that it wants to speak to China from a position of strength". The real issue is dominance.

Comparisons with the cold war between the US and the USSR are made more frequently in the US. We note some nostalgia for the Reagan era, when the US managed to exhaust their strategic competitor in a ruinous spending spree on military capability. We think the comparison is misleading. The Soviet economy was stagnating well before the competition with the US intensified in the 1980s, and the asymmetry in economic power was massive by then, while China continues to catch up quickly with the US. Beijing is drawing on the dividends on strong economic growth to upgrade its military power without sacrificing its other priorities.

Joe Biden's National Security Advisor Jake Sullivan quipped that the US should focus less on slowing China down and more about the US "running faster themselves". This is where Biden's foreign policy meets his domestic agenda. His "big investment plan" is designed to preserve the US technological leadership. This may work and deal with "secular stagnation". After all, the competition with the USSR underpinned the space programme which produced some key innovations and contributed to the development of the High-tech sector in the US.

Still, securing geopolitical dominance comes with a macroeconomic cost. The rise in US military spending under Reagan fuelled a persistent fiscal deficit and dependence on foreign investors which prolonged the phase of high real interest rates ushered in by Paul Volker's monetary tightening. Joe Biden is helped by an accommodative Fed, but he also found a very deteriorated twin deficit position to start with. The ongoing rise in market interest rates is a warning shot. Beijing may consider that the US will not have the wherewithal to "walk the talk", but a lesson from the old cold war is that overconfidence on either side is dangerous.

The ghost of cold wars of old

Scratch a macroeconomist long enough and, more often than not, a science-fiction buff will appear. Paul Krugman famously traced back his interest in the subject to his reading of Isaac Asimov's Foundation trilogy when he was a kid. We suspect he is not alone in this case. Your humble servant confesses that his latest sci-fi guilty pleasure is an alternate history TV series based on the premise that the USSR could have been first to land on the moon in 1969, re-starting the competition with the US, triggering a massive expansion in the space program ("For all mankind"). It seems that cold war references are en vogue in the pop culture. They abound in the commentariat as the US administration's top diplomatic team (the Secretary of State together with the President's National Security Advisor) are meeting their Chinese counterparts in Alaska. **The question for us is whether the right cold war reference is 1980, when the US chose to economically exhaust the USSR, or 1957, when the Soviet success in sending a satellite in orbit triggered a massive technological investment in the US to catch up**, pushing the technological frontier.

Let's start with the first historical precedent. The point was explicitly made in an Op Ed in the Los Angeles Times on 15 March by General McMaster – one-time National Security Advisor to Donald Trump – and Anthony Ward, an Oxford scholar. Their starting point is Ronald Reagan's Directive 75, issued in 1983, which epitomized the shift in the US foreign policy from seeking a détente and a degree of cooperation with the USSR, to exerting constant pressure on their strategic competitor. The idea was that the US could force the USSR into a ruinous spending spree on technology and military capability which would end up exhausting its economic capacity. This proved successful and **the two authors propose a similar approach to dealing with China: extinguishing the source of their strategic power, i.e., their economic might, instead of confronting it directly**. They offer a powerful mixture of restriction in western investment in China, *"constructing a new global trade and supply chain system that reduces dependency on China"* and blocking access to technology, together with *"maintaining preponderant military power in the Indo-Pacific region"*.

The 1957 precedent may be more relevant when it comes to Jake Sullivan, Joe Biden's National Security Advisor. In a wide-ranging piece in the New York Times on 17 March, which we think is essential reading, David Sanger and Michael Crowley highlight Sullivan's words on the campaign trail last year: *"we should put less focus on trying to slow China down and more emphasis on trying to run faster ourselves"* This is where national security concerns meet the economic thinking of the new US administration. **The big investment package which, more than the USD 1.9trn emergency fiscal stimulus currently implemented, is the President's central economic project, is also a key element in his foreign policy**. Retaining technological leadership is crucial to ensuring the US remains the world's dominant super-power.

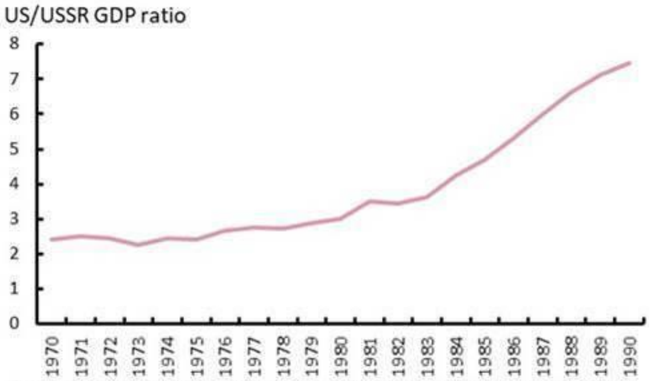
These two strategies are not mutually exclusive. **What we find striking is that – in another analogy with the evolution in the US strategic thinking at the end of the 1970s – no one is now defending a cooperative approach**. Only nuances of "standing up to China" are being discussed. Sanger and Crowley refer to a piece published in Foreign Affairs three years ago by Kurt Campbell and Ely Ratner. It was a thorough indictment of the approach pursued by successive US Presidents towards China since the 1990s. The dominant view then – that free trade and economic liberalization would naturally pave the way to political liberalization in Beijing and a friendly attitude towards the West - led to the US actively helping China to join the WTO and benefit from globalization. This did not detract Beijing from a course which Campbell and Ratner define as competing more and more aggressively with the US, not just in Asia but globally, for instance by *"watering down multilateral sanctions, shielding regimes from Western opprobrium, and making common cause with Russia to block the UN Security Council from authorizing interventionist actions"* The first sentence of their piece is quite striking : *" The United States has always had an outsized sense of its ability to determine China's course".*

An interesting point in our view is that Campbell and Ratner worked for Democratic administrations previously, and have joined Biden's team, the former at the White House, the latter at the Pentagon where he is in charge of an assessment of the military competition between the US and China. Contrary to a popular view in Europe, Democrats are not necessarily less hawkish than Republicans when it comes to foreign policy. The main tenets of the cold war strategy with the USSR were developed under a Democratic administration.

The limited lessons from Reagan's strategy

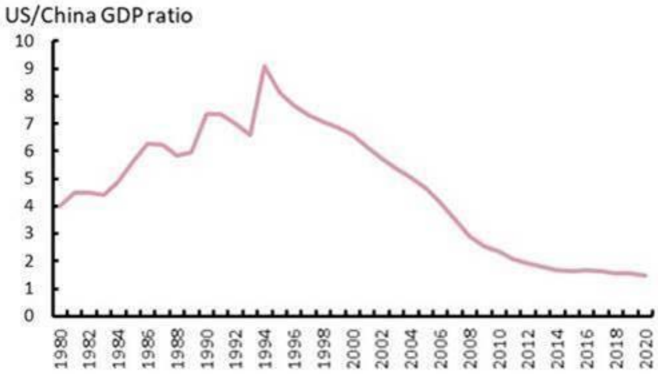
Historical precedents have their limits. The competitive pressure exerted by the US under Reagan very likely contributed to the economic demise of the USSR, which growth differential with the US widened markedly in the 1980s, but throughout the 1970s, although the US had to deal with two oil shocks, a slowdown in productivity and rampant inflation, the relative economic performance of the soviets had been slowly eroding. When Reagan issued Directive 75, the US GDP was already 3.6 times the USSR's, against 2.4 times at the peak of the Vietnam war (see Exhibit 1).

Exhibit 1 – The USSR was already losing the rate in the 1970s



Sources: United Nations, Bureau of Economic Analysis (BEA) and AXA IM Research, March 2021

Exhibit 2 – US vs China: an image in reverse?



Sources: OECD and AXA IM Research, March 2021

Command and control models can be fairly efficient in the early stages of development, when GDP grows essentially by pouring a massive amount of capital into a labour-intensive economy. They tend to lose the battle in the second stage when the economy needs to diversify away from investment to become more reliant on consumption, innovation and productivity. The inability of the USSR to turn into a consumer society was plain to see in the 1970s, when the Communist Party broke away from the timid economic liberalization of the early 1960s, largely out of fear of being unable to maintain its grip on society outside of a strict state-operated – not just state-controlled - economy. "

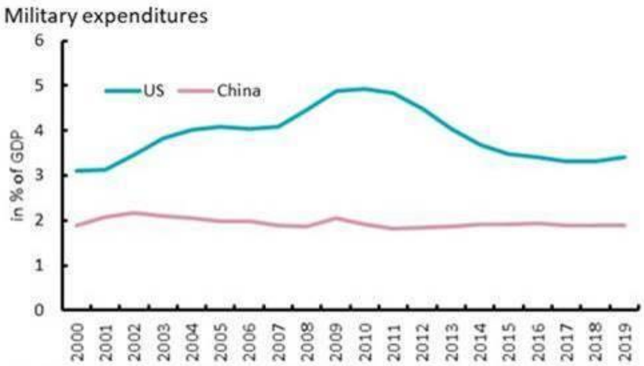
Wearing the USSR out was easily within the reach of the US in the 1980s. Anyone who had the dubious pleasure of riding in a Lada car 35 years ago may be able to match this theoretical point with a sensory experience. It's quite debatable when it comes to today's China. The US could probably have "smothered" China economically in the early1990s, in the wake of its victory over the USSR, when China's GDP was barely more than a tenth of the US (see Exhibit 2). It is questionable in our view if this is still in the US grasp, now that – measured in US dollars – the US economy is only 1.5 times that of China.

Every year, the US department of defence produces a report on China's military capability. Its tone is increasingly alarmist. We quote from the latest one: *"DoD's first annual report to Congress in 2000 assessed the PRC's armed forces at that time to be a sizable but mostly archaic military that was poorly suited to the CCP's long-term ambitions (…) the PRC has marshalled the resources, technology, and political will over the past two decades to strengthen and modernize the PLA in nearly every respect. Indeed, as this report shows, China is already ahead of the United States in certain areas"*. But what we find striking is that China has been able to do this without raising the share of its GDP spent on the military, according to data from the World Bank (see Exhibit 3). **China has been using the dividends of high growth to upgrade its military without sacrificing other priorities.** Transparency on defence spending is always an issue, but a report by the US Centre for Strategic and International Studies confirms the point. This is exactly the opposite of what occurred in the USSR in the 1980s where, at peak, military spending stood at 14.5% of GDP. Assuming Chinese GDP continues to grow at 5% per annum and the US at 1.75% (the current consensus estimate of its potential growth), without raising its share in GDP, the level of military spending in China would exceed that of the US in 30 years. In a nutshell**, China is not "overspending" on defence, but its strong growth allows it to continuously catch up with the US.**

McMaster and Ward push for a wide alliance to roll-back China's access to foreign markets. In the 1980s the US successfully marshalled the support of their allies, spooked by the USSR's apparent progress in the 1970s (in South-East Asia and Africa). The USSR was looking even more dangerous and politically strong even if its economy was stagnating. The Eastern European block was under complete control from Moscow after the intervention in Prague – and the (transitory) suppression of Solidarnosc in Poland in December 1981. In the current configuration, while on a regional basis some old allies of the US are clearly joining Washington DC in hardening the tone against China's assertiveness (before heading to Alaska, State Secretary Blinken stopped in Japan and secured an endorsement by Tokyo of Biden's muscular approach to Beijing), **there could be cracks in the West resolve to roll back China's economic emergence.**

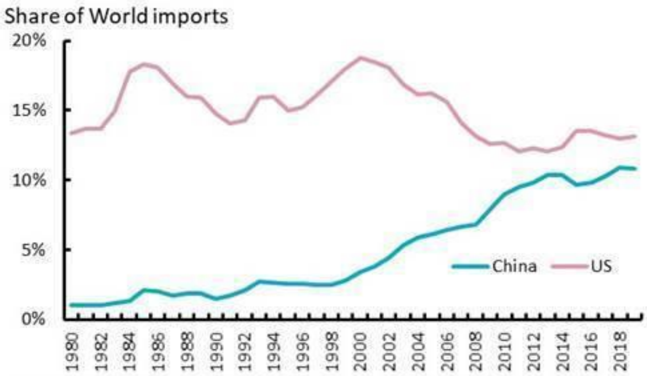
Indeed, this a key limit of McMaster and Ward's analogy with the early 1980s in our view. The USSR was a threat to the whole West without offering any viable economic opportunity (the soviet block was a "non-entity" for global trade at the time). China may be an economic threat – e.g., by hollowing the manufacturing base of more mature countries - but it is also a massive market opportunity, similar in size to the US (see Exhibit 4). Those planning to supply China can hardly curtail China's access to their own markets. We have already explored in Macrocast why the calculation for the EU is not straightforward, especially since Beijing offered European businesses a level of access to China which they US counterparts are far from securing.

Exhibit 3 – No "military crowding out" in China



Sources: World Bank and AXA IM Research, March 2021

Exhibit 4 – Who wants to choose?



Sources: International Monetary Fund and AXA IM Research, March 2021

The South China sea and the technological challenge

The Chinese leadership carefully studied the demise of the USSR and opted for a completely different economic strategy. **The conversion of China from an "invest and export" model to a more self-sufficient, consumer-driven economy is not complete yet**, **but the country is getting close to the point at which it can push the technological frontier on its own.** China ranks 14th among the 131 countries featured in the Global Innovation Index 2020, stable relative to 2019 and up three slots relative to 2018. To quote from the GII report – put together by the World Intellectual Property Organization - *"China stands out for producing innovations that are comparable to those of the high-income group, including the top 10 economies, such as the Netherlands, the United Kingdom, and the United States of America"*.

The US stands higher in the ranking (3rd in 2018), but looking ahead, its advantage could erode. True, the US is still by far in first position when it comes to fundamental research and the quality of its universities, but the performance of its primary and secondary school system is poor, while China ranks first in the PISA score for reading, maths and science. This should over time push the quality of higher education up as well – China already ranks 3rd on this component.

Still, **at the moment there are still areas in the technological race where China has not yet caught up, and they could be crucial**. We were intrigued a few months ago by a piece for Bloomberg by Andrew Browne. To roll out all the benefits of 5G, continued improvement in the capacity of micro-chips is needed. There are only three global manufacturers left at the most advanced stage in this field: US Intel, South Korea's Samsung and Taiwan

Semiconductor Manufacturing Company (TSMC), the latter two relying on US technology. China at this stage – Huawei in clear - is entirely dependent on Taiwan, while Washington tries to lure TSMC to build manufacturing capacity in the US and restrict Chinese companies' access to this vital supply.

This sheds a light on the US military interest in the South China sea. This is not just about protecting historical allies and securing supply lines in the West pacific. **Ensuring the territorial protection of Taiwan and its political independence from Beijing – and hence the continuation of its collaboration with the US – is part of the US technological strategy.**

The cost of assertiveness

Still, all this is part of the "slowing down China" approach, to return to Jake Sullivan's point. The risk is that all this turns into a "lose/lose" situation, with two sets of technical standards emerging, one for China and its sphere of influence and one for US allies, with global productivity growth as a victim. **From a collective welfare point of view, a focus in Washington DC on "running faster" would be welcome.** This is where Biden's investment plan comes into play, and this goes beyond ploughing more money into fundamental research and digitalization. The Global Innovation Index lists for each country the indicators on which it is faring less favourably. The quality of infrastructure is an area of weakness for the US, where it ranks 24th (to give a sense of reference to our European readers, France ranks 16th and Germany 12th). The new administration's focus on this issue is thus understandable. It also comes with a cost.

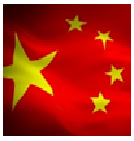
We have already discussed this in Macrocast. On paper, Biden's investment push is supposed to be 100% costed, as it would be offset by tax hikes, in particular at the upper end of the income ladder. However, political conditions – the need to get some Republicans on board – make this increasingly dubious. We think it is increasingly likely that such a fiscal push – assuming by now it is not already seriously dented by political capital spent on the emergency stimulus – would add to the US fiscal deficit. This is where, again, the comparison with the cold war can shed some light on some of the potential ramifications of the "superpower clash" between the US and China.

Ronald Reagan's strategy entailed a steep increase in military spending. Even if his administration curbed government expenditure in other areas, the cost of the cold war, together with the tax cuts which were another key tenet of his 1980 platform, triggered a lasting drift in the US budget deficit. At the end of his second term, the deficit was still higher than at the end of Jimmy Carter's and averaged 5.4% of GDP across his presidency. This fiscal drift was increasingly funded by foreign investors. By the end of Reagan's second term, the US had stopped being a creditor vis-à-vis the rest of the world, displaying a negative net international position. It is plausible that **the lingering twin deficits unnecessarily prolonged the phase of high real interest rates triggered by Paul Volker's massive monetary policy tightening in 1980**.

The Biden administration starts from a different position: monetary policy is of course extraordinarily accommodative, but conversely the fiscal and current account position of the United States is much worse than what Reagan found when he "doubled down" on military expenditure. The point we want to make here is that choosing confrontation, or competition with another superpower can entail a macroeconomic cost. Biden's strategy is a gamble. Just like Reagan's mixture of supply-side reforms, low tax and aggressive competition with the USSR was a way to revitalize the US, re-assert its global leadership role and sense of confidence after a tough 1970s decade, Biden's progressive platform and strong support to investment while standing up to China is a way to mend and give a new common purpose to an increasingly polarized society. These policies can succeed when judged against those ultimate goals, but they also come with a macroeconomic cost.

We have already discussed in Macrocast how the ongoing rise in market interest rates could jeopardize the investment plan. At close on Friday, US 30-year real yields turned positive again. The ramifications for emerging markets are already materializing, the most fragile ones already feeling the heat. We cannot help but remember that the persistently high level of interest rates in the early 1980s was the immediate cause of the EM debt crisis of 1982-1983.

We don't want to leave our readers with an unremittingly bleak assessment. **Geopolitical competition can also boost potential growth.** This is where we go back to our initial point on the space program. At peak, in 1968, the budget of NASA stood at only 0.8% of the US GDP. While the Apollo programme was later described as a massive waste of money and NASA was one of the first victims of the fiscal constraints triggered by the two oil shocks, the space race provided useful innovation. It is for instance the need to reduce as much as possible the weight of electronic equipment which led to the invention of the microchip. Beyond the strictly technical realm, the need to coordinate a very large and complex program across hundreds of firms within very precise security specifications may have accelerated the modernization of business management. Maybe the Biden administration will be lucky, and his macro strategy will finally put an end to "secular stagnation". Readers of Asimov know that when the empire looks fatefully compromised, there can be a second, and even a third chance.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC left policy unchanged. GDP forecasts revised higher. Inflation outlook remains around target. Median rate forecast still unchanged through 2023 • January retail sales revised up to 7.6% (from 5.3%), but retreat 3.0% in February • Philly Fed survey hits all-time high of 51.8 • Yet jobless claims rise unexpectedly and consumer comfort dips in latest week	• Post-Fed yield reaction, with real yields rising further after Fed last week • February spending release, watching for echo of swing in retail sales • PCE inflation expected to tick higher to 1.7% (from 1.5%), core expected unchanged at 1.5% • Home sales (Feb), watching for weather-related disruption similar to construction • Current account (Q4), trade (Feb) – trade drag?
	• After a temporary suspension, EA countries resume vaccination with AstraZeneca, following the EMA opinion (benefits>risks) • TLTRO-III take up surprised to the upside at €330.5bn • Tightening of restrictions in 16 departments in France (non-essential retail closed)	• March Flash PMIs and German IFO to continue to show solid manufacturing momentum • After weakening of new loans to NFCs, worth monitoring EA bank lending data • EU Council and Euro summit to discuss the response to the pandemic, watch for progress on "COVID vaccine passport"
	• BoE left policy unchanged. Financial conditions seen "broadly unchanged". More positive near-term news, "less clear" medium-term • EU instigates legal challenge on UK for breach of NI protocol terms • Govt publishes "Industrial Decarbonisation Strategy", to lower CO2 by two-thirds over 15y	• CPI inflation, expected to edge up from 0.7% in February • Labour market release, 3m to Jan, unemp expected to rise modestly from 5.1% • Retail sales, rebound from Jan's 8.2% monthly fall – consensus expects +2%, some upside • March 'flash' PMI readings
	• The BoJ unveils the conclusions of its review. Neg rate is unchanged but a new interest scheme has been introduced. 10y yield range has been widened to +/-0.25bps and ETF purchases will be purchased more flexibly • Feb export normalised after New Year	• March Manufacturing PMI Flash to gauge the sustainability of production • March CPI Tokyo is usually a good proxy for national level
	• Jan-Feb data shows an uneven impact from the virus resurgence at the start of 2021, with domestic demand weakened but production recovery accelerated	• Beijing's reaction to what appears to be a disappointing meeting in Alaska bears watching
	• Front-loaded rate hike in Turkey (200bp) Brazil (75bp) Russia (25bp) above market expectations. Rates on hold in Indo, Taiwan • Q4 2020 GDP up 6.8%qoq (-0.1%yoy) in Chile – average 2020 GDP growth at -5.8% - stellar vaccination pace should grant collective immunity by mid-2021	• CB meeting in Hungary, Czech Rep, Philippines, Mexico (a last possible rate cut put at risk by latest inflation developments and the rise in UST), SA, S.Korea – expected on hold • Mid-March CPI in Mexico and Brazil • Feb CPI in HK and Singapore • Q4 2020 GDP in El Salvador, Dom Rep

Upcoming events	US :	Mon: Existing home sales (Feb); Tue:New home sales (Feb); Wed: Mfg & serv PMI (Mar); Thu: GDP (final, Q4), jobless claims; Fri: Core PCE price index (Feb), Michigan cons sent (final, Mar)
	Euro Area:	Wed: EA Comp PMI (Mar), Ge, Fr mfg&serv PMI (Mar); Thu: EA M3 MS (Feb), Fr mfg confi (Mar); Fri: Ge IfO busi climat index (Mar), Sp GPD (final, Q4)
	UK:	Tue: Unemployment (Jan), BoE Bailey speaks; Wed: CPI (Feb), Comp PMI (Mar); Thu: BoE Bailey speaks; Fri: Retail sales (Feb)
	Japan:	Mon: Leading index (final, Jan); Wed: Mfg PMI (Mar)
	China:	Mon: One-year loan prime rate (Mar)

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