

12. COVID-19 Reinforces the Trend Towards a More Bi-Polar World

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The current pandemic crisis has revealed US vulnerabilities with respect to its dependence on medical equipment and pharma products from abroad, China in particular. The recent stalled delivery shocked US government officials. Therefore, reducing trade dependencies for critical basic goods from China and other countries will probably be on the agenda of the Democrats as well as the Republicans ahead of the presidential election in November.

However, de-globalization is hardly a new development. Indeed, there is a compelling argument that the long-running trend towards deeper integration in global trade and capital markets began to retreat around the time of the global financial market crisis in 2007-2008, which weakened the nervous system of global trade – the financial architecture that was built on free markets, de-regulation and free capital movement. Huge bailout packages for the financial industry at a time when wealth disparity reached new extremes gave rise to populism. Donald Trump's election and his economic brinkmanship saw America abandon its decade-long championing of free trade and low tariffs.

In this regard, the fallout from COVID-19 is likely to reinforce trends that have already been in place since the GFC, including shorter supply chains and the shift to a more bi-polar world order with the US and its allies on one side and China and its allies on the other. The bone of contention is less the "unfair trade practices of China", but more China's aim to achieve global technological supremacy, thereby threatening to undermine US economic, and even military, dominance.

These trends will likely come not only at a political but also at an economic cost with negative ramifications for global productivity, growth and inflation. Fortunately, new technologies, like robotics and 3D printing to name just two, can help to mitigate these economic costs.

Evolution of Great Power Competition

The political rapprochement process between the US and China took off with Beijing's "reform and opening up" in the 1970s, and was characterized by optimism on both sides regarding the mutual benefits of the engagement culminating in China's accession to the WTO in 2001. While the events at Tiananmen Square in 1989 were a first test of Western willingness to engage with Beijing, mid 2000s marked the start of a changing US-China relationship. At that time, conflicting values became more and more visible leading to growing mutual suspicion. Spurring Chinese economic growth and rising wealth did not have the desired effect of China adopting western values, and promoted China's confidence in its own political and economic system and a will to assert its interests abroad. This set the world on a path to confrontation that would end the three decades of economic and political rapprochement. A prominent speech of deputy secretary of State Robert Zoellick in 2005 reflects the growing scepticism in the US that China was not going to fulfil its "responsible stakeholder" duties of reducing trade distortions and market opening, thereby threatening the post-World War II order of US dominance.

Concerns in the US reached a fresh high in 2014 when Chinese President Xi introduced several tech-focused initiatives (e.g. Made in China 2025) by which China would channel massive amounts of state investments into developing an indigenous technology complex with the aim of becoming the leader in emerging technologies like artificial intelligence, quantum computing or internet of things. As this coincided with the emergence of Chinese technology "champions" such as Tencent, Alibaba, Huawei or ZTE, the US was reminded of its sputnik moment back in the Cold War.

US Global Leadership Still Unquestioned

It is largely unquestioned that China became a true competitor for the US in areas like quantum computing and artificial intelligence over the last ten years. Many pundits have good arguments (sizable government funding, many successful tech start-ups, an army of talented programmers and easily accessible big data) why China may reach global supremacy in these areas within the next five years¹. However, it will take Beijing probably at least a decade, if not even longer, to seriously trouble Washington in financial and economic terms, as China is trailing the US on several important counts, such as nominal GDP, depth of its bond and equity market and dollar dominance. Despite these facts, the Trump administration concluded that it is the last chance of the US to defend its global economic and technological supremacy before it is too late. This leads us to believe in a scenario for at least the next five years, which we call "Battleground Clash".

Battleground Clash: A Bi-Polar World Order

The most likely scenario going forward for the next five years of US-China relations is protracted, wide ranging, and disruptive recalibration of international relations affecting nearly all facets of global affairs. The US and China are unlikely to find a lasting compromise on fundamental differences in their respective worldviews. The EU is likely stuck in the middle as rifts between the US and the EU, and even within the EU, are hard to overcome. In particular, the latter will make it difficult for the US to rally allies and thereby hamper its ability to bring the full economic power to bear on China. On the other side, president Xi's firmly established leadership allows him to push back US trade demands to some extent. This sets up a baseline scenario in which US-China tensions continue to intensify. Trade and, in particular, technology tensions will probably continue to play out through non-tariff measures (such as investment restrictions). A prime target continues to be Chinese technology firms, as the US is likely to continue its campaign to cut Huawei out of the global 5G roll out using hard and soft power pressure to leverage countries into opting for alternative suppliers in their 5G infrastructure. China will not hesitate to retaliate and restrict some US corporation's access to the Chinese market, which can compete with the US market regarding its size and, therefore, importance. Moreover, China will intensify its charm offensive overseas trying to increase its economic and political influence in other

regions, of which the Belt and Road Initiative is the most prominent example. The swelling conflict should increase the pressure for both sides for “decoupling”, which may expand to even more areas, including financial markets (such as listing of Chinese firms on US equity exchanges), increasing the need for supply chain reorganizations.

Negative Ramifications for the World Economy

Our battleground clash scenario is a protectionist, de-globalization scenario, in which supply chains will have to be reorganized in the coming years. Companies with long supply chains will face greater pressure—particularly where those supply chains are seen as presenting risks to US national security. From a macroeconomic perspective, this shakeup will create both winners and losers. Countries that lose production (in particular China) and those on the other side of the equation, to which the production facilities are moved will benefit reciprocally from a positive shock. That said, this will not be zero-sum, at least in the short term, as considerable time and capex will be needed to train workers, build new productive assets, and integrate them into global markets.

There are other consequences as well that will have negative ramifications for the world economy. It is impossible to see how manufacturers will benefit from a smaller universe of possible suppliers. Supply chains may become less efficient as companies face lower quality and/or higher prices of the intermediate goods purchased from new suppliers. This could have far-reaching consequences for national economies at the micro level if lower product quality affects productivity—for example, via poorer quality machine tools and goods—and for the global economy in aggregate if this yields lower total productive capacity and overall output.

But there is an additional risk to productivity: Protectionism reduces competition between countries and companies and dampens the process of “creative destruction,” which is seen by economists as a self-directed feature for the revitalizing of an economy. The result is that weaker business models survive longer than they would if they were subject to stricter market discipline. This means fewer resources are freed up by defaulting businesses for new, more innovative capital deployment.

Moreover, the more interaction that takes place on a global scale, the higher the technology transfer, which results in productivity gains for all. Companies that trade with each other learn from competitors faster and adopt new technologies sooner²⁾. Furthermore, the level of foreign direct investments in a country, which usually also brings with it foreign know-how, is highly correlated with global value chain participation. There is merit to the theoretical and empirical research on this topic: More protectionism will hurt the global economy by lowering the curve of potential growth and increase inflation pressure due to higher production costs.

New Technologies Source and Solution of the Problem

New technologies are the essence of the geopolitical conflict, but they do help to mitigate the economic costs of supply chain reshuffling. The pandemic crisis has ruthlessly shown the need for digital technologies. When the real world goes offline, companies without a digital strategy struggle to survive. Therefore, technological trends like augmented reality, automatization, robotics and 3D Printing will most likely receive a steroid shot in the arm. A broader use of these technologies is just a question of time and will help to mitigate the above mentioned costs. Logistics companies are at the forefront of innovation already, with the use of drone and robotics technologies are already implemented or in the test phase.

Therefore, in the future, countries like the US will be increasingly able to produce labor intensive basic goods at home without experiencing drastic economic consequences. The adoption of new technologies will come at the risk of mass unemployment in sectors which adopt new technologies. Therefore, governments will likely slow down this process making sure labor market distortions will remain manageable.

- 1) *AI Superpowers: China, Silicon Valley, and the New World Order*, Kai-Fu Lee, Houghton Mifflin Harcourt, New York, 2018
- 2) “Is productivity growth shared in a globalized economy?”, *World Economic Outlook*, International Monetary Fund, April 2018

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