Dealing with the New Geopolitical Paradigm

By Scott B. MacDonald, Ph.D.

“The great questions of the day will not be settled by means of speeches and majority decisions but by iron and blood.”
— Otto von Bismarck

Summary: Spin the geopolitical wheel and it seems wherever the needle lands something is going on – the Straits of Hormuz, the South China Sea, and the U.S.-Mexican border. The whiff of tear gas hangs over Caracas, Hong Kong and Port-au-Prince. One wonders what happened to globalization and multilateralism. The simple answer is that they are slipping away and the forces of nationalism and protectionism are replacing them. Indeed, the world has entered a “new Cold War” and geopolitical risk is likely to increase in the years ahead. Trade will not disappear, but will become less important while global growth is likely to track on a more moderate pace. For investors, strategies are being constructed around what securities fit into their geopolitical bloc and how risk outside the bloc can be managed. This raises questions over companies with extended supply chains and Emerging Markets. Economic sectors less dependent on external variables will probably be more attractive, but profitability expectations will have to be brought more in line to a world with greater risk and slower growth. But we would add that slower growth does not necessarily mean recession — indeed the Fed’s pivot could result in lower rates longer, helping the growth cycle move into 2020. All the same, volatility will be a steady companion as the new Cold War deepens.

Big Changes, Big Consequences

The core change in the global economy is the rise of China, which is probably the most significant development since the end of the Cold War. It represents a challenge to the “old order” defined by U.S./Western dominance in global trade, financial markets and ability to influence other countries. Since 1978 China has undergone a massive transformation from being predominantly rural and agriculturally-oriented to being an increasingly urbanized country, which has assumed the mantle of being the workshop of the world.009 and 2016 period alone, fighting between the rebel and government forces has resulted in the death of 30,000 people.

Global growth has stabilized but remains weak... (year-on-year real GDP growth)

Napoleon Bonaparte once stated, “China is a sleeping giant. Let her sleep, for when she wakes she will move the world.” Although Napoleon is long gone, China in the early 21st century has woken and is moving the world. This includes a sustained effort to recreate China’s rightful place in the world as the Middle Kingdom, the center of all things. The Chinese way is built around an autocratic leader, backed by a single political party, grounded in nationalism and heavily geared to state capitalism.

Although China still has tremendous challenges at home, it is doing what the U.S. did in the aftermath of the Second World War, creating an institutional framework for Middle Kingdom 2.0. This includes the Belt and Road Initiative (BRI) (with the goal of tying together Eurasia’s various economies from the Pacific to the Atlantic), the Asian Infrastructure Investment Bank and the Silk Road Fund. These give Beijing the ability to project power and dominate Eurasia and, through that landmass, the world.

The U.S. finds itself in the role of the British Empire in seeking to contain or accommodate the rise of a rival power. In the nineteenth century, Germany was a latecomer to unification and colonial empire, both of which upset a longstanding balance of power in Europe and led to tensions in the world’s far corners. The German challenge was constructed on the sinews of economic and military power, which eventually led to an arms race and ultimately war. In the lead-up to 1914, it was thought impossible for there to be war between Germany and Britain. Indeed, Sir Norman Angell’s The Great Illusion (1910) put forth the idea that the economic cost of war was so great that no one could hope to gain by starting a conflict the results of which would be so destructive. The results were horrible, but the conflict nonetheless happened.

Global GDP (2017)
New Geopolitical Paradigm

Where China sends its rare earth compounds

2017, exports in tonnes (‘000)

The U.S. remains a formidable economic and military power, but the real competition with China is just beginning. Looking ahead, the rivalry will focus more on who gains the commanding heights of technology (like AI and telecommunications). But the rivalry will also focus on other factors, such as China’s efforts to replace the U.S. dollar with the yuan, access to international capital markets, access to China’s rare earths (see table above), consumer market access and quite possibly, the creation of competing Internets of Things. This also means that prospects for a trade deal between the two powers are not high. Any deal done is likely to function like a truce as it is very difficult to resolve the issues dividing the two powers.

China is also active in creating a broad range of partners, many of which are authoritarian in their political makeup and regard U.S. power as a threat. Chief among these is Russia, which has interfered in U.S. politics and backed governments that have clear-cut differences with Washington, such as Venezuela, the Assad regime in Syria and, at times, Iran. Under Vladimir Putin there has been an aggressive push-back against the West’s push deeper into Eastern Europe (Georgia and Ukraine), a region seen of paramount geostrategic importance to Russia.

Warming Sino-Russian Ties

As Sino-American relations have soured, Sino-Russian relations have improved. In 2018, trade turnover between Russia and China rose by close to 30%, reaching a record number of $107.06 billion, according to China’s General Administration of Customs. The U.S. trade war with China and Western sanctions against Russia for its annexation of Crimea have helped drive the two Eurasian giants together.

In June 2019, Presidents Xi and Putin met in Moscow to further clarify a framework of relations. The text from the summit indicates that Eurasia’s two largest countries have embarked upon a “comprehensive strategic partnership”, which covers the Arctic (in particular China’s access to Northern Sea Route), space, the internet and innovation. In terms of foreign policy there is also an agreement to take a joint approach to such pressing issues as Iran, Venezuela, the Korean Peninsula and nuclear proliferation. Although there remain points of friction between Beijing and Moscow, the deepening common front is aimed against the U.S.
Europe and Japan Face Unsettled Waters

For the rest of the world the state of play between Beijing and Washington is not a positive development as it will increasingly force governments to choose. It will also put the brakes on global trade, though not kill it. Although the G7 and G20 will remain important, the world is already a G2 affair. Like it or not, China and the U.S. are the dominant players; if others, like Europe and Japan, want a bigger say they will have to make changes. For Europe that entails pulling its own weight in a military sense, while rethinking its dependence on Russia for its energy (as Germany appears content to do with Nord Stream 2). It will also have to give further consideration as to the national origin of the technology it uses for such things as 5G and what this means in terms of national security and the impact on local European companies, such as Finland’s Nokia and Sweden’s Ericsson.

Europe has become a modern-day version of the Holy Roman Empire, which was a multi-ethnic construct of territories and city-states in Western and Central Europe that emerged during the Middle Ages and was finally dissolved by Napoleon in 1806. At the apex of the Holy Roman Empire was the Emperor, who was elected by a handful of Electors. Oftentimes those Electors were bribed, usually in favor of the Hapsburg candidate. While there was a certain pomp and circumstance to the Empire, it became an increasingly fragile structure, riven by religious and regional rivalries, which eventually led to the Thirty Years War (1618-1648) and the rise of the nation state, effectively neutralizing the Empire.

1 Nord Stream 2 is a planned 1,230-kilometer (764-mile) undersea pipeline that will carry natural gas from Russian fields to the European network on Germany’s Baltic coast. It will double the capacity of an existing undersea route, the original Nord Stream, which opened in 2011. Russia’s Gazprom PJSC owns the project, with Royal Dutch Shell, plc and four other investors including Germany’s Uniper SE and Wintershall AG providing half of the 9.5 billion-euro ($10.7 billion) in costs. As of June, 2019 the link was more than 57% built.
Covering much of the same territory as the Holy Roman Empire, the European Union’s grand experiment has had a great run, providing peace since 1945 and giving birth to the world’s largest and most affluent economic bloc. Sadly the props for that experiment are weakening. Older generations with memories of the Second World War and Cold War are passing from the scene, leaving younger generations who have no memory of the destructiveness of earlier conflicts. Europe’s younger generations face frustrations with a seemingly out-of-touch and unelected elite in Brussels, who make key decisions as to how people manage their lives, including the imposition of economic austerity in some countries and migration policy. At the same time, Europe failed to clean up its debt mess from the sovereign debt crisis. Instead, it kicked the can down the road, leaving bad debt in many banks (Deutsche Bank and most Italian banks) and has ever since relied heavily on the European Central Bank’s monetary policies to grind out economic growth.

What complicates the landscape for Europe is that its expansion into the rest of the continent was checked by a more assertive Russia in Ukraine, while the relationship with the United States has become more complicated. The Trump administration questions the value of NATO and why the U.S. should finance much of Europe’s defense spending, especially when countries like Germany are willing to increase their dependency on Russian energy.

The more protectionist stance of the Trump administration is also a major worry for Europe, considering its weak economic growth prospects. But that is not all – within Europe there is a questioning as to the balance of benefits within the Union. This has been a factor in Brexit, the rise of nationalist-populist political parties (some of which advocate either leaving the EU like the UK or pulling out of the euro currency union). There is a certain sense of pessimism over the European experiment as caught by Gavekal co-founder, Louis-Vincent Gave (June 17, 2019): “Europe just wants to survive, not only over the next 30 years, but until the end next week.” The ghost of the Holy Roman Empire is haunting Europe. Still part of “the West”, Europe will have to choose among the options of being aligned with the U.S.; becoming part of a Chinese dominated Eurasia; or forging a separate path that entails upgrading its military power.

As for Japan, three factors dominate the future: China is the major power in the neighborhood, something it occasionally reminds Tokyo of; the U.S. alliance remains central to keeping Japan’s autonomy vis-à-vis its larger neighbor (though the Trump administration is difficult to work with); and the country’s dismal demographics raise serious questions about Tokyo’s ability to maintain its role as one of the world’s largest economies (see chart above).

Prime Minister Shinzo Abe has worked hard at balancing these three factors while seeking to put Japan on a path to sustainable economic growth. This is greatly complicated by the changing nature of global geopolitics and the exposure to China risk by Japanese companies with Chinese supply chains. However, Japan remains as a counterpoint to China in the region and the yen remains the third most used currency in global transactions behind the dol-
lar and euro, despite China’s efforts to internationalize the yuan. Japan also maintains an influential role in much of Asia through its foreign assistance and role at the Asian Development Bank, where it shares a leadership role with the U.S. Despite U.S. protectionism, Japan is clearly aligned with the U.S. in the new Cold War.

The Non-aligned and Mother Nature

Two other important factors need to be considered in the changing global political economy – the existence of actors that are not going to fall easily into either the U.S. or Chinese blocs and climate change. Countries like Brazil, Iran, India, Saudi Arabia and Turkey are large enough and have strong enough cultural and historical identities to forge their own paths in a world dominated by China and the United States. Certainly, Iran, India and Turkey have been great powers in the past and each has sought to carve out its own sphere of influence.

As the world is changing, so too will the economic and foreign policy needs of these countries. There has already been a push for closer relations over the past decade between India and Japan due to concerns over China. Turkey, under President Erdogan, is less in line with the U.S. and Europe and is happy to buy Russian weapons and expand trade and investment with China. India and Iran share the same neighborhood and economic interests; the former needs Iran’s oil and Iran desperately needs to develop new trade ventures. Both countries have prickly relations with Pakistan, which is aligned with China, including the development of a corridor linking western China to the Arabian Sea via Pakistan’s port of Gwadar.2

These countries have their own national agendas and they do not necessarily feel beholden to one side or the other. This leaves an X-factor in the new Cold War landscape, which opens the door to potential conflicts in which Beijing or Washington do not necessarily have a stake, but may feel compelled to take a side. This is one way that wars happen.

The other issue is climate change, which does not easily fit into the new Cold War framework, but the consequences from it are likely to be more radical. Food and water are increasingly seen as national security issues, especially for countries with large populations.

Still other countries, like Nigeria, Pakistan and the Democratic Republic of the Congo (DRC), have rapidly growing populations that are outstripping institutional abilities to accommodate them. According to the United Na-

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2 For its part India is helping Tehran develop the port of Chabahar, which lies on the coast of Iran’s Sistan-Baluchistan province near the Pakistan border. In 2016, India pledged to invest $500 million in the port’s development, before going on to sign an 18-month deal to take over operations of the port in December. Part of Iran-India’s goal is to make Chabahar into a deepwater port, which would allow ships to offload and on-load before they enter the Persian Gulf.
tions, the world’s poorest nations are growing the fastest and are expected to push the world’s population to 11 billion. This is also happening at a time when more extreme weather is becoming a norm, in particular drought and flooding, leading to a loss of agricultural land, sea-level rise and the spread of disease. Climate change is likely to drive hard-pressed young populations in places like West Africa and the Middle East toward safe havens, such as Europe. It will also impact South Asia and South America and the Caribbean. The environmental factor will increasingly impact markets, ranging from agri-business companies, makers of large-scale farm equipment and fertilizer to municipal and sovereign bonds.

**The Impact on Business and Investment**

The changes taking place in the global economic and political system are decidedly going to impact the way business and investment are conducted. We see the following trends:

1. Any company doing business outside of their own borders must reassess where and what they are doing. Companies like Adidas, Nike and Walmart are rethinking their supply chains and reliance on China as a cost-efficient place for production. Agriculture has certainly been on the firing line from the tariff wars, receiving two rescue packages from the Trump administration thus far. Makers of autos, farm machinery and even semiconductors are also caught in this. Companies are going to face challenges in shifting their operations to more friendly countries or giving thought to robotics in advanced economies where labor costs are higher.

2. The global reorganization does not mean that business immediately goes back to the home country. China is witnessing the dismantling of its location as the workshop of the world, but Bangladesh, Indonesia, Malaysia, Thailand and Vietnam are set to benefit (some have already lured away footwear and textile business from China). Mexico could be added to the group, though the threat of future tariff actions from President Trump hangs over the Latin American country.

3. The economic battlefields between the U.S. and China started with technology and will only intensify in that sector. The U.S. action against Huawei was a major blow to that company (it could be taking a $30 billion hit from the U.S. clampdown). It also signaled that the gloves are off for technology in general, telecommunications and AI in particular.

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**Most Populous: 2100 Top 10**

<table>
<thead>
<tr>
<th>Country</th>
<th>Pop. 2100</th>
<th>Percent of World</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>1,450M</td>
<td>13.3%</td>
</tr>
<tr>
<td>China</td>
<td>1,065</td>
<td>9.8</td>
</tr>
<tr>
<td>Nigeria</td>
<td>733</td>
<td>6.7</td>
</tr>
<tr>
<td>U.S.</td>
<td>434</td>
<td>4.0</td>
</tr>
<tr>
<td>Pakistan</td>
<td>403</td>
<td>3.7</td>
</tr>
<tr>
<td>DR Congo</td>
<td>362</td>
<td>3.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>321</td>
<td>2.9</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>294</td>
<td>2.7</td>
</tr>
<tr>
<td>Tanzania</td>
<td>286</td>
<td>2.6</td>
</tr>
<tr>
<td>Egypt</td>
<td>225</td>
<td>2.1</td>
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Source: United Nations
4. There is a strong possibility that the next area of Sino-American friction is energy. The U.S. and China already have squared off over Venezuela, the holder of some of the world’s largest proven reserves. If oil prices rise due to an extended period of geopolitical ructions in the Persian Gulf, pressure could mount on China’s balance of payments. As of 2017 oil and natural gas account for 19% and 7% respectively of total energy use (according to BP), with coal accounting for 60%.

Considering the growing constraints on China’s exports, a bad turn of geopolitical events that pushes up oil and natural gas prices could cause pain in China, in particular its current account balance of payments, which has in surplus for a lengthy period.

5. Other parts of the Chinese and U.S. economies are open to weaponization. Although there has not been a massive sell-off in U.S. Treasuries, U.S. data only extends to April 2019 (released on June 17, 2019). The trend line thus far shows U.S. Treasuries held by China still holding above $1.1 trillion and Beijing remains Washington’s largest foreign creditor. However, if the relationship deteriorates badly, the U.S. will have to find other buyers of its debt. This works as long as the dollar remains the global currency. If China and its allies push to knock the dollar out as the world’s main currency of exchange, one pressure point on the U.S. would be the growing fiscal problem faced by Washington. According to the U.S. Congressional Budget Office, the average fiscal deficit is expected to be above the average deficit from 1969 to 2018 of 2.9% of GDP, jumping to an average deficit of 4.3% in the 2020-2029 period.

6. Cyberwarfare is set to increase. The U.S. and China (and Russia, Israel and Iran) have been at this for a number of years. The size and scope of Chinese attacks on the U.S., which some regard as acts of war, are set to escalate. In 2018 Chinese attacks on telecommunications and the hospitality sector increased. According to FireEye, Chinese hackers are thought to have been behind major strikes on Boeing, General Electric Aviation, and T-Mobile. With trade war tensions up, look for 2019 to see more of the same.

7. Global coordination of economic policy could be seriously undermined. One of the important factors that kept the Great Recession in 2008-09 from becoming a Great Depression like the 1930s was the ability of the G20 to coordinate economic policy to find a path out of the crisis. In a world of hardened blocs, this type of policy coordination is likely to be more difficult to achieve, even among supposed allies. This could be a big issue if central banks become embroiled in competitive monetary loosening.

**Final Thoughts**

It was Otto von Bismarck, the key force behind Germany’s unification, who stated, “Only a fool learns from his own mistakes. The wise man learns from the mistakes of others.” The global political economy has been down this road before — the creation of a great dividing line into camps or blocs. This is an action that pulls business and investors into one orbit or another. The great era of globalization is over and the trend is back to a world of competing blocs. While we could see a further slowing in global trade as adjustments are being made, a complete breakdown is not likely. The menu of what is traded between countries is being trimmed, but there are plenty of products and services that each country still needs. Investors need to embrace the new paradigm that geopolitical risk is likely to play a more central role in shaping markets in the decade ahead. The old Cold War did have a balance of power and no major war occurred. The trick in the new Cold War is to make certain that it does not turn hot and that cooler heads prevail allowing some of what was gained from globalization to continue. Challenging days loom ahead and investors need to pay greater attention to what this means to their portfolio strategies.

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3 China is the world’s largest user of coal and its largest importer, followed by India. Australia accounts for 35% of China’s imports and Indonesia another 31%. Due to pollution concerns, China plans to reduce its use of coal from 2017’s 60% of total energy to 35% in 2040.