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China: Strategy & Counter-strategy

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This article is not about who released the Corona virus! … I have been wondering, for some time, how long the Chinese domination over global commerce will continue. Didn't the USSR unravel? Didn't the Berlin wall fall?

Just as I was composing my thoughts on this important issue, Harvard Business Review (Sept-Oct 2019) featured an article by J Stewart Black and Allen J Morrison, titled "*Can China avoid a growth crisis?"* Readers may recall that the 1990s marked a shift in trade power from Japan to China. Black & Morrison state that:

- China today is where Japan was in 1995 – largely driven by a dynamic domestic economy;
- China's working age population is shrinking – unless labor productivity improves, GDP growth will remain challenged;
- Shrinking earning population normally leads to shrinking consumption;
- A closed culture makes it difficult for expats to integrate into China. So, immigration too is not a solution;
- Innovation as a solution to these problems is not a feature of China;
- China is high on debt.

Black and Morrison have correctly diagnosed the problems in China, and their similarities to Japan of 1995. However, one cannot be sure that the 1990s model of transfer of baton from Japan to China will repeat itself now. Let me quote a classic tagline from the "Economist": *Some people believe history repeats itself; others read the Economist*.

China as a political animal was, and is, very different from Japan. At the helm of China is an ambitious leader who has obtained a mandate to stay in power for the foreseeable future. China has territorial aspirations that Japan chose to give up after World War II. The Chinese aggressive intent has taken several forms:

- Placing its rigs in disputed territory in the South Seas;
- Turf battles with India on Arunachal Pradesh;
- Opaque relationships with rulers of some African countries, that might not meet basic governance standards;
- Belt & Road Initiative – formerly called One Belt One Road – an ambitious project aimed at enhancing China's dominance over global trade, while cornering several countries into a debt-trap. It extends across 68 countries, representing 65% of the world's population and 40% of global GDP.

In my view, while Japan is a tough competitor, China is a ruthless competitor.

The thoughts so far are independent of Covid. Post-Covid, Japan has earmarked a budget of USD2bn for Japanese companies to shift production from China back to Japan; and a further USD200mn for them to shift production from China to other countries. Countries like India have initiated discussions with large companies that have a base in China, to convince them to shift to India.

During times of extreme uncertainty, it is normal for strategists to paint multiple scenarios, assign a probability distribution, and chalk out a plan of action for each such scenario. This is an insurance against being caught flat-footed when scenarios unfold. On the same lines, I see two possible scenarios in the post-Covid trade-world:

- <u>Scenario 1</u>: *Self-sufficiency becomes the* ***new normal***
  In this scenario, countries will create more barriers to trade, and corporate value chain decisions will be internally focused. Global competitiveness as a theme will be replaced with local competitiveness. In such a scenario, Japan's desire of in-shoring might get fulfilled.

- Scenario 2: *Self-sufficiency becomes the* ***new aspiration***
  Every country will aspire for self-sufficiency as part of risk mitigation. But, in the absence of any significant trade barriers, companies will need to be globally competitive. This is a scenario where Japan might have to sacrifice its in-shoring aspiration at the altar of cost-competitiveness. Off-shoring to low-cost destinations will continue, with some risk mitigative measures to reduce China dependence.

I consider Scenario 2 more likely than Scenario 1. In either scenario, the outsourcing-to-China model is at risk.

Actions of Japan and India mentioned above are a blend of strategy and micro-economics - more of instinctive tactics, than a well-thought out strategy. The unstated presumption is that China is a sitting duck waiting to see its share of the global economy being snatched by other countries. Such a presumption is fundamentally flawed and runs the risk of complacency. We should not stop at viewing countries other than China as competition, when China itself needs to be out-smarted. It is therefore critical to assess what might be China's strategy, and plan accordingly.

If we were to expand the lens beyond strategy and micro-economics to include macro-economics, political science and game-theory, then the strategic frames change drastically. I would expect China to play one or more of the following games:

- Game 1: *Expand the Africa model to the Middle East*
  Let us understand the Africa model of China better. Africa is strong in minerals and other natural resources. In many countries in the region, democracy is at best, on paper. Change of leadership is triggered by death or coup, rather than fair elections. This setting makes it easy for China to work out opaque arrangements with heads of state, while the benefit to citizens of those countries is marginal. China and Chinese companies have forged a web of such relationships in the African continent.

  The political system of Middle East is further away from democracy than even the African continent. As with Africa, the strength of Middle East is its natural resources (oil and gas). The fiscal position of many countries in the region including Saudi Arabia and the Sultanate of Oman was dire even before Covid. Oil prices have crashed post-Covid. The 2018 Arab Spring movement of their people will be fresh in the minds of Arab monarchy. It is logical for China to be their white-knight.

  A common market that extends from China to Middle East and Africa will completely transform global trade. It will be a diagonal split of the world map! Given the brashness of some of China's actions, it might not just be an Extended Chinese Market. The term "MNC" can be re-engineered from Multi-National Company to Multi-National Country, with China as the *prima donna*.

  A dangerous consequence would be China and US coming face to face in the Middle East. US has cultivated this region for long as part of its own energy security strategy. The coming US presidency election can have a bearing on developments. Will a trigger-happy US President keep China wary; or will China get brazen and risk World War III? I call this, "the Chinese hegemony risk".

- Game 2: *Belt & Road Initiative (BRI)*
  BRI is scheduled for completion in 2049, when the People's Republic of China turns 100. Covid is a blessing in disguise for this project. At a time when countries are grappling with unemployment, this mammoth infrastructure project is like a gift from God. Since many countries will find it difficult to mobilize money to pump-prime their economy, Chinese money backing BRI is a tempting proposition. It will give jobs to the jobless, and help many heads of state keep their jobs.

Some countries which were waiting in the side-lines might choose to join BRI. This would leave the United States, Japan, India and Australia as the only major countries not to join the BRI wagon.

- Game 3: *Currency Wars*

  In the early part of the last century, British Pound Sterling was the dominant currency. The US Dollar took over post World War II. Euro is struggling to share the honors. China has been itching to increase the footprint of its currency. China and Japan have a sizeable holding of US Treasuries. It is a complex catch-22 relationship. In the normal course, China would not want to do anything to weaken the USD, because it will hurt its own export competitiveness.

  China's recent move on digital currency is interesting. On the one hand, it can be viewed as a mere digitization of its physical currency. In that case, it will amount to only a more efficient payment system. Non-transparency on money in circulation can be a new Chinese googly. However, if China were to allow the new digital currency to float independently – and link BRI investments in some weaker countries to their acceptance of this new digital currency – that would open the pandora's box.

  Economists have studied multiple exchange rates for the same currency. But multiple currencies for the same country. Research interest in countries like Zimbabwe will increase!

The three potential games of China are risks for the rest of the world. Chinese hegemony risk, BRI risk and Currency war risk are not mutually exclusive. The combination of these three risks can transform global power dynamics.

We are perhaps entering an era where country strategy and company strategy need to work cohesively. This has always been the case in specific high capital investment industries such as energy, defense and aircraft. More industries might have to follow the same model. Off-shoring by some companies might gravitate to countries where their home country has strong political capital. Such alignment of country and company strategies runs the risk of increasing crony capitalism and boosting the position of ruling parties in certain countries. This is precisely the political system of China, Middle East and much of Africa. Are we at the cusp of a shift from democracy to authoritarianism?

International institutions such as World Bank and International Monetary Fund are wired to ensure that illiquidity does not affect the ability of troubled countries to fulfil their obligations. Countering China's games will require a different type of institutional framework that goes beyond liquidity support and economic "advice", to chalk a sustainable independent path for countries. This will require competencies in strategy, economics and political science. Countries and companies too will require similar broader competencies. These broader decision-making frames could throw up, for example, off-shoring options for companies that are different from what pure strategy models may suggest.

In prevailing strategy models, economics and politics are exogenous variables i.e. they are considered while finalizing strategy. However, they are not integrated into strategy models. Economics might have to integrate with Strategy, to create a new discipline – "*Stratonomics*". The addition of Political Science to the equation could lead to "*Stratonotics*".

Stratonomics and *Stranotics* will be required for companies, countries and a new breed of institutions. The birth of new disciplines and new institutional frameworks is normally a delight for academicians and researchers. But are we ready?

Feel free to get in touch at team@mavuca.in to share your experiences or discuss how we can help you.