

## US v China superpower battle is heating up

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Pippa Malmgren | Principalis Asset Management | 04 December 2013

There is much talk about the demise of the US. But it just keeps proving it can break all the rules that apply to everyone else. What other country can blast through its self-imposed debt ceiling and have markets rally? Can publicly announce the intention to print money on a record scale and have the market buy more of US bonds?

The Chinese are, of course, America's principal creditor – and China's view is that the US has a long history of defaulting on its debt, mainly by debasing the currency.

The US "paid" for the American Revolution by printing and debasing its currency, then called Continentals. They became worthless and led to the phrase, "not worth a Continental", as they retained only 1/40th of their value. The US defaulted on its creditors again when the debts from the American Civil War overwhelmed it. Confederate Notes devalued when inflation rose by 700% and, ultimately, by 5,725%. America defaulted again after getting into debt in the 1960s after it tried to pay for both Vietnam and The Great Society program which integrated African Americans into being voters and equal citizens. In fact, the US devalued continuously until Paul Volcker raised interest rates to 21%.

But, perhaps the true definition of a superpower, is that you can continuously default on your currency and everyone continues trusting your bonds and your currency.

China fears currency debasement and inflation. China's modern history proves that every time they try it, they get internal conflict and war. Most recently, Tiananmen Square was a result of the last serious bout of inflation (14%). The People's Republic of China came into being in 1949 as a result of the Chinese Revolution that was both a source and a result of a devastating hyperinflation. Similarly, the Boxer Rebellion from 1899 to 1901 was brought about by an inflation that became infinitely worse when the Eight-Power Allied Forces took control and demanded repayment of vast war debts. By 1918, China's bank notes were worth only half of their previous value.

So, some countries can devalue with greater abandon than others. Being a superpower with strong domestic institutions, the US can do it – repeatedly. China, being not yet a superpower and lacking domestic institutions that are strong, cannot.

### SELF-SUFFICIENCY

But, perhaps there are other aspects to being a superpower which permit investors to retain faith even in spite of deliberate devaluation.

This might include being self-sufficient in critical needs like food and energy. On that basis,

the US is getting stronger every day, given its extraordinary domestic resources. China is doing its best to catch up by building a global network of relationships, commercial and diplomatic, that will help it secure access to food and energy.

It can be argued that the US and China are now competing in a great game for control and influence over various parts of the world. Lord Curzon, the Viceroy of India, said countries are "pieces on a chess board upon which is being played out a great game for the domination of the world".

Today, the US is increasingly withdrawing from that great game. The relationship with Saudi Arabia and other Arab nations has been perhaps damaged irreparably by America's unwillingness to assist on the Iranian nuclear issue, by America's support of the rebels during the Arab Spring, and by its loss of interest in the region given new-found domestic energy reserves. China is happily stepping into the breach.

Similarly, Africa has ceased to be a focus of US foreign policy. The main focus of America's presence in Africa is with respect to the Middle East and terrorism. China's main focus in Africa is both commercial and strategic. America's strategic needs are largely met by existing footholds like the island of Diego Garcia in the Indian Ocean, which permit it to respond to events in the Middle East. China, in contrast, is adding to its strategic footholds by buying the old Nato base on the Azores, giving it a strategic presence in the Atlantic.

It is also building strategically important airports in the Himalayas and Greenland. Nicaragua has confirmed recently that China is backing a private venture to build a new 130-mile canal that will diminish dependence on the American-controlled Panama Canal.

## **SUPERPOWER STYLES**

The point is that the key to the US being a superpower is not the level of its debt or its currency policy or even its presence of the best military in the world.

The crucial issue is how is a country uses its ability. It seems obvious that the Chinese are innovating as fast as they can in this arena while the US is relying on the past and assuming that China can't catch up.

This is what investors need to think about. How long can the US cruise on the old model before China draws level with the new model?

This is precisely why the Chinese are so upset about the US effort to once again inflate away its debt. It is not that China will be defaulted on. It is that the export of inflation is so deadly to China and can do far more damage to its effort to become a self-sufficient superpower than almost anything else the US could have thought of.

Who has the upper hand? I think it has to be the country than can and will default on its debts while retaining the loyalty of investors. China has a long way to go before it can achieve that level of loyalty – although I do not doubt it will get there, eventually.



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