

Chinese Chess Game

By John Mauldin | November 1, 2019



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Every investment decision should have an exit strategy. What will you do if your idea doesn't work? Ideally, you make that decision before you invest. Mistakes are inevitable but survivable *if* you recognize them quickly and act to minimize their costs.

The same is true in business, international relations... or even a chess game. Great ideas don't always work out as expected. Then what?

In [last week's letter](#), we discussed some serious flaws in the decision to bring China into the world trade system. People across the spectrum mostly see this now; although they differ on what to do about it.

When the US and ultimately the rest of the Western world began to engage China, resulting in China finally being allowed into the World Trade Organization in the early 2000s, no one really expected the outcomes we see today. There is no simple disengagement path, given the scope of economic and legal entanglements. This isn't a "trade" we can simply walk away from. But it is also one that, if allowed to continue in its current form, could lead to a loss of personal freedom for Western civilization. It really is that much of an existential question.

Doing nothing isn't an especially good option because, like it or not, the world is becoming something quite different than we expected just a few years ago—not just technologically, but geopolitically and socially. Today I want to dive deeper into this topic and how it will change the world economy and our individual lives. This letter is a little scarier than usual, but maybe that is because I am actually writing it on Halloween.

Orderly World

We'll start by reviewing how we got here.

My generation, and I suspect many if not most of my readers, came of age during the Cold War. The world order was pretty clear in those 40 or so years. You had the US, its NATO allies, plus a few others like Japan and Australia lined up against the Soviet Union and the Warsaw Pact countries, i.e. Eastern Europe. Most international trade and cultural exchange took place within those two blocs. Very little trade occurred between them. There were very conflicting views of governmental and economic order. One was largely democratic and market oriented, the other was totalitarian and centrally planned.

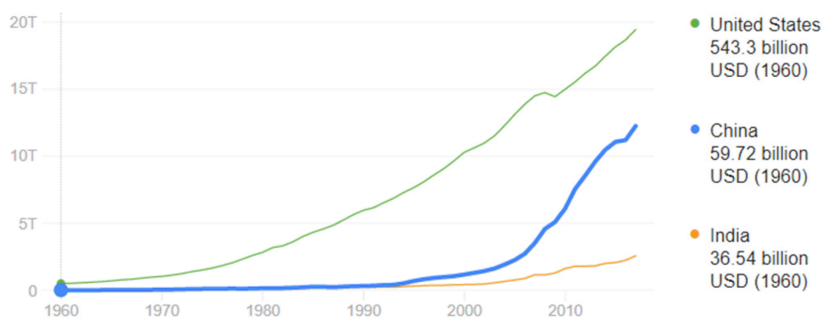
The rest of the world—most of Asia, Africa, and Latin America—essentially didn't matter, economically or militarily. It was the site of occasional proxy conflicts between the superpowers (Vietnam, Afghanistan, etc) and in some cases, produced vital commodities like Middle Eastern oil, but they were mostly an economic non-factor. We called it the "Third World." In practice, it was a bipolar world.

China was a huge, impoverished odd duck in those years. In the late 1970s, China began slowly opening to the West. Change unfolded gradually but by the 1990s, serious people wanted to bring China into the modern world, and China wanted to join it.

Understand that China's total GDP in 1980 was under \$90 billion in current dollars. Today, it is over \$12 trillion. The world has never seen such enormous economic growth in such a short time.

China / Gross domestic product

12.24 trillion USD (2017)



Source: [Google Public Data](#)

Meanwhile, the Soviet Union collapsed and the internet was born. The US, as sole superpower, saw opportunities everywhere. American businesses shifted production to lower-cost countries. Thus came the incredible extension of globalization.

We in the Western world thought (somewhat arrogantly, in hindsight) everyone else wanted to be like us. It made sense. Our ideas, freedom, and technology had won both World War II and the Cold War that followed it. Obviously, our ways were best.

But that *wasn't* obvious to people elsewhere, most notably China. Leaders in Beijing may have admired our accomplishments, but not enough to abandon Communism. They merely adapted and rebranded it. We perceived a bigger change than there actually was. Today's Chinese communists are nowhere near Mao's kind of communism. Xi calls it "Socialism with a Chinese character." It *appears* to be a dynamic capitalistic market, but is also a totalitarian, top-down structure with rigid rules and social restrictions.

So here we are, our economy now hardwired with an autocratic regime that has no interest in becoming like us. The arrangement works well in many ways, but it has a downside. And technology is making that downside increasingly hard to ignore.

As Jonathan Ward, author of [*China's Vision of Victory*](#), whom I quoted at length last week, says in one of his client briefs:

As of now, many US businesses, financial institutions, and Allied nations continue to contribute to the advancement of China's economy and industrial base: In other words, to the foundations of China's growing global power.

This ongoing situation has roots in a prior American strategy towards China. For decades, American strategy towards China was known as "engage and hedge," meaning that the United States would engage commercially and diplomatically, while "hedging" by maintaining our advantages in military deterrence.

But because of China's intentions, which we overlooked, this policy amounted to funding an arms race against ourselves. We have empowered and emboldened our greatest and most dangerous rival.

Rather than converting the People's Republic of China into a trusted friend or "responsible stakeholder," engagement has led—and continues to lead—to the enabling of a massive strategic adversary.

Engagement will eventually lead also to the demise of our military deterrence, as China continues to convert economic and industrial power to military advancement.

The problem, as we will see, is that like generals preparing to fight the last war, we are looking at our military "hedge" through the lens of past conflicts. And while there is no question the US would prevail in any conflict that remotely resembled past wars, the rules are changing.

Just as we say in the investment world that past performance is not indicative of future results, geopolitical engagements don't always end as we expect.

Hundred-Year Marathon

Another good resource is Michael Pillsbury's [The Hundred-Year Marathon](#). He marshals a lot of evidence showing the Chinese government has a detailed strategy to overtake the US as the world's dominant power. They want to do this by 2049, the centennial of China's Communist revolution.

The strategy has been well documented in Chinese literature, published and sanctioned by organizations of the People's Liberation Army, for well over 50 years. And just as we have hawks and moderates on China within the US, there are hawks and moderates within China about how to engage the West. Unfortunately, the hawks are ascendant, embodied most clearly in Xi Jinping.

The Chinese Communist Party recently concluded its Fourth Plenum, a gathering of top party and government leaders. It left little doubt about the party's intentions. Bill Bishop had this reaction in his [Sinocism](#) letter (an invaluable resource, by the way):

The Plenum Communique reiterated that China is facing many risks, as one would expect given that nine months ago, Xi convened a three-day meeting of just about the same audience on risks; it articulated the advantages of the PRC's system of socialism with Chinese characteristics; it emphasized that the Party needs to lead everything, and discussed further refinements to the "Party eats the State" reforms from last year's Third Plenum...

... On the first couple of passes, the document and its goal of advancing the modernization of China's system and capacity for governance reads a bit like a top-level roadmap for a highly functioning authoritarian superpower.

Xi's vision of the Chinese Communist Party controlling the state and eventually influencing and even controlling the rest of the world is clear. These are not merely words for the consumption of the masses. They are instructions to party members.

Grand dreams of world domination are part and parcel of communist ideologies, going all the way back to Karl Marx. For the Chinese, this blends with the country's own long history. It isn't always clear to Western minds whether they actually believe the rhetoric or simply use it to keep the peasantry in line. Pillsbury says Xi Jinping really sees this as China's destiny, and himself as the leader who will deliver it.

To that end, according to Pillsbury, the Chinese manipulated Western politicians and business leaders into thinking China was evolving toward democracy and capitalism. In fact, the intent was to acquire our capital, technology, and other resources for use in China's own modernization.

It worked, too. Over the last 20–30 years, we have equipped the Chinese with almost everything they need to match us, technologically and otherwise. Hundreds of billions of Western dollars have been spent developing China and its state-owned businesses. Sometimes this happened voluntarily, as companies gave away trade secrets in the (often futile) hope it would let them access China’s huge market. Other times it was outright theft. In either case, this was no accident but part of a long-term plan.

Pillsbury (who, by the way, advises the White House including the president himself) thinks the clash is intensifying because President Trump’s China skepticism is disrupting the Chinese plan. They see his talk of restoring America’s greatness as an affront to their own dreams.

The Assassin’s Mace and Modern Warfare

“The Assassin’s Mace” is part of ancient Chinese lore. It is the story of a lone warrior-assassin who uses a hidden weapon to destroy a mighty, overwhelming enemy. Pillsbury says it resembles how China is “militarily engaging” the West.

Pillsbury is a recognized scholar of all things Chinese, particularly their military philosophy. He contends China will employ unconventional military tactics, “The Assassin’s Mace,” in any potential confrontation with the United States. Where we see strengths, they see weaknesses. His account of participating in US military wargames is worth the price of his book. Summarizing quickly the section on the first game:

It was three hours before the war game ended, but when the final move was made, the map on the floor was like a chessboard showing checkmate, with the American king trapped and defenseless. For the first time in the history of Pentagon-sanctioned military simulations, the United States had lost a war game. To win, I had employed tactics derived from my evolving understanding of Chinese strategy. The weapons and military strategy that guided my tactics had their roots in ancient Chinese warfare, and their modern incarnations are...

... Twenty similar war games were conducted by the Pentagon over the next few years. Whenever the China team used conventional tactics and strategies, America won—decisively. However, in every case where China employed Assassin’s Mace methods, China was the victor.

What are we talking about? Pillsbury spends whole chapters citing specific documents and research, but here are few quotes. The first refers to a controversial book published by two PLA colonels, later withdrawn because of its controversy.

America saw conflict only through the lens of military means, instead of the broader strategic picture encouraged by ancient Chinese thinkers such as Sun Tzu, which emphasized intelligence, economics, and law.

*“Clearly, it is precisely the diversity of the means employed that has enlarged the concept of warfare,” Qiao and Wang wrote in their controversial 1999 book *Unrestricted Warfare*. “The battlefield is next to you and the enemy is on the network. Only there is no smell of gunpowder or the odor of blood... Obviously, warfare is in the process of transcending the domains of soldiers, military units, and military affairs, and is increasingly becoming a matter for politicians, scientists, and even bankers.”*

Two days after the September 11 attacks, the two colonels were interviewed by a Chinese Communist Party newspaper and said of the attacks that they could be “favorable to China” and were proof that America was vulnerable to attack through nontraditional methods.

Later in the chapter:

... That’s why Major General Li Zhiyun, the director of foreign military studies at China’s National Defense University, published a book of articles by sixty-four army authors detailing a long list of American military weaknesses. The book’s theme was that the United States could be defeated with an Assassin’s Mace strategy. One perceived US weakness is America’s reliance on high-tech information systems. No nation in the world has been as active as China in exploring the defenses and vulnerabilities of computer systems involving key US military, economic, intelligence, and infrastructure interests.

Again, later:

*China was moving toward a free market economy and would sell off all of its massive government-run corporations, and the second was that there was no chance China would surpass the United States economically, and even if it did—by, say, the year 2100—China would be a free-market, peace-loving democracy by then anyway—at least according to the “Golden Arches Theory of Conflict Prevention” popularized by the New York Times columnist Thomas Friedman and in vogue at the time. According to Friedman’s book *The Lexus and the Olive Tree*, the theory states that, “No two countries that both had McDonald’s had fought a war against each other since each got its McDonald’s.”*

But Thomas Friedman may have been completely wrong. Again quoting:

Once China is strong enough economically and militarily to defy the United States and its allies, Chinese officials could use cyberattacks to harass anyone whose speech they disapprove of; many people outside of China, from Asia to North America, would consequently have to watch what they say and wonder whether they’ll be punished.

CHINA WILL “HARMONIZE” DISSENT ON THE INTERNET

One of China's weapons in its war on free speech is censorship of the Internet. There are more than one million Chinese employed in the online censorship business. Most of the world's Internet users are Chinese, but because Chinese government officials monitor and block access to the websites of human rights organizations, foreign newspapers, and numerous other political and cultural groups, Chinese citizens don't have access to the same Internet that free people do. To be "harmonized" is a euphemism for being censored.

Pillsbury devoted whole chapters, as have others, to US and Western vulnerability precisely because of our technological prowess. Bill Bishop, Jonathan Ward, and others present a sober view of China's intent and capabilities. Its investments in artificial intelligence, robotics, and other technology let Beijing leverage relatively small amounts into outsize capabilities. Further, the ability to target satellites and hack government and military computer networks should certainly bring one pause.

In any case, we have reached a crossroads. What do we do about China now?

Targeted Response

In crafting a response, the first step is to define the problem correctly and specifically. We hear a lot about China cheating on trade deals and taking jobs from Americans. That's not entirely wrong, but it's also not the main challenge.

I believe in free trade. I think David Ricardo was right about comparative advantage: Every nation is better off if all specialize in whatever they do best. The Chinese at one point were very good at large-scale, labor-intensive manufacturing, although they are losing their cost advantage now. We in the US have other strengths. Given time, these things sort out and everyone prospers (though it is true we have done a terrible job helping American workers make the transition. We have to improve there).

However, free trade doesn't mean nations need to arm their potential adversaries. Nowadays, military superiority is less about factories and shipyards than high-tech weapons and cyberwarfare. Much of our "peaceful" technology is easily weaponized.

This means our response has to be *narrowly targeted at specific companies and products*. Broad-based tariffs are the opposite of what we should be doing. Ditto for capital controls. They are blunt instruments that may feel good to swing, but they hurt the wrong people and may not accomplish what we want.

We should not be using the blunt tool of tariffs to fight a trade deficit that is actually necessary. The Chinese are not paying our tariffs; US consumers are. It is only because the dollar is the world's reserve currency that we have the exorbitant privilege of running a trade deficit. We *need* a large trade deficit to finance our debt.

Importing t-shirts and sneakers from China doesn't threaten our national security. Let that kind of trade continue unmolested and work instead on protecting our advantages in quantum computing, artificial intelligence, autonomous drones, and so on.

The Trump administration appears to (finally) be getting this. They are clearly seeking ways to pull back the various tariffs and ramping up other efforts.

I know there are those who want total economic disengagement. I'm sorry, but that cure might be worse than the disease. Our economies are simply too intertwined and co-dependent. Forcibly separating them would set off a cataclysmic global recession—and weaken the US at a time when we need all our strength. It would also justify the paranoia already prevalent in China's hawkish leaders.

We need to be more strategic about our own scientific research. I'm a big fan of DARPA, which has developed many extraordinarily useful technologies, not only for the military but for businesses.

It is not inevitable that China will outpace the US. We have smart people, too, and many more around the world would like to join us. We should welcome those who hold our values and put them on the team.

Houston, Philadelphia, Dallas, and ???

I intend to be in Houston in mid-November, although details are fuzzy, and then in Philadelphia November 20–21. Then of course Dallas for family Thanksgiving and the wedding of one of Shane's best friends the following Saturday. There are other locations on the potential list.

This letter has already run a little long, so I'll hit the send button and get dressed as I can hear the sounds of little monsters coming to our door looking for candy. Halloween is evidently quite the big event here in Dorado Beach. I am told the adult party is one of the year's biggest. I'm looking forward to meeting new neighbors and not worrying about anything scarier than a few costumes.

"Normal" things like Halloween trick-or-treating remind me of what we truly share as humanity... besides having to listen to The Monster Mash all night. Have a great week!

Your hoping we can find a peaceful ahead analyst,



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