China’s emergence as a global economic power has remade the geopolitical landscape. Beijing appears to be in a hurry to decouple its economy from the U.S. and at the same time replace Washington as the top player in the regional and global hierarchy. China has a variety of strategic capabilities to blunt the American-made order, but Beijing is beset by internal weaknesses and vulnerabilities, including the demographic effects of its one-child policy, high debt and a stagnating economy, that make the task of challenging the U.S. militarily or financially difficult. Reducing these challenges in the medium term will not be easy. That is bound to put investors, once keen on China, on edge about the country’s trajectory.

Shifting Alliances: China, Russia and the U.S.
Ironically, it was the United States that took the initiative to pull China into greater engagement with the rest of the world. More than half a century ago, U.S. President Richard Nixon, along with Secretary of State Henry Kissinger, secretly traveled to China to meet its ailing leader Mao Zedong in an act of daring that transformed the geopolitical dynamics of the superpower rivalry. Although fellow communists, China and the Soviet Union were on such terrible terms that Mao feared a Soviet invasion. Nixon, the first American president to travel to China, helped end more than two decades of hostility between the two countries. The visit laid the groundwork for Beijing’s opening to the world and full diplomatic relations by 1979. The two
countries became tacit allies to confront the Soviet Union until its collapse in 1991, essentially ending the Cold War.

The nature of the relationship has changed over time. Today, China and the U.S. are firm frenemies. They have complicated diplomatic relations and intertwined economies while engaged in a battle for technological supremacy. Washington has called China “the most serious long-term challenge” to the world order. Perhaps one reason is that China has unleashed hackers to break into and steal secrets from American companies and government agencies. Beijing’s saber rattling over Taiwan’s future, staging military drills in the Taiwan Strait after U.S. House of Representatives Speaker Nancy Pelosi flew to Taipei, is part of the effort to push the U.S. out of the Indo-Pacific region.

China’s foreign policy moves are putting geopolitics in focus for investors. Until recently, Chinese leaders had emphasized the country’s peaceful rise and the economy was humming along nicely. However, President Xi Jinping and his administration advocate a more assertive foreign policy and are determined to counteract the U.S.-led system of rules which underpins the global political, monetary and financial system. Beijing has tried to leverage its economic power through initiatives like the Belt and Road Initiative, forming currency blocs to internationalize its currency and setting up the Asian Infrastructure Investment Bank.

China-Russia Pact: Tread with Caution

Over the past decade, China has forged closer links with Russia, another centralized autocracy, to challenge U.S. hegemony. But it’s an unequal relationship. Three decades ago, Beijing and Moscow were economic equals. Today, China’s economy is ten times larger than Russia’s. In this relationship, China is the economic powerhouse, while Russia provides the military expertise to modernize China’s armed forces.

Although Russia’s invasion of Ukraine has turned Vladimir Putin into a pariah, Xi has remained steadfast in his backing for the Russian president. China has made its strategic alignment with Russia a key cornerstone of its foreign policy. Xi’s support puts at risk dealings not just with the U.S. but also with the European Union, a trade relationship worth $777 billion. Trade with the U.S. accounts for another $657 billion. China provides about 18% of U.S. imports and over 22% of the EU’s.

**DISPLAY 1**

Russia’s Growing Reliance On Chinese Imports

<table>
<thead>
<tr>
<th>Years</th>
<th>China’s Imports from Russia as a % of China’s Imports</th>
<th>China’s Exports to Russia as a % of China’s Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>13%</td>
<td>26%</td>
</tr>
<tr>
<td>2020</td>
<td>3%</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: MSIM EM Research, Haver

**DISPLAY 2**

China Means a Lot to Russia, Russia Doesn’t Mean That Much to China

<table>
<thead>
<tr>
<th>Years</th>
<th>Russia’s Imports from China as a % of Russia’s Imports</th>
<th>Russia’s Exports to China as a % of Russia’s Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>20%</td>
<td>22%</td>
</tr>
<tr>
<td>2022</td>
<td>15%</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: MSIM EM Research, Haver

---

1 OECD, Haver  
2 OECD, Haver  
3 Council for Foreign Relations, Haver
On the other hand, shipments to Russia account for only 2% of China’s total exports. For Chinese companies, Russia is too small a market to be worth the risk. In defiance of Western sanctions on Moscow, China is importing heavily discounted Russian oil, so much so that in May, Russia replaced Saudi Arabia as the country’s biggest oil supplier. This helps to insulate the Kremlin from the effects of Western sanctions. A defeated Russia would lead to the isolation of China.

However, having felt the bite of the U.S. sanctions in the past, Beijing is unlikely to cross any U.S. red lines with regards to helping Russia’s war efforts. The communist leadership was alarmed by the speed with which Western countries froze a large portion of Moscow’s $640 billion foreign exchange reserves. China, with its vast foreign currency reserves, would be harder hit. Over $1 trillion, accounting for roughly a third of China’s $3.2 trillion in foreign reserves, are held in U.S. dollars (USD). Despite past talk of potentially diversifying into the euro, or more recently into cryptocurrencies, China has few viable alternative stores of wealth and would lose access to its foreign reserves. Of course, Beijing can retaliate by seizing the substantial assets that Western corporations hold in China. At the end of last year, foreigners owned $3.6 trillion in direct investments and another $2 trillion in shares, bonds and other investments.

Source: MSIM EM Research

---

4 Bloomberg, Haver
5 The Guardian
6 CEIC, Haver, CNBC
7 World Bank
Sharp Elbows: China’s Assertiveness Riles Up Neighbors

For the European Union (EU), China’s support for Russia was just the latest source of friction. As the world’s second and third largest economies, China and the EU have been at an impasse since March 2021 over human rights concerns. Countries that were once part of the Soviet empire, such as the Czech Republic, see Xi’s moral support for Putin as menacing to European security. Last year, the bloc imposed human-rights-related sanctions on China for the first time since the crushing of the Tiananmen Square protests in 1989.

And it’s not just faraway Europeans who are wary. China’s neighbors are nervous about the country’s economic and military dominance in the region. Japan seeks a closer regional partnership with the U.S., and South Korea, under a new president, is now willing to downplay historical grievances against Tokyo to form a tighter front against Beijing. India, smarting from border skirmishes with China, is actively engaged in the Quadrilateral Security Dialogue, a regional grouping, along with Australia, Japan and the U.S.

Trade Wars, TechSpying and Human Rights Hurt U.S.-China Dealings

The U.S.-China trade war has led to large share shifts in global trade. U.S. imports from Vietnam rose from 9% to 20% of those from China in the last four years. And China now accounts for a smaller share of U.S. imports and has seen a noticeable decline in the share of tech-related imports. Beijing’s intellectual property rights infringement has led to a blacklisting of exports to Chinese companies. Chinese telecommunications and surveillance industries face their biggest hurdles importing from the U.S.

The U.S. tech embargo, which began as a narrow effort against a Chinese telecom giant, has expanded to at least 60 firms. Beijing is getting used to being sanctioned. During Xi’s tenure, three different U.S. administrations have penalized China for its human rights and trade practices. The most recent penalties ban imports of products made with forced labor from Xinjiang province, in response to reports of atrocities against Uyghurs and other Muslim ethnic minorities. There is a long list of “unfair” Chinese practices including not adhering to its purchase commitments within the Phase One trade deal signed in February 2020.

China is also racing to challenge U.S. tech supremacy in several areas like semiconductors, Artificial Intelligence, 5G technology and green energy.

Preventing Taiwan Independence Preferred to Forced Unification

The war in Ukraine has also put the spotlight on Taiwan’s precarious international position. Beijing asserts that Taiwan, an island of 24 million people, 100 miles off its coast, is a renegade province that must be brought under mainland control. China has sought after the island since 1949 when nationalists fled the mainland after losing the civil war. Chinese leaders became more emboldened to push for unification in part by Western silence over the Communist Party’s crackdown on democracy in Hong Kong. Taiwan leaders rejected China’s offer of “one country, two systems.”

A voluntary reunification seems remote, leaving China with the military option. Washington has maintained a policy of “strategic ambiguity” for more than 70 years, supporting the One China policy but also using its military to deter the Chinese from invading Taiwan. As long as the U.S. had total military superiority, Beijing had to temper its ambitions, but China’s armed forces are catching up. In its most recent report, the Pentagon warned that China was developing technologies to conduct long-range precision strikes as well as space and cyber capabilities to counter U.S. dominance.

But we think such speculation is premature. Beyond hawkish headlines there is little evidence that China is getting ready to invade Taiwan. Launching the kind of assault that Russia inflicted on Ukraine would be a daunting task for the People’s Liberation Army. Losses would be heavy in the face of determined Taiwanese resistance. An invasion could lead to the destruction of globally vital electronic and semiconductor industries. The country’s top tech talent would flee. The economic costs of China launching an invasion, or even a blockade with the aim of forcing a political settlement, would be catastrophic. China would be cut off from critical technologies and from the U.S. financial system. In

---

 DISPLAY 4

A Gradual Decoupling

China’s Share of U.S. Imports is Declining


---

US Census Bureau, Empirical Research Partners
our view, China’s policy seems not to force unification, but rather to prevent Taiwan’s independence and recognition as a formal nation state.

**Economic Dragon, Financial Flea**

Beijing is making moves to limit its vulnerabilities to U.S. financial sanctions, but with slow progress. Despite its dominance as the second largest economy and a leader in international trade, China is a financial lightweight. Though there is a shift away from the USD—its share of reserve currencies fell to 59% of total in the first quarter 2022, its lowest level since 2020—the renminbi accounts for only a quarter of that move. Russia holds nearly a third of the world’s renminbi reserves, an unhelpful development given the extensive sanctions on Moscow. China has proposed to build a renminbi currency reserve by teaming up with Indonesia, Malaysia, Hong Kong, Singapore and Chile so that each contributes 15 billion yuan to be stored at the Bank for International Settlement. However, as the contributing members can contribute in yuan or USD, this can only be seen as a half measure. It will take many years before the renminbi can pose a serious challenge to the USD as a reserve currency.

The Chinese currency also has virtually no footprint on global trade transactions. Renminbi accounts for only 3% of the world’s international payments. The USD is the dominant currency of international trade, where roughly 40% of international trade transactions are paid with USD, even though the U.S. accounts for only 10% of global trade. Some countries have moved to make tactical payments using yuan to pay for Russian goods. Trades in yuan and ruble surged post the Russia-Ukraine war. Recently, India’s biggest cement producer paid in yuan for a cargo of Russian coal. China will continue to ramp up efforts to prop up alternative payment systems, but we believe that such a transition will be a slow process and may take perhaps as long as a decade before the yuan can play a significant role in reducing the dollar’s usage in international trade.

**Internationalizing the Renminbi Will Take Time**

Chinese policymakers have created mechanisms to facilitate trading in yuan, such as the Cross-Border Interbank Payment System (CIPS) which settles international claims. But this is an untested system. In theory, this is a rival system to the Clearing House Interbank Payments System (CHIPS), supervised by the Fed, which settles payments between banks. However, finding a way around CHIPS and its U.K. and euro area counterparts is very difficult. Payments through CHIPS are denominated in USD which helps sustain the U.S. currency’s role in cross-border transactions. It may take decades before China and the renminbi can rival the dollar.

Another piece in Beijing’s toolkit is e-CNY, the digital yuan, a central bank digital currency, which is “technically ready” for cross-border use, according to a white paper released by the People’s Bank of China (PBOC). This too has limitations. Using e-CNY allows for the possibility of illicit transactions such as money laundering, which would make the Chinese government, and specifically the central bank, vulnerable to sanctions.

**Beijing’s Ongoing Challenges**

U.S.-China relations appear to be the worst since Nixon’s trip. Having benefited greatly from its integration into global markets, China now seems to be seeking to use its economic power to displace the U.S. on the world stage. As President Xi prepares for a Communist Party congress in the fall to consolidate his rule via a historic third term, he faces a myriad of domestic and international hurdles. The country’s economic trajectory is looking subdued, hurt by a falling population, real estate debt and deglobalization as companies look for alternative manufacturing

---

**DISPLAY 5**

China: Economic Dragon, Financial Flea

U.S. Financial Might is Built on the USD’s Dominance

<table>
<thead>
<tr>
<th>Share of Global Nominal GDP</th>
<th>Share of Global Trade</th>
<th>Share of Global Reserves</th>
<th>Share of Global Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>China 18%</td>
<td>US 24%</td>
<td>China 13%</td>
<td>US 10%</td>
</tr>
<tr>
<td>RMB 2%</td>
<td>RMB 3%</td>
<td>USD 59%</td>
<td>USD 41%</td>
</tr>
<tr>
<td>Source: MSIM EM Research, Haver, Bloomberg, J.P. Morgan, SWIFT</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Note: RMB = Renminbi</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
centers. The crisis over Taiwan and the war in Ukraine have not helped. The challenge for Xi is that he cannot appear weak on the international arena by backing down in the face of Western pressure. On a recent telephone call, President Xi warned U.S. President Joe Biden not to interfere in Taiwan, saying that “those who play with fire will perish by it.”

Yet, China’s growing problems on the home front—rising youth unemployment, threats of mortgage payment boycotts and rising bank loan losses—will limit its freedom to take bold actions in the international arena. A U.S.-China reengagement that improves the global macroeconomic environment is unlikely to be forthcoming in the short term. Summits with the U.S. president may help Xi navigate the 20th Party Congress, but favorable outcomes are not always guaranteed. The implications of Beijing’s geopolitical challenges are that China in the Xi Jinping era will be volatile and, as other papers in this series will explore, only selectively investable.

Risk Considerations
There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, equities securities’ values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries. Stocks of small-capitalization companies entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio’s performance. Illiquid securities may be more difficult to sell and may have a potentially large negative impact on the Portfolio’s performance. Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. Cryptocurrency (notably, Bitcoin) operates as a decentralized, peer-to-peer financial exchange and value storage that is used like money. It is not backed by any government. Federal, state or foreign governments may restrict the use and exchange of cryptocurrency. Cryptocurrency may experience very high volatility.

DEFINITIONS
Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country’s borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

IMPORTANT INFORMATION
There is no guarantee that any investment strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, equities securities’ values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries. Stocks of small-capitalization companies entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio’s performance. Illiquid securities may be more difficult to sell and may have a potentially large negative impact on the Portfolio’s performance. Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. Cryptocurrency (notably, Bitcoin) operates as a decentralized, peer-to-peer financial exchange and value storage that is used like money. It is not backed by any government. Federal, state or foreign governments may restrict the use and exchange of cryptocurrency. Cryptocurrency may experience very high volatility.

The views and opinions and/or analysis expressed are those of the author and not necessarily those of Morgan Stanley or its subsidiaries and affiliates. The views expressed in this material may change at any time without notice due to market or economic conditions. The views expressed in this material are based on the investment manager’s research and analysis of the market and economy. The investment manager may hold positions in securities of issuers discussed in this material. Certain statements in this material are based on information from third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and the Firm has not sought to independently verify information taken from public and third-party sources. This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision. Past performance is no guarantee of future results. This material is not a product of Morgan Stanley’s Research Department and should not be regarded as a research material or a recommendation. The Firm has not authorised financial intermediaries to use and to distribute this material, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this material is appropriate for any person to whom they provide this material in view of that person’s circumstances and purpose. The Firm shall not be liable, for, and accepts no liability for, the use or misuse of this material by any such financial intermediary. This material may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this material in another language, the English version shall prevail.