Confluence
INVESTMENT MANAGEMENT

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By Bill O'Grady

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Revisiting Thucydides

The Thucydides Trap is an idea that comes from the ancient Greek historian of the same name who described a situation where the incumbent superpower of the time, Sparta, was faced with an insurgent power, Athens. The two powers ended up in a ruinous war. Thucydides postulated that when an established superpower is being threatened by a rising one, the likelihood of war increases.

Graham Allison did a study of the trap[1] in 2017, examining earlier examples but focusing on the situation between China and the United States, which appears to have at least some of the same characteristics that Thucydides outlined in his *History of the Peloponnesian War* that led to the conflict between Athens and Sparta. Allison, as noted above, was primarily concerned about the potential for war between China and the U.S., but he also analyzed 16 other historical rivalries and concluded that 12 resulted in war while four did not. Obviously, this ratio is not comforting. Allison did conduct an examination of the trap conditions that didn't result in war and tried to draw conclusions, but the concept of the Thucydides Trap has become a model for examining the U.S./China situation.

However, Hal Brands and Michael Beckley are proposing something of a twist to the trap. They don't dispute that the odds of conflict rise when there are rising powers that threaten the existing power arrangement. But their position is that it isn't exactly true that a rising nation is the problem. Instead, what leads to war is if the rising power perceives that its rise is slowing. They call it the "peaking power trap." They argue that the real problem arises when an insurgent power begins to fear that its acceleration is slowing and thus the perception that a window of opportunity is closing is what produces war.

In this report, we will examine the idea that China may be reaching such a deceleration and therefore perceives that time is no longer on its side. If that is the case, there may be no better time than the present to move quickly to secure its geopolitical goals while it has the power to achieve them. The analysis starts with a review of the concept of the "high growth/low cost" (HG/LC) producer and the risks that emerge when that phase comes to a close. We will also include a discussion of population issues. From there, we will examine China's geopolitical constraints and its capacity to overcome them. Finally, in the section on market ramifications, we will look at how these two issues combine to potentially raise the problem that Brands and Beckley have introduced.

China's Economic Situation

Since the industrial revolution, the world has tended to see a HG/LC producer. This producer is important to the world economy. It becomes the supplier of manufactured goods to the world because it produces them efficiently at low cost. The development pattern is fairly standard. Growth is driven by investment and, eventually, rising

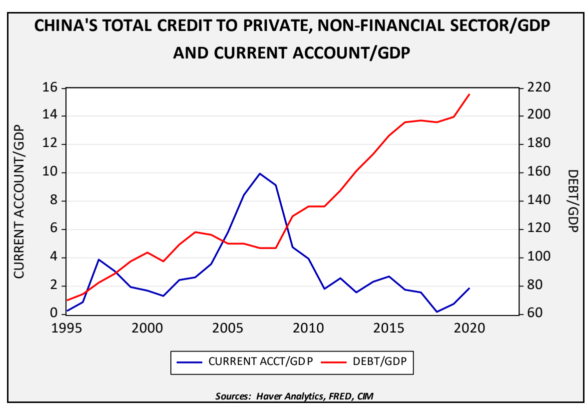
[1] Allison, G. (2017). *Destined for War: Can America and China Escape Thucydides's Trap?* New York, NY: Houghton Mifflin Harcourt Publishing Company.

exports. The HG/LC nation starts out with a low base of investment; as the country industrializes, it enjoys strong growth. At the same time, the rapid growth creates attractive investment opportunities that are often met with increasing debt. Eventually, the HG/LC nation reaches a point where it has mostly industrialized. Usually by this point, it has become a major exporter. Eventually, the world reaches its capacity to absorb the exports. At this juncture, the HG/LC nation has high levels of debt and, often, some degree of malinvestment. The next step is usually for economic growth to decline to a sustainable level along with some process of debt adjustment. Instead of relying on investment and exports for growth, the HG/LC nation shifting from that status needs to derive its growth from domestic consumption.

Economic history exhibits a "parade" of these HG/LC nations. Britain, which started the industrial revolution, was first. The U.S. followed, nearly simultaneously with Germany. After WWII, Japan mostly filled this role, although Germany again exhibited some characteristics of the HG/LC producer.[2] As China opened to the world under Deng, it became the most recent nation to achieve HG/LC status.

History tends to show that when a former HG/LC nation needs to restructure away from that phase of development, the transition is often painful. Although Britain's transition seemed rather smooth, it was supported by its colonies. It used the colonies to absorb its excess production through exports, allowing it to mostly maintain the HG/LC model but with a much slower growth rate. The German transition was affected by two world wars, which distorted the initial phase in the first half of the 20th century. During the second half, when Germany had a period as the HG/LC producer as part of its postwar rebuilding, it managed its transition by moving up the value chain (e.g., Volkswagens to BMWs)[3] and through a form of colonization via the Eurozone. Essentially, Germany has treated the Eurozone as a target for exports, forcing its excess production on the rest of Europe. The 2011 Eurocrisis was partly due to the unsustainability of this model. The U.S. transition phase was the Great Depression, which was caused by a rapid decline in private sector debt that had built up during the investment/export phase of its HG/LC era. In Japan's postwar HG/LC period, the era ended with nearly three decades of sluggish growth and the slow liquidation of non-financial private sector debt.

China is the current HG/LC nation but is rapidly coming to the end of that era. One element of the problem is that China's economy has grown to the point where other nations won't tolerate it driving growth through exports. This development, which became evident in the wake of the Great Financial Crisis, forced China to shift away from using exports for growth to domestic investment, funded by debt.

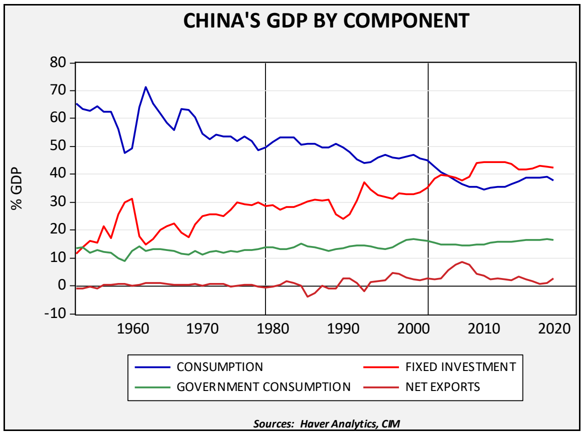


[2] Both Japan and Germany had some level of destruction to their industrial bases during the war. Reindustrialization required growth to be driven by investment and exports.

[3] (VWAGY, USD, 31.24; BMWYY, USD, 33.28)

As the above chart shows, China's credit to the private sector has soared in the wake of the 2008 Great Financial Crisis; its current account to GDP ratio has declined.

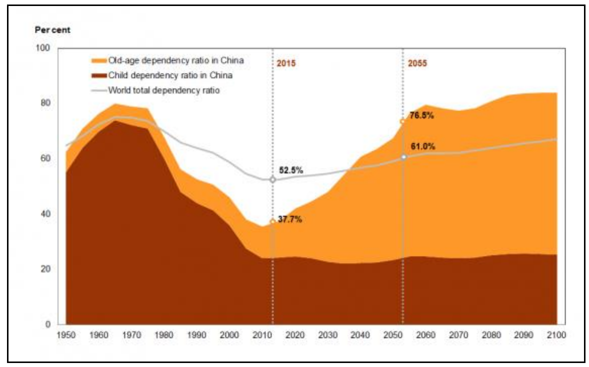
The composition of China's GDP tells a similar story.



This chart shows GDP by component. Since the 1960s, consumption has been mostly declining, while investment has steadily risen. We have placed two vertical lines on the chart; the first represents when Deng Xiaoping began his market reforms in 1979 and the second when China entered the WTO. Entering the WTO accelerated the trend of investment- and export-driven growth.

China now stands at a difficult position. To achieve high levels of growth, it encouraged debt-driven investment. Most likely, its sustainable growth rate is between 2% and 3%, not the 6%+ seen in recent years. To achieve this growth, China has simply expanded its debt to fund a level of investment necessary for this growth target. Unless it has unlimited debt capacity, it is unlikely China can continue this process. The recent, [well-publicized problems in Chinese real estate] reflect the leadership's decision to change the model. However, it isn't obvious whether the country is willing to live with much slower growth. In Beijing's defense, no nation has made the transition seamlessly. General Secretary Xi's anti-corruption campaigns and his attempts to bolster Chinese nationalism may be in preparation for a growth slowdown.

Complicating matters for China is the fact that it benefited from a falling dependency ratio[4] during its high-growth phase.



(Source: United Nations)

China implemented an official "one-child policy" in 1979, which coincided with its economic liberalization. As the above chart shows, the dependency ratio fell steadily from the late 1970s until around 2010. The ratio has started to deteriorate and from the "wrong" side. In other words, it's not getting worse due to more children, which would mean that the ratio eventually gets better. Instead, it's getting worse from the old-age side of the equation, which only improves with a *Logan's Run* outcome. Assuming that result is impossible, China's slowing economy will be supporting a larger dependent population. Barring mass immigration (highly unlikely, especially compared to the U.S.), this chart would argue that the combination of economic restructuring and less favorable population dynamics suggests China may be at, or somewhat past, its peak.

[4] Defined as the population aged 0-14 plus 65+ divided by population aged 15-64.

China's Geopolitical Imperatives

If China decides it needs to go to war before its advantages wane, what will it do? China has become an exporting power, dependent on foreign sources of key inputs. Although its situation isn't as extreme as Imperial Japan, both nations share a risk that the U.S. could implement a naval blockade and constrain their ability to conduct trade. Japan's response to this threat was the surprise attack on Pearl Harbor. It was a bold move, but luckily for the U.S. (and unlucky for Imperial Japan), the U.S. aircraft carrier fleet was not in harbor and was spared from the attack, meaning the U.S. had ample firepower to retaliate soon after Tokyo's attack.

Unlike Japan, China has enough natural resources that if it was willing to grow very slowly, it could retreat within its own borders. This characterizes Mao's China. We doubt Xi would take that option. The best way for China to avoid a blockade would be to control the "first island chain" that surrounds it. The key to controlling the first island chain is to absorb Taiwan. We discussed this issue at length in an earlier series.[5] If China had direct control of Taiwan, it could effectively project power outside the first island chain, making a blockade much more difficult for the U.S. Navy.

As a result, we believe China's key geopolitical imperatives are to prevent a successful blockade and possess the capacity to project power outside the first island chain.

Ramifications

One of the logical inconsistencies of Allison's description of the Thucydides Trap is that the insurgent power shouldn't attack first if it is really on a steadily rising path. In China's case, Deng's dictum of "hide your strength, bide your time" seems like sound advice. However, if a leader in China perceived that the nation's power is at its zenith and would be facing decline in the coming years, moving sooner rather than later would make more sense. General Secretary Xi's recent belligerence suggests that he is pressing the issue.

It is widely reported that China views the U.S. as a declining power. If that were true, China should simply wait because time would appear to be on its side. Nevertheless, we are seeing aggressive actions on the Chinese/Indian border, the persistent militarization of small islands in the South China Sea, and obvious air incursions over Taiwan, which doesn't look like a power that believes time is on its side. It looks more like a leadership that has concluded that time is of the essence.

If Brands and Beckley are correct, the chances of conflict are more elevated than the consensus. The current crowd forecast from CSET has 9% odds of an attack on Vietnam, Taiwan, or India in the next six months. It is still too soon for investors to structure portfolios for a conflict in the region. However, the Chinese leadership has been taking action on multiple fronts, raising investment risks in China. Less risk-tolerant investors should exercise caution when investing in China for the time being.

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[5] See WGRs, "The Geopolitics of Taiwan: Parts I (5/3/2021), II (5/10/2021), and III (5/17/2021)."

Confluence Investment Management LLC

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