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THE SPECTER OF DEGLOBALIZATION AND THE THUCYDIDES TRAP

Nouriel Roubini

IN THE CLASSIC game of "chicken," two drivers race directly toward each other, and the first to swerve is the "loser." If neither swerves, both will probably die. In the past, such scenarios have been studied to assess the risks posed by great-power rivalries. In the case of the Cuban missile crisis, for example, Soviet and American leaders were confronted with the choice of losing face or risking a catastrophic collision. The question, always, is whether a compromise can be found that spares both parties their lives and their credibility.

There are now several geo-economic games of "chicken" playing out. In each case, failure to compromise would lead to a collision, most likely followed by a global recession and financial crisis. The most important contest is between the United States and China over trade and technology, which would lead to a decoupling of the global economy and, possibly, full-scale deglobalization. Other games of "chicken" include the risk of a military conflict between the United States and Iran and the risk of a hard Brexit in the tense relations between the UK and the EU.

A full-scale trade, currency, tech, and cold war between the United States and China would push the current downturn in manufacturing, trade, and capital spending into services and private consumption, tipping the American and global economies into a severe recession. And that's just for starters.

Luckily, in the short term America's President Donald Trump wants a deal with China in order to stabilize the economy and markets before his re-election bid in 2020; China's President Xi Jinping also wants a deal to halt China's growth slowdown. So both sides want to save face, but neither wants to be the "chicken" because that would undermine their respective domestic political standing and empower the other side. Still, without a deal by year's end or early 2020, a collision will become likely. As the clock ticks down, a bad outcome may become more likely.

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Photo: CIRSD

Nouriel Roubini at a recent Horizons Discussion in Belgrade

The problem is that while compromise requires both parties to de-escalate, the tactical logic of "chicken" rewards crazy behavior. If I can make it look like I have removed my steering wheel, the other side will have no choice but to swerve. But if both sides throw out their steering wheels, a collision becomes unavoidable.

The good news is that Washington and Beijing are talking to the other and a Phase One deal looks likely. The bad news is that there are big egos in the mix, some of which might prefer to crash than be perceived as a "chicken." And even if a Phase One deal is reached (as of early December 2019 this has not happened), it may only turn out to be a short-term truce in a medium- and longer-term strategic rivalry between the United States and China: over time, the risk of a trade, currency, tech, and cold war between Washington and Beijing is rising. Thus the future of the global economy hinges on games of daring that could go either way.

Temporary Buzz

In May and again in August 2019, escalations in the trade and technology conflict between the United States and China rattled stock markets and pushed bond yields to historic lows. But that was then: in more recent months, financial markets have once again become giddy if not irrationally exuberant. American and other global equity indices are trending toward new highs, and there is even talk of a potential "melt-up" in equity values. The financial-market buzz has seized on the possibility of a "reflation trade," the hope that the recent global slowdown will be followed in 2020 by accelerating growth and firmer inflation, which helps profits and risky assets.

> *While the United States and China may agree to a truce, the ongoing decoupling of the world's two largest economies will almost certainly accelerate again after the American election in November 2020.*

The sudden shift from risk-off to risk-on reflects four positive developments. First, the United States and China are likely to reach a "phase-one" deal that would at least temporarily halt any further escalation of their trade and technology war.

Second, despite the uncertainty surrounding the United Kingdom's election (a few days away at the time of writing), Prime Minister Boris Johnson has at least managed to secure a tentative "soft Brexit" deal with the EU, and the chances of the UK crashing out of the bloc in a disorderly way have been substantially reduced.

Third, the United States has demonstrated restraint in the face of Iranian provocations in the Middle East.

And, lastly, the U.S. Federal Reserve, the European Central Bank (ECB), and other major central banks have gotten ahead of geopolitical headwinds by easing monetary policies. With central banks once again coming to the rescue, even minor "green shoots"—such as the stabilization of the American manufacturing sector and the resilience of services and consumption growth—have been taken as a harbinger of renewed global expansion.

Yet there is much to suggest that not all is well with the global economy. For starters, recent data from China, Germany, and Japan suggest that the slowdown is still ongoing, even if its pace may becoming less severe.

Second, while the United States and China may agree to a truce, the ongoing decoupling of the world's two largest economies will almost certainly accelerate again after the American election in November 2020. In the medium to long term, the best one may hope for is that the looming cold war will not turn hot.

Third, while China has shown restraint in confronting the popular uprising in Hong Kong, the situation in the city is worsening, making a forceful crackdown likely in 2020. Among other things, a militarized Chinese response could derail any trade deal with the United States and shock financial markets, as well as push Taiwan in the direction of forces supporting independence—a red line for Beijing.

> *Whenever the next severe downturn occurs, high and rising private and public debts will prove unsustainable, triggering a wave of disorderly defaults and bankruptcies.*

Fourth, although a "hard Brexit" may be off the table, the Eurozone is experiencing a deepening malaise that is not related to the UK's impending departure. Germany and other countries with fiscal space continue to resist demands for stimulus. Worse, the new head of the ECB, Christine Lagarde, will most likely be unable to provide much more in the way of monetary-policy stimulus, given that one-third of the ECB's Governing Council already opposed the current round of easing.

Beyond challenges stemming from an aging population, weakening Chinese demand, and the costs of meeting new emissions standards, Europe also remains vulnerable to Trump's oft-repeated threat to impose import tariffs on German and other European cars. And key European economies—not least Germany, Spain, France, and Italy—are experiencing political ructions that could translate into economic trouble.

Fifth, with crippling American-led sanctions now fueling street riots, the Iranian regime will see no other choice but to continue fomenting instability in the wider region, in order to raise the costs of America's current approach. The Middle East is already in turmoil. Massive protests have erupted in Iraq and Lebanon, with the latter being a country that is effectively bankrupt and at risk of a currency, sovereign-debt, and banking crisis. In the current political vacuum there, the Iranian-backed Hezbollah or other radical groups could decide to up the ante with Israel. Turkey's incursion into Syria has introduced many new risks, including to the supply of oil from Iraqi Kurdistan. Yemen's civil war has no end in sight. And Israel is currently without a government. The region is a powder keg; an explosion could trigger an oil shock and a renewed risk-off episode.

Sixth, central banks are reaching the limits of what they can do to backstop the economy, and fiscal policy remains constrained by politics and high debts. To be sure, policymakers could turn to even more unconventional policies—namely, monetized fiscal deficits—whenever another downturn occurs, but they will not do so until the next crisis is already severe.

Seventh, the populist backlash against globalization, trade, migration, and technology is worsening in many places. In a race to the bottom, more countries may pursue policies to restrict the movement of goods, capital, labor, technology, and data. While recent mass protests in Bolivia, Chile, Ecuador, France, Spain, Hong Kong, Indonesia, Egypt, Iraq, Iran, and Lebanon reflect a variety of causes, all are experiencing economic malaise and rising political resentment over inequality and other issues.

Make no mistake, the specter of deglobalization looms ever larger, and no tactical truce or temporary leave may be able change this harrowing reality to come.

Eighth, the United States under Trump may become the biggest source of uncertainty. Trump's "America First" trade and foreign policies risk destroying the international order that the United States and its allies created after World War Two. Some in Europe, like French President Emmanuel Macron, worry that NATO is now "brain dead" while the United States is provoking rather than supporting its Asian allies like Japan and South Korea. At home, the impeachment process will lead to even more bipartisan gridlock and warfare, and some Democrats running for the party nomination have policy platforms that are making financial markets nervous.

Finally, medium-term trends may cause still more economic damage and disruption: demographic aging in advanced economies and emerging markets will inevitably reduce potential growth, and restrictions on migration will make the problem worse. Climate change is already causing costly economic damage as extreme weather events become more frequent, virulent, and destructive. And while technological innovation may expand the size of the economic pie in the long run, artificial intelligence and automation will first disrupt jobs, firms, and entire industries, exacerbating already high levels of inequality. Whenever the next severe downturn occurs, high and rising private and public debts will prove unsustainable, triggering a wave of disorderly defaults and bankruptcies.

The Coming Recession

Thus, the disconnect between bubbly financial markets and the real economy stuck into a new mediocre is becoming more pronounced. Investors are happily focusing on the attenuation of some short-term tail risks, and on central banks' return to monetary-policy easing. But the fundamental risks to the global economy remain. In fact, from a medium-term perspective, they are actually getting worse.

Indeed, there are three negative supply shocks that could trigger a global recession in the medium term. All of them reflect political factors affecting international relations, two involve China, and the United States is at the center of each. Moreover, none of them is amenable to the traditional tools of countercyclical macroeconomic policy.

In a rivalry that has all the hallmarks of a Thucydides Trap, China and America are vying for dominance over the industries of the future: artificial intelligence (AI), robotics, 5G, quantum computing, electric and autonomous vehicles, bio-tech, and so forth. Suffice it to say this could lead to economic decoupling on a planetary scale, which would precipitate full-scale deglobalization.

The first potential shock stems from the Sino-American trade and currency war—again, notwithstanding recent indications of a possible truce and temporary trade deal. But it is likely that that's all it is: a truce to bide time before the tensions escalate again over the medium term.

Hence the second potential shock: the slow-brewing cold war between the United States and China over technology. In a rivalry that has all the hallmarks of a Thucydides Trap, China and America are vying for dominance over the industries of the future: artificial intelligence (AI), robotics, 5G, quantum computing, electric and autonomous vehicles, bio-tech, and so forth. The 5G technology will soon be the standard form of connectivity for most critical civilian and military infrastructure, not to mention basic consumer goods that are connected through the emerging Internet of Things. The presence of a 5G chip implies that anything from a toaster to a coffee maker could become a listening device. This means that if Huawei is widely perceived as a national-security threat, so would thousands of Chinese consumer-goods exports. I will come back to this. Suffice it to say this could lead to economic decoupling on a planetary scale, which would precipitate full-scale deglobalization.

The third major risk concerns oil supplies. Although oil prices have fallen in recent weeks, and a recession triggered by a trade, currency, and tech war would depress energy demand and drive prices lower, A confrontation involving American and Iran could have the opposite effect. Should that conflict escalate into a military conflict, global oil prices could drive oil prices above $100 per barrel. That, after all, is what happened in 1973 during the Yom Kippur War, in 1979 following the Iranian Revolution, and in 1990 after Iraq's invasion of Kuwait.

All three of these potential shocks would have a stagflationary effect, increasing the price of imported consumer goods, intermediate inputs, technological components, and energy, while reducing output by disrupting global supply chains. Worse, the Sino-American conflict is already fueling a broader process of deglobalization, or at least a division of the global economy into two incompatible economic blocs. In either scenario, countries and firms will no longer count on the long-term stability of these integrated value chains. As trade in goods, services, capital, labor, information, data, and technology becomes increasingly Balkanized, and the digital realm would become a "splinternet," wherein Western and Chinese nodes would not connect to one another. And global production costs will rise across all industries.

China and the United States will both expect all other countries to pick a side ("you're with us or against us"); the middle ground may most likely become uninhabitable. Everyone will have to choose, and the world may well enter a long process of deglobalization and fragmentation.

In this Balkanized world, China and the United States will both expect all other countries to pick a side ("you're with us or against us"), while most governments will try to thread the needle of maintaining good economic ties with both. After all, many American allies now do more business (in terms of trade and investment) with China than they do with America. Yet in a future economy where China and the United States separately control access to crucial technologies such as AI and 5G, the middle ground may most likely become uninhabitable. Everyone will have to choose, and the world may well enter a long process of deglobalization and fragmentation.

Whatever happens, the Sino-American relationship will be the key geopolitical issue of this century. Some degree of rivalry is inevitable. But, ideally, both sides would manage it constructively, allowing for cooperation on some issues and healthy competition on others. In effect, China and the United States would create a new international order, based on the recognition that the (inevitably) rising new power should be granted a role in shaping global rules and institutions.

If the relationship is mismanaged—with the United States trying to derail China's development and contain its rise, and China aggressively projecting its power in Asia and around the world—a full-scale cold war will ensue, and a hot one (or a series of proxy wars) cannot be ruled out. In the twenty-first century, the realization of the Thucydides Trap would swallow not just the United States and China, but the entire world.

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PREPARED?

It is easy to imagine how today's situation could lead to deglobalization, namely a full-scale implosion of the open global trading system. The question, then, is whether monetary and fiscal policymakers are prepared for sustained—or even permanent—negative supply shocks.

Following the stagflationary shocks of the 1970s, monetary policymakers responded by tightening monetary policy. Today, however, major central banks such as the U.S. Federal Reserve are already pursuing monetary-policy easing, because inflation and inflation expectations remain low. Any inflationary pressure from an oil shock or trade wars will be perceived by central banks as merely a price-level effect, rather than as a persistent increase in inflation.

Over time, negative supply shocks tend also to become temporary negative demand shocks that reduce both growth and inflation, by depressing consumption and capital expenditures. Indeed, under current conditions, American and global corporate capital spending is severely depressed, owing to uncertainties about the likelihood, severity, and persistence of the three potential shocks.

In fact, with firms in the United States, Europe, China, and other parts of Asia having reined in capital expenditures, the global tech, manufacturing, and industrial sector is already in a recession. The only reason why that hasn't yet translated into a global slump is that private consumption has remained strong. Should the price of imported goods rise further as a result of any of these negative supply shocks, real (inflation-adjusted) disposable household income growth would take a hit, as would consumer confidence, likely tipping the global economy into a recession.

Given the potential for a negative aggregate demand shock in the short run, central banks are right to ease policy rates. But fiscal policymakers are also be preparing a similar short-term response. A sharp decline in growth and aggregate demand would call for countercyclical fiscal easing to prevent the recession from becoming too severe.

In the medium term, though, the optimal response would not be to accommodate the negative supply shocks, but rather to adjust to them without further easing. After all, the negative supply shocks from a trade and technology war would be more or less permanent, as would the reduction in potential growth. The same applies to Brexit: leaving the European Union will saddle the United Kingdom with a permanent negative supply shock, and thus permanently lower potential growth. And even an oil price shock could be persistent over time, if not semi-permanent.

Such shocks cannot be reversed through monetary or fiscal policymaking. Although they can be managed in the short term, attempts to accommodate them permanently would eventually lead to both inflation and inflation expectations rising well above central banks' targets. In the 1970s, central banks accommodated two major oil shocks. The result was persistently rising inflation and inflation expectations, unsustainable fiscal deficits, and public-debt accumulation.

Finally, there is an important difference between the 2008 global financial crisis and the negative supply shocks that could hit the global economy today. Because the former was mostly a large negative aggregate demand shock that depressed growth and inflation, it was appropriately met with monetary and fiscal stimulus. But this time, the world would be confronting sustained negative supply shocks that would require a very different kind of policy response over the medium term. Trying to undo the damage through never-ending monetary and fiscal stimulus will not be a sensible option.

The Reality to Come

And so we come back full circle to geopolitics. Despite the mutual awareness of the Thucydides Trap—and the recognition that history is not deterministic—China and the United States seem to be falling into it anyway. Though a hot war between the world's two major powers still seems far-fetched, a cold war is becoming more likely.

America blames China for the current tensions. Since joining the World Trade Organization in 2001, China has reaped the benefits of the global trading and investment system, while failing to meet its obligations and free riding on its rules. According to the American narrative, China has gained an unfair advantage through intellectual property theft, forced technology transfers, subsidies for domestic firms and other instruments of state capitalism. At the same time, its government is becoming increasingly authoritarian, transforming China into an Orwellian surveillance state.

For their part, the Chinese suspect that America's real goal is to prevent them from rising any further or projecting legitimate power and influence abroad. In their view, it is only reasonable that the world's second-largest economy (by GDP) would seek to expand its presence on the world stage. And leaders would argue that their regime has improved the material welfare of 1.4 billion Chinese far more than the West's gridlocked political systems ever could.

Regardless of which side has the stronger argument, the escalation of economic, trade, technological, and geopolitical tensions may have been inevitable. What started as a trade war now threatens to escalate into a permanent state of mutual animosity. This is reflected in the Trump Administration's new national security and defense strategies, which deem China a strategic "competitor" that should be contained on all fronts.

Accordingly, the United States is sharply restricting Chinese foreign direct investment in sensitive sectors, and pursuing other actions to ensure Western dominance in strategic industries such as artificial intelligence and 5G. It is pressuring partners and allies not to participate in the Belt and Road Initiative, China's massive program to build infrastructure projects across the Eurasian landmass. And America is increasing it naval patrols in the East and South China Seas, where China has grown more aggressive in asserting its dubious territorial claims.

The global consequences of a Sino-American cold war would be even more severe than those of the Cold War between the United States and the Soviet Union. Whereas the Soviet Union was a declining power with a failing economic model, China will soon become the world's largest economy, and will continue to grow from there. Moreover, America and the Soviet Union traded very little with each other, whereas China is fully integrated in the global trading and investment system, and deeply intertwined with the United States, in particular.

Make no mistake, the specter of deglobalization looms ever larger, and no tactical truce or temporary leave may be able change this harrowing reality to come.