# More on Trade and Other Wars

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**Summary:** Nowadays, we can’t avoid considering geopolitical developments because they are playing a greater than normal role in affecting economies and markets.  Recent geopolitical developments have led me to raise my probabilities of trade and other types of wars, such as capital wars, cyber wars (and possibly even shooting wars). To be clear, I’m not saying they’re probable, and I’m not sure that my assessment is right.  I’m just saying that it seems to me that the odds have increased relative to where they were, and I am just sharing the thinking that leads me to that conclusion.

**What Happened?**

Most recently, Donald Trump threatening to raise the stakes by $100 billion and the Chinese promptly indicating that they will match the moves dollar for dollar and step by step took me and people closer than me to the negotiations by surprise.  These developments broke my scenario that trade tensions would subside and increased the odds that a different and scarier agenda might be in play that raises the odds of trade, capital, cyber, and/or shooting wars on the horizon.

Before the last few days’ events, I thought trade tensions would subside because the Chinese are very amenable to a trade deal, because there are lots of ways to make a good deal happen, and because aggressive posturing ahead of midterm elections is understandable. Because I’m confident that those three things are true, I had expected the saber rattling to go quiet as the negotiations happened behind the scenes.  That was the picture I painted for you.  When I painted it, I said that if there was a step-up in the conflict, my scenario would be broken and I’d seriously worry. Then Trump raised the stakes by another $100 billion, which led the Chinese to promptly shift their mode from quiet negotiation to publicly stating that they will match the Trump administration’s moves dollar for dollar and minute for minute. Now we have a very public game of chicken going on. Maybe Trump’s statement was just an impulsive slip-up that he will backtrack on, or maybe he was serious.

In any case, I’m worried and forced to look harder at the question of where Donald Trump is leading us. What is his real agenda? Are these statements just negotiating maneuvers that will eventually lead us to having peace with better terms for the US, or are they steps on a path toward trade and other types of wars (and what might those other types of wars look like)?

Right now, I don’t think it’s clear to anyone, including some of the people closest to Donald Trump, what exactly his strategic objectives are. However, it is possible that he and his appointees Robert Lighthizer (US Trade Representative), Peter Navarro (head of the National Trade Council), and now John Bolton (National Security Council head) really mean what they have said.  As for what they have said, here are a few notable ones.

Robert Lighthizer said:

* “Given the current financial crisis and the widespread belief that the 21st century will belong to China, is free trade really making global markets more efficient?  Is it promoting our values and making America stronger?  Or is it simply strengthening our adversaries and creating a world where countries who abuse the system—such as China—are on the road to economic and military dominance?”

Peter Navarro wrote a book called “Death by China: Confronting the Dragon—A Global Call to Action.” When asked about the title, he said: “It’s an economic death because of China’s unfair trade practices and the loss of the US manufacturing base.  Also, literal death because of the loss of consumer safety: toothpaste, baby formula, a dizzying array of products.  There are also human rights abuses—China’s forced labor camps…Also, the military buildup of China.  It’s an evocative title, yes, and it has multiple meanings.”

John Bolton said:

* “Our goal should be regime change in Iran.”
* (On bombing Iran): “The inconvenient truth is that only military action like Israel’s 1981 attack on Saddam Hussein’s Osirak reactor in Iraq or its 2007 destruction of a Syrian reactor, designed and built by North Korea, can accomplish what is required.  Time is terribly short, but a strike can still succeed.”
* On North Korea: “I think the only diplomatic option left is to end the regime in North Korea by effectively having the South take it over.”

They and the president sound like populist fighters (for good or for bad, which is for you to assess).  Besides seemingly willing to be much more confrontational with China, this administration appears ready to step out of the Iranian deal when it comes up for assessment in May, which will likely lead to some forms of conflict with Iran and with other countries that signed on to this deal.

Having said this, I ordinarily wouldn’t read too much into these statements alone.

However, stepping back from these developments and statements, as explained before, it seems to me that the most analogous period to now is the mid/late 1930s, which was similar because of the a) big deleveraging’s, b) monetization’s of debt that helped the deleveraging’s by pushing the markets and the economies higher, c) large wealth gaps that were increased by the monetization’s as well as new technologies and open trade, d) rising protectionism, e) the emergence of strong populist leaders arising because of the wealth and opportunity gaps and large numbers of people believing that the system did not work for them, f) the emergence of new world powers to challenge the old, g) growing militarism and nationalism, h) tightening’s of monetary policies, and i) more conflicts internal and external, with the external conflicts helping to support the populist leaders.

You know from [my study of populism](https://www.linkedin.com/post/edit/populism-phenomenon-ray-dalio) that I learned that the most important thing to watch when a populist leader comes to power is conflict. If it increases between the left and the right to produce operational inefficiencies and if it increases between countries to produce international tensions, the odds of one or another or a few types of war developing increase.

If you haven’t read about Thucydides’ Trap, and if you’re interested in how it might apply to US relations with China, I suggest Graham Allison’s “Destined for War: Can America and China Escape Thucydides’ Trap?” In it, he explains that in the last 500 years there were 16 times when emerging powers became as strong as or stronger than existing dominant powers, and war resulted in 12 of them.  In the other four, extraordinary steps were taken to prevent war.  The war occurs because the rising power naturally wants to have increasing power, which the declining power naturally doesn’t want to give up, and there is plenty to argue about so there is typically a testing of each other’s powers.  That testing typically starts with small confrontations, which escalate into big ones. Like most things, this dynamic has a logical cyclicality to it—wars leading to peace periods that lead to wars, and so on. In a nutshell, it is that from each war the new dominant power emerges because there is a clear winner so there is not much sense in fighting against a clear dominant power, so there is peace until a new rival emerges and the previously explained conflict dynamic occurs, and so on. For good reasons, now and in the 1930-45 period, this cycle corresponds with the long-term debt cycle. Because both are long enough to typically come along only once in each person’s lifetime, they’re difficult to recognize while they are taking shape and they seem implausible.

I’m also told that it’s wise to watch the populist leader’s rhetoric about the rival country because it is meant to influence the population’s psychology—i.e., to paint the picture of that country as a friend and good or an enemy and bad—in support of its actions.  The Trump administration’s recent descriptions of Chinese actions, using works like “economic attacks” and “enemy,” are concerning.

From studying history, I believe that another thing to watch out for as a straw in the wind is a shift to “state capitalism.” By state capitalism, I mean the government redirecting “business” activity toward the service of the country and away from the service of the shareholder.  This tends to happen when there is a growing risk of war because war puts increasing pressure on the national leaders to bring all the resources of the country, including companies, into the service of the country.

Naturally, leaders who consider the odds of war significant also want to make sure that the country’s productive means are capable and self-sufficient, which is a reason for protectionism.  For instance, a country might decide that it needs a stronger steel industry in the event of war, even if that is not the most economical use of resources, because it fears potentially being cut off from key supply lines and strategic assets.

At the risk of reading too much into them, Donald Trump’s recent interventions in the economy—e.g., his executive order preventing Broadcom from buying Qualcomm—are notable in that regard.

The turn to state capitalism, protectionism, nationalism, and militarism arises when the probabilities of war rise, and reinforces the rival country’s fears and tensions between the rivals.

**What Types of Wars?**

As for what types of wars are possible, we should think beyond trade wars to consider the possibility of other types of wars.  Because the opposite side of a trade/current account deficit is a capital account surplus (i.e., our borrowing/selling of bonds to the Chinese to finance the deficits, which has led to the Chinese having a large inventory of bonds), one should consider the possibility that this trade war could also become a capital war. I won’t now digress into what such a war would look like because that’s a subject that warrants more words than can fit into here now. However, I will say that it will be even uglier than a trade war, and that to whatever extent anyone believes that the US has the advantage in a trade war because it has a big deficit (so it has more to gain) one could say the same for China in a capital war because it has the bigger deficit.

**Managing Money through Major Political Shifts**

While we are not political experts, we have studied and experienced political effects on economies and markets for over 40 years. While we typically avoid betting on political shifts happening, and we will sometimes take risks off the table when political risks are very high, we understand pretty well political changes such as in fiscal policies, monetary policies, regulatory policies, currency regimes, etc.—and we believe we have an edge in being able to anticipate the knock-on effects they will have on assets and the economy relative to what is priced.  It is for this reason that when we stress-test our systems and processes across the last 120 years, through all the major wars and depressions and political crises, our systems do well.  Our philosophy for managing money through such geopolitical shifts is to know where our edge is, and to neutralize those exposures on which we do not have an edge, while ensuring our portfolios are liquid (to be flexible) and diversified (to not have concentrated risks).  Our advice for others is to do the same.