Allison Nathan: Geopolitical tensions between the US and China have been running high for some time. The trade war between the two countries has been ongoing since 2017. But the US's downing of a suspected Chinese spy balloon earlier this year, increasingly hostile rhetoric between the two countries, and President Biden's plans to unveil further curbs on US investment to China ahead of this month's G7 summit have brought the tensions and their economic and investing implications back into focus. I'm Allison Nathan, and this is Goldman Sachs Exchanges.

On this special episode, we're breaking down our most recent Top of Mind report, now available on GS.com. We dig into the tensions and, crucially, how they're affecting the investability landscape between the two countries for
companies and investors. We speak with Harvard's Graham Allison, who's extensively studied and documented the US-China relationship, and Rhodium Group's Dan Rosen, who's done a lot of work tracking and evaluating US-China investment and trade flows.

We first asked Allison about what's behind the recent rise in US-China tensions, which he actually predicted in his 2017 book *Destined for War*. He explains that the rise in hostilities comes as no surprise because history has showed time and time again that such hostilities occur whenever a rapidly rising power has seriously threatened to displace a major ruling power. He refers to this as a Thucydidean rivalry.

**Allison Nathan:** How would you describe the current state of US-China relations? And how does that compare with previous periods?

**Graham Allison:** In one word, “bad.” And if I were given many words, I would say “very bad.” Unfortunately, the relationship has declined. The worst state that it's been since Kissinger and Zhou Enlai began their conversations, now 50-plus years ago, that began the reopening and the
reestablishment of relations between the two countries.

So why has this relationship become increasingly hostile? I think, as *Destined for War* explained, for the very reason that Thucydides explained, that, when a rapidly rising power seriously threatens to displace a major ruling power, stuff happens. In the last 500 years, we saw 16 cases in which a rising power seriously threatened to displace a ruling power. And in 12 of those cases, the outcome was war.

Is China a meteoric rising power? Duh. Look at every indicator for the last generation. Who was the number one manufacturing workshop of the world when China entered the WTO? US. Who was it by 2010 and is it today? China.

Who was the number one trading partner of everybody in 2000? Who is the number one trading partner today? Who's actually the largest GDP measured by purchasing power parity? China, about a quarter of the US in 2000 and today slightly larger. So basically nobody can dispute that China is a meteoric rising power, and it's impossible to realistically deny that the US is a colossal ruling power.
whose reach is global all the way around the world, who has SOCOMs that are responsible for security in every area of the world, and is a major and indeed predominant power in Asia, indeed, has been the architect of the international order that for now more than seven decades has not seen great power war.

So this is a classic Thucydidean rivalry. And I would say the answer to your question is 75% of the answer is in the structural challenge of a rapidly rising power confronting and seriously threatening the position of an established ruling power. Add to this the identity of the two rivals. For Americans, accustomed to being at the top of every pecking order for now a century, what we call the American Century, it's part of who we are. And so for China to challenge our position as number one is to challenge us psychologically. Americans are shocked by the idea that Chinese are not taking their place that we've assigned them in the American-led international order.

And on the other hand, anybody that knows anything about China knows that, in China's conception of China, even the word itself in Mandarin means “Middle Kingdom,” which is the connection the earth and heaven. And
China's conception of its own role in the world is as the center of the universe, and everything else revolves around it. And in their story, for thousands of years, they occupied their legitimate appropriate position. And then they were displaced by Westerners, who showed up with technology to humiliate them in what they call the Century of Humiliation. But now they're regaining their strength. They're doing what Xi calls the Great Rejuvenation of the Great Chinese People, by which they may be returning to their natural place as the center of the universe.

So just to conclude, a rising power that is seriously threatening the US position specifically in Asia as the predominant power inevitably sets up a rivalry. And that then is refracted in the perceptions of both places. In my book, I describe the so-called Rising Power Syndrome, “I'm bigger, I'm stronger, I deserve more say, I deserve more sway, all these rules were put in place before I even arrived.” And the Ruling Power Syndrome, which is, “Who do you think you are? What do you think you're doing? Who provided this environment in which you ever grew up in the first place? You should be grateful.”

Over and over, these story lines play out. So that's the
main thing that's playing out. In addition, it's magnified by the two identities and therefore, I would say expect things to get worse before they get worse.

**Allison Nathan:** Even as Allison expects relations to deteriorate, he doesn't believe that a war between the US and China is inevitable, but he does warn that extraordinary efforts will be required to avoid one.

**Allison Nathan:** Clearly, you're relatively pessimistic about the relationship, so do you think war is inevitable?

**Speaker:** No. My book says war is not inevitable. So what the Thucydides trap and argument says and what I believe is that, normally, in rivalries like this one, the outcome is war. Normally. In 12 of the last 16 cases. So if you knew nothing other than just history as usual, then war would be not only possible but likely. So if all we can manage in relations between the US and China is business as usual and diplomacy as usual, then we should expect history as usual.

But that is not a fatalistic prediction about catastrophic war but to remind us that, in some cases, four of the 16
that were described in the book, extraordinary diplomacy, extraordinary strategic imagination can produce extraordinary results. Now, I do not in any way believe that war between the US and China is inevitable. I think recognizing the Thucydidean pattern reminds that, if we just resign ourselves to letting things happen, things will happen. But that should be the motivator for stretching strategic imagination.

Many people said war was inevitable between the US and the Soviet Union. A lot of predictions, this is for sure going to happen. But it didn't happen. Why not? Not by accident. There was a lot of good fortune, but because people developed a coherent strategy for dealing with something over decades. They stuck with it. They managed some constraints in the competition. They developed a lot of patterns of the behavior. So I think this is a challenge of strategic imagination to get beyond history as usual.

**Allison Nathan:** But domestic politicians are pushing Biden farther and farther right, and there seems to be a pretty hawkish contingent in China. So do you think the stage is being set for that extraordinary diplomacy?
Graham Allison: Certainly, the politics both in Washington and in Beijing and the populism in both places and the nationalism, especially in China, make things harder than it was for Athens and Sparta, to go back to Thucydides' classic case. But I think in both Biden and Xi, you have two very sane, experienced political leaders. Each of them knows that war between the US and China would be catastrophic for his own country. So nobody in China wants a war with the US, and nobody in the US wants a war with China.

So I think, for Biden and for Xi, the challenge of each trying to find their way to some coherent strategic concept for engaging the other that's sturdy enough to contain or to manage the political demons within each society is extreme but not impossible.

Allison Nathan: To succeed, Allison advises policymakers to embrace something he calls a “rivalry partnership” in which the powers both compete and cooperate. Here he is again.

Allison Nathan: So what would your advice be for
policymakers today?

**Graham Allison:** My main idea, I've said publicly and it's the same idea I tell people about privately with a few wrinkles, and it would be the following. Ask yourself which should rational leaders in Beijing and Washington find more compelling? The incentives to compete or, alternatively, the incentives to cooperate?

So I suggested to China and to Washington, take a page and write on the front page "incentives to compete," and then start making bullet points. But then turn the paper over and in the back, "incentives to cooperate." And now do the bullet points.

If I take it from an American perspective, am I compelled to compete with you because you want to be the predominant power in Asia? Another reason to compete, you would like to be the predominant economy in the world with everybody else mostly dependent on you so that, if somebody were doing something you didn't like, you could squeeze them, the way you did the Japanese when you cut off rare earths. We think we'd be better off if we were in that position. So we will constrain exports of advanced
semiconductors to you to maintain our lead in applications, including AI, and you will continue trying to get us more dependent on the supply chains for green energy like EVs because that'll give you some leverage.

So think of the reasons. Turn it over, though, before you're done. We are both living in what we learned in the nuclear age as called a MAD world, mutual assured destruction. Both the US and China have nuclear arsenals that, if used against the other, would completely destroy the other society. I do my best to destroy you and disarm you. You can still retaliate in a way that destroys me. So at the end of this war, you're dead and I'm dead.

Now, Ronald Reagan looked at that in the Cold War and concluded, quote, “a nuclear war cannot be won,” because at the end of the war, your society is destroyed. Don't put that in the win column. And therefore -- big “therefore” -- must therefore never be fought.

Another thing. How about a MAD climate world? So if your greenhouse gas emissions can so disrupt the closed biosphere that we both live in that neither of us can survive, I have a pretty compelling reason to find a way to
cooperate with you to constrain greenhouse gas emission.

It's the next level. Financial crises. If the financial system is so integrated that if a great recession occurs here, that becomes a worldwide depression, absent you and me cooperating with stimuli to prevent it, which is what happened in 2008, 2009, US and China cooperating, I have a pretty important incentive to cooperate.

So I would say, if I make these two lists, they're both overwhelming, having to compete with you, having to cooperate. So I think we need a strategic concept that embodies these two contradictory sets of imperatives, to compete and to cooperate. And this could be called a rivalry partnership.

So we're fierce rivals and intense partners. Sometimes in business it's called coopetition. If you want an example of it in business, look at Apple and Samsung. They're fierce competitors in smartphone markets, but who's the biggest supplier of parts for Apple? It's Samsung. It's pretty uncomfortable, but it's life. So life usually consists not simply of black and white but many shades in which parties learn that they can compete in some spaces and
cooperate. And is that difficult? Yeah. Well, life is difficult.

**Allison Nathan:** We then turned to Dan Rosen to understand how the US-China economic relationship has evolved amid the rise in geopolitical tensions. He finds that while bilateral trade is still high, it's well below the level it would have been in the absence of trade frictions. And investment flows between the two countries have declined sharply.

**Dan Rosen:** Looking at the bilateral relationship, we have a divergence between trade dynamics and several kinds of investment dynamics. On trade, despite all the trade war talk in the past, US-China trade remains at extremely high levels. That's mostly been driven by strong household-level consumption patterns in the United States.

However, if we had used a pre-Trumpian baseline for where trade would be, we probably would say that trade is well underneath the level that it would have been if the two economies were just proceeding apace with comparative advantage and taking advantage of one another's comparative advantages. That is not happening. So we
have both an elevated level of trade versus, say, two years ago or four years ago or six years ago. And at first glance, that seems to suggest that trade is bulletproof. But really, against where it would be, we're still well under where we would have been in a business-as-usual 2015 world, straight lines forward.

On the investment side, we have a very different picture. We have two different channels there worth talking about. One is foreign direct investment by companies, and the other is portfolio.

On the direct investment side, advanced economy, FDI flows to China are reduced properly measured for the United States and for other major advanced economies like the European Union as well. Chinese data last year properly read showed pretty significant downturn in the level of foreign direct investment inflows by the end of the year. Not only are values reduced in absolute turns but also, again, against the baseline of how they should have grown, given that China is increasingly in middle income territory, now's the time when global companies should be dramatically increasing their investments into a maturing Chinese middle income economy. So against what should
be the case, it's even a worse story to tell.

One other really interesting observation about US flows to China and European Union flows to China, in the past three years, about 80% of total foreign direct investment flows to China have been the work of just 10 American companies and 10 European countries. So it's really only a handful of super giants that have very well-established positions in the Chinese economy to defend their operations that are still upping the ante and staying in the game. Virtually everybody else is on the sidelines or being very careful about making additional direct investment outlays in China.

On the outbound Chinese side to the United States, we've never gotten back to the high watermark of 2015-2016 where we had gotten up to about $50 billion a year of incoming Chinese activity. That's down in like the $5 billion a year or less territory now for some years. That is mostly because of concerns about capital outflows in Beijing, but it's also been increasingly because of more pronounced concerns about some security considerations in Washington.
So both those factors have put a low ceiling on two-way engagement in the foreign direct investment channel, which should have otherwise been one of the most exciting areas of growth in the relationship.

Finally, on the portfolio side, two-way portfolio flows started at a very low level where they've historically not gone through the steep part of the takeoff curve yet. And with the advent of, for example, MSCI inclusion of China and the ideal global portfolio, these were supposed to be the golden years for seeing that normalize to much higher levels.

Yes, you can say the pandemic slowed that down a little bit, but it's really not the pandemic so much as the tardiness of Beijing in dealing with a variety of portfolio relevant basic macro financial policy reforms to do with exchange rate, capital account, assurances that the door's not going to be closed after investment goes in. And then, yes, on top of that, you have the geopolitical leaning in of Washington that's tapped the brakes quite robustly on the prospect of significant US portfolio flows to China.

**Allison Nathan:** While geopolitical concerns out of
Washington have curbed US investment flows to China, Rosen doesn't think President Biden's impending executive order will have a significant impact on those flows. Here he is talking about this.

**Dan Rosen:** I don't think it'll be as impactful as it was originally intended or conceived by some people. And certainly not as impactful as some of the more vociferous hawks would like it to be. This has been a long time coming by current standards, and it's going to require more notification. If a firm wants to make an outbound investment that meets a set of specific criteria, they're going to be required to provide certain information about the nature of the technology involved, the values, the partners they're working to the Treasury department.

My guess is that it will just be notification for the most part. That it's not going to be notification and then we'll let you know if you can do it. It'll be notification, and we'll let you know if we have a problem. And my guess is that the regime at this stage anyway is principally going to be focused on a handful of very specific technology areas -- artificial intelligence, quantum computing, for example -- and it's an executive order, which bear in mind can be
reversed by another president, is not a permanent state of US regulation. It's inherently temporary, which means it's not the end of the issue.

We'll have to see how it's implemented, how effective it is. Surely more to come. Surely it'll have room for the addition of other sectors if they are shown to meet the criteria used to explain whatever sectors do land in this. But by and large, if it is narrowed down the way it is rumored to have been narrowed down and given the guardrails that we hope to see in this, then I think the general verdict will be we can live with this. It's not going to be kneecapping American investment in China.

**Allison Nathan:** But even if the impending restrictions don't materially reduce US investment in China, Rosen thinks the substantial differences between the economic systems of the US and China will. As long as that remains the case, he says, further economic and financial decoupling that entails fewer investment opportunities between the two countries is likely.

**Dan Rosen:** Consider that interoperability in high technology trade and investment between the United States
and Canada is acceptable to us, both from a commercial and a government perspective, because due diligence companies can operate on both sides of the border, and they can provide some assurance that we understand how the technologies are being used, what the end users are of a supercomputer. We know what we're getting and that we're not opening ourselves up to, at the company level, reputational risks or, from the national level, security risks in that deepening relationship.

Just in the past several months, we have additional examples of Beijing being very clear that they are not going to permit the same amount of normal commercial due diligence to take place that we would expect from a peer market economy partner. We have a thing called China Pathfinder we do with the Atlanta Council which looks systematically or comprehensively at the nature of China's economic system compared to a typical OECD economy. So how close or far is China from market economy norms? And we backcast that. So we're looking at the arc of Chinese change from 2015 and 2016 forward. The progress toward attainment of market norms has stalled out, and China hasn't been able to make additional progress towards marketization.
And then a lot of areas has taken a step backwards, in fact, and turned to a more government-driven set of solutions for how the economy is guided forward rather than letting markets point the way. And that is a sufficiently broad-based phenomenon that, unless and until there is some decisive redirection from the top in Beijing, I think there is naturally going to be an organic hesitance by American companies to deepen engagement that is taking place even before we get to national security considerations.

**Allison Nathan:** But even as the two countries decouple, Rosen still sees many opportunities for companies and investors in both countries to engage with each other.

**Dan Rosen:** Decoupling in no way needs to be maximal. When we actually look at what activity is subject to these kind of national security concerns, it's a very significant amount of activity, but it's far from being the totality of our two-way economic relationship or China's engagement with the rest of the market world or the whole world. So there's a lot of stuff which will continue to be permissible and accretive to our economic welfare and to China's economic welfare.
Allison Nathan: Rosen also doesn't believe that decoupling is a foregone conclusion. He notes that Chinese leaders have shown a greater ability to shift policy direction when warranted than they're generally given credit for. So he thinks a policy shift that's conducive to deeper US-China engagement could occur. Here he is again.

Dan Rosen: Some outspoken China critics commonly assert that the Communist Party of China is playing a 100-year game and has never demonstrated any seriousness about liberalizing policy, especially in the economic area. I think that flies in the face of the facts. The amount of structural adjustment, disruption of state-run industry and business in China since the 1970s has been extraordinary. And at many times, leaders made the decision to course correct and alter the direction of policy. That happened in 1978-79. It happened in 1984. It happened in 1992. It happened in 1998 when as many as 35 million state-owned enterprise workers were laid off and the property sector was essentially opened up for privatization almost overnight. It happened even in 2013 when Xi Jinping first came into power and his initial impulse was to put on the table a really significant program
of reform that would have seen center local fiscal reform, the introduction of independent directors onto boards, including of state-owned companies, and many other examples that I've documented in a number of articles.

And so we have a demonstrated ability in Beijing, when the evidence becomes unmistakable that China's own betterment requires a different set of policies and ideas, that Beijing is able to do that. For the moment, we certainly haven't seen since 2015-2016 much inclination to have a big bang in a different direction. But then again, it's only been, like, five months since the summarial end to zero COVID that reminded us once again that, when push comes to shove, Beijing is capable of making some pretty significant changes of course.

This year, it's going to be extremely difficult to achieve high growth. Productivity seems to be headed down towards something like zero. And this really is not a sustainable picture. Unlike other countries that went sideways and had a lost decade like Japan in the 1980s, China still of course has 800 or 900 million people waiting their turn at development. Beijing does not have the luxury to simply take a pause on economic development for a prolonged
period of time.

So if we're correct about the structural analysis of limits to growth under the current model, then rather than assume that somehow China learns to live comfortably with low growth, one has to start considering that there could be another significant change in policy direction ahead.

**Allison Nathan:** With questions about how US-China tensions will evolve and the economic and investing implications sure to remain in focus, we'll continue to keep a close eye on all of it. I'll leave it there for now.

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