

## South Korea: Beyond the US-China trade and hegemonic war

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**The South Korean economy has suffered the fall-out from the US-China trade war. Examples of the hegemonic competition between great powers throughout history remind us of the magnitude of the challenge ahead. For now, the South Korean government's biggest stimulus since the global financial crisis seeks to buffer its economy, while the rivals learn to share the world stage.**

While the US-China trade war has affected the US and Chinese economies, it has also taken a toll on Asian economies that have tight production links to China. South Korean exports, for example, fell 11% in July from the year before, its 8<sup>th</sup> consecutive month of decline. Meanwhile, job losses in the manufacturing sector are expected to continue. While GDP growth rebounded in the second quarter (+1.1% yoy), this was on the back of strong government spending.

### THUCYDIDES'S TRAP

The rivalry between the US and China has

triggered references to the conflict between Athens and the Spartans in 5<sup>th</sup> century BC. Professor Graham Allison, a political scientist in the US, calls it "Thucydides's Trap" – when a rising power causes fear in an established power, it eventually escalates into war<sup>1</sup>.

The Thucydides's Trap concept basically draws its argument from the text of the ancient Greek historian Thucydides's – "It was the rise of Athens and the fear that this inspired in Sparta that made war inevitable".

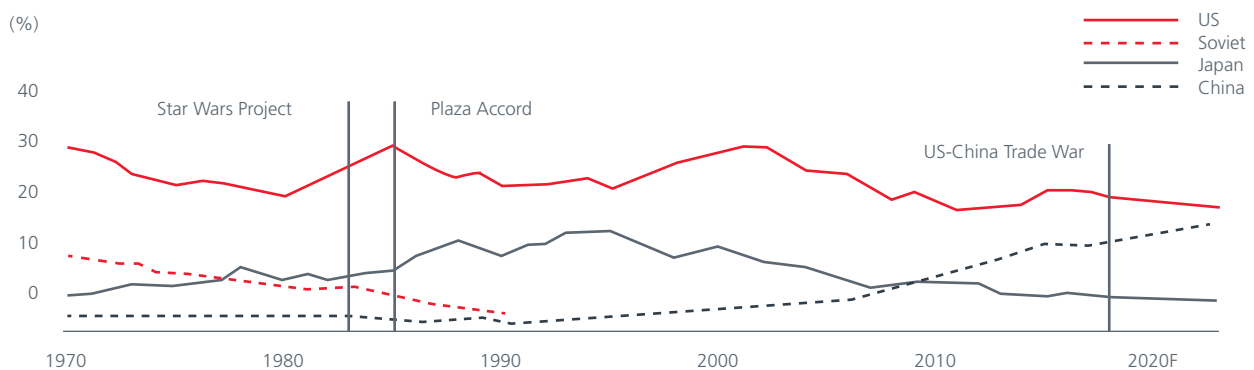
In 5<sup>th</sup> century BC, a fierce rivalry existed between two leading states, Sparta and Athens. Sparta, the dominant state, fearing the rise of Athens, organised the Peloponnesus League, a confederation of Greek city states and went to war, ultimately defeating the Delian League, an alliance organised by Athens.

According to Professor Allison, among the 16 examples of hegemonic competition between the great powers after the 15<sup>th</sup> century, only 4 did not result in war. See Fig. 1. These included the hegemonic competition between the US and Soviet Union from the 1940s which involved an arms race (Strategic Defense Initiative) started by

**Fig. 1 . Examples of hegemonic competition<sup>3</sup>**

Period	Dominant State	Emerging State	Struggled for	Result
Late 15C	Portugal	Spain	World empire, trade	-
Early 16C	France	Hapsburgs	Western Europe	Battle of Pavia
16,17C	Hapsburgs	Ottoman Empire	Central Europe, Eastern Europe, Mediterranean	Battle of Lepanto
Early 17C	Hapsburgs	Sweden	Northen Europe	Thirty Years' War
Mid-late 17C	Netherlands	England	World empire, ocean, trade	Anglo-Dutch Wars
Late 17C ~ Mid 18C	France	England	World empire, Europe	Seven Years' War
Late 18C ~ Early 19C	England	France	Europe	Napoleonic Wars
Mid-19C	France, England	Russia	Influence over World empire, Central Asia, East Mediterranean	Crimean War
Mid-19C	France	Germany	Europe	Franco-Prussian War
Late 19C ~ Early 20C	China, Russia	Japan	East Asia	First Sino-Japanese War, Russo-Japanese War
Early 20C	England	US	Hegemony of World Economy and superiority of naval power in the western hemisphere	-
Early 20C	England	Germany	Hegemony of Europe, ocean	World War I
Mid-20C	Soviet Union, France, England	Germany	Europe	World War II
Mid-20C	US	Japan	Asia-Pacific area	Pacific War
1940s ~ 1980s	US	Soviet Union	Hegemony of the World	-
1990s ~ Present	England, France	Germany	Political influence in Europe	-

**Fig. 2 . Trend of Global GDP Distribution<sup>4</sup>**



the US in 1983 to defend itself from the Soviet Union’s intercontinental ballistic missiles. The Soviet Union, which had started to experience declining economic growth from a slow-down in agricultural productivity, eventually collapsed from the continuous arms race.

**THE RISE AND FALL OF GREAT ECONOMIC POWERS**

While prior wars focused on military might, the core of hegemonic competition has largely shifted

to economic influence after World War II. However, history tells us that the outcome can be surprising, and the continued ascendancy of any economy is not guaranteed.

After the Chinese civil war in 1949, the US and Japan united against communist power and ideology. USD60 billion worth of military supply orders from the US to fight the Korean (1950) and Vietnam (1965) wars caused the US to suffer a massive trade deficit with Japan. Japan’s GDP rose to become two-thirds of the US (See Fig. 2). Its manufacturing industry boomed as exports soared

on the back of a competitive exchange rate as well as significant technology transfers from the US

This hegemonic competition did not end in a war as the Japanese economy subsequently lost steam after the Plaza accord. In 1985, Japan signed the Plaza accord which sought to correct the over-valuation of the US dollar by asking the main current account surplus countries (Japan and Germany) to boost domestic demand and appreciate their currencies. Accordingly, the yen appreciated sharply - up 46% against the US dollar and 30% in real effective terms by the end of 1986. As a result, Japan's export and GDP growth essentially halted in the first half of 1986. Pressured to respond, Japanese policymakers introduced a sizeable stimulus which led to an unprecedented boom in asset prices, and ultimately a collapse - what is now known as Japan's Lost Decades<sup>5</sup>.

## THE HEGEMONIC COMPETITION BETWEEN THE US AND CHINA

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China's GDP is currently two-thirds of the US' (Fig. 2.) and forecasts suggest that China will become the world's largest economy by 2050<sup>6</sup>. China is currently the world's largest producer of aluminium<sup>7</sup> and steel<sup>8</sup>. Many of its tech companies are market leaders and it is becoming a world leader in developing 5G technology. With its "Made in China 2025" blueprint, China aims to transform the country into a hi-tech powerhouse that dominates advanced industries such as robotics, advanced information technology, aviation and new energy vehicles.

The US views these ambitions as a threat to its technological leadership. Among other things, the US wants China to respect intellectual property rights, provide safe guards against unfair competition from its state-owned enterprises and provide a more level playing field.

At the same, hegemonic power goes beyond trade and potentially extends to the exchange rate and capital markets. Whoever owns the global reserve currency becomes the hegemonic power. On the exchange rate front, China wants

to share the global reserve currency spotlight, but this would require allowing market forces to play a greater role in determining the renminbi's value and opening up the capital account further. Meanwhile, China has chosen to open up its capital markets at its own pace, to avoid destabilising capital outflows and excessive volatility in its financial markets.

Changes in global order affect other economies. Due to China's rapid progress and South Korea's delays in innovation, South Korea's lost about 50% to 60% of global market share in light industries over the last 20 years. Previously known as one of the four Asian tigers, South Korea experienced exceptionally higher growth rates in excess of 7% per annum from the early 1960s to 1990s. Its growth outlook has since been clouded by ageing demographics, a low birth rate and more recently the decline of its manufacturing sector on the back of the US-China trade tensions as well as export restrictions imposed by Japan. In addition, if China achieves its goal of self-sufficiency in core components as laid out in its "Made in China 2025" blueprint, this could further hurt South Korea's hi-tech export sector.

## HOPE AND UNEXPECTED TURNAROUNDS

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With the world economy becoming ever more intertwined, emerging powers will have to share the world stage. The resolution of global issues will require the participation of more players, China included. It will be necessary to achieve mutual understanding and adopt a set of universal values - this will not be easy, as we have seen.

At the same time, the unpredictable path of events suggests that wild cards cannot be ruled out. Some form of the trade resolution ahead of the US presidential election will lift animal spirits as well as business and consumer sentiment. For South Korea, successful negotiations between the US and North Korea, can lead to greater inter-Korea economic co-operation, giving the South Korea economy a new boost. In view of the faltering economy, the South Korea government

has unveiled its most expansionary budget since the 2008 global financial crisis. Fiscal spending will rise 9.3% yoy in 2020, as the government looks to support economic growth through innovation and investment.

Thucydides's Trap helps us understand the magnitude of the challenge ahead for the US-China relationship and the urgency for a solution. Although the current realities appear dark, the eventual outcome need not be negative. While it will take time, a resolution will lift South Korea's growth potential and increase the attractiveness of its financial markets to foreign investors. For now, within the South Korea fixed income market, we are neutral on credit given increasingly stretched valuations. The Bank of Korea is likely to cut rates again in the fourth quarter and we will be looking for opportunities to tactically trade duration.

Sources: <sup>1</sup>Destined For War: America, China and Thucydides's Trap. Graham Allison. <sup>2</sup>This theory is not universally accepted as presented in "There is no Thucydides's Trap". Arthur Waldron. June 2017. <sup>3</sup>Graham Allison (2017). Destined for War: Can America and China Escape Thucydides's Trap. <sup>4</sup>United Nations, Shinhan Investments. <sup>5</sup>IMF. April 2011. Global Prospects and Policies. <sup>6</sup><https://globalsecurityreview.com/will-global-economic-order-2050-look-like/> <sup>7</sup>Mineral Commodity Summaries 2019. US Department of the Interior. US Geopolitical Survey. <sup>8</sup>International Trade Administration. Global Steel Trade Monitor. August 2019.

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