

Living in the Grayzone

Living in the grayzone

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Introduction

In the unfolding narrative of global geopolitics, this tale begins with contemplation of the end of US hegemony and the emergence of a new world order characterized by a gray zone conflict. This shift, prompted by events such as the war in Ukraine and the potential conflict over Taiwan, challenges traditional Cold War notions and introduces a dynamic where the term "grayzone" aptly captures the heated nature of contemporary geopolitical rivalries.

Unlike the Cold War, this 21st-century gray zone conflict is not frozen by a nuclear equilibrium but demands decisive victories. Military college manuals define gray zone warfare as the use of hostile measures just short of war itself, presenting a spectrum of shades that can evolve based on geopolitical events. Quantum forecasts suggest that should Russia face defeat in Ukraine, China, driven by its aversion to democratic victories, may intervene, reshaping the geopolitical landscape.

Global alliances are crystallizing into two distinct formations: an autocratic alliance led by China with Russia as a subordinate partner, and a democratic alliance led by the United States. These alliances draw in the N-factor states, countries that do not align formally with either camp. The intricate dance to entice or coerce these states becomes a crucial aspect of this evolving geopolitical landscape.

Beyond the political realm, alliances have profound economic implications. The widening base of alliance structures increases their power, but comes with challenges such as slower decision-making and the need for more effort to maintain cohesion. As grayzone conflicts unfold, economic models shift, leading to the end of globalization and the resurgence of big government intervention.

The gray zone conflict introduces a paradigm shift in monetary and fiscal policies. Central banks are tasked with anchoring inflation in the face of supply shocks, while fiscal policies aim to de-bottleneck economic systems. The acceptance of big government emerges as a positive force, as seen in the new Washington Consensus focusing on reversing capital misallocation and promoting industrial rejuvenation through state-private partnerships.

The gray zone conflict introduces the possibility of de-dollarisation as alliances influence the composition of global reserves. The rise of the renminbi as a potential challenger to the dollar, coupled with the weaponisation of FX reserves and changing economic structures, could reshape the global reserve currency landscape.

As the gray zone conflict unfolds, global geopolitics is navigating uncharted territory. The balance between alliances, economic models and the role of major currencies will shape the future world order. This narrative suggests a nuanced interplay between geopolitical events, economic shifts and the resilience of traditional norms, providing a complex tapestry that requires careful navigation in the uncertain chapters that lie ahead.

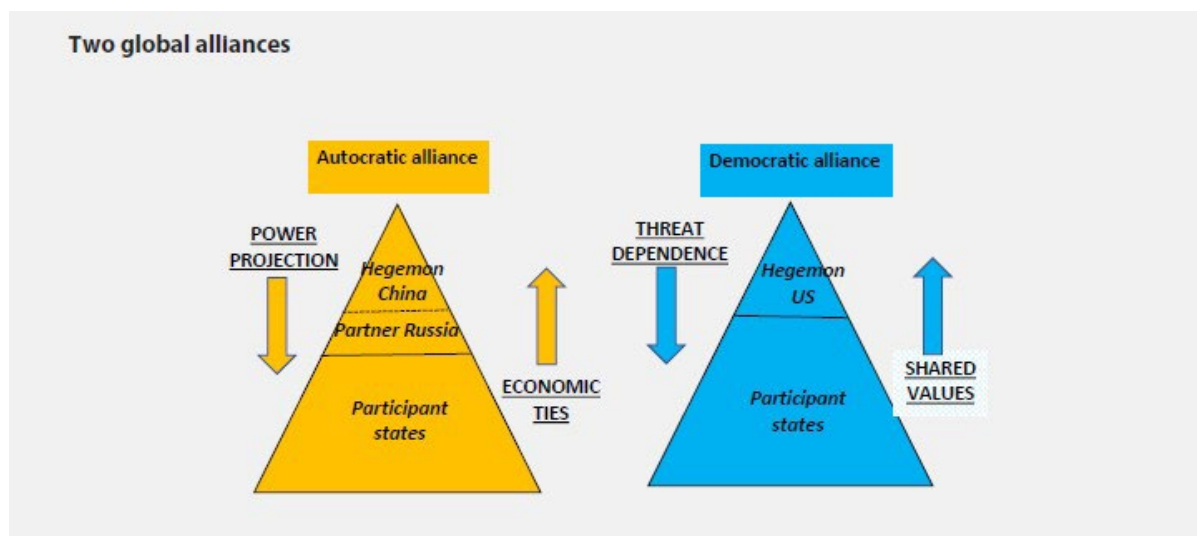
Chapter One: Learning to live in the grayzone

Once upon a time, before telling of the coming war in Ukraine, we spoke of the end of US hegemony, the coming global (dis)order and a cold war between the totalitarian states and democracies.

The name ‘cold war’ was wrong. Instead, it is a grayzone. The reason it is not a cold war is because it is hot; the war in Ukraine and the likelihood of one over Taiwan have changed the nature of geopolitical rivalry from a cold war to a gray zone conflict between hegemons and their allies. The difference is that the cold war of the 20th century was a conflict frozen by nuclear *Gleichgewicht* and the 21st century grayzone war has to be won.¹

The military college manuals describe grayzone warfare as opponents using every hostile measure short of war itself.² The grayzone has many shades of gray. The reason why it will get darker, according to our quantum forecasts, is if Russia looks like losing in Ukraine, Beijing will defend it irrespective of economic cost. China cannot tolerate a victory of democracy as great as the defeat of Russia. If Russia wins, Europe is lost and US hegemony is sorely tested. But of course, there are many other things that can occur to change the shades of gray.

This brings us to alliances. There are two global alliances emerging: an autocratic one led by China with Russia as a junior partner; and a democratic one led by the US. The autocratic alliance is on the left and the democratic alliance on the right.



And then there is the N-factor i.e. all the states that belong to neither alliance. They are scattered around the orbits of influence but are not part of the alliances. The N-factor states make up around 50% of world population.³ India, Brazil, Indonesia, Turkey, the Gulf states, South Africa and Saudi Arabia are examples of these N factor states. So they cannot be pushed aside. Some can be coerced, but most must be enticed to join one or other alliance. For example, it is hard to see India being in the new so-called Global South alliance led by China even if it gets cheap oil from Russia.

The N-factor states are often attracted to the Chinese hegemonic alliance by: their colonial history (ironically, most of the leader nations of the democratic alliance were imperial powers of one sort or another); Soviet support for their former independence movements, of which many rulers see

themselves as the heirs; the conceptual neatness and economic success of the Chinese political system; and the failures of capitalism (Covid care, climate disaster and the inequalities of globalisation). This all makes persuading these states to join with a distant democratic alliance in a faraway war a hard job... and one which is being handled badly.

The N-factor states probably do not share enough interests to form a coherent whole. Certainly, the BRICS don't. But N-factor states can disrupt, particularly through bilateral alliances with a hegemon such as China/Russia. An example is Saudi Arabia and China's deal on oil. It will boost RMB trade at the expense of the USD. It will provide arms for oil to Saudi Arabia. It hefts China's standing in the Middle East. And it diminishes US power in the region and over global oil prices. Possibly disruptive bilateral alliances will be focused on supply and demand for energy and commodities and sometimes shared values such as autocracy as a neater, better system than democracy. We shall spend the future in one alliance or another.

Alliances govern economies and markets decisively. It is a mistake to see them as purely political. Between the alliances there is currently shared trade, technology, wealth (international reserves) and cultural exchange. How these will be affected by the gray zone war will be important economically and for capital markets.

China's alliance structure is much like imperialism. It gets its membership by offering economic enticement such as the Belt & Road initiative. This looks like "aid" but is a tool to further China's reach. China can also rely on the bad memories of colonial empires widely embedded in the nationalist mythology of many states. And China can offer an autocratic model which is in the comfort zone of many of the countries it seeks to recruit into its alliance because they are totalitarian too or defective democracies.

China has codified its alternative to the liberal world order in a series of doctrinal Strategic Initiatives, which for example replace individual human rights with the concept of the right to decent living standards- leaving the matter of how to achieve them to the state which is, of course ranked above the rule of law.

What differentiates the democratic alliance from China's is that it is based upon the defence of shared values. China's pyramid of alliances is based upon the extension of China's reach, disruption of the democratic alliance and its replacement by the Chinese model. To envisage these alliances, we can draw them as circles or orbits of influence with triangles of hard alliances within them. The dots in the circles but outside the triangles of each alliance are the N-factor states which tend towards one or the other hegemon alliance without being a formal part of it.

The economics of the pyramid structure of an alliance means that as the pyramid widens to include more states, the power of the alliance increases, and cost of war falls for the hegemon that dominates the alliance. For example, if NATO were to be fully activated, the US would account for less than half the human assets and military hardware.

The US-led alliance in Ukraine has destroyed more than half of Russia's military assets and probably more of its economic growth potential, for a total cost of less than 7% of one year's US defence spending. The economic effects of alliances don't stop there. For example, partners in alliances tend

to trade more with each other and, according to one study, alliances lead to an increase of 30% in partners' holdings of each other's foreign exchange reserves over and above what would be proportionate to trade.⁴ But there is a cost attached to wide alliances. As the pyramid becomes enlarged towards the base it becomes harder to take decisions quickly, enforcement weakens, and more effort must be devoted to holding the pyramid together. The doubters (e.g. France) must be enticed back into the fold.

There are two things that the 2+N economic global (dis)order makes inevitable: the end of globalisation and the return of big government. Globalisation is doomed by its failures and ignores its successes. It provided a rules-based system that was open enough to lift China's masses out of poverty (the great labour arbitrage in international trade). But it created massive global inequality, hollowed out the industrial capability of wealthier countries and allowed countries not playing by the same rules to expand their reach economically and militarily. It also propagated the ideology of liberal economics ("the less regulation and the smaller the state the better") and "growth befits all" narrative. Both were false or at least represented only partial truths.

The tombstone of this period of history has now been written in the US in the form of the new Washington Consensus recently recounted by Janet Yellen and Jake Sullivan.⁵ They merit careful reading. It is likely they will form the cornerstone of the democratic alliance's policy (including that of the EU) for many years, irrespective of regime change. The new Washington Consensus' focus is on reversing the misallocation of capital by markets and on creating industrial rejuvenation by joint state and private investment in key sectors (e.g. the Chips and the Inflation Reduction Act). This is to be shared with global partner states. The economic model is no longer "heartless", but one aimed to benefit the workers and the middle classes and the real economy, not the financial one.

The second change will be the acceptance of big government as being a positive force. This is enshrined in the new Washington Consensus. But it can also be seen as the result of perceived failures of the free-market capitalist model (inequality of Covid treatment, climate catastrophe and inequality created by globalisation). The mindset of people has changed to one of expecting government to be interventionist in a positive way - economically and socially. But beyond that, the gray zone war will continue to mean a much greater commitment to defence.

Forget NATO for a moment. Japan is undergoing a massive change in its defence posture. The defence budget is being doubled to around the equivalent of \$300bn over five years, which would put Japan in third or fourth place in the global defence spending league.⁶ Traditionally, Japan was a country that preached Samurai bows and arrows until Commodore Perry turned up with muskets and cannon. This led to a turn on a dime which transformed Japan into a first. Nevertheless, achievement of Japan's defence ambitions will be challenging. Demography means there is a shortage of young people. And many of those young people may not view a military career as attractive.

All these policy changes are well and good and of worthy intention. But they are unlikely to be achieved without substantial economic decoupling from China and, of course, on a much less significant scale, from Russia. That comes at a cost. There will be less cultural exchange and empathy (shall we be able to understand each other enough to avoid war); more trade fragmentation; lower growth and higher inflation. And that sets up a feedback loop to less innovation. Geopolitical risks tend to raise rather than lower inflation. This is because they disrupt the supply more than they diminish demand (not a foregone

conclusion, but a fact).⁷

Globalisation was the cheapest way of making things. It gave us deep supply chains which were highly elastic to changes in domestic demand. Globalisation, driven by China, with its massive labour force joining the world economy, was a significant driver of the ‘Great Moderation’ of stable growth and low inflation. ‘Friend-shoring’ or ‘On-Shoring’ substitutes a less economically optimal system for globalisation. It substitutes “just in case” for “just in time”. But security comes at an economic cost in terms of productivity (of capital and labour as well as total factor productivity i.e. innovation), inflation and greater volatility.

McKinsey’s work shows that the number of global corporations seeking to regionalise their supply chains rose from 25% in April 2021 to 44% in April 2022.⁸ An ECB study finds that friend-shoring on a global scale along geopolitical lines would reduce global trade by 12-19% (depending on the flexibility of labour markets) and would reduce global GDP by 5% (with a maximum range as high as 6.9%). Inflation would be hefted by 0.9-4.8% p.a. (depending on a flexible labour response).⁹ These estimates assume friend-shoring happens smoothly and gradually, like Apple exiting China for India. But geopolitics tends to be jerky. That would make the effects worse – at least in the short term.

Of course, all this bad news may not happen. But there is one element that could make it worse. Militarisation of economies is not included in these estimates of friend-shoring costs. To varying extent, the shift in economic structure to a war footing is inflationary (it boosts income and spending through wages to produce defence goods more than it produces consumer goods to meet demand generated by increased income to defence workers). Defence spending is also a tax on productivity as it is normally measured – unless one factors in that the alternative to militarisation is not having an economy at all.

There is no area of the macro-economic world more at risk from the gray zone war than monetary and fiscal policy. The gray zone creates a new paradigm for both. Christine Lagarde in a speech at the Council for Foreign Relations defined the role of central banks in the fragmenting gray zone as being to anchor inflation in the face of supply shocks (a function of more inelastic supply chains than in the halcyon days of globalisation).¹⁰ She defines the purpose of fiscal policy as de-bottlenecking economic systems, not protect everyone from the pain of economic adjustment. This means programmes like the NextGenerationEU (NGEU), or the “Fit for 55” green energy plan in Europe and the Chips Act and “Inflation Reduction Act in the US. These are good while blanket bailouts of the vulnerable and not-so-vulnerable in a natural gas crisis are bad.

International reserves are already in the frontline of the gray zone confrontation. Much effort is being expended by China and various EMs to dethrone the USD as the global reserve currency. There is much complacency among policy makers and investors that this cannot happen. A country with an international reserve currency is widely expected to enjoy: critical mass in terms of its economy, trade, and capital flows (including an adequate supply of its currency to international markets); the rule of law and robust institutions; deep and open capital markets; and a convertible currency with adequate supply of risk-free sovereign bonds to permit foreign holders of the currency to reinvest it safely in liquid assets.

This describes the US dollar; less so the euro due to its small stock of risk-free EU bonds; and not at all the renminbi. So the USD can never be dethroned from its position of accounting for roughly 60% of global FX reserves. And if it could be, how would 60% of the FX toothpaste be stuffed into the 30%

tube (10% if the EUR is excluded on the same grounds as the USD) of other reserve currencies?

This thinking seems flawed under gray zone conflict. For a start, the conditions described above to qualify as a global reserve currency are not conditions but a post hoc description of the dollar. They may not all have to be satisfied by a challenger. The most likely challenger is the renminbi as the obvious player whose economic size punches way above the use of its currency as an international currency and which has ambitions to change that. China will not open its capital account or financial markets along the lines of the US or EU.

China has two competing objectives: to maintain political (really CCP) control of its economy while expanding its global role. This however does not mean it cannot internationalise its currency. The use of the renminbi as a reserve currency has matched growth of trade in China's currency, despite this seeming lack of openness.¹¹ Key to this has been the 39 bilateral swap agreements which China has with other central banks. These deals appear to replace the "convertibility" condition of a global reserve currency and provide both liquidity and legal legitimacy.

Anecdotal evidence supports this to some extent. According to SWIFT, RMB's share in the global payment system rose sharply to record 3.7% as of 3Q23 up from 1.5% about a year earlier and CNY/CNH settlements for China's cross border commodity trade has doubled every year since 2020 to reach 20% of all total goods trade flows. China and Brazil signed an agreement to trade in mutual currencies and a Brazilian bank joined China's Cross Border Interbank Payment System (CIPS). Saudi Arabia is also selling oil to China in RMB. Expect much more of this. So far this has not resulted in an increase of RMB as a share of global reserves. Its share has weakened slightly to about 2.5% over the last two years.

Nor is replacing the dollar a purely Chinese phenomenon. Gold holdings by global central banks and official institutions (like sovereign wealth funds) have increased by 800 tonnes this year (up to end Q3) after purchases of 1078 tonnes in 2022. Of course, in absolute terms, gold holdings still represent a small proportion of central bank reserves (+/- 4% for the PBoC). But the trend is clear.

Now consider how the alliances can affect de-dollarisation. The concept is that countries within an alliance triangle will tend to hold the currency of the hegemon leader disproportionately. This is borne out by reality. Over 50% of the holdings of safe USD assets are held by governments that are in US alliances (Mutual Defence Treaties).¹² The figure rises to 75% if agreements on military cooperation are added.

Now let us test some scenarios, remembering that the USD accounts for about 60% and the EUR 20% of global reserves and that the "normal" relationship of the change in reserves to a change in trade is 0.5x (i.e., a 1% fall in the trade of country A with a country B results in a 0.5% fall in the share of country B's currency in the international reserves of country A), but under geopolitical fiat this "elasticity" can be 1x or higher.) For the moment, we shall use the 0.5x figure and switch to 1x in the final scenario.

If all the nations outside the democratic alliance (the latter is defined as member states of NATO, EU, neutral Europe, Japan, Korea, Australia, New Zealand, and ASEAN) were to switch to invoicing of their international trade conducted outside the democratic alliance into RMB, the USD share of global

international reserves would drop only 6% points. If you add a 10% reduction of China's holdings of USD and assume that Hong Kong repeg the HKD to the RMB, this becomes a 10% fall in USD share. The USD now accounts for just 50% of global reserves. Add to this a higher reserve to trade elasticity of 1% (due to geopolitical decisions) and a 20% (instead of 10%) cut in China's holding of USD and the USD would drop decisively below 50%, even if it remained the single biggest reserve currency.

Of course, these assumptions are simplified and the examples may seem extreme, but the conclusion is that, in a worsening grayzone conflict, like that leading up to either a Taiwanese war or outright intervention by China in support of Russia's war in Ukraine, even the most extreme of these scenarios is feasible.

And this is for two reasons: China could fear that its USD assets would be frozen like Russia's and dethroning the USD would satisfy its gray zone war aims. And do not assume that China is incapable of weaponising its reserves or cannot change their composition. A quick glance at the allocation to USD and EUR of China's reserves says otherwise even if the fall in holding of USD is gradual.

The grayzone can last a long time but ultimately one side must win, or we embark on mutually destructive outright war. The grayzone war seems characterised by escalation. But while it lasts the USD's role as the global reserve currency is likely to be gradually and progressively diminished as members of the Autocratic Alliance shift to RMB. However this trend will be offset by another; members of the Democratic Alliance will increasingly hold USD as a safe haven. The outcome is at least volatility for the USD. But the safe haven status of the USD is likely to prevent anything like a collapse.

Militarisation will occur in almost all major economies to a significant degree. Structurally, governments will be big, kind and interventionist, but productivity and growth will be low and inflation high. Ageing demography will reinforce this trend. It is likely central banks will ultimately have to shift targets to tolerate higher inflation. Supply chains will become relatively inelastic. Economic and inflation cycles will steepen and sharpen. This necessitates a rethink of the role of fiscal and monetary policy.

Growth everywhere will become more domestically-focused and international trade will be targeted, where possible, to benefit members of the alliance. This applies to both dominant global alliances. Profit share in national income will fall to the benefit of labour. The elimination of extremes in wealth and poverty will be an enduring policy aim – in China as much as in the West.

The traditional economic drivers of EM growth will be largely absent as growth in rich countries and China becomes more inwardly-focused and service-driven. Most emerging economies do not possess sufficient critical mass to replace export-led growth with domestic demand.

Chapter Two: The ladder of escalation

In 1956, Herman Kahn created the Escalation Ladder. To this day, it is a potent tool of statecraft. It has much to offer on what will happen in the Russia-Ukraine war.

First, what is it? The Kahn Escalation Ladder is a model of the different levels of conflict that can occur between two or more parties. It was developed by Herman Kahn in his book, *On Escalation* (see Appendix 1). The ladder has 44 steps (the original had 18), ranging from a 'Show of Force' to a 'Civilian Devastation Attack'. The ladder is not a linear progression and there are many possible paths that conflict can take. However, the ladder does provide a framework for understanding the different levels of conflict and the potential consequences of escalation.

At inception, the model was oversimplified. Since then, it has been modified to become multidimensional. Some of the ways it has been modified are:

- opponents have individual ladders reflecting cultural norms (e.g. Russian disregard for life versus Western norms - as in the famous Kursk speech by Margaret Thatcher), escalation being an integral part of war for Russia and a means of military signalling for most democratic forces.
- different geographic theatres are individually represented e.g. East China Sea versus Atlantic with different escalatory responses in each. There may be an objective of furthering peaceful trade globally, but it is impeded by China's attempted military dominance of trade routes, such as the Straits of Taiwan. So escalation in both sectors will be different.
- individual strategic areas such as cyber space versus land-based warfare etc. For example, the Allies can back Ukraine fighting Russia on its territory, but refrain from attacking Russian cyber space assets..

If you turn on today's escalation model on a war room screen, it is now a multidimensional framework with its individual fields that can be adjusted and related simultaneously. It is still a simple model, but it looks more like snakes and ladders played on a 3-D frame. Nowadays, there are varying distances between steps and a facility to step down as well as up - and to do so in one theatre, but not another.

We hate models, economic and otherwise; but not this one because it is not based upon historical correlations. It is linear and relies on getting inside your present enemy's head (*a la* McNamara). The Kahn Ladder is not a museum piece, its use is implicit in a lot that is going on. Some examples:

It was material in calculating energy price caps that would deprive Putin of oil-based revenues but keep Russia pumping oil. So the West has experienced an energy glut, not freeze or famine and Putin's oil revenues would fall initially by 48%. Clever that! Remember nearly all the microeconomic models said Russia would refuse to export and the oil price would be USD150/bbl; it's currently about half that. Of course, the effect of price caps and sanctions waned over time as Russia built up its dark fleet, Emerging Economies, like India, bought Russian crude and recycled it to Europe as refined product and not least because of outright cheating by western shippers like the Greeks. But all that is another story.

The escalation ladder is key also in setting the tempo of arms shipments to Ukraine. Increased shipments were pre- announced and then delivered in incremental escalatory steps. The Kremlin huffa and puffs and after a few weeks ratchets down its rhetoric (claiming absurdities like “we have destroyed the weapons” e.g. Bradley APCs before they had actually arrived!) The next arms delivery escalation of more sophisticated weaponry is then planned on the assumption that the Russians will step up escalation rhetoric (i.e. the threat of the use of nuclear tactical weapons) and then step down.

The use of the escalatory ladder meant the Democratic Alliance failed to arm Ukraine to win the war outright and so fought it implicitly on Putin’s terms. In other words, Ukraine got as much support as was deemed consistent with limiting Russia’s reactions to what could be managed “safely” for Ukraine’s allies but not for Ukraine of course. The Kahn ladder was instrumental in how and why the West did so. It also meant that Russian escalation threats (Dmitry Medvedev rhetoric) came to lack credibility – certainly as regards the use of nuclear weapons.

The lessons that the escalation ladder holds for us are these:

1. The US is afraid of the higher rungs of the escalatory ladder. Ukraine will thus not be armed to win this war. So it won’t.
2. But the costs of a static war are not static. The technology of fighting the war of attrition advances and the costs of fighting it in human and material terms escalate.
3. The issue then becomes not how big the absolute resources of the combatants are but how much of those resources can be applied to the battlefield (the ‘butter to guns ratio’) and if the troops have the will to fight.
4. Russia will be willing to sacrifice men and material in a war of attrition waiting for the Democratic Alliance to tire of supporting Ukraine.
5. China will not escalate unless Russia is seen to be losing the war outright.

Thus, Kahn’s Escalation Ladder brings us to a point where neither side will risk further escalation beyond what is needed to maintain a war of attrition. The outcome is anyone’s guess.

Appendix 1: Who was Herman Kahn?

Herman Kahn (February 15, 1922 – July 7, 1983) was an American physicist, strategist, and futurist best known for his controversial studies of nuclear warfare. He was a founding member of the Hudson Institute, a conservative think tank, and is often cited as one of the fathers of scenario planning.

Kahn was born in Bayonne, New Jersey, and studied physics at the University of California, Los Angeles. After graduating, he worked as a research scientist for several aircraft companies. In 1948, he joined the RAND Corporation, a think tank that was funded by the United States Air Force.

At RAND, Kahn worked on a variety of projects, including the development of nuclear weapons and the study of nuclear strategy. He was one of the first people to think seriously about the possibility of a nuclear war, and he developed a number of theories about how such a war could be fought and won. Kahn’s work on nuclear war was controversial, and he was often criticized for being too optimistic

about the chances of survival in a nuclear war. However, he also argued that it was important to think about the unthinkable, and his work helped to shape the way that the United States thought about nuclear strategy during the Cold War.

In addition to his work on nuclear war, Kahn was also interested in other topics, such as economics, technology, and the future of the world. He wrote several books on these topics, including *On Thermonuclear War* (1960), *Thinking About the Unthinkable* (1962), and *On Escalation* (1965).

Kahn was a controversial figure, but he was also a brilliant thinker and a visionary. His work on nuclear war and the future of the world helped to shape the way that we think about these issues today.

Here are some of Kahn's notable contributions:

Kahn's Escalation Ladder: a model of the possible ways in which a conflict can escalate, from low-level violence to all-out nuclear war.

Scenario planning: A method for thinking about the future by developing a range of possible scenarios.

The concept of "limited nuclear war: the idea that a nuclear war could be fought and won without leading to the destruction of the world.

The concept of "mutual assured destruction: the idea that the United States and the Soviet Union were both so destructive that neither side could win a nuclear war.

Kahn's work has been criticised for being too simplistic and for not taking into account the role of human psychology in war. However, it remains an influential body of work, and it continues to be studied by military planners and policymakers today.

Appendix 2: Kahn's Escalation ladder: uses and limitations

Kahn's Escalation Ladder is a model of the possible ways in which a conflict can escalate, from low-level violence to all-out nuclear war. It was developed by Herman Kahn, a nuclear strategist and mathematician, in his 1965 book *On Escalation*.

The ladder has 44 steps, which are divided into three categories: Political and economic steps: these steps involve the use of economic sanctions, propaganda, and other non-military means to pressure an adversary. Military steps: these steps involve the use of conventional military forces, such as airstrikes, invasions, and blockades. Nuclear steps: these steps involve the use of nuclear weapons, either strategically or tactically.

The ladder is not a linear progression, and it is possible to skip steps or move back and forth between steps. For example, a conflict could start with economic sanctions and then escalate to a conventional war, or it could start with a nuclear attack and then de-escalate to a conventional war. The purpose of the ladder is to help decision-makers understand the different ways in which a conflict can escalate, and to consider the potential consequences of each step.

Kahn believed that by understanding the escalation process, decision-makers could be better prepared to manage a crisis and prevent it from escalating to nuclear war. The ladder has been criticized for being too simplistic and for not taking into account the role of human psychology in escalation. However, it remains an influential model of escalation and it is still used by military planners and policymakers today.

Original Kahn Escalation Ladder – 18 steps

Political and economic steps: Economic sanctions, Propaganda, Break diplomatic relations, Blockade, Increase military spending, Mobilize reserves, Invade neutral territory, Coup d'état Revolution

1. Military steps: Air strikes, Naval blockade, Amphibious assault, Ground invasion, Chemical and biological weapons, Limited nuclear war
2. Nuclear steps: Strategic nuclear war, Tactical nuclear war, Full-scale nuclear war

Chapter Three: The new alliances of trade

We don't think the living standards of emerging economies are going to converge with the rich countries in the next decade.

The *obvious* reasons are:

Globalisation is over. 'Friend-shoring' and 'Onshoring' are the new mantra. On-shoring and friend-shoring have the potential to cut international trade by 12-19%; to raise the world's core inflation by 1.0-4.8%p.a. and lower global GDP by 1.0-5.0%. This is not a propitious background for global trade or emerging economy convergence to the living standards of rich countries.

China is in deep trouble and the CPC doesn't understand why. The CPC leads the economy, according to Xi ideology. But now that has been surpassed. So no redress is possible because any attempt to change course would have to recognise that Xi's rule has been an unmitigated disaster. That would cause Xi and the CPC to lose too much face. It would certainly bring into doubt the infallibility of Xi and the CPC. That avenue could delegitimise the regime in the eyes of the masses.

A lot of emerging economies became feeder economies to China's manufacturing behemoth, post the Asian financial crisis of 1998. But that's not where there will be much growth from now. Any growth in China will be hoarded domestically and in services more than in manufactured products and construction. Also, the emerging economies have no products that they can switch from supplying China to export to the rich countries.

The *less obvious* reasons are these:

In the grayzone, global economic architecture is heavily influenced by alliances. The new Washington Consensus imposes conditionality upon trade with China and excludes, not only investment and trade in anything threatening US security, but also goods where China is not playing by market rules.

This is an example of how alliances can shape trade and economics. Members of the two major world alliances led by China and the US as hegemons will trade more within each alliance and hold more of the currency of each alliance's hegemon (China or the US) as their reserve currency.

If a country opts to be in the 'Global South', it can expect no favours from the Democratic Liberal Alliance. No-one is going to help a BRICS member who sings the Russian song – even off-key - to access Democratic Alliance markets. Over 50% of the world's poorer population may belong to the Global South, but a BRICS alliance is not going to help its living standards converge with rich countries. On the contrary, it creates vulnerability. The idea that these countries can dump the US dollar as a reserve currency and for trade applies only to China, and even then, as we shall see, not without considerable costs and difficulties. Practically all the other countries will go on having to trade in US dollars to get the currency they want to own.

Look at the world map. From Ethiopia to the Atlantic lie the Sahel and the African countries that are now a solid band of coups and voodoo economics. They are trying to link to Russia or South Africa, which are hardly architects of economic logic or success. So Africa is likely to be a growth market, but

only in failed states, robbed by Russia and hedged about by rings of containment to stop their populations fleeing northwards to Europe.

Latin America is also heading into a lost decade. Brazil's Lula knows little about economic reform and has chosen the wrong side in the New World Disorder. Brazil is 50% of everything in Latin America. Peru, Colombia and Mexico and now Ecuador are already, or heading towards, being 'narco' states. Argentina is steering towards the edge of the right-wing universe and risks falling off it. It remains the country of dreams but devoid of realities. An example is Javier Milei's promise to dollarize the economy and do away with the peso; to dollarize anything you first have to have dollars. There is no common Latin American ideology driving these countries left or right. It is just a dash for the economically dysfunctional.

The Middle East is looking to play its last oil card by doing bilateral deals - more with Russia and China than with the US. It's all a kind of 'Belt and Bankroll' (with Petro-RMB) thing that promotes pro-China/Russia power globally. What matters to China is the 'influence dividend' it brings and the fact that both sides of this transactional relationship are autocracies. That makes the Autocratic Alliance more credible.

If Africa, Latin America and the Middle East are not going to drive economic convergence, that leaves Asia. But Asia is a factory economy. It needs to export manufactured products to grow. Apart from China and India, most Asian economies do not have the critical mass to grow their economy using domestic demand to achieve a convergence trajectory to reach the living standards of rich countries.

How did we get to such a bad place? Leaving aside Russia as a country of unfulfilled and unaffordable imperial dreams, let's look at the emerging economies. How can so many be seduced or subdued by what are really ignorant potentates in gongs and military attire? There must be rational and economic causes. International trade and manufacturing have been the laggards of this economic recovery. Is that about to change? We don't think that much. Why? Because the shift in demand within rich countries from manufactured products to services is structural. Reversion to the mean will not happen.

For example, most of the reasons we choose a particular car are now based on the services integrated into its design. Groceries are done using a GPS-type app that guides you to where what you want is located on the shelf. Supply chains and manufacturing lines are now dominated by services. We pay for this in the price of what we buy, much of which is classed as a manufactured product.

Here is a nice example from a fascinating paper by Andrew Bailey, Governor of the Bank of England. The price of a loaf of bread was once (in the 18th century) synonymous with the price of wheat, which made up nearly all of a loaf's value-added. Then, with the advent of the industrial revolution and more diversified supply, the price of wheat and bread started to diverge. Today, only 20% of the price of that terrible gastronomic experience, the British sliced white loaf, is accounted for by wheat. The rest is logistics, marketing, and packaging.

At a guess, this is what is happening to global manufacturing output: physical output – the metal in your auto- is today's wheat and the product – the car - is today's bread. Back in the days of the Stepford Wives when you bought a car whose value added was dominated by the material that made it (steel, plastic aluminium, zinc, rubber etc). Now you buy a bundle of services it provides. Metaphorically, the

metal is what emerging economies produce. The car is what rich country software applies to it in order to produce a Tesla.

For most manufactured products, the service content is probably two-thirds of the price. Moreover, the service component is unlikely to originate where the material product does. Think EVs-batteries-Tesla-cobalt and the Democratic Republic of Congo and guess where the value-added accumulates. Most of the productivity of the manufactured product may accrue to its service component. But it is counted as manufacturing production. This creates the illusion that manufacturing productivity is high and service productivity low. In fact, they are indistinguishable. More important, for emerging economies this also means that international trade in 'physical' manufactured products and commodities (of which less will be needed) may remain structurally weak.

For most emerging economies, high growth and convergence with the rich stopped some time ago. This occurred because, apart from pandemics and supply chain interruptions, they fell between the cracks of the global manufacturing/export economy and the global service economy. De-industrialisation meant that China became the dominant global manufacturer. The rich countries de-industrialised. Services became the engine of growth in the rich economies. The emerging economies were left in an exclusion zone between both engines of growth.

Most emerging economies fell into the stagnation of exclusion, caught between China's emergent manufacturing economy and the rich countries' fast-growing services sector. A lucky few benefited from energy and commodity booms feeding the Chinese manufacturing machine. One or two like Vietnam did well in manufacturing as alternatives to China or as component suppliers to China. But in general, most did not gain much from being a part of this great reorganisation of the world economy into Chinese manufacturing and rich country services – otherwise known as globalisation, or more accurately perhaps as the great Chinese 'labour cost arbitration'. That is why local populations in so many economies are on the streets today chanting mantras of economic nonsense.

Old, prejudiced and inflexible as we are, we cannot see this changing. There is no road map to recovery for most emerging economies. This has profound consequences for the global world order. For example, it means that the 'Global South' is only likely to become a fertile ground for Beijing and Moscow to sow, if not reap, the ideological fruit of their alternative Autocratic alliance.

Chapter Four: Freedom, democracy and prosperity

Freedom, democracy and prosperity are inextricably linked. In our grayzone world of democratic and autocratic alliances, the victory of the former over the latter is essential for human development in the 21st century – and for investment performance.

Once upon a time we wrote that democracy and the rule of law were necessary ingredients to transforming middle-class states into rich countries. For a time, it looked like the thesis was wrong as the autocracies, with their singular economic focus on raising living standards, snappier decision-making and fast track implementation, delivered better results than democracies. We even doubted our own thesis.

However, the case for democracy, freedom and prosperity is still strong; indeed, these factors are inextricably entwined. History has shown that democratic freedoms and the countries adopting them have increased and with them has come prosperity.

Democracy can be valued for its intrinsic virtues, providing individual freedom (civil liberty) and the ability to participate in politics (self-determination). Surely, it must be viewed as an inherent human right. Democracy is broadly understood to mean ‘rule by the people’. It means more than people choosing their leaders in free and fair elections. It means individual rights and the right of citizens to influence important decisions and hold their leaders accountable.

But there are things more valued by people than just ‘democracy’ in the abstract. Will democracy produce better or worse outcomes than autocracy across other dimensions? Are democratic countries better governed than autocracies? Do they grow more and foster more prosperity? Are they more peaceful?

Democracy is relatively new to humanity, but it has spread fast over the last 200 years. In the late 18th century, no country could be meaningfully characterised as a democracy. But elections spread throughout the 19th century.

Many countries became ‘electoral autocracies’, in which political leaders were chosen through elections, but citizens lacked additional freedoms to make those elections free and fair. Only a few countries held elections that were sufficiently meaningful to call them electoral democracies. And even fewer had the additional individual and minority rights and the constrained governments to consider them liberal democracies.

But then electoral and liberal democracy spread to many countries in the 20th century. By the end of the century, they had become common political systems around the globe and could be found across all world regions. Today, the world is about evenly split between autocracies and democracies, according to most definitions. So the two alliances in our grayzone world are evenly balanced in terms of countries.

Population has a different balance. In 1950, almost 220 million people lived in liberal democracies and another 230 million lived in electoral democracies. This number increased in the next decades and by the late 1990s the majority of the world’s population lived in electoral and liberal democracies.¹³ But

the world has become less democratic in recent years. More countries have been ‘autocratising’ i.e. losing the features of democracy as defined above. For a long time, the number of autocratising countries was offset by democratising ones.

Since 2012, the number of countries that are becoming more autocratic has been higher. Fewer countries and people are living in democracies. The level of democracy globally has dropped back to the 1990s. The challenge between the democratic and autocratic alliances has intensified.

Will the democratic alliance win the future? Well, there is plenty of evidence of a positive correlation between democracy and economic growth. First, the obvious, but still compelling observation: most democracies are to be found in countries with greater wealth per person: poverty breeds autocracy; prosperity aligns with democracy.

Second, there’s the same close correlation between GDP, annual income per person and democracy. The lowest per capita GDP corresponds with the lowest level of democracy.

But more than just GDP is the general improvement in what we can call ‘prosperity’. Prosperity comes from a society that works for everyone – a society that is inclusive and has a strong social contract that protects the fundamental liberties and security of each individual; is driven by an open economy that harnesses the ideas and talents of the people of a nation.

When societies are inclusive and enjoy political equality, it is more likely that in a functioning economy, wealth generation will be more broad-based, leading to greater personal development. This leads to a flourishing society and in turn, greater prosperity. From individual freedom comes social equality and from that comes prosperity. The key institutions that facilitate the path to prosperity include an independent judiciary, constitutional checks and balances, independent electoral institutions and free and fair elections. In other words, prosperity depends on full adherence to the principles of liberal democracy.¹⁴

Democracies breed their own support in a self-reinforcing loop. Successful democracies that perform well on what the public cares about – economic growth, control of corruption, peace and political stability and public good provision - will increase support for democracy, which in turn reinforces democracies. Unsuccessful democracies do not.¹⁵

However, the challenge to the spread of democracy is increasing. Democratic practices have been backsliding around the world. Even countries in Europe illustrate this trend, with their governments undertaking increasingly undemocratic practices. There has been a growing sense of being ‘left behind’, citizens’ dissatisfaction with the performance of their democracies, and the rise of populism. Since the mid-1990s, the proportion of citizens who are ‘dissatisfied’ with the performance of democracy in their countries has risen by almost 10% globally.¹⁵ After the global financial crash and the pandemic slump, enthusiasm for democracy and market economies has waned.

The ‘Chinese’ model has gained traction among some ‘n-factor states’ because it apparently can deliver prosperity without the trappings of discredited liberal democracy. Xi’s China now promotes its alternative at every opportunity. It has done so in several ‘global Initiatives’ that set out Xi’s view of a world in the image of China’s: the Global Cultural Initiative (GCI); the Global Security initiative (GSI)

and the Global Development Initiative (GDI). They are summed up in its Global Community of Shared Future (GCSF), which claims to build a world for equality, common development and security to deal with the challenges of the 21st century.¹⁶

In Xi's thought, individual human rights are replaced by the right to a decent living standard. But how you get to this goal (e.g. through Stalinist labour camps) is not an issue. There is no concept of the supremacy of law; the party is law. In democratic societies, politicians are governed by the rule of law. But in China, the party decides and even overrules the law. A democratic world where leaders are accountable and individual human rights are assured are not part of Xi's model for the future for China or for any of its non-Chinese partner states.

The current grayzone world still suggests that, while autocracies remain extremely dangerous, they are not unbeatable. Autocrats are far from infallible and their errors provide openings for democratic forces. The effects of corruption and a focus on political control at the expense of competence expose the limits of the authoritarian models offered by Beijing, Moscow, Caracas or Tehran.

In Russia's war in Ukraine, the army's lower ranks get rewarded for reporting successes even if the reality was failure. Senior ranks amplify this effect. If a platoon is wiped out, it is reported as heroically liquidating a superior Ukrainian force. Everyone on the Russian side, except the dead, is happy. The living get bonuses and rewards.

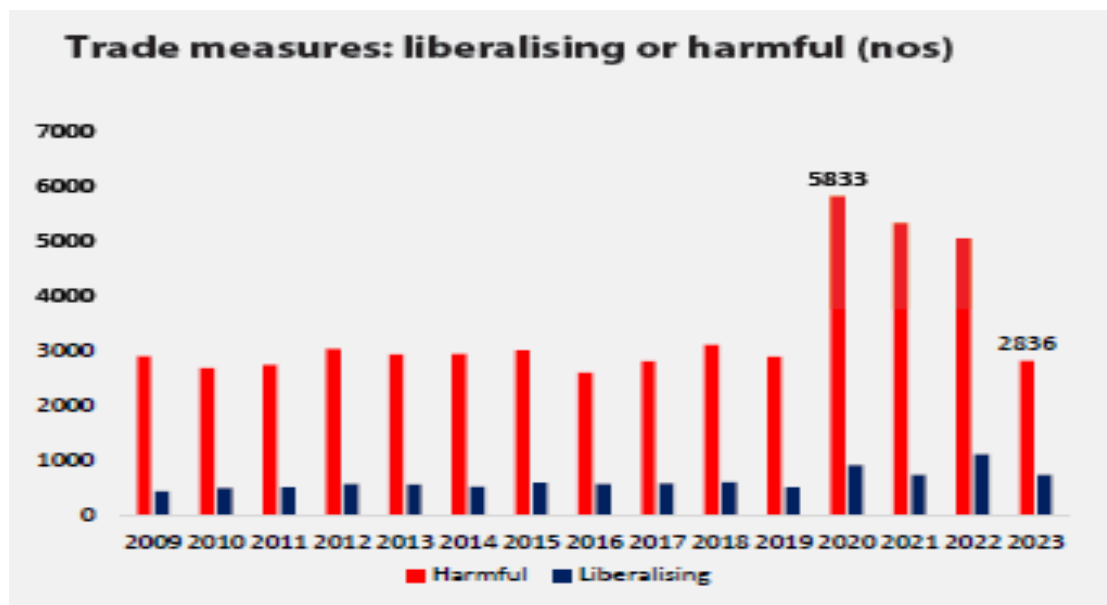
The Russian army operates using scientific and mathematical models – not local initiatives on the ground. So the 'success' which was a failure is entered into the model as data showing few Russian soldiers taking out more Ukrainians despite having only rifles. The model then predicts that to kill so many Ukrainians, you only need a much lower ratio of Russians and they don't need sophisticated weaponry to do so. But the highest cost will be the result of under provision of military medical care and frontline treatment centres that increase deaths and destroy troop moral.

So the next attack on Ukrainians will be done with undermanned, under-armed Russian units because that is what the model says is all that's needed. Logistics like loots, food and toiletries will also be adjusted below real needs by the model.

The same self-sustaining errors of procedure are replicated across all military and economic forecasting and decision making in autocratic states. Is this good news for democracies? Well, yes. But the errors of autocracies are often catastrophic for democracies too. Chernobyl is a case study in shared disastrous outcomes.

Chapter Five: The economics of the grayzone

Globalisation is over. It was already ending before the pandemic and war killed it off. But grayzone hostility has finished the job. Protectionist measures have been rising exponentially since 2017 because of popular resistance to inequality created by globalization.



Instead, a country's trade will be increasingly focused within an alliance of like-minded countries. Capital flows would be concentrated among alliance members. Alliance members would hold the currency of the hegemon of that alliance and trade with each other disproportionately.

There are multiple papers that support or contest our findings. One paper, from the IMF no less, reckons that globalisation or international trade is driven by greed, not geopolitics which never influences it.¹⁷

This is obviously historical gobbledygook, as the amount of trade done during the Cold War by the West with the 'Iron Curtain' countries or Mao's China proves. Trade with these countries didn't exist before the fall of the Wall and China's liberalisation. And when the gulag economies did liberalise (in terms of massive labour arbitrage), that pushed up globalisation - hardly a proof that the existence of the cold war did not damage trade. Now we face new grayzone wars that will push trade down.

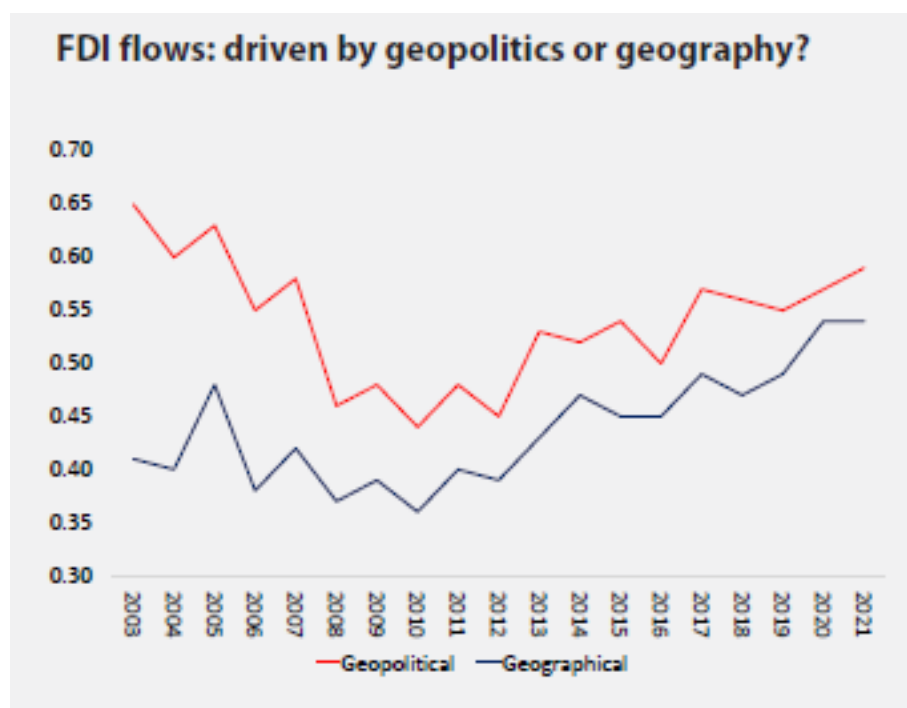
Other papers find that, although the gross value of China's exports have declined as a share of global exports by 3-4%, China's value-added (VA) as a percentage of the value-added of global manufacturing supply chains, is continuing to rise almost everywhere, including to the US, at least up until 2022.

This finding, using VA, contradicts the findings of the traditional calculus of judging exports in terms of their shipped value as percentage of global trade. The reason is the Chinese are now shipping more of their exports through 'friendly nations' to their final destination.

So a greater part of the value-added of these exports is accumulated in intermediate countries in the global supply chain as traditionally measured. But actually, the value-added increasingly accumulates to China, once the supply chain is allocated to its geographical origin and centre of control. Rather than

disproving our grayzone theory of trade, this supports it, but adds a dimension of subterfuge and evasion. It can be put like this. In grayzone warfare it pays to camouflage your soldiers and tanks. It also pays to camouflage your trade so that it is not targeted by sanctions.

The new trade supply chains matching these alliances will take time to emerge. So far, they are hard to see. This is partly because much of the data used by the “nothing is happening” school of economics are out of date, covering up to 2021 and 2022 on a very preliminary basis. A fair assumption might be that trade follows production which follows investment. So let’s transit to capital and investment flows. FDI flows are already being heavily influenced by geopolitical alliances.¹⁸



The official diplomatic semantics describe this trend as “de-risking” rather than “decoupling”.¹⁹ But if you buy less of a country’s stuff that is decoupling; de-risking only describes the speed at which decoupling happens, not what happens. It’s a bit like sex really; whether it’s over on a minute or an hour, it is still sex.

Another tenet of the grayzone thesis is that friend- or on-shoring would push up costs and inflation. This is the price for increased security to the detriment of productivity. The ECB’s latest survey shows that more than 20% of EU corporations intend to onshore and nearly 40% intend to leave the EU.²⁰ And yet the EU, unlike the US, is at the greatest economic risk in the grayzone war. In both the cases of a corporation moving out of EU or moving into EU, a key determining factor seems to be geopolitics. If energy is included as part of geopolitics (and the EU is the most vulnerable to the geopolitics of energy supply), this aggregation becomes the most dominant factor in relocation into or out of the EU.

Even if the decision to move in or out of EU is based on economics, the economics were not there before global supply chains and the geopolitical location of enterprises became a source of more risk than profit – a characteristic which is now cemented into place by the grayzone.

The uplift of global inflation as a result of the recasting of global supply chains to friend- and on-shoring, is estimated at 0.9% a year if labour markets are flexible (a fat hope in the EU!) and as much as 5.3% a year in the case of totally inflexible labour markets.

As yet, it is too early to tell which of these global estimates (both from the ECB - although very similar to other academic studies) are accurate because the process of relocation has only just begun and is masked by the 'to and fro' of post-Covid economics.

It also quite feasible that a corporation leaving the EU because of the cost of energy will end up with lower costs. In this case, relocation may depress inflation. So the final outcome is uncertain, but we tentatively suggest that the relocation process and other grayzone effects (like big government and defence spending) will end up causing higher structural inflation say around an additional 1.0-1.5% on structural annual inflation compared to the end of the period of the Great Moderation. Call it 3% annual structural inflation globally instead of 2%.

The final tenet of the grayzone thesis is that alliance members would hold the currency of the hegemon, disproportionately more compared to what 'normal' trade would dictate. In other words, a country in an alliance, doing 10% of its trade with rest of the alliance, would hold 30-40% of its reserves in the currency of the alliance's hegemon and other alliance members' currencies.

We disagree with the consensus that China could not USD share of global reserves to fall to 40% from currently the mid 50% (if the USD assets of China's banks are included). In our view, China could do it. However, any downward pressure on dollar reserves by those countries outside the Democratic alliance would be countered by the members of the Democratic alliance holding more USD. Which wins?

If getting out of the dollar were happening anywhere, it should be happening in China. But it is not – at least to the degree that the grayzone alliances would dictate, particularly if China were really preparing for military hostilities with Taiwan. China's total holdings of USD assets (including the PBoC, the banks and the CIC) is USD5.0-5.5 trn. The PBoC accounts for USD3.4 trn of this.

The way this massive piggy bank is invested sloshes around. Often a change in holdings in one visible asset class (e.g. US treasuries) may simply represent a shift out of US treasuries into T-bills, agency bonds or more obscure holdings of the same USD asset through a Belgian or Luxembourg custodian intermediary.

The PBoC's holding of US assets is about 48% of total reserves, down about 4% points since 2018. Even the PBoC's holding of gold has not risen dramatically; it remains a minute 4% of reserve assets. The USD share of the foreign assets of CIC and the state banks (i.e. mainly Belt&Road lending) is still around 60% and trending down only very slowly. So the USD share of China's FX assets is declining only gradually and is still well north of 50%.²¹

It seems that China is not obeying the rules of grayzone. Does this mean that it has not learned from what happened to the foreign assets of Russia when it invaded Ukraine? In any case Beijing does not seem to be preparing financially for cross traits war or embargo.

There is a third possible reason. It is simply very hard to replace the USD in trade or as a reserve currency. The USD's "exorbitant privilege" still operates in the grayzone war. The failure of China's endeavour so far to establish a globalised renminbi or digital yuan means that dollar privilege stands strong, albeit very gradually weakening.

And for all the mouthing of the innumerate leadership of countries like India and Brazil in the so-called 'Global South', trading in anything but the USD means having to find someone willing to hold your own dodgy currency instead of the USD. And it won't be the Chinese – they didn't get rich by being dumb. But the same applies to China. Who would China sell its USD5.5 trillion to in order to replace it with renminbi? Toothpaste does not fit back in a tube.

What all this seems to indicate is that the safe-haven demand for USD will continue to rule. A sell off of USD by China seems unlikely, short of imminent war with Taiwan. Indeed, the USD benefits from continued support both from members of the Democratic alliance and continued demand from the Autocratic alliance with Beijing as its hegemon.

There is a conundrum. China is hefting its strategic reserves of oil and food. Current oil reserves could be as high as 1.1bn bbl (up from an estimated 400mn bbl a few years ago). This makes sense if you are preparing for conflict with Taiwan even if it is a few years hence. But China is not cutting its exposure to the dollar in symphony with what is happening to its strategic reserves of oil and food.

There can be four reasons for this incoherence:

1. The difficulty in replacing the dollar – as discussed above.
2. Beijing does not expect a war with Taiwan. Either that or its policies to deal with any fall out of such a war are inconsistent (bureaucratic or strategic incoherence).
3. The fallout from a Taiwanese conflict is not expected to entail sequestration of China's dollar assets as this would damage the global economy too much.
4. China expects any freezing of its assets to be short-lived. Presumably under this scenario the hypothesis would extend to trade embargoes. In other words, the world could not forego Chinese manufactured goods for long.

Our guess is that the China's 'go slow' on reducing dollar dependence is a function of 1, 3 and 4 above. As such, it represents a potential miscalculation of the readiness of democracies to make sacrifices in the case of a violation of Taiwan's independence.

The economic lessons:

First, international trade is not going to be the engine of global growth and that's bad news for emerging economies. The decline in manufacturing as a share of output is structural and will not recover to replace services. This is because much of the 'things' we buy are now are not "things" but intangibles like software (i.e. services) Again, that's bad news for the Emerging Economies.

Second, China's structural economic issues will not be dealt with surgically. This is because there is no corrective capability in the Chinese Communist Party to face reality without causing the downfall of Xi and almost every one of his policies as potentially, erosion of the the legitimacy of the CPC.. These

weaknesses will be amplified in the grayzone by restrictions on China's access to global technology and human expertise. China's sustainable real GDP growth rate will collapse through 3% a year to around 1-2%. This is politically unsustainable. Third, after emerging economies, the EU remains the biggest global loser from the grayzone.

Chapter Six: From butter to bullets

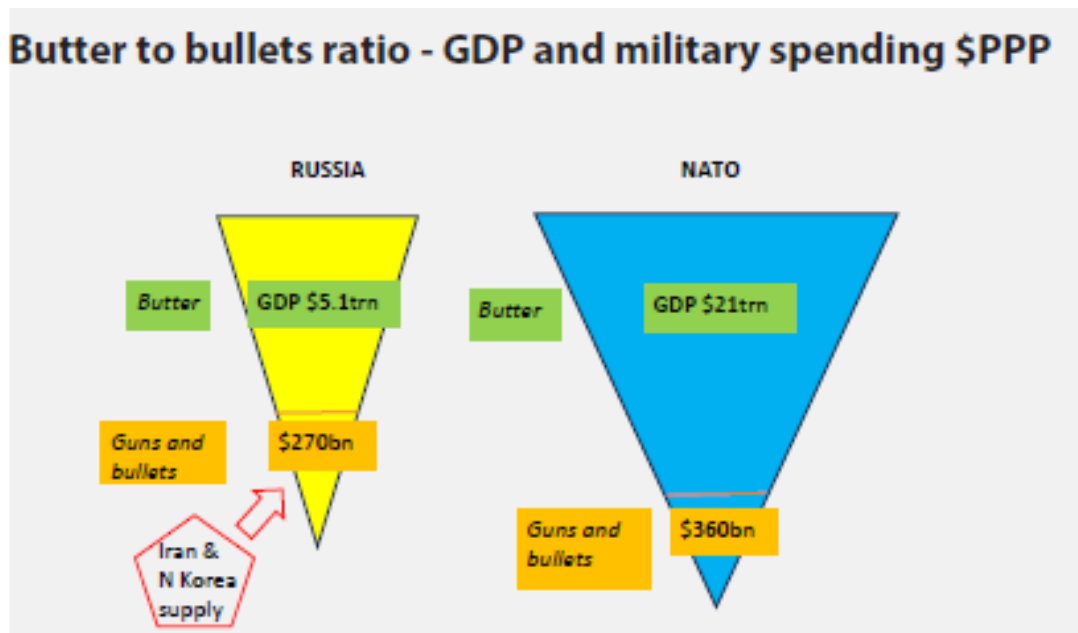
The Russians are now at least as resilient as the Ukrainians. A Ukrainian intelligence operative put it: “The Germans were put on the earth to make guns, tanks and fast cars; the Russians to suffer and the Americans to worry about the next economic downturn.”

The Russians are really good at suffering in silence and have a paradoxical obedience to their government and low expectations of it. Dumb suffering has been the lot of Russians for hundreds of years under different governments with varying degrees of incompetence and cruelty (cruelty, such as that of Stalin or Ivan the Terrible, is actually popularly admired).

So the Russians can continue to throw 200,000 of their own into the trenches for each of the next two years. That is triple what the Ukrainians can manage. So far, the Russians have lost 280,000 combatants (the Ukrainians about one-third of that number). Mass has its own form of excellence. But does mass in terms of soldiery make the war sustainable for Russia?

The concept of war sustainability needs definition. Here we shall define sustainability as a measure of economic resources usable in war. This simplifies down to two measures: the economic resources available (in theory) to fund war and the armaments supplied to the battlefield. That leaves a lot out like relative technological defence prowess.

But for ease of understanding, let’s call the two factors: butter and bullets. The triangle on the left is Russia’s; that on the right is NATO. The top of each triangle is GDP (we shall widen this definition of economic resources later) and the bottom is armaments.



What does this tell us? NATO’s GDP dwarfs that of Russia. If economic mass sets the supply of armaments, NATO should be able to wallop Russia. But this is not so, because NATO is a messy conglomerate of democracies which will only translate a small part of its relative economic strength into war material. Partly, this is due to fear of escalation and partly because the good burghers of NATO

states, who have votes, would not tolerate a large portion of their welfare being taken up by the war effort.

In contrast, Russia is an elected dictatorship which can, with impunity, divert a far greater proportion of its economic resources to the battlefield – at least for a time. The real test of Russian resilience will be tested if another round of conscription is implemented.

All of this can be simplified into the ‘butter to bullets ratio’ - the rate at which GDP is converted into military spending (in USD PPP) and then how much of this spending gets delivered to the Ukrainian theatre of war. Russia and NATO deliver amounts of ‘bullets’ to the battlefield that are not that far apart, despite widely differing economic resources measured by the flow of GDP.

But the Butter to Bullets story does not stop there. Liquid assets controlled by the state (a stock) need to be included. So do stockpiles of war material that can be mobilised (e.g. Russia’s claimed 8,000 stockpiled tanks- see below - and the US old Abrams being sent to Ukraine). This produces an interesting result. Russia and NATO both convert about 4% of butter (GDP plus usable stocks of assets) into bullets (measured in PPP terms).

Interestingly, China, not directly involved in the Ukraine war, only converts about around 2% of its total Butter (measured by state-controlled assets and GDP) into defence spending. What this tells us is that China has still big potential for military spending if it does become involved in global hostilities about Taiwan.

The ‘butter to bullets’ ratio is very approximate as defined here. It could be widened to include the resources inherent in the quality, technology and reach of the military industrial complex which would boost the US standing. But even in the crude form given here it reminds us that:

- 1) Democracies are vulnerable in war to inherent limits to how much butter can be converted into bullets. Comparing butter to butter for friend and foe tells little about the ability to conduct war.
- 2) Economically weaker autocracies can level the playing field with much richer foes by being able to allocate proportionately much more butter to bullets (and do it faster) than democracies. Think North Korea, which has precious little butter but rather a lot of bullets.
- 3) In order for autocracies to maintain a higher butter to bullets ratio, they have either to incite fear in their populations (Russia) or whip up nationalism (China) to increase popular tolerance for higher conversion rates of butter to bullets.

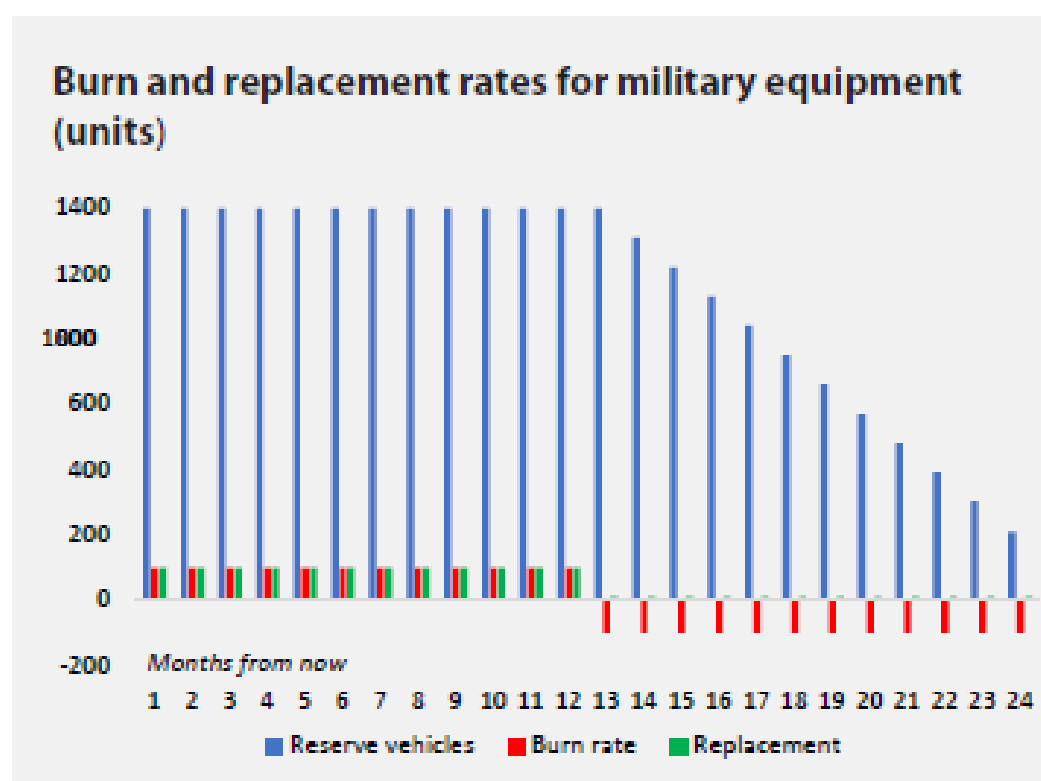
In sum, Russia can closely match NATO in terms of what it can put into the war. Democracy quarantines a large portion of economic resources from any war effort. And this quarantined portion is likely to rise during the US presidential campaign and possibly, beyond depending on the next president.

In macro-economic terms, we reckon the cash cost of the war to Russia is about USD130bn a year, or 6% of Russia’s nominal GDP. That cost estimate excludes the long-term damage that the war is doing to the Russian economy beyond paying for it. To meet these cash costs, Russia can run a 4-5% of GDP budget deficit (to be funded by subservient commercial banks and the Central Bank of Russia, if

necessary). Russia can also draw down its stock of non-sequestered financial assets (CBR International Reserves, the National Wealth Fund and the National Reserve fund – in total USD200-300bn). So even in the worst-case scenario, the macro balances speak to the war being sustainable by Russia for two or more years.

But wars are not fought just on cash. The hard issue is: can military logistics keep enough material flowing to the trenches? Admiral Bauer, Chair of NATO's Military Committee, put it well (to paraphrase). "We started this war with the warehouses half empty; now we can see the floor". Bauer also said that 'just-in-time' inventory management in NATO had left it totally unprepared to fight this kind of war. And he emphasised the woeful inadequacy of the build-up in arms production within NATO to even sustain current ordnance usage.

But how about Russia? To get an idea, we calculate a 'burn rate'. This is the supply of new and reactivated material (e.g. tanks) less the rate of losses of those tanks. This equals the number of remaining active tanks. We calculate it on a monthly basis. When the number remaining drops below 40% of the current number of active tanks, the game is over. At current burn rates, Russian military material supply from its own resources could keep the war going for 18-24 months or so. That is not great. But it is a lot better than Ukraine with reduced NATO aid.



Using tanks as an example (though the figures do not differ markedly for artillery and APVs), Russian war sustainability could be increased. First, they can produce more new tanks than their current 20 per month rate. Two new production facilities are due to come online. That should raise production to 30-40 units. Second, they could cut their losses of 250-300 tanks a month. Third, Russia still has usable (as opposed to degraded) stocks of 5000-6000 tanks out of total stocks estimated at 8300. They could increase the rate at which these tanks are refurbished. But it is unlikely as there is no evidence that it has happened in the past.

Fourth and most important, there could be increased supply for Russia from North Korea and China. OISINT images of Pyongyang freight yards point to this starting to happen. North Korea has already supplied more than 1,000 containers of war material to Russia. So far this is by trans-shipment in two container vessels between the North Korean port of Ranjin and the Russian Dunai military facility²². It will accelerate when the Russian and North Korean rail links can be put in service. RUSI considers this supply could be a substantial boost to Russia's ability to pursue the war.²³

The unsavory conclusion is that the war will become unsustainable for Ukraine by autumn 2024, but not for Russia until up to 12 months later. In the end, both Ukraine and Russia will need more resources to continue the war. But Ukraine's resources will start to run out sooner if supplies from the US are substantially curtailed. When it comes to burn rates on the front, there is no substitute for US supply of arms to Ukraine. Nobody else can make up any substantial US shortfall in material.

For now, the Russian war in Ukraine is background noise. People have got used to it. Indifference will no longer be possible if the scenario of Ukraine losing and Russia winning starts to unfold. That would immediately empower the ambitions of both Xi and Putin on the world stage. This would produce a crisis of confidence that would undermine the global economy. Although war is inflationary, it is the deflationary impact of war on the confidence factor in the real economy that would reign supreme.

The effective paradigm of NATO, the EU and transatlantic relations could come under a lot of pressure, particularly if the US steps back in its support for Ukraine. The EU had achieved internal unity and solidarity with Ukraine as the glue.

If Trump, or a Trump surrogate, were to regain the White House, the NATO-EU Commission working alliance would be smashed like an eggshell against a wall. The transatlantic alliance would break down. Both Europe and Ukraine would be hung out to dry. Of course, France and the UK would step into replace the US nuclear umbrella for Europe. But it would be a poor surrogate as defence against a renascent Russia backed by China.

Failure to get the right result in Ukraine will fracture the EU along historical lines that have nothing to do with Brexit. The eastern EU states know what it is to face off with Russia. The western EU states have lost collective consciousness of what this was like. The old EU dominators like Germany and France will try and declare partial victory and compromise (in vain) with Moscow.

There would be an arms race in Asia, as countries learn that the US umbrella is unreliable.

Then there is the Middle East conflict. The odd thing is that the Middle East crisis, gigantic as it is in terms of human suffering and the scale of urban warfare, leaves both China and Russia on the sidelines as opportunistic bit-players. It is not that the events lack scale or involvement of both Russia and China.

The crisis has the potential to disrupt global oil flows. But this is unlikely as most Arab states see Hamas as a potential threat to their own dictatorships and shed few tears for its plight. Nevertheless, the potential for global spill-over effects provides every justification for China and Russia to be involved at scale.

But that is not happening. Russia is involved in Syria supporting the Badhar Al-Assad regime but steers well clear of any attacks by Iranian proxies on US assets. So the neutral box is ticked there. China and India are seen by Arab oil producers as the last growth markets for oil in the world. Russia is in this context is a competitor to Middle Eastern producers. China sees the Arab states as secure energy suppliers, unlikely to impose embargoes at the behest of the US in case of conflict with Taiwan. Above all, Middle East oil traded in renminbi furthers China's aim of dethroning the USD.

So there is every "reason" for the Middle East to fit neatly into the global grayzone architecture. But neither China or Russia currently play a major role or iterate policies that could enable them to do so. Instead, Russia and China have shifted their stance away from seeking a balanced relationship between Israel and the Palestinian cause to being openly anti-Israeli. They forego the "honest broker" role.

For Russia this merely plays to the tune of the war being another example of the evil of US policy of ignoring the Twin State solution to the detriment of Palestinians. The war for Putin is a blessing as it distracts and detracts from aid to Ukraine. But, in reality, Russia has little to offer any Middle Eastern Arab oil producer. Russia remains an oil supply competitor that routinely fails to live up to its undertakings to OPEC and a client state of Iran, which hardly endears it to Saudi Arabia or the Gulf States.

China has greater potential to become influential in the Middle East. First, it is a major oil market. Second, China's aim to set up a naval base in Oman to complement to those it has in the Red Sea, could, at the least give it a role in maritime security. Third, it provides Middle Eastern states with diversification of strategic relationships. China could defy US policy and defend Middle Eastern autonomy at crucial moments when, for example, the Middle East wants to export oil to countries that the US doesn't want to get it. China could facilitate that.

But there is one more thing to consider. Israel, like a mini-Taiwan, is a significant portal by which China accesses leading edge technology. This is being ignored in the formulation of China's attitude to the Israel-Hamas war. China was and is a major beneficiary of Israeli semiconductor fabs and of associated R&D

Israel's abundance of Western chip design and manufacturing expertise makes it a linchpin in the transfer of US semiconductor technology to China. Though the small country is not the world's largest chipmaker, over half of Israel's \$4.5 billion in 2022 exports to China were "computer, electronic and optical products.

Beyond viewing China as an export market, Israel has welcomed PRC firms seeking to tap into its prime chip design talent pool, just as it has with companies from the US and its allies. Since purchasing the Israeli IT research company Toga Networks in 2016, Huawei has 500 researchers in

This makes it all the more intriguing why China would shift its stance to a policy that singularly fails to condemn the Hamas attack on Israeli civilians and that blames Israel and the US for creating the crisis. The timing, in the middle of an on-going grayzone war that deprives China of access to western high-grade technology is puzzling. One possible answer is that the Chinese and Russian autocracies' ideology of defeating the Democratic Alliance on the global stage takes supremacy over economics, welfare, and even short-term political opportunity. Therefore, the Middle Eastern narrative is made to fit the

grayzone over-arching narrative, even if this means that China or Russia loses the opportunity to enhance their role in the conflict by playing the honest broker.

Chapter Seven: The grayzone through the wormhole

“A wormhole is a hypothetical structure connecting disparate points in spacetime. Among other things it theoretically permits time travel.” “It is better to begin at the end than end at the beginning”.

The failure of mainland China’s obvious attempt to usurp the Taiwanese elections (by getting the two opposition parties, the People’s Party (TPP) and the Kuomintang (KMT), to join forces to contest the presidential elections) has failed. This has set in motion the following sequence of events (much as the flapping of a butterfly’s wings in one remote corner of the world can cause chaos in another).

The KMT and the TPP will be punished for trying it on and failing dumbly. The Democratic Progressive Party (DPP) candidate Lai Chin-te and his highly competent running mate Bi-khim Hsiao will win decisively.

China cannot deal with that. So forced to choose between backing down or delivering on his promise to integrate Taiwan by force, Xi will choose the latter. By this time next year, Beijing will confront Taiwan with blockades or invasion. The West will defend Taiwan.

Even if this forecast is wrong, the ante will have been upped dramatically. It is most unlikely that even a victory of the KMT in Taiwan would usher in a ratcheting down of tension in China’s other theatres of the grayzone (e.g. the South China Sea or Ukraine).

China’s strategy of confronting the liberal democratic world order is a mosaic of theatres relatively independent of each other, but united towards achieving the common goal of world dominance and replacing the liberal rule-based world order with new architecture being set out in the Global Strategic Initiatives.²⁵ A KMT victory in Taiwan’s presidential elections would convince Xi that he was on the right track in pursuing his geopolitical goals. So apply 100% discount factor to the meaningless love-in of the Xi - Biden summit. There will be no détente.

China will double down on helping Russia win the war in Ukraine. Inadequately armed by its democratic allies, Ukraine will travel down the road of losing the war of attrition. A war of attrition implies a stasis between combatants on the line of contact but spiralling costs in terms of resources including humans and the both the cost and technology of war.

Russia simply has greater staying power. Ukraine is more likely to fight on alone than obey an order from its allies to make peace and hand victory to the Russians. The Ukrainians who have proven themselves valiant soldiers will become formidable and effective partisans. NATO and EU are increasingly in the cross hairs of Russia and, by proxy, China.

The EU will be riven by the rise of populist parties. We thought these were economically innocuous; the closer they got to power, the less fiscally disruptive they became and the less they questioned EU support. Italy’s Meloni, with her party, the Brothers of Italy and Le Pen’s National Rally are examples. But that has changed. Most rising populist parties are now economically disruptive because they have become anti-EU at a critical point for many key EU policies that affect economics. The rise of populist parties and sentiment will weaken support for Ukraine in several countries: Netherlands, Belgium, Slovakia, Romania, Poland (truck drivers) and later Spain.

It will also change the composition of the European Parliament and the appointment of the EU Commission (elections due in June 2024). The result will be populist parties grouping with players like Hungary's Orban to defeat key projects such as Ukraine's membership of the EU, aid for Ukraine and EU integration. Such generous EU policies are vulnerable to populist attack because they have not been well thought through.

An example is the Polish truckers strike blocking the border for Ukrainian trucks entering Poland. Ukraine is an agricultural powerhouse and freeing Ukrainian exports to the EU, plus paying EU benefits to Ukrainian farmers would hit the traditional beneficiaries of EU agricultural policy (Poland, France, Romania etc.) very hard. Moreover, paying Ukrainian farmers subsidies on a par with their EU member state peers would bankrupt the EU agricultural budget. That matters because the EU agricultural and fisheries budget represents 35% of total EU spending.

So the political and financial support for EU integration, the defence of Ukraine, the Next Generation EU programme and the Green New Deal will wane. Already there is a substantial populist backlash against EU green policies. There will be no agreement on the perennial issue of how to deal with the fiscal debts and deficits of southern Europe. These national disparities were masked for two years by solidarity in confronting Russia in the way that a high (emotional) tide hides rocks. But the rocks haven't moved. When they reappear, so will the doubts about the euro, sovereign debt and all that caboodle. All of this plays out perfectly into Xi and Putin's strategy to subvert democracy, the international rule-based order and, of course, NATO.

The US remains the last bulwark, but one set to weaken. Trump may lose the 2024 presidential election, but only just. Alternatively, if Nikki Haley runs as the Republican candidate, Trump could still contest as an independent, splitting the Republican vote and allowing Biden to win. So Biden will totter on for another term in office, but probably won't make it to the end. of it. If Trump wins, you simply flip back to the beginning of this wormhole and multiply all the bad outcomes by "N"— i.e. choose a number between five and infinity!

The process of US weakening is bad given that:

- (1) Ukraine will not be funded appropriately and no other country can replace US guns and ammo;
- (2) By end 2024, Putin will be confirmed in office and
- (3) China will be upping pressure on the Democratic Alliance and entering open hostility with Taiwan.

However, the US weakening is relative, geopolitical and political. And it is not really economic. The US still looks better than most places if you are lucky enough to live there and are not poor.

That is where the wormhole ends and most forecasts begin.

The sum of global growth is structurally close to zero – for all the reasons we have pounded you with: demography, big government, the economics of alliances, the China swamp etc. Despite this, next year looks mediocresly fine - until it doesn't. There will be no global recession because falling inflation will

raise real wages, labour markets will remain tight and household wealth is still high. Investment will be ho-hum.

There's no fiscal tightening worth talking about except in Germany where the *Bundeverfassungsgreicht*'s ruling on dodgy funding by the ruling coalition will force cuts in fiscal spending of around 0.8% of GDP. In relative growth terms, the US does best and the EU and Japan the worst.

Central banks will declare an inflation victory without winning one. Inflation will settle at around 3% a year, or 100bp above central bank targets. But a sea-change in central bank culture will let them cut interest rates, while failing to win what Isabel Schnabel (ECB) terms "the last mile".²⁶

China is not able to address its structural problems. In fact, Beijing is busy pumping more money into bankrupt property developers to address problems of over-leverage and insolvency. Secular real GDP growth will fall away towards 1-2% a year but will be styled up to claim 4%-plus. It will be espionage or treason to declare otherwise. But this fake growth rate is not enough to avoid political change forever. The rest of the emerging economies do not have the critical mass to achieve high growth domestically and global trade will be poor.

The biggest global secular shift is from manufactures to services. That's bad for inflation globally, bad for emerging economies and bad for heavy-duty manufacturing economies trapped in their glorious past, like Germany. Large Language Models (LLMs) do not revolutionise productivity and AI doing so is years away.

Japan finally has to adjust monetary policy to reality and do away with yield curve control on bonds. There is no collapse in the global debt mountain yet.

Coda: What could go right?

Let us argue against all this and show a way that things could be better.²⁷

My guess is that the story would start in the US with someone like Nikki Haley winning the election. With Democratic Alliance safe and both Russia and China contained, the spinoff would spread to Europe.

Chapter 8: Europe in the winning grayzone

This story starts at the rather large electronic fence that contains Russia to within its territory and amputates its imperial ambitions. Behind this it decays. But the decay is violent both inside Russia and towards its neighbours, using proxies to achieve plausible deniability. There is a flourishing school of revisionist history that says the conditions set for peace with Russia were so severe in terms of paying for its atrocities and war damage, that the error of Versailles was repeated and Russia's decline into a violent pariah state was assured.

By the end of the decade, the shape of Europe is set by the front-line states on Europe's eastern border, not in the salons of the Elysée Palace. Finland, Sweden (whose forces are integrated with Finland), the Baltics, Poland, Hungary (which has long since buried Orban and reverted to its European vocation), Romania and Ukraine are now the outstanding front line of military powers of Europe. Poland has an army twice the size of Germany (whose army is double that of today). Ukraine has the most experienced, battle hardened, high-tech fighting force in Europe. The moral direction is guarded by the Baltics, who have a gift for setting the tone of right and wrong. A job in the military is now seen as a sound career for bright young things rather than joining an investment bank or hedge fund. How the world has changed.

If you consider Europe with each country sized by GDP per capita you get one thing. If you draw it by 'military might' you get another. Traditionally, power in the EU was set by money. France and Germany were the richest, so the Franco-German alliance ruled. These twin states are still the richest, though the east is closing fast. But military capability has long since demolished the dominant rule of GDP per capita as the bellwether of political power.

This reflects the reality that Russia is next door and hostile. There is a common enemy. A common enemy is a great unifier of domestic politics, a harmoniser of political aims across borders and a setter of priorities. We saw that in the Cold War in the 20th century and then in the Russian War in Ukraine. Fiscal targets are a second-order priority behind the need for public investment to keep the economy on course (to meet climate targets, raise defence spending and carry out restructuring initiatives (a continuation of the NextGenerationEU fund model). Institutionalised European defence expenditure sits comfortably at 3-4% of GDP (4% in the East and 3% in Germany, France and Italy).

One of the benefits of the increase in EU government deficits, funded by EU collectively issued bonds, was a rise in the international role of the euro to about 30% from 20% of international reserves and trade. This was due to the increased availability of 'risk free' EU bonds as an alternative to US treasuries.²⁸

The EU has expanded its reach to the Balkans. Ukraine is, of course, in both NATO and the EU. Moldova is now a fully-fledged member. And post-Erdogan Turkey is also in the EU. The EU focus on the Balkans was a 'soft power' response to Russia's attempts to take over the Black Sea. After the grain war, blackened ship hulks still dot the rocks, but Russia's rusting Black Sea fleet is now dwarfed by the naval forces of Turkey, Romania and Ukraine. This is perhaps the best outcome of Europe becoming a significant security actor in support of NATO military goals rather than becoming itself a military alliance.

This did not happen easily. There was a lot of friction along the way. Key institutions of the EU had to be remodelled completely to accommodate the new locus of power in the east. EU member state unanimity for all key bills was over; now it is by majority. The EU common agricultural policy had to be completely recalibrated to integrate Europe's new agricultural power-house Ukraine, which now supplied 30-40% of the world's grain (Russia had shrunk to 10% in good years). The understanding of what democracy means had to be enlarged to accommodate the rough and sometime offensive democratic genres of countries like Poland and Hungary. But quarantining member states was not really an option for the genteel EU and its *acquis Communautaire*.

At the end of this decade, the EU will not become a military union. But it will become a major global security actor consolidated around NATO. In fact, NATO is the efficient substitute for the EU army. NATO has a large number of non-EU partners as members or partners (with security guarantees). The US and the UK remain core to this alliance. But the mantle will spread to Asia with close associations between NATO and AUKUS, Korea and Japan. Countries like Singapore, Indonesia, Philippines and Vietnam enjoy solid NATO, in addition to US, security guarantees.)

The division of responsibilities between the EU and NATO evolved from the successful allocation of roles at the beginning of Russia's invasion of Ukraine. The EU Commission handled the economic and social issues of support for Ukraine and NATO ran the military portfolio. That arrangement worked very well. It allowed the EU to wean itself off Russian energy in a year without economic collapse or popular unrest.

The UK will remain a key European member of NATO, may even rejoin the EU (at least in substance). The anger and passion of Brexit needed a long time to wane. This was on both sides. The EU had to get more pragmatic – the UK cannot be treated like Morocco or Peru. The British army and the UK's defence of Ukraine has earned it a lot of good will. Eventually, the economically illiterate and irrational (or just plain corrupt) Brexit backers will die off or their influence die out.

The world will be a safer place, but still faces a common nuclear enemy behind the walls of Europe to the east and elsewhere with Saudi Arabia and Iran having joined the ranks of the 'tin pot' nuclear states. These walls are not those of the Cold War, but of ceasefire lines with frequent violations and repostes.

Let us take this further. Let us imagine a scenario where the Democratic Alliance stays strong, Russia is contained and China backs off confrontation with Taiwan. This off-ramp optimism can then be imagined for starting in Europe.

Chapter 9: Grayzone conflict versus the Cold War

The grayzone conflict is characterised by hostile acts short of outright war. However, a grayzone conflict can contain outright war zones with limited participation. These are normally localised conflicts fought between proxies of bigger powers - hegemons, such as the US or China, or big regional powers, like Iran.

As argued in previous chapters, the current global grayzone conflict is defined by conflict between an Autocratic Alliance (led by China and Russia) and a Democratic Alliance (led by the US). The outright warzones are currently Ukraine and the Middle East. Potentially, Taiwan could be another.

Global economics has been restructured within and around the two major Alliances (Autocratic and Democratic). The restructuring itself is economically expensive.

Each Alliance is dominated by a hegemon - China or the US. Non-aligned states (called the N-factor states which have over 50% of the world's population) try to pursue self-interested goals by cherry-picking arms and trade deals tailored to their national ambitions. The N-factors' ability to do so is permitted or curtailed by the Alliances. Dominance over these states is a key goal of the hegemons in the current grayzone conflict, because it is necessary for global dominance.

Within each Alliance

Within each Alliance, the hegemon's currency is increasingly used as the currency for trade and international reserves. Each Alliance tries to maximise the use of its hegemon's currency with two objectives: to *minimise* vulnerability to the weaponisation of its foreign currency-denominated assets and flows by the opposing Alliance; and to *maximise* its own hegemon's political leverage over trade partners (particularly the N-factor group).

An example is China's action to diversify its holdings of US dollars in its \$5.5bn of state-controlled international assets as well as reducing the role of the dollar in China's international trade. This aims to reduce the risk of its dollar reserves being frozen (as happened to Central Bank of Russia) and increases Beijing's power over its trading partners.

The economic footprint of the state gets bigger at the expense of the private sector. Therefore, economies become less efficient and productive.

Also, militarisation of economies increases, sometimes dramatically e.g. Russia is an example with 60% of public spending now being on guns not butter. Trade becomes dominated by exports and imports among members of the Alliance. Security of supply lines is prioritised at the expense of productivity. For security and political reasons, globalisation is replaced by 'on-shoring' and 'friend-shoring'.

The global inflationary cost is 0.5-2.0% pts per year, depending on how willing or able labour markets are to make sacrifices and adjust wages for lower labour productivity. So inflation everywhere is higher. Central banks struggle to pursue low (say 2% a year) inflation targeting while looking (vainly?) to the fiscal authorities to debottleneck the supply side of economies.

Economies become more cyclical as inflation also becomes more volatile and increasingly influenced by grayzone conflicts.

Between each Alliance

There is a weaponisation of 'normal' economic factors that now become part of the state's arsenal. Examples are: energy embargoes and sanctions; freezing and confiscation of central bank international reserves; blocking of international supply choke points (Red Sea, Al-Mandab straits, Persian Gulf, Straits of the Bosphorus, Straits of Taiwan etc.).

Relations between Alliance members are dominated by the optimisation of power, not economic efficiency as under globalisation. Trade and financial flows are used to export each hegemon's ideology. Examples are China's Five Global Strategic Initiatives, the Belt & Road Initiative and the US's rule of law and liberal economic world order. There is thus a conflict of alternative ideologies.

Alliances reduce the cost of both grayzone and open warfare. The wider the Alliance, the less are the costs of conflict to the hegemon, but the more complex decision-making and implementation become.

For example, if NATO mobilised fully against Russia, less than one-third of the boots on the ground in Europe would be American. Ukraine's war against Russia, which has hugely damaged Russia's military capacity, costs the Pentagon less than 7% of its annual budget and most of the ordnance it supplies (\$43bn approximately in the last 12 months) is made in the US. It is Ukrainians not Americans who fight and die. But coordinating war goals, strategy and tactics is more of a nightmare in a bigger Alliance.

N-factor states (e.g. the BRICS) are attracted to Russia and China because of: colonial history (e.g. Russia often supported their independence movements); the neatness and track record of China's economic model; not being democracies themselves and their current dictatorial regimes having no interest in becoming democratic; and what they see as being 'free' money from China. What they may not like is that China's aims are imperialistic and colonial.

The N-factor states will always be opportunistic partners, not reliable members of either Alliance. But they, particularly the big ones (Brazil, India, South Africa), must be won over or neutralised by the Democratic Alliance if it is to prevail and endure.

How Alliances differ

The key difference is that the Democratic Alliance is characterised by shared values and trust. They are the lynchpins that hold the Democratic Alliance together. But both lynchpins are vulnerable to populism.

In contrast, the Autocratic Alliance is characterised by China's ambition to achieve world dominance or at least undo that of the US. The Autocratic Alliance is thus all about the global projection of China's power. The vulnerability is that China's model for world order may not entice N-factor states sufficiently to achieve that end (e.g. the unraveling of Beijing's Belt and Road initiative).

Grayzone and the Cold War: similar but not the same

There are shared characteristics between the 21st century grayzone conflict and the 20th century Cold War. There is the competition of ideologies. Mutual deterrence makes use of nuclear weapons less likely. Proxy wars confer 'plausible deniability' on hegemons that seek to avoid outright war. There are trade sanctions (e.g. Cocom versus restrictions of technology sales to China and Russia). And finally, the weaponisation of economic relations aims to weaken the opponent's ability to pursue its goals.

But there are differences. The economic cost of the Cold War was very low (the nuclear deterrent was

highly cost-effective and cheap at the price). The gulag economies had never been integrated with the free world's. So their isolation was no loss (except for the opportunity cost of not integrating them into the global system). The economic cost of undoing globalisation in the grayzone conflict is immense to all parties. This economic cost looks likely to get much worse if China blockades (let alone invades) Taiwan and the Democratic Alliance tries to stop it doing so.

The loss of Taiwan's hi-tech semiconductor (TSMC) products, plus the sanctioning of China's exports, would be a global economic disaster because China is so integrated into the global economic system as both supplier and consumer.

Russia in the Cold War and today only exports energy and minerals. So from a global perspective, Russia is economically dispensable and doomed to poverty. In contrast, a confrontation with China, even limited to the grayzone domain, would cut global GDP by 8-10% and China's GDP by 20-30% (leading to regime change) with global inflation in double digits due to supply shortages.

In the Cold War, all the West had to do was to accelerate the arms and technology race, ratcheting up the economic cost of deterrence to Russia at minimal cost to itself and wait for Russia's economy to collapse. Russia could not expand to meet this challenge because its economic motor was spluttering and its energy sector was in decline.

The Chinese economy is in incomparably better shape, despite its structural flaws. It has a ready global market for its goods across a myriad of sectors and is a source of essential and efficient supply to its global trade partners (e.g. 9 out of 10 of our smart phones come from China with input from nearly all Asian economies).

Given the rise of populism and the decay of politics in the Democratic Alliance, the Autocratic Alliance has a much better chance of winning than Russia ever did in the Cold War. Or perhaps, which is more important, Beijing thinks this is the case.

In sum, the Democratic Alliance is as socially, politically, and economically vulnerable as the Autocratic Alliance, albeit in different ways. That was never the case during the Cold War when the appeal of Bertrand Russell's brand of ideology ('Better Red than Dead') only attracted the trendy hippy left (of which I was one).

Endnotes

¹ The equilibrium of a cold war depended upon high-impact, low-probability events (mutual nuclear destruction). Grayzone war entails high-probability, relatively low-impact events (cutting a pipeline or cables or invading a remote island). Escalation is almost inevitable in a grey zone war and, apart from weapon development and deployment, almost impossible in a cold war.

² Grayzone warfare refers to the use of non-traditional means, such as cyber attacks, propaganda and subversion, to achieve strategic goals while avoiding a direct military confrontation. Grayzone warfare seeks to exploit the ambiguity and uncertainty inherent in these situations to achieve advantage over opponents.

³ Sweijs & Mazarr: War On the Rocks: Mind the Middle Powers, 4 April 2023.

⁴ Eichengreen, Mehl & Chitu: Mars or Mercury ? the geopolitics of international currency choice.- Economic Policy, Vol 34, Issue 98.

⁵ Remarks by Secretary of the Treasury Janet L. Yellen on the U.S. - China Economic Relationship at Johns Hopkins School of Advanced International Studies April 20, 2023; Remarks by National Security Advisor Jake Sullivan on Renewing American Economic Leadership at the Brookings Institution April 27, 2023.

⁶ <https://www.japantimes.co.jp/news/2022/12/03/national/politics-diplomacy/defense-budget-five-year-plan/>.

⁷ Perun: Japanese Defence Strategy & Rearmament - Japan's ambitious plans & lessons from Ukraine [https://youtube/2BHnijL9xYc.](https://youtube/2BHnijL9xYc;); Defence of Japan 2022 (white paper): https://www.mod.go.jp/en/publ/w_paper/index.html; Japan Preparing for War (ARTE) <https://youtu.be/q-g9RyJm9y8>

⁸ McKinsey: Taking the pulse of shifting supply chain August 2022.

⁹ Friend-shoring global value chains: a model- based assessment, prepared by Maria-Grazia Attinasi, Lukas Boeckelmann and Baptiste Meunier, published as part of the ECB Economic Bulletin, Issue 2/2023.

¹⁰ Central banks in a fragmenting world, Speech by Christine Lagarde, President of the ECB, at the Council on Foreign Relations, C. Peter McColough Series on International Economics New York, 17 April 2023.

¹¹ VOXEU: The renminbi's unconventional route to reserve currency status Alain Naef, Eric Monnet, Camille Macaire, Arnaud Mehl, Barry Eichengreen, 31 October 2022.

¹² Board of Governors of the Federal Reserve System International Finance Discussion Papers ISSN 1073-2500 (Print) ISSN 2767-4509 (Online) Number 1359 October 2022. Geopolitics and the U.S. Dollar's Future as a Reserve Currency Colin Weiss

¹³ Electoral democracies are defined as when citizens have the right to choose the chief executive and the legislature in meaningful, free and fair, and multi-party elections. Liberal democracies have electoral democracies but also citizens enjoy individual and minority rights, are equal before the law, and the actions of the executive are constrained by the legislative and the courts.

¹⁴ <https://prosperity.com/rankings>

¹⁵ Acemoglu, D, N Ajzenman, C G Aksoy, M Fiszbein, and C A Molina (2023), "(Successful) Democracies Breed Their Own Support." Review of Economic Studies, <https://voxdev.org/topic/institutions-political-economy/support-democracy-and-future-democratic-institutions>

¹⁶ <https://www.annualreviews.org/doi/pdf/10.1146/annurev-polisci-060820-060910> 6. <https://www.annualreviews.org/doi/abs/10.1146/annurev-polisci-060820-060910>

¹⁷ https://www.mfa.gov.cn/eng/zxxx_662805/202309/t20230926_11150122.html

¹⁸ IMF Long Live Globalization: Geopolitical Shocks and International Trade Serhan Cevik WP/23/225

¹⁹ Bank of Finland BOFIT Policy Brief 2023 No. 14 Heli Simola Trends in Chinese value chains 2018–2022

²⁰ IMF G20 Report (2023) on Strong, Sustainable, Balanced, and Inclusive Growth, November 2022

²¹ PBoC 2023 RMB Internationalization Report; <https://www.gov.cn/xinwen/2022-09/24/5711660/files/003e0bd04d4742a5a06869fdc37ea8c8.pdf>

²² RUSI: The Orient Express: North Korea's Clandestine Supply Route to Russia.

²³ Russia's domestic artillery shell production is being supplemented by imports from North Korea sufficiently to sustain fire in 2024, according to the Estonian Defence Forces. Russia has 4m shells remaining that will last one year. In addition, North Korea is currently shipping 300-500k pieces that can last one month with further deliveries to come.

²⁴ Source: China Talk: Chipmaking amid war in Israel: Dec 2023- Nicholas Welch

²⁵ The three pillars of China's new world order are: Global Strategic Initiative, Global Development Initiative and Global Civilisation Initiative, though it can be argued that the 'Belt and Road' initiative is another.

²⁶ "The Last Mile": Isabel Schnabel, Member of the Executive Board of the ECB, Keynote speech at the annual Homer Jones Memorial Lecture, St Louis, November 2, 2023.

²⁷ "Mura bhfuil tú in ann argóint leat féin, cinnte nach féidir leat a bheith ag smaoineamh ar chor ar bith" ("If you can't argue with yourself, sure you can't be thinking at all")
(daithi de roishte – in an unpublished novel that you will never have to read!)

²⁸ Living with High Public Debt, Serkan Arslanalp and Barry Eichengreen, Federal Reserve Symposium, August 2023; https://www.kansascityfed.org/Jackson%20Hole/documents/9749/JH_Paper_Eichengreen.pdf