The CCP's Fragility

Kevin Kelly, Co-Founder of Wired magazine, wrote in his 1994 book on complex emergent systems titled *Out of Control,* that:

> *The most obvious way to do something complex, such as govern 100 million people or walk on two skinny legs, is to come up with a list of all the tasks that need to be done, in the order they are to be done, and then direct their completion from a central command, or brain. The former Soviet Union's economy was wired in this logical but immensely impractical way. Its* ***inherent instability of organization*** *was evident long before it collapsed.*

In dealing with any type of complex system be they economic, ecological, or socio-political based, the instinctual human response is to want to control and steer them along what we believe to be optimal paths.

Michael Mauboussin notes the danger in giving in to this basic human desire for false certainty and control, writing in his book *Think Twice: Harnessing the Power of Counterintuition:*

> *The problem goes beyond the inscrutable nature of complex adaptive systems. Humans have a deep desire to understand cause and effect, as such links probably conferred humans with evolutionary advantage. In complex adaptive systems,* ***there is no simple method for understanding the whole by studying the parts, so searching for simple agent-level causes of system-level effects is useless.*** *Yet our minds are not beyond making up a cause to relieve the itch of an unexplained effect.* ***When a mind seeking links between cause and effect meets a system that conceals them, accidents will happen.***

Our linear human cognition is ill-suited for grappling with emergent non-linear systems. Nowhere is this perhaps more true, than in the instance of the largest and most complex social systems of all: national economies and their systems of governance.

Yet, despite the scientific evidence and many historical examples showing that attempts to command and control complexity (economies included) not only leads to suboptimal outcomes but can actually create enormous concavities all its own… It doesn't ever seem to stop us from trying.

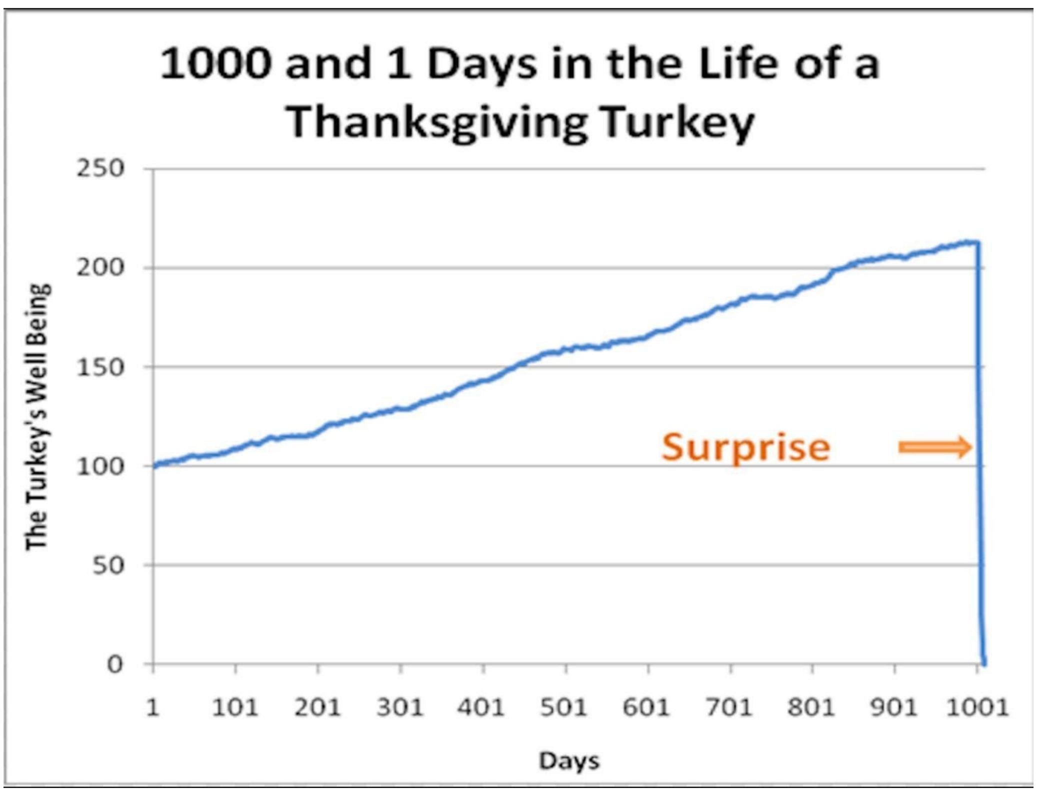
I think a driving reason behind why this is can be explained by Nassim Taleb's Turkey analogy from The Black Swan.

It goes something like this.

Consider a turkey that is fed and cared for everyday by its owners. Every day of the turkey's life he is fed, sheltered, and grows fatter and healthier.

This continuation of positive events reinforces the turkey's belief that he is cared for by his owners and will continue to be so.

This goes on and on, until of course the Wednesday before Thanksgiving rolls around. Then the turkey incurs a rude "revision of belief" and is snapped — quite literally — into what was just a day before, an unimaginable reality. And as Taleb notes, *"Consider that [the turkey's] feeling of safety reached its maximum when the risk was at the highest!"*



You see, the greatest deceiver in complex systems is temporal. It's literally time!

Large complex systems cycle on longer timeframes than the timescale in which popular beliefs and narratives are born and reinforced (ie, home prices can't go down because they've gone up "forever"). Combine this with our instinctual desire to assign cause to effect —

even when no actual linkages exist — and you get a lot of turkeys living in complex systems that have never heard of Thanksgiving…

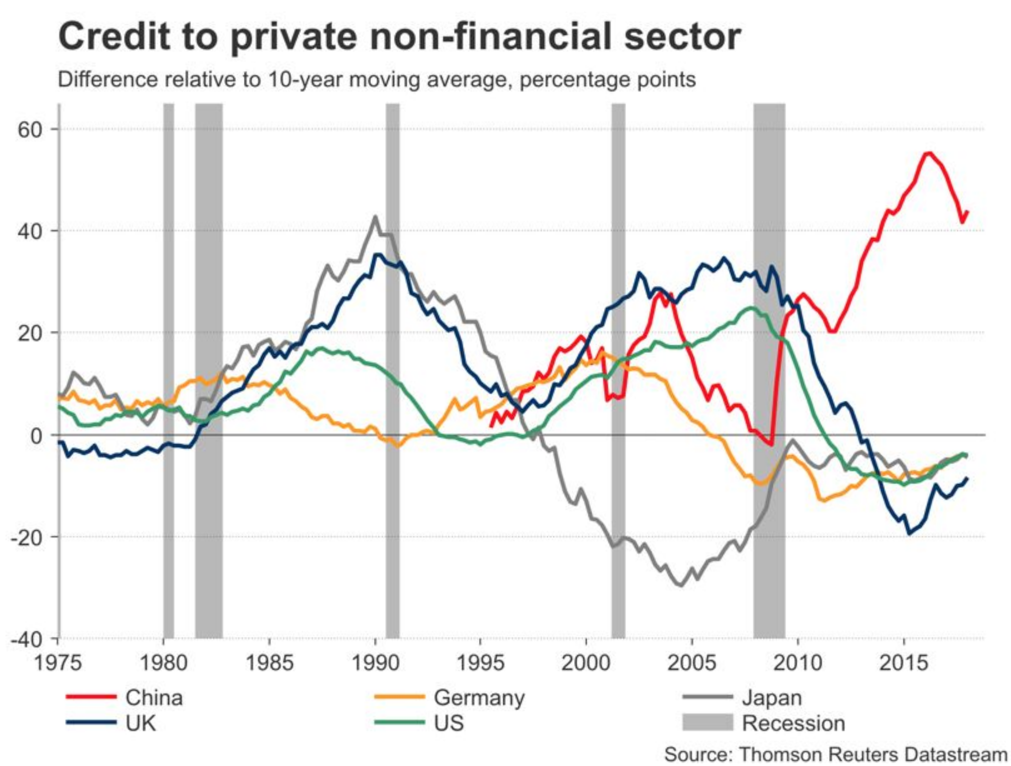
You might be thinking, “why are we talking about complexity and Thanksgiving Turkeys?”

Fair question.

You see… I’ve been thinking (and writing) a lot about China over the last couple of years. We at MO have long noted that China is THE most important driver of the global economy this cycle. When China sneezes, the world gets pneumonia and when it juices, we all get a boost.

Its incredible debt binge over the last 10-years has propped up global demand and has accounted for **over 50% of GDP growth since the GFC.**

The importance of China’s leveraging can be seen in the following chart. It shows credit to the private sector relative to 10-year averages. While the rest of the major global economies have been deleveraging, China has picked up the slack at a pace and scale of credit creation never before seen in history.



Look… We all know that China has a debt problem. A GIANT debt problem. But we all just assume that they’ll deal with it and that’s it.

But, I've been wondering if there's a major fallacy of presumption that we've collectively adopted, here.

I mean, what if China isn't as resilient as we've all come to believe. What if the Chinese Communist Party and its quasi-free market/command and control Frankenstein economy is really just a fattened turkey? Has time and the lack of volatility in China over the last few decades lulled us into the, perhaps, faulty belief, that the modus operandi there will just continue as is?

Maybe, China's unique mix of communism and semi-free marketism isn't an especially resilient system that's more able to handle downturns and an actual deleveraging, as most assume. Maybe, like the USSR of old, it has an **inherent instability of organization** that not only makes it more fragile to shock but actually **guarantees eventual ruin.**

We're going to explore this question in this month's MIR. We're then going to dive into the data that shows that our "China Deleveraging" thesis is just beginning to pick up steam. We'll then discuss why we're about to go through a market period, not unlike 2015, and perhaps much worse. Then we'll go over how one can position for it. And we'll end with a pitch for a unique Greenblatt style spinoff play.

Let's jump in… And to start, let's turn back to our deadlifting expert on fragility, Nassim Taleb.

Taleb wrote on the sources of fragility in socio-economic systems in a 2015 paper for Foreign Affairs titled *The Calm Before the Storm: Why Volatility Signals Stability, and Vice Versa.* He noted there are five principal sources of fragility, these being:

1. A centralized governing system
2. An undiversified economy
3. Excessive debt and leverage
4. A lack of political variability
5. No history of surviving past shocks

Let's go through each source using China as our example.

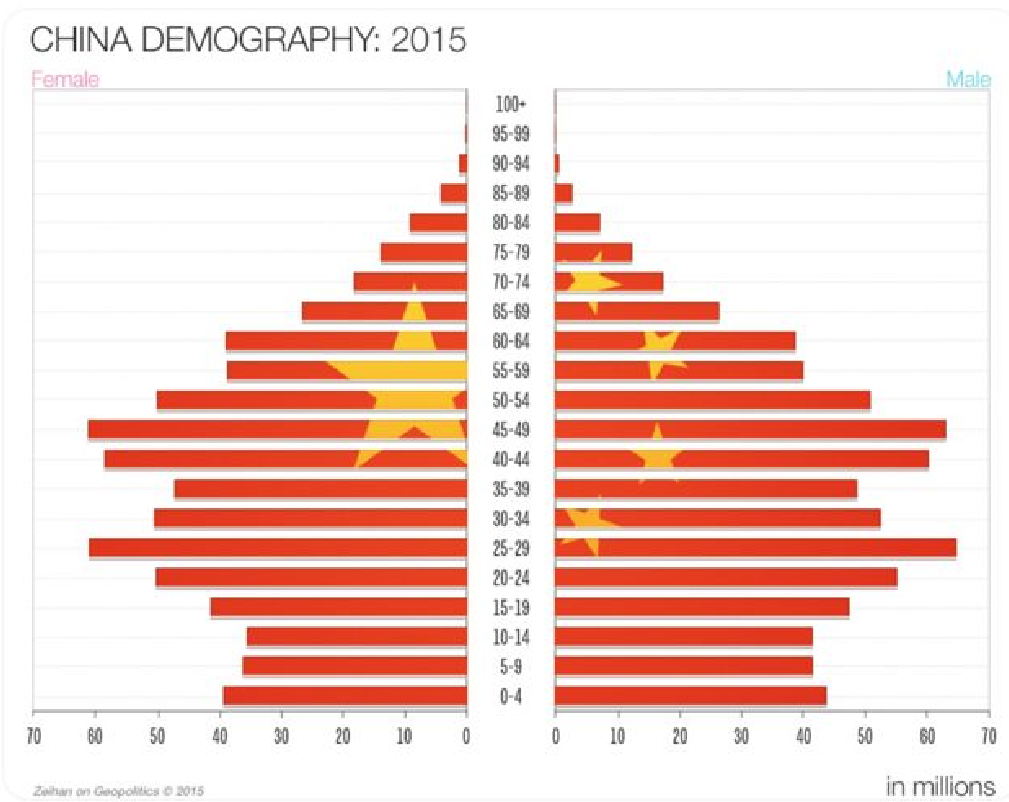
On the first principal source of fragility Taleb writes that (all bolding is emphasis by me) "on its face, centralization seems to make governments more efficient and thus more stable. **But that stability is an illusion.**" Because, "although centralization reduces deviations from the norm, making things appear to run more smoothly, **it magnifies the consequences of those deviations that do occur.**"

Since we're unable to *actually* identify cause and effect in complex systems, we are wont to misattribute the lack of volatility over extended periods of time as evidence of successful control of a system. When in reality, time is the real arbiter of truth and the ax just hasn't fallen yet. Lack of volatility (effect) does not equate to smart governance (cause) in a complex economy.

China is the poster boy for a centralized governing system. Direction flows from the top down and this is only becoming more so, as President Xi Jinping further consolidates power.

We can already see some of the negative consequences facing China that have directly resulted from a misguided policy from up top. The most notable being China's infamous "one-child policy".

China now has the fastest aging population in the world. As of 2015, China has approximately 7.7 working-age adults to support every elderly citizen. By 2030, that ratio will drop to 4:1. By 2050, just 2:1.



Why is this such a bad thing? Well, the reason is that **China is going to grow old before it ever gets rich**; putting it permanently in the middle-income trap. McMahon writes in his book *China's Great Wall of Debt* that:

> *The middle-income trap is an idea first conceived by World Bank economists who found that, of the 101 developing economies that, in 1960, could be classified as having been*

"middle income" (that is, they weren't stuck in poverty, but they didn't qualify as developed nations either), only 13 — a group that includes Japan, South Korea, Singapore, Israel, and Ireland — managed to become rich nations by 2008. Many of the other countries who didn't make the cut looked as though they were on track until growth slowed and never recovered. Thailand and Malaysia were lauded as "tiger economies" during the 1990s until the Asian financial crisis struck. Similarly, Brazil and Mexico were once among the fastest-growing economies in the world, but now they seem permanently stuck in the middle-income bracket.

China's former free speaking Finance Minister Lou Jiwei, laid out the Party's concerns in a 2015 speech, saying:

In the next five to ten years, the chance of China sliding into the middle-income trap is extremely high. I put the odds at 50-50. Why don't I feel optimistic? In other countries, this process—of property rights, opening up, allowing the trade of land—took twenty years to evolve, but China, owing to the problem of growing old before growing rich, only has five to ten years to make the adjustments.

Supporting an aging population means more resources going to healthcare and pensions and less being invested back into the economy. This means slower growth.

The World Bank defines rich nations as having a GDP per capita of $12,475 or higher (rising 2% a year). China's is roughly $8,800. At China's currently stated (though likely inflated) growth rate of 6.5%, they would enter the club of rich nations sometime in the next decade. But if you throttle that growth down to 3% a year, it would then take them around 50 years. And at 2% growth, never.

That math scares Chinese leadership whose social compact with the people is entirely predicated on rapidly improving standards of living. The CCP reversed the One Child policy in 2015, but the damage has already been done...

On the second source of fragility, Taleb notes that "economic concentration can be even more harmful than political centralization." Because concentration "makes a state more vulnerable in the face of random events." And "**even worse is when large state-sponsored or state-friendly enterprises dominate the economy**; these tend to **not only reduce competitiveness but also compound the downside risks of drops in demand** for a particular commodity or product by responding only **slowly and awkwardly to market signals.**"

An economy mired in too much government interference may excel for long periods of time. But ultimately, they are more vulnerable to shocks — random events as Taleb calls them — because they don't fully benefit from a free emergent price system that efficiently allocates resources (financial, human, and physical). Friedrich Hayek wrote about why exactly this is in his excellent essay *The Use of Knowledge in Society*, saying:

> *The peculiar character of the problem of a rational economic order is determined precisely by the fact that* ***the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.*** *The economic problem of society is thus not merely a problem of how to allocate "given" resources—if "given" is taken to mean given to a single mind which deliberately solves the problem set by these "data." It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly,* ***it is a problem of the utilization of knowledge which is not given to anyone in its totality.***

China's economy is dominated by state-owned enterprises (SOEs) and local governments that have borrowed billions to construct massive ghost cities and full-scale replicas of the Taj Mahal, Egyptian Sphinx, Eiffel Tower, Niagara Falls and on and on — adhering to the classic Gershenkron model of growth. This has added to China's breakneck GDP growth but the ultimate ROI on many of these projects is… well… questionable.

China says it's now trying to restructure its economy away from one dependent on large construction and exports, to one more reliant on domestic consumption. But doing so is no easy task. It means steelworkers being retrained as hairstylists and other such service jobs. Even more importantly, it means the CCP relinquishing more control over the workings of the economy. A prospect that doesn't quite square with Xi's "Made in China 2025" vision.

Highly indebted and highly leveraged is the third source of fragility. Taleb notes that this is perhaps the single most critical source of fragility.

He writes, "Debt issued by a state itself is perhaps the most vicious type of debt because it doesn't turn into equity; instead, it becomes a permanent burden. Countries cannot easily go bankrupt — which, ironically, is the main reason people lend to them, believing that their investments are safe."

Excessive debt and leverage sit at the heart of nearly all economic collapses. It creates the *perpetually unstable organization of the critical state* as Buchanan noted in his book *Ubiquity: Why Catastrophes Happen*, when he said:

> In this simplified setting of the sandpile, the power law also points to something else: **the surprising conclusion that even the greatest of events have no special or exceptional causes.** After all, every avalanche large or small starts out the same way,

> when a single grain falls and makes the pile just slightly too steep at one point. What makes one avalanche much larger than another has nothing to do with its original cause, and nothing to do with some special situation in the pile just before it starts. **Rather, it has to do with the perpetually unstable organization of the critical state, which makes it always possible for the next grain to trigger an avalanche of any size**.

How does China fare here? Well, China accounts for a staggering 63% of the money created globally since 2007.

That's a big pile of debt.

Moving on to the fourth source of fragility, which is a lack of political variability. Taleb writes that "contrary to conventional wisdom, genuinely stable countries experience moderate political changes, continually switching governments and reversing their political orientations." And **"It is political variability that makes democracies less fragile than autocracies**."

The contentious and on the surface, dysfunctional, politics that we put up with here in the US — and many other Western democracies — are actually a healthy sign of a robust system of government. It makes for a lot of political gridlock and not much getting done. But that's not necessarily a bad thing.

China, on the other hand, has no political variability. President Xi is now its leader for life and the regime is becoming ever more authoritarian. It's nationwide security camera network, its "social credit" system", and it's 're-education camps' — which hold over a million ethnic Uighurs — have laid the groundwork for a dystopian future that would make Orwell blush…

The fifth marker of fragility is the lack of a record of surviving big shocks. Taleb writes that "States that have experienced a worst-case scenario in the recent past (say, around the previous two decades) and recovered from it are likely to be more stable than those that haven't." This is because "this marker also involves the idea of "antifragility," the property of gaining from disorder. Shocks to a state are educational, causing them to experience posttraumatic growth."

Kevin Kelly wrote a line in his book that I absolutely love and which applies here. It is:

> ***In turbulence is the preservation of the world.***

Robust systems gain from disorder. This is a basic law of nature. Systems that are not amenable to this rule, eventually fracture.

China has evolved remarkably well since the major shocks of the Maoist period. But that was nearly 40-years ago. A long time. Especially, for a country that so actively whitewashes or all-out erases the 'less pleasant' sections of its history. This makes me wonder: how can a system absorb shocks and weather turbulence when it can't even learn from its mistakes?

Antifragile systems benefit from turbulence. These are democracies, market economies, biological systems.

Fragile systems on the other hand, are like teacups. A teacup, Taleb writes, "will not benefit from any form of shock. It wants peace and predictability, something that is not possible in the long run, which is why time is an enemy to the fragile."

Kelly went on to write in *Out of Control* that:

> *The USSR didn't collapse because its economy was strangled by a central command model. Rather it collapsed because **any central-controlled complexity is unstable and inflexible.** Institutions, corporations, factories, organisms, economies, and robots will **all fail to thrive if designed around a central command.***

This seems to be a lesson that we need to learn time and time again. In particular, it appears to be a lesson that China specifically needs to learn because it has failed to do so time and time again throughout its history.

Writing in her 2013 book *China Alone*, one of my favorite China commentators, Anne Stevenson-Yang, notes how China has historically followed 30-year cycles of opening up, growth, and reform only to then about-face, turn inward, and contract. She writes:

> **In reliable thirty-year cycles**, China decided to become a republic in 1919, established the People's Republic in 1949, then did an about-face in its most basic policies and economic practices in 1979.
>
> ...Throughout China's history, a cycle of reform and growth has led inexorably to excessive concentration of resources in the hands of a small elite, followed by a new cycle of contraction, "chaos" and reconstruction. The periods of rebuilding after a crisis have generally been the most creative and hopeful, times like the 1911 Republican period, the first few years after the 1949 Communist takeover, and the Dengist period, to name a few, when China has begun to develop new, grassroots structures for a more pluralistic governance system. Each of these periods of political ferment has been flawed, perilous, and full of promise that the country will successfully navigate its way to a more resilient, balanced, and responsive political system capable of fostering a modern economy.
>
> China's rise through the 1990s was as glorious as any of the previous dynasties, and **there is a historical symmetry to be found in the nation's coming decline…**

This all begs the question…

Maybe China isn't a Rising Dragon, after all.

Perhaps, it's just a teacup.

And if it's just a teacup, meaning it's fragile and likely to shatter in the coming slowdown. Then what does that mean going forward?

What will replace the current system? Will the CCP continue its recent trend of becoming ever more authoritarian and tightening its control over the economy — following the country's historical cycle of closing itself off to outsiders, after a period of openness.

What would that mean for geopolitics? Global commodity demand? Or, even better, what would that do to global supply chains?

We can't *know* what's going to happen in China in the coming years. But the market does seem to be either willfully ignorant or just totally complacent to the possibilities; especially considering the historical precedents.

This is something we should all keep front of mind going forward. I keep getting the sense that we're at one of those giant slow turning inflection points in history. The ones you read about in history books and think to yourself "how did people not see that coming, how could they be so blind?".

Let us try and not be so blind…

*******REPORT WRITTEN IN 2018*******