

The Revenge Of The Ottoman Empire

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The fall of Constantinople in 1453 closed one channel of trade for Western Europe

But that action forced another channel of trade to open and led the way towards industrialization

In 1453, Constantinople fell to the Ottomans. This was bad news for the then Christian world as it meant the Ottomans now controlled most of the Mediterranean Sea (which had been the cradle of Western civilization) and most of the Silk Road. If Europeans wanted spices or silk, they would have to pay whatever price the Ottomans demanded. Unless, of course, another route could be found to link Europe with India and China. Cue Christopher Columbus's discovery of the Americas in 1492, and Vasco da Gama's voyage around Africa to India in 1498. With Portuguese, Spanish and Italian navigators setting off into the great unknown, **the world's center of economic gravity promptly shifted from the Mediterranean Sea to the Atlantic Ocean.** The Ottoman Empire gradually slipped into economic irrelevance and by the 19th century it was dubbed the "Sick Man of Europe". To someone sitting in Constantinople, the world most likely felt like it was "deglobalizing". But to anyone based in London, Rio de Janeiro or Cape Town, that notion would have been laughable.

One takeaway from the above tale is that if trade gets blocked in one place, it may reappear in another one and be that much more powerful, perhaps with unintended consequences to boot. In this case, the direct corollary of the Ottoman's capture of the Eastern Mediterranean sea, and its trade, was for Western Europeans to colonize the Americas, then Africa, seize most of the world's gold, purchase slaves and ship them over to the Americas to work on large plantations. Those big plantations ended up being a first step towards industrialization. **The Ottomans could not have known it, but by blocking Silk Road trade they ended up giving impetus to the modern era and gradually transformed the Mediterranean sea into an economic backwater.** The Ottomans sawed the very branch on which they were sitting. The law of unintended consequences at work.

Why recall this history today? Because in recent years, we have seen:

- 1) The Western world attempt to trigger a collapse in the Russian economy by blocking access to the US dollar, euro, British pound and Swiss franc. Unsurprisingly, Russia immediately shifted to selling its commodities for renminbi, Indian rupees, Brazilian real or Thai baht, and trade between Russia and the world's major emerging markets went parabolic, as shown in the left-hand chart overleaf.
- 2) The United States encourage domestic producers to repatriate production from China which is a non-democratic Communist country. Or, alternatively, to move production to countries that happen to not be non-democratic and nominally communist—for example, Vietnam.

The end result? China's trade surplus has essentially tripled over the past few years, as shown in the right-hand chart overleaf.

EM-EM trade is no longer constrained by the need for US dollars

Monthly imports from Russia, US\$



Gavekal Research/Macrobond

China's trade surplus is ballooning

6m moving average



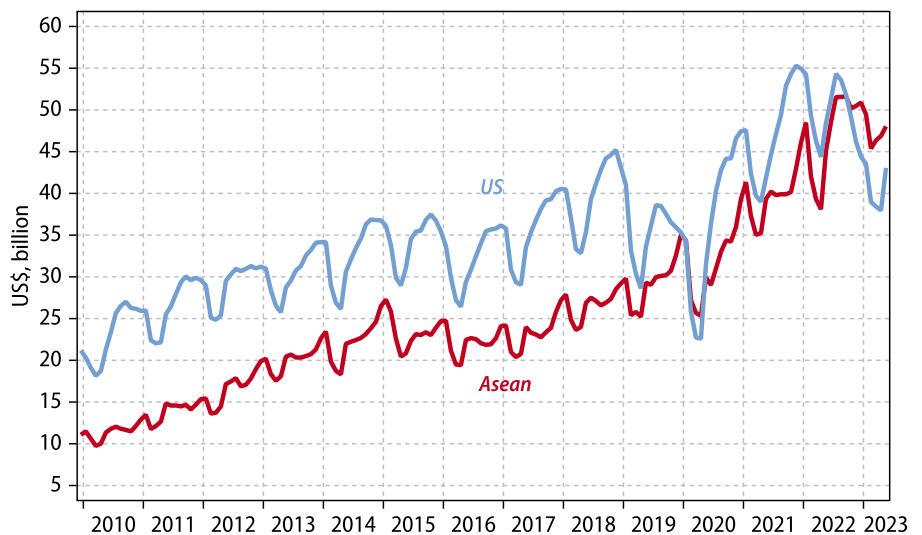
Gavekal Research/Macrobond

1) The surge in Chinese trade

China's trade surplus did not triple due to North American or European consumers deciding to buy three times as many plastic toys for their kids. Necessity is the mother of invention, as the saying goes, and the surge in China's surplus is linked to it opening up new markets for its products. Back in 2017, the value of Chinese exports to Asean economies amounted to 60% of China's exports to the US. Today, China's exports to Southeast Asia stand at roughly 120% of China's exports to the US.

China exports more to Southeast Asia than the US

Chinese exports, 3m moving average



Gavekal Research/Macrobond

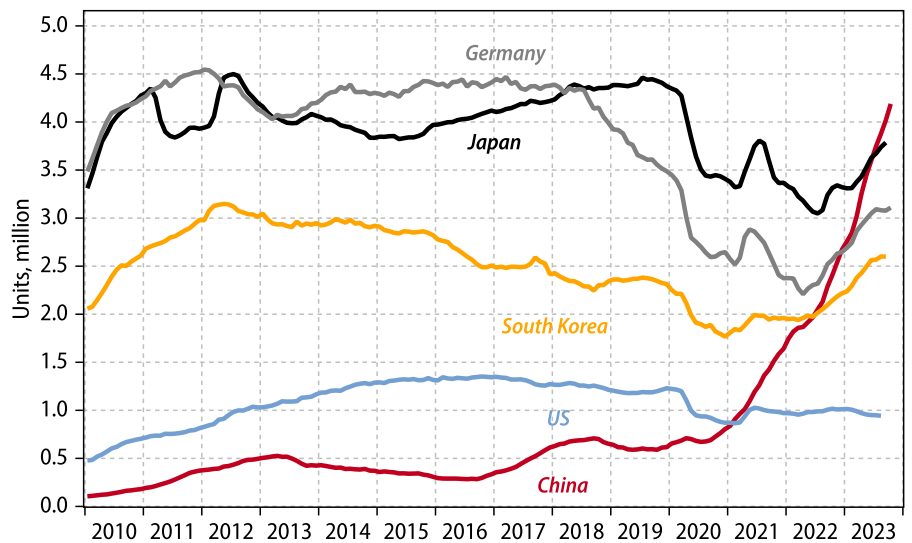
Chinese exports to Southeast Asia has come to exceed those to the US

China did this by moving up the value chain and exporting decent quality, aggressively-priced capital goods and other higher value-added products. The most visible example of this is how China came from nowhere five years ago to become the world's largest car exporter. These cars are typically not sold in the US or Europe, but have been snapped up by drivers in Southeast Asia, the Middle East and Latin America. Just as importantly, while the cars have captured the general public's imagination (hard not to notice Chinese cars

when every shopping mall, or airport, one enters in an emerging economy now has very attractive Chinese cars on display), one can draw parallel stories for power plants, earth-moving equipment, tractors, telecom switches, turbines, and machine tools—basically, all the capital goods that are heavily in demand across India, Indonesia, Brazil and Saudi Arabia.

China has emerged from the pandemic as an auto export powerhouse

Exports of passenger cars; rolling 12m sum



Gavekal Research/Macrobond

Over the last few years, China has emerged as the world's biggest automobile exporter

China's export boom helps explain why its economy has kept the show on the road. Let's face it, in the last five years China has faced an epic real estate bust, which if the experiences of Japan in 1990, Sweden in 1992, Thailand in 1997, South Korea in 1998, the US in 2008, and Southern Europe in 2011 were any guide, should have doomed the Chinese economy. Those markets all endured domestic banking crises and huge deflationary busts. Predicting that the same causes (falling real estate) would lead to the same consequences (failing banks and economic meltdowns), thus felt like a no-brainer. But we now know that in spite of a significant contraction in real estate—one that saw most large private-sector Chinese property developers implode—China's economy managed to keep its head above the water.

China's success in export markets explains why it has endured a massive property bust without cratering its economy

How could that be? How could China withstand both a frontal attack from the US (a country that controls the pipes of global financial flows to an even greater degree than the Ottoman Empire controlled the Eastern Mediterranean), and a real estate slowdown? **The answer, as with Columbus and Vasco da Gama, is that necessity is the mother of all discoveries and inventions.** Trade will tend to flow, either where it is the most profitable; or alternatively, if walls and barriers are put up, then trade will flow around these walls and find new destinations.

All of which brings us back to the Gavekal foundational concepts of Ricardian growth and Schumpeterian growth.

2) Where will Ricardian growth come from?

From its infancy as a firm, Gavekal has identified economic development as deriving from one of two sources:

Economies have two main sources of economic growth

- **Ricardian growth** that stems from falling trade barriers, new roads, and improvements to modes of transport and communication. Such developments pave the way for a more efficient use of existing resources, whether land, labor or capital.
- **Schumpeterian growth**, when new inventions trigger sharp productivity improvements.

With this in mind, through most of my own life, the breakdown of trade barriers seems to have been a constant driver of growth.

- When I was growing up in France in the 1980s, the exciting developments were the creation of the European Union, the collapse of the Berlin Wall, and the broader integration of the different European economies into a more coherent, and productive, whole.
- In the 1990s, I moved to the US to go to university just as the North American Free Trade Agreement was being negotiated. Cue more trade, more falling tariffs and more productivity enhancements.
- By the 2000s, I was living in Hong Kong and the entry of China into the World Trade Organization eventually led to the belief that China and the US were becoming so economically interdependent that they came to be known as one gargantuan economic entity dubbed “Chimerica”.

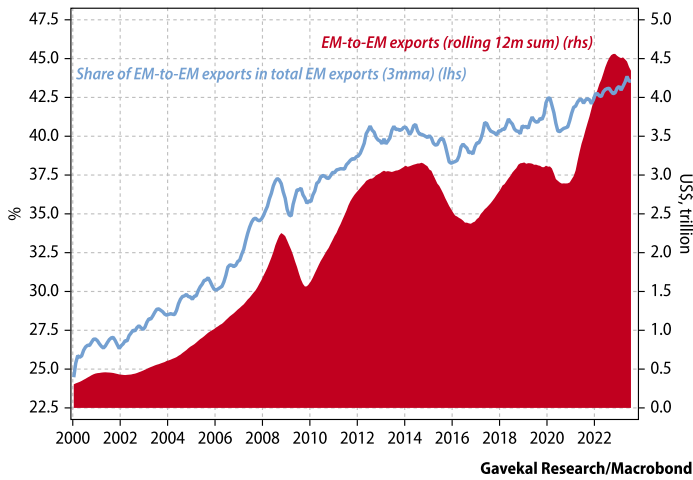
The threat of “deglobalization” signifies a possible death of Ricardian growth

That was then, for things have shifted dramatically in recent years (see my last two books, [Clash of Empires](#) and [Avoiding the Punch](#)) to the point that the new buzzword is deglobalization. It is a word that invites thoughts of falling productivity, rising inflation, contracting living standards and geopolitical strife (Frédéric Bastiat, the 19th century French economist, noted “if goods do not flow across borders, then armies will). After an impressive four-decade run, it is a word that foretells the death of Ricardian growth.

However, like China’s big trade surpluses, does this buzzword reflect a genuine economic reality? Fortunately, it does not. In fact, in recent years, global trade has continued to grind higher, thanks mostly to a sudden acceleration of trade within emerging economies, as shown in the left-hand chart overleaf.

Indeed, Charles and I have argued in numerous pieces that if the 1980s was the era of European integration, the 1990s that of Nafta and the 2000s Chimerica’s time, the next decade will see the broader Eurasian continent integrated as an economic whole (see [The EM-AI Crossroads](#) and [The Indian Ocean: New Center Of World Growth](#)). In that spirit, hardly a month goes by without the announcement of some new road, railway, canal or free trade deal linking the economies of the Istanbul-to-Jakarta axis described in the above reports (draw a line from Istanbul to Jakarta and one finds a population of roughly 3.5bn people—excluding China—that is growing by 1% a year, and with some of the highest income growth in the world). Consider the graphic overleaf showing recent headlines captured from the general media.

The share of EM-to-EM trade is growing



The Istanbul-Jakarta axis — the integration of the Eurasian continent

Iran, Saudi Arabia, UAE and Oman to form a joint navy

India-Iran-Armenia launch trilateral to create corridor to Russia & Europe

China 'Green Lights' A Whopping ¥ 400 Billion BRI Project To Pakistan; Aims To Connect Kashgar To Gwadar Via Kashmir

Saudi Arabia takes step to join China-led security bloc, as ties with Beijing strengthen

Russia and Iran sign rail deal for corridor intended to rival Suez Canal

'Iran may consider extension of sub-sea natural gas pipeline from Oman to India'

India and Russia in 'advanced talks' over free trade agreement

Erdogan says Turkey and Russia to study Putin's gas hub proposal

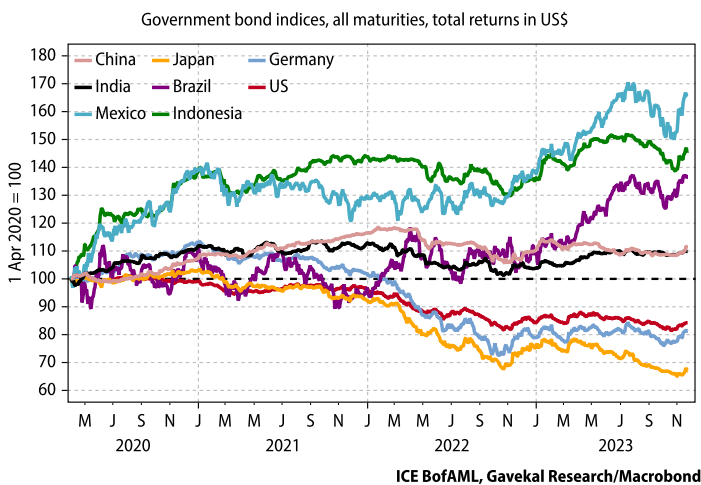
Sources: news headline clippings

Construction of new roads, railways and canals are appearing all across emerging economies because countries across the “Global South” can now:

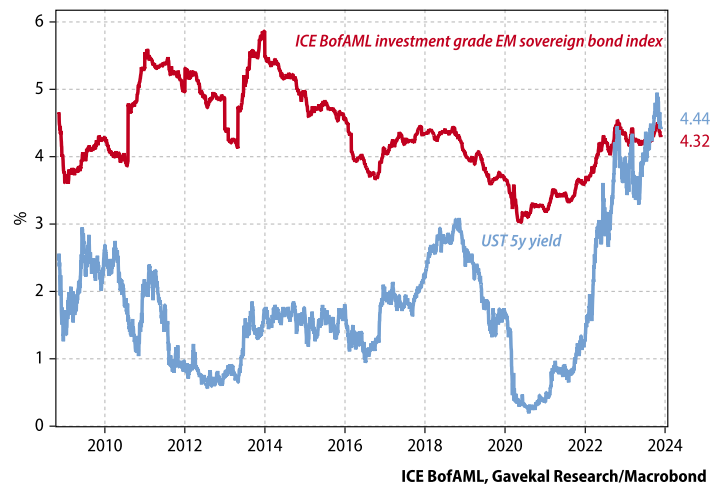
- Purchase commodities in their local currencies, from Russia.
- Purchase capital goods from China, either in their local currency (if they have good relations with China), or, alternatively, in renminbi.

The combination of these two factors is a game changer for emerging economies like Indonesia, India and Brazil, which can now break free from the tyranny of the US dollar funding constraint. This explains why, for the first time in living memory, we have just seen a significant Federal Reserve monetary tightening cycle without a single emerging market going bust. On the contrary, in recent years the US dollar returns offered by most emerging market bonds have trounced those of US treasuries, along with German bunds or Japanese government bonds (see left-hand chart below).

EM bonds have outperformed DM ones in the past few years



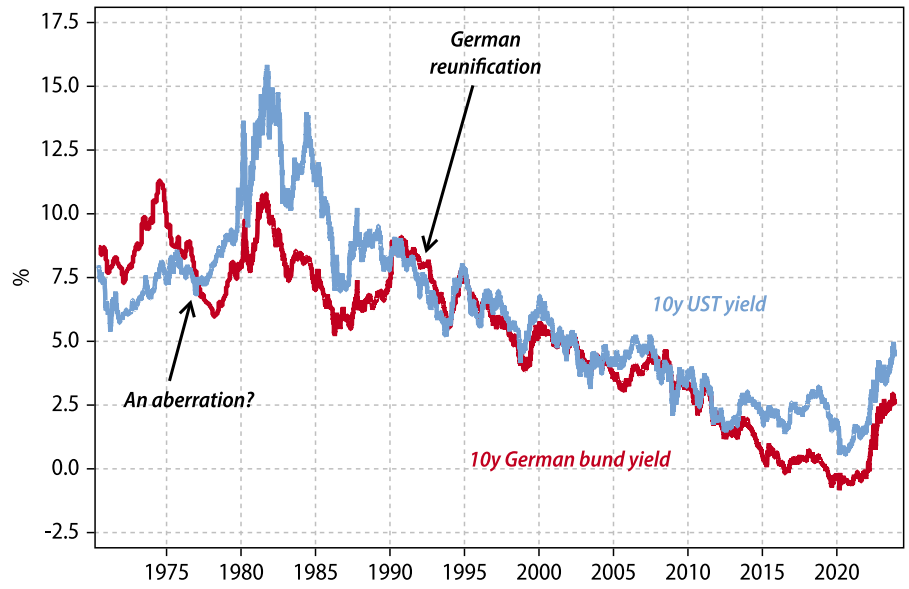
The yield on investment-grade EM sovereign debt is now lower than USTs



Indeed, for the first time ever, the yield on investment-grade sovereign emerging market debt is now lower in aggregate than that on US treasuries, as shown in the right-hand chart above.

This role reversal was recently labeled an “aberration” in a Bloomberg headline. Funnily enough, when yields on German bunds fell below US yields in 1977, this was considered an absurdity, although it became the new norm (temporarily disrupted by the German reunification).

German bund yields being below US ones are now the norm



Gavekal Research/Macrobond

In the 1970s, it seemed incredible to think that German bond yields would fall below US yields, but this has become the norm

The combination of lower financing costs and more choice should lead to lower prices for the end consumer (provided that production keeps up!), as should free trade deals. Such deals, in turn, will create their own demand for more infrastructure spending, which, in turn, can be funded thanks to a drop in military spending (see [Peace Breaks Out](#)). And all of this brings me back to another tried-and-tested Gavekal formula, namely, $(N*(N-1))/2$.

3) The $(N*(N-1))/2$ formula

If an economy contains two cities, it requires one link (say a railway line) to connect them. If an economy contains three cities, it needs three links to connect each city with the other two. If an economy contains four cities, the number of required connections rises to six.

For any number of cities, N, the number of links needed to connect each city to the others, is stated by the formula $N*(N-1)/2$. As more cities/countries join the system, the number of links therefore rises at an accelerating rate. For example, from the early 2000s, global economic activity was massively boosted, not just by connecting China to the rest of the world, but also by connecting Chinese cities to each other, with all the associated construction of rail, air, road, telecommunications and power links this involved.

And what occurred in China is now occurring across the broader Eurasian continent. Obviously not at the same pace (no country will ever be able to match China in mobilizing land, labor capital and natural resources towards the delivery of infrastructure) but it is happening nonetheless. Take India as an example. Over the past few years, India has opened 70 new airports

Economic development involves infrastructure spending that expands at a non-linear rate

and currently has plans to start the construction of another 70. And as more cities start talking directly with each other, this should mean more growth, more productivity and lower prices. Such dynamics bring me back to another staple of Gavekal analytics, namely, the acceleration phenomenon.

4) The acceleration phenomenon

The concept of “acceleration” was developed by Albert Aftalion, a French economist active in the inter-war years. It is most useful in abrupt adjustments but is not easily explained mathematically, which may explain why it has not secured the following it deserves. Here goes the CliffsNotes version:

- Most socioeconomic variables are distributed according to the “normal” law, the famous Gaussian bell-shaped curve.
- This is especially true of incomes: in a “normal” country, where a large share of people have an income close to the average, a few people have very low incomes and few very high incomes. At both ends of the curve (the tails), one finds a very small population in percentage terms.
- As incomes grow over a period of a few years, the right side of the tail will grow much faster (the acceleration phenomenon) than the growth of income. This is where it gets complicated since our minds are accustomed to thinking in linear patterns, yet the number of people earning a certain amount actually grows exponentially.

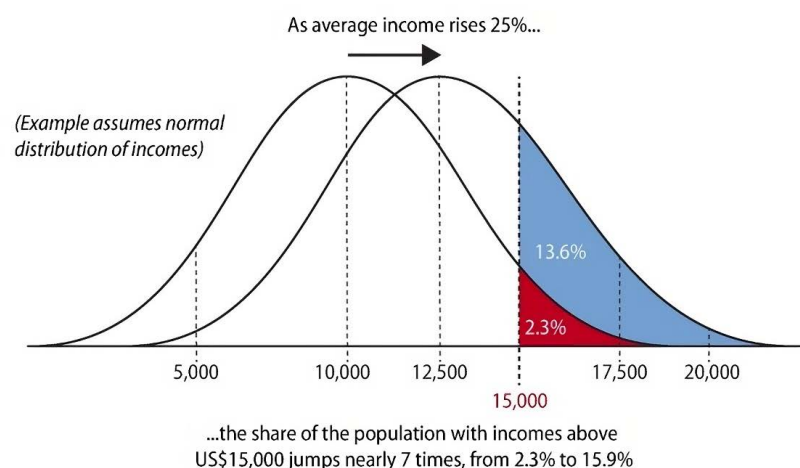
Consumer spending in emerging economies grows according to the non-intuitive acceleration phenomenon

There are certain income thresholds in emerging economies above which most households buy certain goods or services

This matters because when it comes to the purchase of certain goods and services, history points to the existence of key income “thresholds”. For example, if the average income in a country is below US\$1,000, nobody owns a television; when incomes move above US\$1,000, almost everybody buys one. For smartphones, the level seems to be around US\$2,500. For the automobile industry, the critical level seems to be US\$10,000 a year. For university education, the level is US\$15,000 and above. For financial products like life insurance, brokerage accounts and mutual funds, the level seems to be US\$30,000.

Illustrating the acceleration phenomenon

Why growth in some markets can be much faster than total income growth



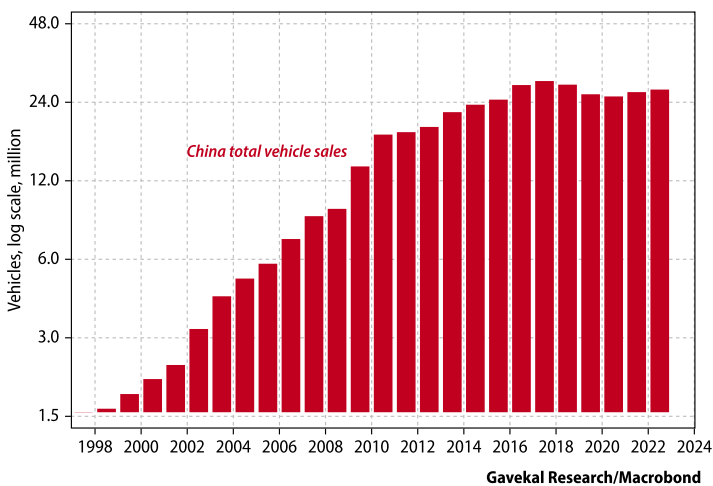
So, let us imagine a country where the average income stands at US\$10,000 per person and let us further imagine that incomes grow by 25% over five years. In this country, the demand for university education won't rise by 25%. Instead, it will rise sevenfold (see [Outliers And Today's Chinese Youth](#)).

Now let us further imagine a few things, namely that:

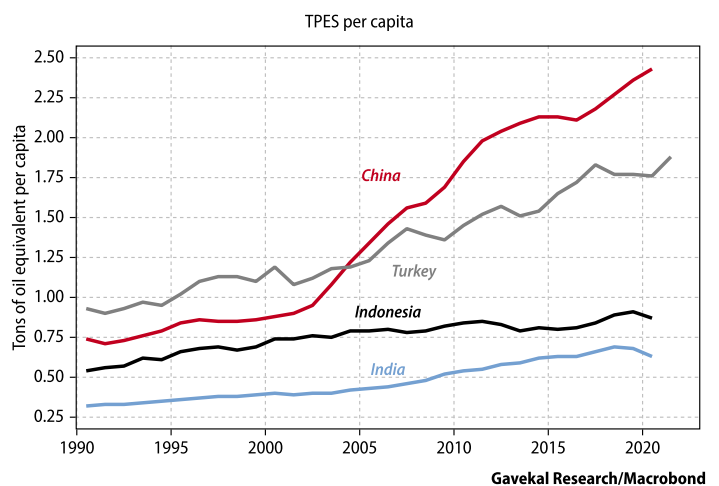
- Just as incomes grow, the prices of goods delivered to consumers—whether cars, or smartphones, or personal computers—actually go down
- As incomes grow, interest rates charged to consumers actually go down (“*on ne prête qu'aux riches*” and all that)

Then all of a sudden, one could face a double-, or triple-charged acceleration phenomenon. This is what happened in China in the 2000s. At the start of the decade, automakers were selling 2mn cars a year. Some 10 years later, annual sales had hit 18mn vehicles, as shown in the left-hand chart below.

China's car sales are proof of the acceleration phenomenon at work



China's energy demand has surged



Unsurprisingly, as cars replaced bicycles on the streets of Beijing, Shanghai and Chengdu, China's energy demand also accelerated, as shown in the right-hand chart above. Could similar events now unfold across Southeast Asia, India and the broader Middle East? Given the growth in incomes, the fact that China is now offering high-quality sub-US\$10,000 cars, and the funding for such purchases, is this not the path of least resistance?

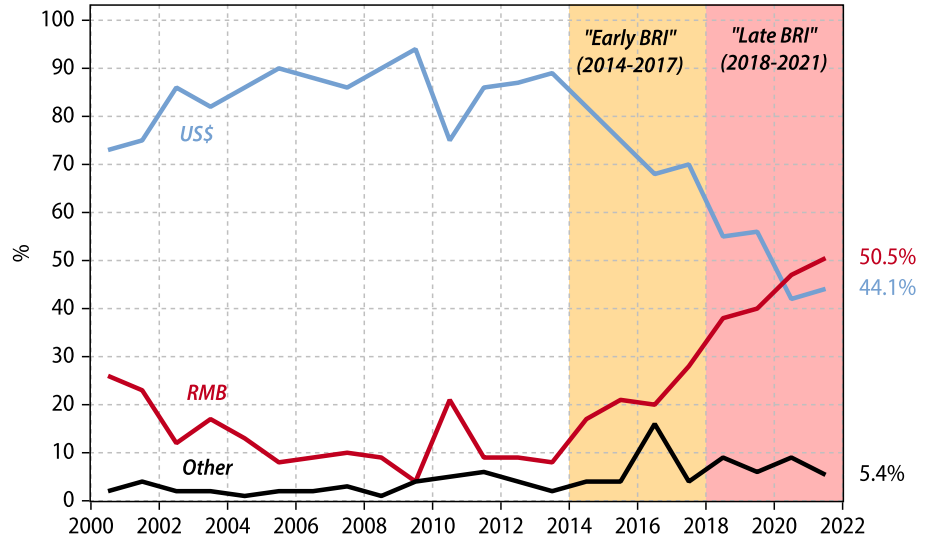
Conclusion

The fall of Constantinople did not trigger “the end of globalization”. Instead, it unleashed a sharp move higher in global trade. Could the same thing happen as a result of the sanctions against Russia and the US's attempts to take China out of global supply chains? Actually, this is precisely what seems to be unfolding. Both of these events mean that the likes of Indonesia, Brazil, Saudi Arabia and India can now use their own currencies to pay for the commodities they need to power their growth and the machine tools they need to industrialize. At the very least, they no longer need US dollars. Last year, for the first time, China made more loans to EM economies in renminbi than in US dollars, as shown in the chart overleaf.

The sanctions imposed by Western nations on Russia could have the kind of unintended consequences that the fall of Constantinople had in Western Europe

Composition of China's loan portfolio by currency of denomination

Official loan sector commitments (in constant 2021 US\$) to LICs and MICs



AidData, Gavekal Research/Macrobond

China is already making more loans to emerging economies in renminbi rather than US dollars

And this is before the recent announcement of Saudi Arabia signing a RMB50bn swap line equivalent with the People’s Bank of China and the possible sale by China of nuclear power plants to the kingdom.

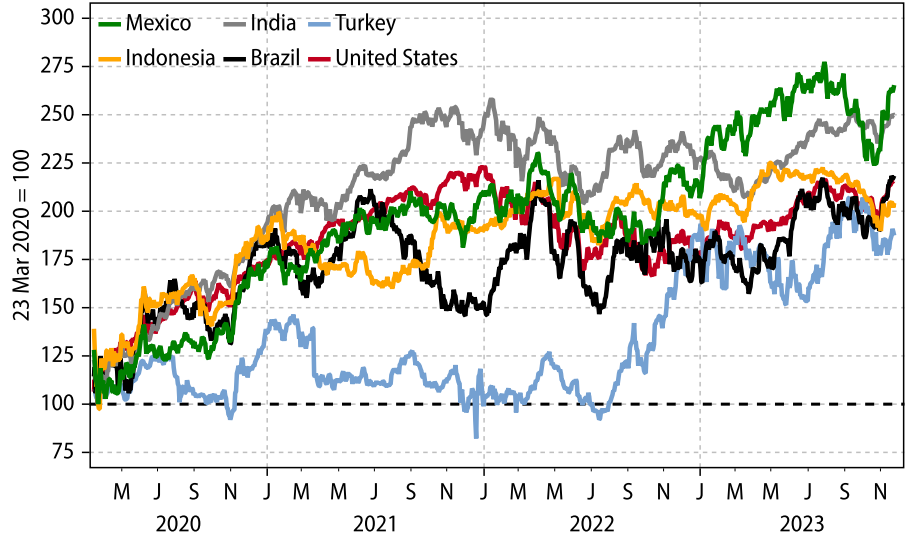
For much of the emerging world, the idea that we are living through an era of deglobalization is laughable

Today, the notion that the world is deglobalizing would seem laughable to anyone living in Dubai, Singapore, São Paulo or Mumbai. Rather, the world is going through a new wave of globalization, which is different from its predecessors. For the first time since Columbus sailed to the Americas (as Churchill said, “Christopher Columbus was the world’s first socialist: he didn’t know where he was going, he didn’t know where he was, and he did it all at taxpayers’ expense”), the world is experiencing a wave of globalization which does not require Western financiers, Western engineers, Western modes of transportation, Western currencies or Western technologies.

Moreover, since the assets of Russian oligarchs were seized, the profits from this globalization are less likely to be recycled into Western assets, whether treasuries, Parisian real estate or English football clubs (see [What Freezing Russia’s Reserves Means](#)). Instead, the profits of this unfolding globalization boom will likely be recycled into emerging markets themselves. This is yet another reason to believe that the emerging market bull market is still in its infancy (see the chart overleaf).

The EM bull market is still in its early days

MSCI mid & large cap index, total return in US\$



The EM equity bull market has arguably only just got going

Gavekal Research/Macrobond