

October 24, 2022

Defining Deglobalization

Words are important. They are a key tool to how we communicate, but they also can narrow meanings and lead to misunderstandings. Often, the term “deglobalization” has led pundits to suggest that this isn’t really happening by deploying something of a “[straw man](#)” argument. The writer will suggest that trade is still happening, therefore deglobalization isn’t really occurring.

Since we have argued that deglobalization is upon us, in light of various reports, it makes sense to provide our definition of terms. In reading these reports, we have some sympathy for their positions. We are seeing a change in how trade is conducted, but we don’t think that international trade will end. However, as we discuss below, in our analysis, the core concepts that have driven globalization are now at risk and will have lasting ramifications. The miscommunication risk of our position is that it is interpreted as global autarky. The risk of others suggesting deglobalization isn’t happening is that they fail to comprehend that the changes underway are so fundamental thereby the assumptions that have underpinned globalization no longer hold.

In this report, we begin with a framing of the reason globalization took on special characteristics after the Cold War ended. Next, we discuss the “end of history” argument and how it created the Washington Consensus. The next section examines how

the “end of history” was not the end of geopolitics. We note the key geopolitical imperatives of China and Russia and examine how investing patterns in the Cold War era led to risky investment decisions. We also discuss the impact of the Washington Consensus on the U.S. economy. We close, as always, with market ramifications.

The End of the Cold War and Globalization

Wars are [fought for several reasons](#). Nations sometimes want to acquire the wealth of an area and thus invade it. There may be an attempt to secure critical areas to protect a nation. Often, there is a multipolicy reasoning to objectives. World War I was partly driven by nationalism and partly by economic concerns. Arguably, France may have wanted to exact revenge for the Franco-Prussian War of 1870. One of Nazi Germany’s goals was “lebensraum,” or “living space,” as Hitler wanted to secure economic resources.

The Cold War was unique in world history in that it was primarily an ideological conflict. After WWII, the U.S. and the Soviet Union were engaged in an ideological contest to determine which system, capitalism or communism, was superior. The focus on ideology changed the nature of the conflict to one where there were a few hot wars (Korea, Vietnam, Afghanistan), but these existed almost like battles in the longer war to prove who had the better system. The seminal documents of the Cold War, such as George Keenan’s [Long Telegram](#), outlined how the Soviet Union viewed the world such that competing systems could

not endure. Essentially, the plan of the Cold War was to isolate the Soviet Union and outlast it.

When the USSR unraveled in 1991, it was treated as a triumph of ideology. This idea was famously framed by Francis Fukuyama in his paper [*The End of History*](#), in which he argued that the triumph of the West was one of the *idea* of the West. In other words, capitalism and its favored political system, democracy, had won, exhausting all rivals. Fascism and state capitalism was vanquished with WWII and communism with the devolution of the Soviet Union. The whole notion of the “end of history” comes from Marx, who postulated that once the world evolved to communism, there would be no further progress. Fukuyama turned this concept upside down, suggesting that it was capitalism that was the ultimate state of humanity.

This position did not go unchallenged. Samuel Huntington wrote a competing paper, titled [*The Clash of Civilizations*](#), where he argued that with the fall of communism the world would return to conflicts driven mainly by culture. Although it is arguable that culture hasn’t necessarily caused conflicts, history has proven him right in that the end of the Cold War did not end international conflict and competition.

What Fukuyama Wrought

The consensus of the elite’s opinion sided with Fukuyama. If his assertions were correct, then the whole world was available for economic development. Neoliberal economics,¹ which became ascendent in the

¹ Best defined as organizing the economy with market primacy with low levels of regulation. To understand the history of the neoliberal movement, see: Yergin, Dan and Stanislaw, Joseph. (1998). *The*

1980s with Prime Minister Thatcher and President Reagan, was seen as the only viable economic system. After all, it was credited with not only vanquishing the 1970s inflation, but it also outproduced the communist bloc. The conclusion of the Cold War ended the perception of the battle of ideas, and the capitalist nations believed it was safe to engage in massive foreign investment in the former communist regions, such as the former Soviet Union, the Central and Eastern European nations, and especially China.

The key point to all of this is the “end of history” narrative, which postulated that capitalism had won because it was a superior economic system, and democracy, which was associated with it, was the best way to organize political systems. Since it was abundantly clear that neoliberalism had won, all nations, even if they were not organized perfectly in this fashion, would be expected to steadily evolve to become capitalist and democratic. This concept became known as the “Washington Consensus.”

If the world economy is now organized around markets, then political and geopolitical risks have become irrelevant. Thus, businesses should organize their activities with one factor in mind—efficiency. Since ideological wars are no longer likely, investment should be sourced in its most efficient location. This position was coupled with internet technology,² which allowed economic activity to be scattered across the globe.

Commanding Heights: The Battle for the World Economy. New York, NY: Simon and Schuster.

² A good discussion of the impact of technology on globalization comes from: Baldwin, Richard. (2016). *The Great Convergence: Information Technology and the New Globalization.* Cambridge, MA: Harvard University Press.

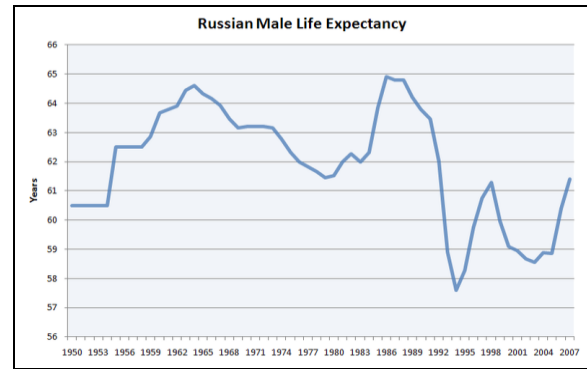
Accordingly, the traditional concerns about foreign direct investment, such as physical security, geopolitical stability, and divergent political systems—the basic elements of geopolitics—were considered irrelevant. Since the ideological battle had been resolved, the focus of investment narrowed to an almost singular focus on efficiency.

What We Have Discovered

Unfortunately, history didn't end, and Huntington proved to be correct. Investment did spread and the global economy was transformed, but international relations had factors other than ideology driving them.

The U.S.'s policy toward China was that it would follow the path implied by Fukuyama, which meant that eventually the country would liberalize over time and would, therefore, not be a geopolitical threat. American companies became deeply engaged in China, with their supply chains becoming acutely entwined. The integration culminated with China joining the WTO in 2001, fostering increasing trade and investment between the West and China.

After the devolution of the Soviet Union, Russia followed the “shock therapy” policy of rapidly privatizing state-owned businesses which had been successful in Eastern Europe. The policy was a disaster. Workers were granted company shares, which they often sold for a fraction of their value. Those who bought the shares amassed tremendous wealth and created an oligarchy. Economic growth collapsed and Russia defaulted on domestic debt in 1998. One snapshot of just how dire the situation became is reflected in male life expectancy.



(Source: [Wikimedia Commons](#))

Declines of this magnitude rarely occur outside of war.

When Vladimir Putin took power in 2000, his goal was to stabilize the country and attempt to recover. Thanks to a rise in oil prices, Russia did see its economy improve, but there was deep resentment among the Russian ruling class over the West's treatment of Russia during the post-Cold War era.

Geopolitics Returns

Despite the belief that geopolitics no longer matter, in reality its issues never went away. Every nation has geopolitical imperatives it must address.

China's geopolitics is all about securing the region of the Hans, who mostly inhabit the area where 15 inches or more of rain fall every year. To do that, it must secure the regions around this core (Tibet, Xinjiang, Mongolia), which are open to invasion. Southern China is isolated by the Himalayas and dense jungles in Southeast Asia and is less of a concern. Invaders could still enter from its long Pacific coast, which they did during the 1800s and into the 1930s.

Historically, China has managed its coastal risk by restricting trade and outside contact. This leads to a unified and safe, albeit poor China. At some point, the country decides it needs to boost economic growth. To do so,

it must open itself to the world. China tends to cycle its focus inward and outward over time.

With Russia, the key problem is that its major power centers sit on the Northern European Plain where there are no significant natural barriers. To defend its core, Russia has traditionally extended its influence as far west and south as it can control, forcing invaders to attack it with lengthy supply chains. However, maintaining buffers is expensive and the “locals” tend to become restive over time. So, Russia’s influence in its near-abroad tends to contract and expand over time.

The Salient Issue

Because U.S. Cold War policy assumed the primary issue was ideology, when it ended, the U.S. seemingly assumed that additional issues, such as geopolitics or other factors, were irrelevant. This position led to decisions that have come into question in recent years.

The decision to expand NATO was made with the idea that Russia shouldn’t be concerned because there was no ideological conflict between it and the West. When Russia annexed Crimea, Secretary of State Kerry claimed Moscow was “[behaving like it’s the 19th century.](#)” Kerry was right: from a traditional view of geopolitics, what Russia did makes sense, but from the “end of history” perspective, it was irrational. [Zbigniew Brzezinski](#) captured the concept brilliantly with this quote:

It cannot be stressed enough that without Ukraine, Russia ceases to be an empire, but with Ukraine suborned and then subordinated, Russia automatically becomes an empire.

From the Russian perspective, a Ukraine out of its sphere of control is a mortal threat. U.S. and Western policymakers believed that sort of thinking no longer applied, but clearly, the Ukraine war suggests otherwise.

The U.S. assumed China would accept its membership within the American-led world order. This one is simple: considering China’s geopolitical imperatives, if it wants to be outward-looking, then it needs to project naval power to avoid being blockaded.³ Control of Taiwan is an important element of that goal. [If China controls Taiwan, it can then project power beyond the first island chain and improve its ability to maintain trade routes.](#) A hostile Taiwan, on the other hand, makes that just about impossible.

Given the Washington Consensus, the U.S. assumed that no nation would deliberately turn inward. However, there is growing evidence that China may be in the midst of a cycle of inward focus. General Secretary Xi’s [Dual Circulation](#) policy, in part, is designed to make China less reliant on the world economy. Purposely avoiding foreign involvement is in direct contradiction to the concepts behind the Washington Consensus.

Risks Rediscovered

The Washington Consensus and its focus on efficiency led firms and nations to make investments with a nearly sole focus on efficiency. This policy has proven to be risky. Here are some examples:

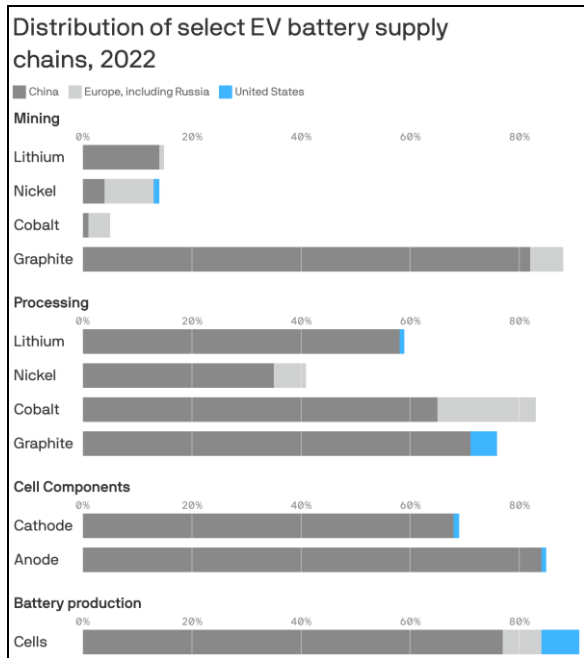
Having the world’s most sophisticated semiconductor foundries within range of China’s short-term missiles and well within reach of the PLA Navy has proven to be a serious mistake. The U.S. and the West are scrambling to build redundant capacity

³ Japan has similar issues. Fear of losing access to resources led Imperial Japan to attack Pearl Harbor.

outside of Taiwan. This activity, however, is costly and less efficient than concentrating production in one area.

Allowing the free movement of technology is now being questioned. It turns out that militaries use cutting-edge technologies, and telecommunication equipment can be used to gather information. The U.S. has recently [enacted harsh measures](#) designed to prevent China from acquiring either the most sophisticated semiconductors or the means to produce them. The U.S. has also now begun [isolating Chinese telecommunications firms](#).

Western policymakers want to reduce carbon emissions, but ***it turns out that the raw materials for the energy transition are dominated by China.***



(Source: Axios)

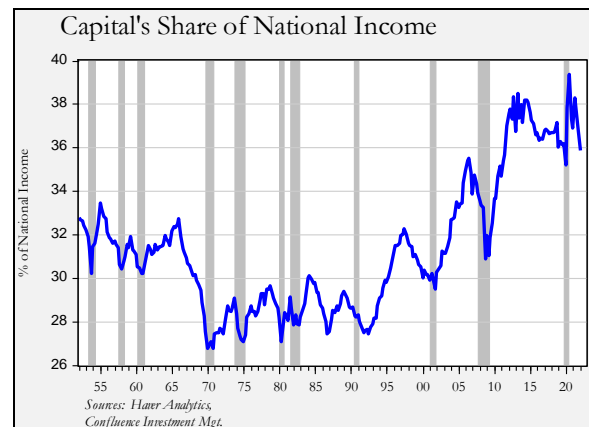
Again, the [West is actively moving to create redundant capacity](#), but that will come at the cost of less efficiency.

It's not just the developed Western markets that evolved toward the Washington

Consensus. Classical economics developed the theory of comparative advantage, that is, nations should produce what they do well and import commodities for which they are less productive. An unspoken assumption in the theory of comparative advantage is that geopolitics doesn't really matter. So, take the case of Egypt. It grows the finest cotton in the world and is a proficient wheat producer. If Egypt were not involved in trade, it would likely produce enough wheat to be self-sufficient. But with trade, it can grow more cotton and import wheat from...Ukraine and Russia. Egypt imports about 50% of its consumption, of which 80% comes from Russia and Ukraine. ***What appeared rational in the post-Cold War world becomes less so in the new world.***

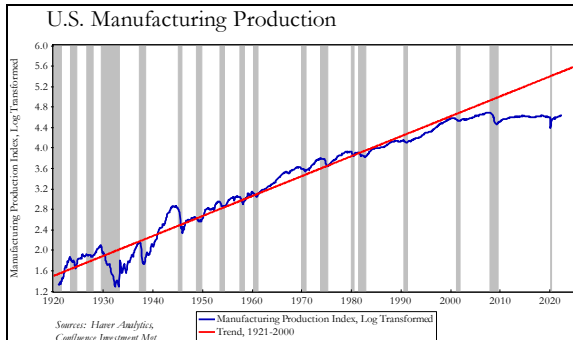
The End of History and the Domestic Economy

The “end of history” and the resulting globalization caused profound changes to the domestic U.S. economy that continue to have political and geopolitical effects. During the Cold War, American elites had an incentive to prove capitalism offered workers a better deal than communism.



This chart shows the relative share of income to capital (profits, dividends, rent, proprietor's income, and interest) to national income. Note that until the early 1990s, the share of income going to capital was constrained. However, after communism

was defeated, the capitalists felt no strong desire to create a “workers’ paradise,” and so, capital’s share has risen steadily.



This above chart shows a century of U.S. manufacturing production. We have log-transformed the data and regressed a trend derived from the period of 1921-2000. Manufacturing fell below trend after the Reagan-Thatcher Revolution and mostly remained below trend. However, after China’s entry into the WTO, the divergence widened significantly.

It was these policies that led to the “rust belt” and contributed to the rise of populism in the U.S. Populism, as we see it, is inconsistent with U.S. hegemony, meaning that if current trends continue, as we expect, then the world will find itself without a hegemon in the coming year.

What Does Globalization Look Like in the Future?

International trade and investment will continue, but the primary focus on efficiency will end. When Treasury Secretary Yellen talks about “[friend-shoring](#),” which implies foreign investment and trade with “friendly” countries, it means adding a condition to such activities that wasn’t considered previously.

A related issue is redundancy. In a world assumed to be completely safe, having limited sources for products isn’t seen as a major risk. The greater number of supplies, the harder it is to achieve scale and lower

prices. In a dangerous world, having additional sources of supply, even if one must pay more for that security, becomes acceptable.

In similar fashion, just-in-time inventory management methods work well when there is security of supply. When disruptions become more common due to any number of reasons, just-in-case methods become superior.

Ramifications

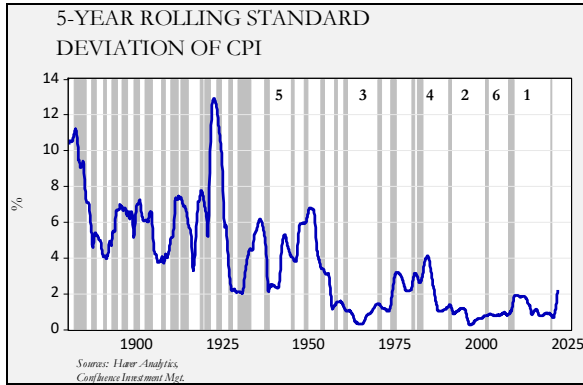
There are two key ramifications from the end of the Washington Consensus and the new globalization. First, inflation will be higher. Constraining efficiency to improve the security of supply will reduce supply and lift costs. Some of that increase will be passed along to purchasers, although to the degree it cannot be shifted, margins could suffer. In addition, with security of supply now in question, holding inventory will be more attractive, but paying for holding that inventory is also inflationary. Finally, as noted in the domestic policy section, addressing the political unrest that has emerged from the Washington Consensus will lead to policies designed to source production domestically. The incentives to buy EVs in the Inflation Reduction Act, which favor U.S. automakers, are an example of this phenomenon.

The second issue is related to the first. As inflation rises, central banks will be forced to raise interest rates more quickly. This situation will likely lead to shorter business cycles. The chart below shows the five-year standard deviation of the yearly change in CPI. The numbers on the chart show the ranking of the length of business cycles. Three of the six longest cycles have occurred in the post-Cold War era. During the period of the Washington Consensus, inflation was unusually stable, which

allowed central bankers to adjust policy at a measured pace. Higher levels of volatility require more rapid policy tightening and raise the odds of recession.

In the end, we define the new globalization as one where concerns beyond efficiency are considered. Simply put, that changes everything.

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