Weekly Geopolitical Report

By Bill O'Grady

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A Smaller World

Being the global superpower is a great burden. There are military, political, economic and financial obligations that are costly to maintain. At the same time, history shows that when there is no dominant hegemon the world tends to suffer from instability and chaos.[1] Although the superpower may wish to abandon the encumbrance, the consequence of an unstable world isn't an attractive alternative.

Since the fall of the Berlin Wall in 1989, the U.S. has been the sole superpower. The costs of that position have become increasingly apparent to Americans, leading to political factions calling for a retreat from the role. So far, the political elites remain committed to the hegemonic role, but it is unclear if it can be maintained.

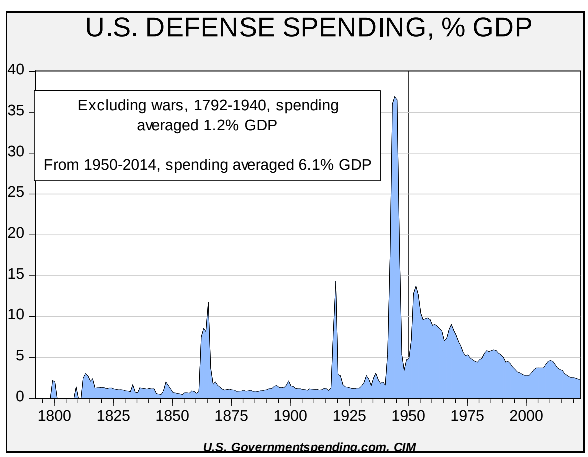
One possible solution to the superpower problem would be to "shrink the world." In other words, some nations may opt out of the international system the U.S. crafted since WWII, which includes open trade, free markets and democracy. As we saw during the Cold War, the communist bloc created a "smaller world" where economies were closed, markets were managed and authoritarianism was the primary governmental structure. Although the creation of a new bloc in opposition to the U.S. may appear to be a retreat from America's hegemonic role, it may actually make the burden more manageable.

This week's report will review the burdens of superpower role. We will examine growing opposition to U.S. hegemony and discuss the impact of "shrinking the world" by allowing the creation of a competing superpower. As always, we will conclude with market ramifications.

Being a Hegemon

The global hegemon has two major roles. The first, and perhaps most obvious, is that the superpower is responsible for global stability. The hegemon must be a dominant military power. It keeps the sea lanes open for trade. Often, it intervenes in local conflicts to prevent them from evolving into regional wars. It usually acts as a balancing power where it pairs off regional powers against each other and prevents either from dominating a region.

The role requires a nation to fund and man a large standing army and navy.



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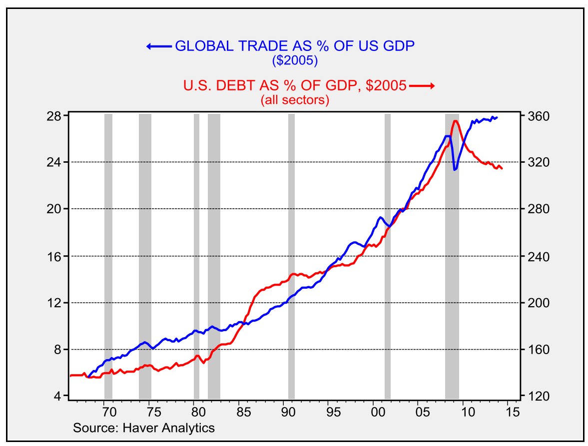
[1] The best analysis of the key role of the superpower is from Kindleberger, Charles, P., *The World in Depression, 1929-39*, University of California Press, Los Angeles, 1973.

This chart shows U.S. defense spending as a percentage of GDP. We have placed a vertical line at 1950, which we estimate is when the U.S. became fully committed to the superpower role. As shown on the chart, from 1792 to 1940, excluding the wars, defense spending averaged a mere 1.2% of GDP. This pattern of defense spending, where there is very little activity until there is mobilization for war, is typical of a non-hegemonic republic. The spending since 1950 has averaged 6.1% of GDP, which is what a superpower is forced to spend due to its expanded global role.

This expanded military has affected America's democracy. When President Eisenhower warned against the encroachment of the "military/industrial complex," he was really warning about the pervasive effects of military spending on Congress, spending decisions, business influence on elections, etc. Although the U.S. has avoided fascism to date, a number of scholars have argued that the cozy relations of government and large business were a key element in the evolution of Nazism.[2]

The other major requirement of being a superpower is financial, mainly, supplying the reserve currency. The reserve currency is the currency that other nations use for universal savings or for trade. Simply put, it is the global currency. In order to supply the reserve currency, the hegemon has to run persistent trade deficits. If the reserve currency nation runs a trade surplus, it has the same effect as a global tightening of monetary policy. Thus, the reserve currency nation, virtually by default, also becomes the "locomotive" for the global economy.

The economist Robert Triffin is credited with the best formulation of this problem, known as the "Triffin Dilemma." As noted above, the reserve currency country must run trade deficits to supply enough global currency to provide ample liquidity to support global trade. As the global economy grows, unless the reserve currency nation can maintain a stable, proportional share of the world economy, the trade deficits will tend to become larger over time. The large trade deficits and the likely need to increase borrowing to absorb all the imports the world wants the hegemon to buy acts to undermine faith in the reserve currency itself. Thus lies the dilemma…the very act of supplying the reserve currency undermines its value.



This chart shows global trade, scaled to U.S. GDP along with U.S. debt, also adjusted to GDP. Note that as world trade as a percent of U.S. GDP has increased, the level of U.S. debt as a percent of GDP has increased as well. The recent period of deleveraging has also led to a sharp slowdown in global trade growth. Essentially, without strong U.S. economic growth, which has been fueled by debt since the early 1980s, global trade and global economic growth has slowed.

Thus, the superpower role requires a large government, high levels of defense spending, and the need for persistent trade

[2] Guerin, Daniel, *Fascism and Big Business*, Pathfinder Press, 1994. Originally published, 1936.

deficits. These requirements place substantial burdens on the citizens of the hegemon, forcing them to fight inconsequential wars and face strong foreign competition for domestic jobs.

Discontent with the U.S.

At the end of the Cold War, the U.S. was the undisputed leader of the world. The Bush administration engineered a large coalition to oust Saddam Hussein from Kuwait, signaling that the U.S. would not tolerate the forcible change of borders. The military prowess the U.S. exhibited in this short conflict shocked other powers. Capitalism and democracy were triumphant. Francis Fukuyama wrote an article titled "The End of History and the Last Man."[3] In that piece, Fukuyama argued that, with the fall of communism, there is no viable alternative to democracy and market capitalism. This notion became known as the "Washington Consensus."

This position was not universally held. Samuel Huntington argued against Fukuyama's position[4], suggesting that the end of the Cold War would unleash cultural conflicts that had been subsumed by the ideological differences between capitalism and communism. For most of the 1990s, the intellectual consensus was that Fukuyama was right. However, over the following 15 years, with the rise of jihadist terrorism and the allure of authoritarian regimes, Huntington's position has gained stature.

Russia under Vladimir Putin has become increasingly aggressive in opposing U.S. policy goals. The attack on Georgia in 2008 and the nearly constant interference in Ukraine's affairs, which recently culminated in the annexation of the Crimea, are examples of direct threats to U.S. global hegemony. U.S. leaders have thought that as China's economy modernizes, it would eventually turn to democracy and away from authoritarianism. After all, this has been the pattern of several Asian regimes, including South Korea and Taiwan.

However, after the 2008 financial crisis, China is increasingly arguing that the Washington Consensus doesn't work, that its authoritarianism provides better government and stronger economic growth without all the volatility that capitalism seems susceptible to. Militarily, China has been encroaching on its neighbors' territorial waters, threatening disputed islands and acting in a belligerent fashion.

Perhaps even more interesting are Russian and Chinese attempts to create alternative organizations to compete with those established by the U.S. over the past 65 years. China has recently chartered an Asian infrastructure bank to compete with the U.S.-backed Asian Development Bank. Both Russia and China have called for a different reserve currency.

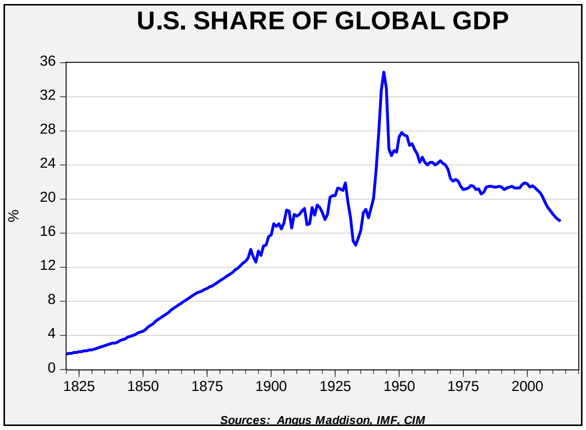
At this point, there is no other nation on earth that could replace the U.S. as a global superpower. China, at best, is a regional power, and Russia may not be able to generate significant influence outside its near abroad. ***However, there is nothing to say that the U.S. couldn't isolate Russia and China***. Sanctions, to some extent, have already isolated Russia. Although China is well woven into the fabric of globalization, the U.S. could put significant trade sanctions on China, but not without considerable pain for both nations.

The Argument for Shrinking the World

The Triffin Dilemma is almost impossible to avoid in the long run. However, the reserve currency role is manageable if the providing

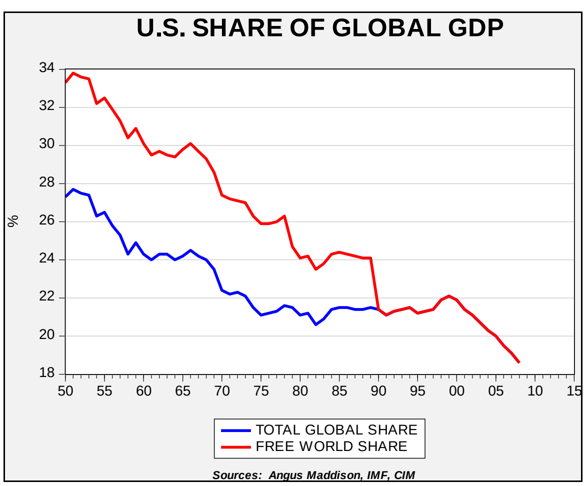
[3] *The National Interest*, Summer, 1989.
[4] *Foreign Affairs*, Summer, 1993.

nation is large relative to the global economy for which it provides the reserve currency.



This is a historical look at America's share of global GDP. In the aftermath of WWII, the U.S. share of global GDP reached nearly 36%. As the world recovered, the U.S. share declined, but even by 1950, U.S. share was 28%. It has been steadily declining and is now around 18%.

However, one of the important factors during the Cold War was that the U.S. wasn't providing dollars to the communist bloc.



By excluding China, the Soviet Union, Cuba and Eastern Europe, America's share of Free World GDP is roughly five points higher. On this chart, we moved China into the Free World in 1979 when Deng Xiaoping opened up China's economy. Because China's economy was small until the late 1980s, this addition was not significant. We unified the series in 1990.

Removing China and Russia from global GDP would add five points to the U.S. share of global GDP. Given China's strong export sector, the Chinese economy would be at a severe disadvantage until it adjusted. Other nations might join the China-Russia axis as well. If the Iranian nuclear talks break down, the Mullahs might join this group. Several of the former Soviet republics would likely join too.

Is a "smaller world" a possibility? It isn't a highly likely outcome but the probability is greater than zero. This outcome is clearly less than ideal. Globalization as we now know it would come to an end. The risk of conflict at the borders of the new blocs would rise. On the other hand, like what was observed in the Cold War, nations would tend to align with one of the two camps. Managing geopolitical situations would be less complicated. It may actually become easier to manage conflicts; containing each bloc would become the primary policy between the two groupings.

If China and Russia continue down the path of rejecting democracy and adopting authoritarianism, the leading democracies may simply decide that future relations will be limited. And so, a return to a Cold War-style world may be in our future.

Ramifications

The most obvious outcome if the "smaller world" scenario were to occur is that there would be a retreat from globalization as it has evolved since the end of the Cold War. This will likely lead to higher inflation everywhere, increased competition for key commodities, driving those prices higher, and increased risk in overseas investing, especially in emerging markets. The U.S. will likely become the destination of choice for flight capital. Military spending will probably rise as states on the borders of the two blocs are forced to improve their security.

At this point, we still view this outcome as a low probability, although it may be rising. China and Russia are rebelling against American hegemony, and creating an alternative system to the U.S. isn't out of the question. We would not expect investors to adjust their portfolios on a tactical or cyclical basis for this outcome. However, for very long-term strategic investments, this outcome should be monitored.

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