

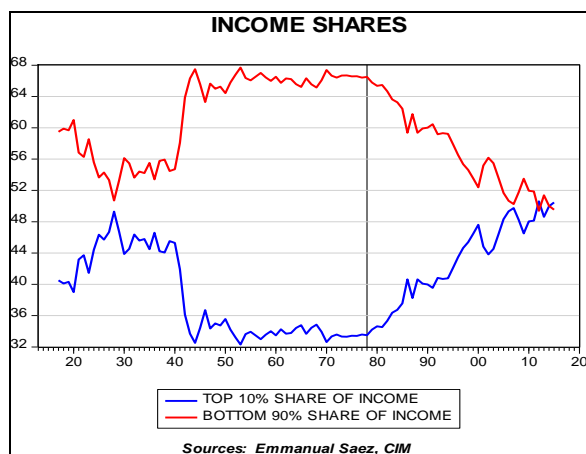
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The Malevolent Hegemon: Part III

This week, we conclude our series by describing what we view as a new model for the superpower role, the Malevolent Hegemon. We will discuss the differences between this model and the previous one. With this analysis in place, we will examine the potential outcomes from this shift and conclude with potential market ramifications.

What is to be done?

Distortions to the U.S. economy have occurred as a result of its role as the global hegemon. U.S. policymakers must decide how to address the inequality issue without triggering high inflation. One solution to this dilemma is to exit the superpower role. This would allow the U.S. to put up trade barriers and run trade surpluses; although potentially inflationary, it would likely increase employment opportunities for the bottom 90%.



This chart shows the income shares of the top 10% and the bottom 90%. Essentially,

the top 10% receive just a bit more than the bottom 90%.

The other alternative is to change how the U.S. manages its hegemony. If foreign nations face stipulations for acquiring the global public goods that the U.S. provides, it may be possible to improve the lot of the bottom 90% without abandoning the superpower role.

The Malevolent Hegemon

We have postulated that U.S. foreign policy has been adrift since the Cold War ended in the early 1990s. It is likely that future historians will mark the First Gulf War as the last major act of the Cold War policy regime. That's because President Bush honored the established borders; when allied troops pushed Iraqi forces out of Kuwait, the allies didn't continue on to Baghdad. As we stated previously, American policymakers during the Cold War made a conscious decision not to change the borders in the Middle East, fearing that such a move would unleash impossible to control forces of ethnic, religious and tribal "cleansing."

After 1991, the Hamiltonian archetype¹ of foreign policy was mostly replaced by Wilsonian or Jeffersonian archetypes. The Wilsonian archetype conducts policy based on moral imperatives. The NATO bombing of Serbia in 1999 was designed to prevent Serbs from attacking Albanians in Kosovo. There was no obvious imperative for the superpower to become involved but Wilsonians believe that the superpower

¹ For a discussion of foreign policy archetypes, see WGR, [The Archetypes of American Foreign Policy: A Reprise](#) (4/4/2016).

should exercise power to prevent genocide.² The Iraq War began as a response to the threat that Saddam Hussein held weapons of mass destruction, but it was subsequently justified as an incursion to remove a tyrant. Later, the war became a tool to spread democracy. Although it wasn't the first time the U.S. had participated in the removal of a Middle East leader, this was the first time that U.S. troops forcibly and overtly brought down a government in the region.³

No president is a perfect fit to the four archetypes. They may be inclined toward one particular archetype but have elements of others. We would judge President Clinton as a Wilsonian/Jeffersonian amalgam. Jeffersonians tend to be the most isolationist of the four. Clinton wanted to reduce U.S. exposure to the world but, as time passed, he increased U.S. involvement and the operations in Serbia suggest he evolved into a Wilsonian. There is evidence to suggest that the second President Bush was similar. He criticized Vice President Al Gore during the 2000 campaign for his globalist positions, but after the terrorist attacks of 9/11 Bush became a full-blown Wilsonian. He worked on “draining the swamp” in the Middle East of potential threats and overthrew governments in Afghanistan and Iraq with the goal of replacing them with democracies. The “experiment” went awry and civil war developed in both states.

² This idea became part of U.N. doctrine called “Responsibility to Protect.” See:

<http://www.un.org/en/genocideprevention/about-responsibility-to-protect.html>

³ Operation Ajax, a CIA operation, precipitated a coup against Mohammad Mosaddegh in 1953. See: https://en.wikipedia.org/wiki/Mohammad_Mosaddegh#Overthrow_of_Mosaddegh. We also would exclude Afghanistan from the Middle East.

President Obama mostly leaned Jeffersonian but had sympathy for the Wilsonian archetype as well. The U.S. supported the overthrow of Muammar Gaddafi in 2011 after the Libyan leader appeared poised to attack protesters who were part of the “Arab Spring.”⁴ In this attack, the U.S. supported France and the U.K.; President Obama described it as “leading from behind,”⁵ which would generally be a Jeffersonian position. At the same time, the Obama White House tended to support the Arab Spring on the hopes that it would lead to the spread of democracy in the Middle East. This is consistent with the Wilsonian archetype. Sadly, in most cases,⁶ it either led to oppression or civil war.

When President Trump took office, the Afghan War was still underway, Islamic State was operating in Iraq and Syria, and Iran was expanding its influence in the region. As we have documented in the previous reports, not only was the economy not working for a significant number of Americans, but the never-ending wars had become unpopular.

The 2016 election was notable for many reasons. Candidate Trump won the GOP primary over 16 other noteworthy and seasoned politicians. Senator Bernie Sanders (I-VT) performed remarkably well in the Democratic primary despite being an avowed socialist. Although Secretary of State Clinton was expected to win the election, President Trump was able to narrowly swing a number of blue collar states to win the White House.

We initially believed Trump spoke like a Jacksonian but harbored Jeffersonian

⁴ See WGR, [Echoes of the Arab Spring](#) (9/24/2012).

⁵ <https://www.theguardian.com/commentisfree/cifamerica/2011/aug/27/obama-libya-leadership-nato>

⁶ Tunisia being the happy exception.

tendencies. However, he has proven to mostly be that rare archetype, a Jacksonian. His initial policy actions seemed to suggest he would be a traditional Republican as he reduced regulation and cut taxes. However, in February of this year, the White House began a campaign to rewrite the trade rules. It appeared he was driving the U.S. toward autarky; he was implementing steel and aluminum tariffs on long-time allies, for example. But, in recent weeks, we have seen an element of policy emerge that we believe just might represent a new form of American hegemony.

The Transition from Benevolence to Malevolence

The first area of this transition is tied to trade. As last week's charts showed, when the U.S. took over the superpower role, it began running persistent trade deficits which are a requirement of the reserve currency role. These trade deficits have adversely affected several important sectors of the economy, leading to the creation of the "Rust Belt" in much of the industrialized Midwest and other parts of the nation. It is important to note that the U.S. accepted these costs ostensibly to defeat communism and prove that the America-led Free World was a superior alliance. A key element of the trade regime was multilateral trade arrangements that bound the U.S. to the same set of rules as any other member of the trade group. This decision limited U.S. sovereignty but made the arrangement attractive to other members. When communism fell, the U.S. extended these benefits to the former eastern bloc states, including China.

A key part of this decision was tied to the narrative that developed after the fall of communism. Best encapsulated by Francis

Fukuyama,⁷ the thesis suggested that the end of the Cold War signaled there was no workable alternative to free markets and democracy. This idea became expressed in what was called "The Washington Consensus," where the U.S. would foster global economic integration and democratization.

One of the most difficult tasks for any organization is understanding success. Failure is analyzed to ensure that whatever led to the adverse outcome is addressed. However, success is usually attributed to the positive characteristics of the winner. Thus, American administrations seemed to take the stance that the America-led Free World defeated communism because of the innate goodness of capitalism and democracy. Although capitalism is superior to communism, that doesn't mean capitalism and democracy are flawless. Put another way, capitalism and democracy were relatively better than communism but created its own set of problems in an absolute sense. And, without the threat of communism, elites in the West felt less compelled to "prove" the superiority of capitalism and democracy by spreading its benefits widely. Paradoxically, this has led to a renewed interest in socialism.

It has become difficult to defend the belief that democracy and free markets are universal values that are inseparable. China's economy is offering an example of an authoritarian government that has delivered strong economic growth. The general belief among Western policymakers has been that developing economies can start as non-democratic but eventually find that a larger middle class and the demands

⁷ https://www.jstor.org/stable/24027184?read-now=1&loggedin=true&seq=1#page_scan_tab_contents

of efficient investment allocation eventually lead to democracy.

Because of the Washington Consensus, the U.S. maintained benevolent hegemon policy because it believed that it would lead to a broadly democratic world with an integrated globalized economy. As we discussed in Part II of this report, an increasing segment of the U.S. population was failing to benefit from American hegemony. This circumstance has helped foster a populist response.

The Exercise of Malevolent Hegemony

It appears we are seeing America's new hegemonic role evolve in two general directions. The first is with trade. President Trump is rapidly moving trade policy away from multilateral to bilateral arrangements. We believe it is telling that NAFTA has been renamed USMCA; perhaps nothing best expresses the new order. Instead of creating a unified North American market, the U.S. plans to become the pivot between Canada and Mexico, with the U.S. dealing with each separately. The U.S. has a trade agreement with South Korea and is in negotiations with the EU and Japan as well.

Moving from multilateral to bilateral gives the U.S. much more leverage in its relationships. Under multilateral rules, perceived trade violations, such as dumping, could be adjudicated by the World Trade Organization. The U.S. appears to be moving to a system where it can treat each relationship separately. If the U.S. wants other nations to behave differently, it can simply address changes bilaterally. Given the size of the U.S. economy and the desirability of the dollar's reserve currency status, the majority of nations will likely be forced to adapt to the new regime. Foreign firms will be encouraged to source

investment in the U.S. to avoid trade sanctions.

The second area of likely change is in defense. As we noted in Part I of this report, in addition to containing communism, the U.S. also "froze" three conflict zones by essentially taking over their defense. This was an expensive decision, but one that did avoid another global industrialized war. We are likely moving to a model similar to "offshore rebalancing," which means less direct U.S. involvement in these areas and more of the defense burden being shifted to regional powers. This action should reduce the costs of defense for the U.S.

Will it work?

As an undergraduate I had a professor that would make a distinction between logical and empirical outcomes. If a student asked a question that stemmed from the logical progression of established tenets, he would offer a direct answer. However, if a question was asked in the similar vein of "who will win the Super Bowl?" then he would respond by saying, "That's an empirical question that can only be determined by observation."

The outcome of malevolent hegemony is an empirical question. In terms of trade, there are two extreme outcomes:

Outcome 1: The world accepts the new hegemonic model and adapts. This would lead to more investment and higher employment in the U.S. The dollar remains the reserve currency with a much higher valuation. Trade impediments and the threat thereof will lead to a reduced dollar supply and the dollar will be stronger in the absence of reduced demand. It is notable that Treasury Secretary Mnuchin has been warning our trading partners against competitive devaluations. However, dollar

strength is a direct result of restraining access to dollars via trade impediments. Although there will likely be some increase in price levels, some of the loss of efficiency due to deglobalization would likely be absorbed by firms via narrower profit margins.⁸ This outcome would be good for much of the U.S. but, compared to the previous regime, clearly less attractive for foreign nations.

Outcome 2: The world rejects American hegemony. If this is the outcome, the world will likely break down into regional blocs. China will vie with Japan and India to control the Far East. It is possible that the three nations work out an arrangement that will foster regional trade. Or, longstanding rivalries will dominate and trade will decline. The Germans are the most obvious power to dominate Europe, but any cursory reading of history will show how problematic this outcome could be. South America would likely fall under the new U.S.-dominated Western Hemisphere bloc. The Middle East would struggle with stability, especially the loss of a stable reserve currency. The dollar would lose its global reserve currency status and in its place would be regional reserve currencies. This would result in a sharp drop in global trade and an increase in inflation.

In terms of geopolitical security, there are also two polar outcomes:

⁸ Another unanswered question is the collinearity of globalization and deregulation. For the past four decades, the two have tended to “march” together. But, if the West is forced to deglobalize, without higher marginal tax rates and reregulation we could see a rapid expansion of automation that would continue to keep price inflation contained. This is another empirical question. “Can deregulation and the rapid introduction of technology continue in the absence of globalization?”

Outcome 1: The world accepts the terms of the new hegemonic model. The U.S. would behave more like an 18th century colonial power, forcing some nations to accept American military bases on their lands and paying for their expenses in return for security. Payments of some sort will be extracted from nations protected within the security umbrella where U.S. forces don’t have a physical presence.

Outcome 2: The world rejects the new model and regional security blocs develop. Similar to the trade model, the world evolves into regional spheres of influence. Regional security will depend on the strength of the hegemon in the area. Obvious conflicts within the blocs will develop; China versus Japan versus India will be an issue in the Far East. In Europe, France and Russia will try to prevent German dominance. The Middle East will likely devolve into persistent conflict. The U.S. will dominate the Western Hemisphere and maintain peace and order.

The two polar positions on trade and security are just that—the most extreme outcomes. Although it is impossible to determine with certainty, some position between the poles is the most likely outcome in each area. Thus, there will probably be some degree of acquiescence to the new American order and some degree of regionalization in other areas.

Regardless of who is in the White House, a shift from the Benevolent Hegemon to the Malevolent Hegemon is likely to continue. Americans are no longer willing to shoulder the full burden of providing the global public goods of the superpower without compensation. Without the specter of communism, the costs of hegemony are considered too expensive.

Ramifications

From a market perspective, with the U.S. as Malevolent Hegemon, the world will be much less globalized. That will almost certainly lead to less efficiency, weaker profit margins and higher inflation. Financial markets will suffer while commodity markets will improve. Certain sectors of equities should do well—demand for defense will rise, commodity producers should do well and firms that can deliver efficiency through technology should also flourish.

The most important market ramification is that the world we have lived in for the past seven decades is changing and unexpected outcomes are inevitable. In this report, we have tried to show the broad outline of what appears to be the direction of foreign policy. However, this evolution does have a strong element of “stay tuned.” In other words, paying close attention to developments will be important.

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