Weekly Geopolitical Report

By Bill O'Grady

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(This will be the last report of 2011; publishing will resume January 9. Happy Holidays to all our readers!)

The 2012 Geopolitical Outlook

As is our custom, we use this last report of the year to offer our outlook for next year. In this issue, we will discuss what we see as the key geopolitical issues that will affect the markets and the world in 2012. This list is not exhaustive but highlights our greatest concerns.

Issue #1: The Eurozone

We have generally treated the Eurozone as a doctor addresses a patient with a chronic illness. Sometimes the patient can carry on what appears to be a normal life. In other periods, the disease returns and brings crippling problems.

Unfortunately, the cycle of crisis and recovery is becoming shorter. Last summer, when Greek fiscal problems resurfaced, the Eurozone took measures to address the crisis. However, the solution didn't really bring a significant market recovery. Essentially, the financial markets want the European Central Bank (ECB) to take a more active role in reducing the sovereign yields of a number of nations, most importantly, Italy. Investors believe that this is the proper role of a central bank, actions that the Federal Reserve and the Bank of England have been willing to perform. Such actions include expanding the central bank's balance sheet to prevent sovereign yields from increasing. The ECB has refrained from aggressive balance sheet expansion, mostly because Germany opposes such a policy. Not only does Germany fear this will cause inflation, but it harkens back to the failed Weimar Republic, which engaged in such policies.

The underlying and unresolved issue remains the fact that, for the past 60 years, the EU has been trying to create a political union via closer economic ties. Essentially, the European elites want to ensure that another world war won't be fought on their soil. To attain this goal, these elites wanted to create a political union; however, national interests have thwarted this goal. Thus, EU leaders have tried to substitute economic links for political union. The euro was the crowning achievement of this movement; there were great hopes that the development of the Eurozone would lead to something similar to a political union.

The current crisis is directly related to this divergence of opinion on European unity. As the situation evolves, it is becoming increasingly clear that Germany is using this crisis to achieve its goals of the Maastricht Treaty. This treaty was mostly designed by France and Germany to address German unification. France was afraid that the German economy would dominate the continent. To prevent this event, France wanted to end D-mark dominance. Thus, the euro was created. Germany, to protect its interests, wanted the EU to enforce fiscal rules by creating a European-wide structure similar to the ECB's creation of monetary policy.

The French (and most other Eurozone nations) vetoed this idea on concerns over the loss of sovereignty. Instead, the treaty enshrined fiscal rules that have proven to be mostly unenforceable.

The most recent EU summit indicates that the crisis is forcing Eurozone nations to adopt the German position. We have serious doubts that the austerity measures being promoted by Germany will be popular. At some point, we expect a populist reaction to austerity, which means a new element of the crisis will emerge.

For the past five centuries, European powers have been trying to dominate a geography that does not lend itself to unification. The fact that no single power could control the region has led to enormous human suffering. Germany's recent behavior suggests that this struggle continues, although now its focus is financial instead of military. Although the conflict occurring in the financial arena suggests a less dangerous situation, in any regard, the potential for problems looms large. We suspect that Germany's efforts to dominate the continent will eventually fail, just like all previous wars to accomplish this same feat have failed. The aftermath will likely be a serious financial crisis, perhaps in magnitude similar to 2008. This outcome isn't necessarily predicted for 2012 but tensions surrounding this issue will persist and remain elevated.

Issue #2: The Weakening of U.S. Global Dominance

As we discussed last year, we believe the slow deterioration of U.S. global dominance is a critical underlying factor affecting numerous geopolitical issues. A U.S. retreat from hegemony would be a major systemic change, a reversal of 65 years of policy.

From 1945 until 1990, the U.S. was locked in a Cold War with the Soviet Union. As the Soviet Union crumbled in the late 1980s, the U.S. became the unquestioned global unipolar power. Although defeating communism was an epic accomplishment, U.S. policymakers found themselves somewhat rudderless outside the duopoly of power that prevailed during the Cold War.

To win the Cold War, the U.S. engaged in a number of policies. One of the most potent policies was the adoption of the dollar as the free world's reserve currency. This action brought stability to the West but it forced the U.S. into the role of global importer of last resort. This factor, along with sustaining free trade through the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), was critical in supporting recoveries in Western Europe and Japan, undermining the appeal of communism. In addition, the U.S. established military bases in Asia, Europe and the Middle East to secure American interests. This action allowed the U.S. to take over the former British role of protecting global sea lanes. Since the industrial revolution, at least one power has had a strong enough navy to ensure that sea lanes were protected; this public service facilitated the steady rise of globalization.

U.S. dominance after the end of the Cold War led to what became known as the "Washington Consensus." Based on the writings of Francis Fukuyama, the theory argued that in the aftermath of communism's defeat there was no viable alternative to free markets for organizing an economy, and no alternative to democracy for forming governments. For the most part, developing nations bought into the first half of this theory, but authoritarianism was adopted by a few nations after Russia's chaotic spiral in the 1990s. Although it could be argued that Russia was never a true democracy, the economic collapse and subsequent debt default led some developing nations to use authoritarian structures. However, it was thought that this structure was only temporary; eventually, free markets will push governments to adopt democracy. Emerging markets did agree that market economies were superior, but this position was tied to the use of export promotion for economic development. Because of the U.S. dollar's status as the reserve currency, the U.S. became the global importer of last resort, and so market development became synonymous with export promotion. Export promotion employed policies designed to suppress domestic consumption, boost savings and lift investment.

Additionally, export promotion development policies usually employed a persistently undervalued exchange rate. Already by the mid-1980s, the dollar's role was causing persistent trade deficits. In response, the U.S. was able to coerce Japan into changing its currency policy at the Plaza Accord in 1985. By the early 1990s, several Asian nations were using export promotion, most notably China. This former adversary's excess savings funded a consumption and borrowing binge in the U.S. Essentially, the policies used by the U.S. and China have led to unsustainable financial and trade imbalances.

Consequently, the U.S. finds itself in a situation where the household and government sectors are heavily indebted and in desperate need of deleveraging and rebalancing. However, the U.S. cannot unilaterally fix these problems and maintain any semblance of growth. If the U.S. tries to simultaneously address the overindebtedness of the household and government sectors without the ability to boost exports and run a trade surplus, the adjustment will come by drastically reducing capacity, leading to massive unemployment and deflation—in other words, a repeat of the Great Depression. However, running large trade surpluses would require the U.S. to abandon the dollar's reserve currency role and the consequent requirement to be the global importer of last resort.

The Obama administration has been slowly building the case for a new direction in foreign policy. The president has made it clear that he intends to focus on Asia, downgrading our interest in the rest of the world. All presidents tend to have a regional focus. However, without the construct of the Cold War or the maintenance of U.S. superpower status, this focus will tend to leave the neglected regions to their own devices. This is in part why Europe is in turmoil and why the Middle East could see increasing tensions. It also goes without saying that focusing on the Far East looks like containment to the Chinese. Thus, changing focus to this region does not mean it will become more stable, but it does define current U.S. foreign policy.

Issue #3: The Rise of Iran

As U.S. troops leave Iraq, Iran has the opportunity to become the dominant power in the region. In fact, if the Assad government maintains control of Syria, Iran will have built a "crescent" that extends from Iran, through Iraq, Syria and into Lebanon. Needless to say, the U.S., Saudi Arabia, Turkey and Israel oppose such an outcome. Unfortunately, it does not appear that the U.S. has strong enough interest in the region to stop Iran's expansion.

Since President Franklin Roosevelt, the U.S. has vowed to defend its interests in the region. Under President Carter, a formal doctrine of preventing any power other than the U.S. from dominating the region has been in place. There were two reasons for this overt position. First, the U.S. wanted to ensure that the West would be the primary beneficiary of Middle East oil. Second, the U.S. wanted to deny the Soviet Union control of the region's natural resources and to prevent them from acquiring a warm water port, a long-time goal of the Soviets and the Czars before them.

However, with the end of the Cold War, the U.S. is primarily protecting the oil flows for Europe and the Far East. Only about 16% of U.S. oil imports come from the Persian Gulf and with North American oil production rising steadily, American foreign oil dependence is declining. If the U.S. is the global superpower, it should provide oil security as a global public good. However, if the U.S. has decided that this is no longer a high priority policy goal, other nations may be required to bring security to the region.

Unfortunately, oil supply is mostly fungible. If the U.S creates a power vacuum in the region that leads to conflict, we would expect oil prices to rise sharply. Thus, the Obama administration's goal of focusing on the Far East may fall prey to events in the Middle East that threaten global prosperity.

Issue #4: Questioning Globalization

For the most part, we have seen steady global integration since 1945. Much of this has come from America's leadership. Providing the reserve currency, being the importer of last resort and protecting the world's sea lanes with the U.S. Navy have all been critical in supporting the expansion of global trade and integration. However, there are political costs to global integration. Foreign competition can force changes on industries; jobs can be lost to overseas competitors. This competition can cause firms, especially in the developed world, to more aggressively substitute capital for labor. Not only are jobs lost, but the new jobs created require higher skill levels. This can widen income differences and increase social tensions.

Globalization brings great benefits. It improves productivity and allows for emerging nations to lift their populations out of poverty. It usually brings peace, as nations trading with each other have less incentive to fight each other. However, over time, the benefits of globalization can be overshadowed by the costs. To some extent, the Occupy Wall Street movement reflects those worries about the costs of globalization. The recent decision by the movement to occupy port facilities suggests an anti-globalization focus.

A retreat from globalization would tend to make the world a more inflationary and dangerous place. In a period of high unemployment, however, the temptation for the political class to adopt anti-globalization measures will be high.

Issue #5: The Passing of Kim Jong Il

The announcement of Kim Jong Il passing came as we hit our publishing deadlines. Reports suggest he died on December 17^{th}. However, we have written on North Korea several times over the past four years and so his demise did not come as a complete surprise.

Kim Jong Il suffered a stroke in 2008; after his recovery, he began preparing succession plans. He passed over his two older sons, instead choosing the youngest, Kim Jong Un. This youngest son is thought to be in his late 20s and does not appear to have been groomed for the position. In fact, Kim Jong Il did little to prepare anyone to replace himself, probably because he didn't feel secure enough to have a replacement lurking in the background. In addition, his three sons did not exactly appear to be of leadership material. In June 2001, his oldest son, Kim Jong Nam, was detained in Japan for traveling with a false passport; his story was that he wanted to visit Disneyland. Kim Jong Nam was favored by China, which led some in the military to favor the second son, Kim Jong Chol. The military has been worried about China's influence in North Korea. However, according to some unconfirmed reports, Kim Jong Il felt his second son was 'too effeminate.' Kim Jong Un was considered a dark horse among the sons due to his youth. To some extent, he may have simply been a compromise choice.

Thus far, the nation's leadership appears to support the 'Great Successor,' which means that the political factions in North Korea were expecting Kim Jong Il's demise. However, we do expect the new leader to be severely tested. Kim Jong Il took three years to solidify his position and required a purge. He also had to pledge his loyalty to the military by making sure that it received the first cut of economic goods. Kim Jong Il's brother-in-law, Jang Song Thaek, is probably the second most powerful person in North Korea. We expect he will act as the main power until, or if, Kim Jong Un is powerful enough to rule on his own.

For the next few months, we expect North Korea to be cautious in global affairs. However, later this year, it's possible that the new leader will try to prove his leadership qualities by causing problems for North Korea's neighbors. If this does not occur, we can be fairly sure that the new leader is simply a figurehead and that North Korea will remain calm in 2012.

Ramifications

The issues discussed in this report have the potential to weaken support for "risk" assets, such as equities and commodities, and lift the prices of "safety" assets, such as Treasuries and the dollar. We never know in advance which one, if any, will seriously affect the markets. To some extent, geopolitical analyses are similar to severe weather predictions—just because conditions are ripe for an event doesn't necessarily mean it will occur. However, we believe these five issues represent the most significant risks of 2012.

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