Confluence Investment Management

Weekly Geopolitical Report

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The New World Order: Part II

This report is the second installment of our four-part series on The New World Order. This week we will focus on two themes. First, we will examine the global public goods the superpower provides, and second, we will analyze how the U.S. has provided those goods. The global hegemon will often face tensions between the desires of domestic constituencies and its foreign obligations. Every superpower has to negotiate these pressures and each tends to have its own particular ways of meeting both objectives. However, it should be noted that no superpower can subjugate the goals and aspirations of its citizens indefinitely. In other words, if the cost of hegemony becomes too high, a nation may be unable to maintain the position. History shows that no superpower dominates forever. History also shows that there are sometimes "gap" periods between superpowers; unlike 1945, the changeover is not always simultaneous.[1] I believe the evolution we are currently seeing, which will be discussed in Parts III and IV, will keep the U.S. as the reigning hegemon but with a much different manner of exercising that role.

The Global Public Goods from the Hegemon

The superpower's public goods[2] consist of two broad categories, military and financial. In terms of the military, the hegemon acts as the global peacekeeper. Although it doesn't become involved in all conflicts, it does have the power to do so and will tend to intervene when a conflict threatens what the hegemon considers to be a vital interest.[3]

Since global economic growth is usually in the interest of the hegemon, the other key objective is to protect global shipping. Anything from thwarting piracy to preventing regional powers from becoming "gatekeepers" at important shipping chokepoints is the responsibility of the superpower. Thus, the hegemon is usually the largest naval power in the world.

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[1] In fact, one could argue that the Great Depression and WWII stemmed from the fact that Britain was struggling to maintain the superpower role while neither the U.S. nor the U.S.S.R. was willing to accept the mantle.

[2] A public good is generally a product or service that is difficult to exclude, such as police or fire protection. Once provided to one consumer, it is almost impossible not to provide to all. Because the good is non-excludable, the private sector won't provide it because consumers will "free ride" the producer, i.e., they will consume the good without paying for it. Public radio is a good example. Thus, governments usually provide public goods and use the coercive power of the state to ensure the product is paid for. The superpower provides these goods usually at the cost of its taxpayers. Since the modern superpower doesn't have direct sovereignty over other nations, it is hard to collect taxes from other nations to pay for these global public goods. Instead, colonization and the reserve currency has been the method of funding these activities.

[3] For example, the Carter Doctrine states that the U.S. considers the Middle East a "vital interest" and it will intervene to prevent any outside power from dominating the region. Britain viewed the region as being similarly important after the Royal Navy switched from coal to oil for its fuel.

In addition, the superpower usually needs to engage in covert actions for those dangers that don't warrant direct military action but still need to be addressed.[4] The hegemon, with this extensive intelligence apparatus, provides information to allies that cannot afford or are simply unable to collect themselves. Not only does that help with global security, it further ties other nations to the hegemon.

Essentially, the hegemon has to be able to project power globally. It needs to employ both direct and covert methods to fulfill this requirement. Unlike a "normal" nation, who only needs to defend its own sovereignty, the superpower needs to maintain global order.

The financial public goods the superpower provides are as follows:

1. Act as consumer (importer) of last resort;
2. Coordinate global macroeconomic policies;
3. Support a stable system of exchange rates;
4. Act as lender of last resort;
5. Provide counter-cyclical long-term lending;
6. Provide a truly riskless AAA asset for benchmarking purposes; and
7. Supply deep and predictable financial markets.

Every hegemon creates its own policies to meet both its domestic needs and provide these global public goods. The Dutch and the British, the two previous superpowers, implemented the gold standard for international economic policy. This met the financial public goods of numbers 2, 3, 6 and 7. The gold standard committed nations to an international regime where a trade surplus nation would accumulate gold, which would raise prices on domestic goods, making that nation less competitive and, eventually, lead to an erosion of the surplus. Thus, providing long-term lending (#5) occurred somewhat automatically, although it tended to enforce austerity on a trade deficit nation that its working classes would oppose. Since suffrage was limited, these working classes were unable to express their preferred policies at the ballot box and had to suffer through falling wages or unemployment until the trade deficit was resolved. For individual nations, #5 was not met, but for the entire global economy, the gold standard did establish stability that counter-cyclical long-term lending would provide. The gold standard, through its mechanism of balancing trade and money, tended to reduce the lender of last resort role (#4).

The first public good was provided, along with the global security public good, through colonies. Colonization not only provided a global footprint for projecting military power, it provided economic depth that allowed the colonizing nation to build wider markets. This economic depth facilitated the role of importer of last resort because the colonizer could run a trade surplus with its colonies to prevent the importer of last resort role from becoming a constant drain on resources.

How the U.S. has Exercised the Hegemon Role

Due to historical and institutional constraints, the U.S. did not have the hegemon "tools" that Britain had when America became the leader of the free world in 1945. And so, American policymakers

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[4] It should be noted that until after WWII, the U.S. only had a rudimentary domestic intelligence unit, the Federal Bureau of Investigation. At present, the U.S. has 17 agencies that conduct intelligence activities.

had to create new ways of projecting financial and military power to meet the challenge of hegemony.

First, by the time the U.S. accepted the role of superpower in 1945, the gold standard was severely compromised. The strong economic expansion fostered by defense spending during WWI led to more political power for the working class and women who worked in the factories to make military goods. This factor gave these groups power and led to expanding suffrage, which undermined the gold standard. During the Great Depression, nations that abandoned gold recovered quicker than those who maintained the link. The incentive to devalue against gold and "beggar thy neighbor" was strong. Returning to a full gold standard was risky; there was great fear that communism would be an attractive alternative to capitalism, and the automatic stabilizers inherent in the gold standard would lead to stifling austerity and support the search for alternative economic systems. So, at Bretton Woods in 1944, the U.S. established a system in which the U.S. dollar would become the reserve currency. In this system, instead of holding gold, nations would hold dollars. They could convert to gold at a fixed rate if they became concerned about American policy, but, in general, the U.S. ended the gold standard and implemented a dollar standard. Essentially, this tied the fate of the free world's economy to that of the U.S., the supplier of the reserve currency.

The U.S. began as a rebellious colony which separated from the British Empire. Although Theodore Roosevelt gained a few colonies after the Spanish/American War, America didn't conceive of itself as a colonial power. After WWII, the U.S. strongly supported the decolonization of the European empires. However, if the U.S. wasn't going to use colonies to project power, it had to come up with other methods to fulfill this hegemonic role. Instead of colonies, the U.S. created a series of defense agreements, including NATO and a long-term defense agreement with Japan. It also created international institutions, such as the World Bank and the IMF, to act as facilitators of global finance. These institutions became tools of American power projection. In addition, the U.S. created a series of basing agreements which allowed the American military to project power across the world without direct control of the hosting nation.

Finally, America had to abandon its traditional small government/small military stance it had enjoyed as a normal nation. The U.S. had to project power globally. Thus, it needed a military to match that role. In order to build that military and support the constant expansion of consumption to meet the importer of last resort requirement, government support for consumption and the consequent expansion of government bureaucracy led to a massive increase in the size and scope of the federal government. And finally, a large national security infrastructure had to be built to give policymakers information about threats and to engage in covert activity. The secret nature of these agencies tended to undermine democratic institutions.[5]

To sum up, the U.S. exercised its superpower role differently than its predecessors. First, it replaced the gold standard with the dollar standard, making the greenback the global reserve currency. Second, instead of colonies, the U.S. used a series of international institutions to guide

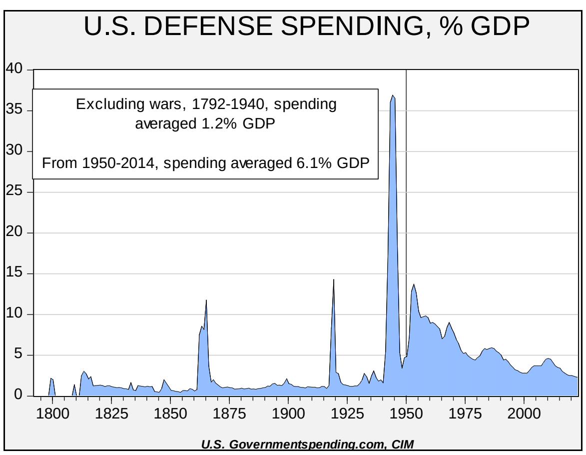
[5] All these issues were expressed by Senator Robert Taft in the late 1940s and early 1950s. He was concerned that accepting the superpower role would forever change the unique nature of the U.S.

global policy. In addition, the U.S. used treaties and basing agreements in lieu of colonies.

The Changes to America from the Hegemon Role

The first major change that occurred in the U.S. was the expansion of the government. For most of America's history, the federal government was relatively small. There was some modest expansion in the early 1900s of anti-trust and safety regulations, but it took the Great Depression for government to expand significantly. The successful prosecution of WWII and the recovery from the Depression left most Americans more comfortable with larger government.

First, the U.S. needed to change its military stance from buildup and demobilizations for war to a large and persistent military to project power globally.

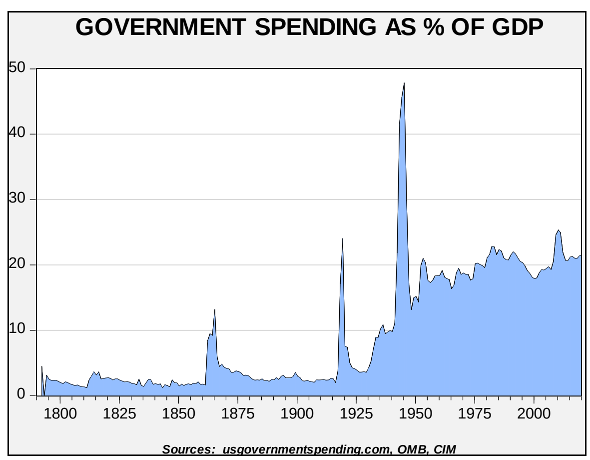


This chart shows U.S. defense spending from 1792 to 2014. Until the U.S. accepted the superpower role in the late 1940s, defense spending spiked during wars and fell rapidly during demobilization. In fact, from 1792 to 1940, excluding the wars, defense spending averaged a mere 1.2% of GDP. Since 1950, defense spending has averaged 6.1% of GDP. To a great extent, the U.S. has been on permanent war footing.

The defense spending became part of the fabric of the American economy. The "military-industrial complex" that President Eisenhower warned about indicated how important military spending had become to the economy.

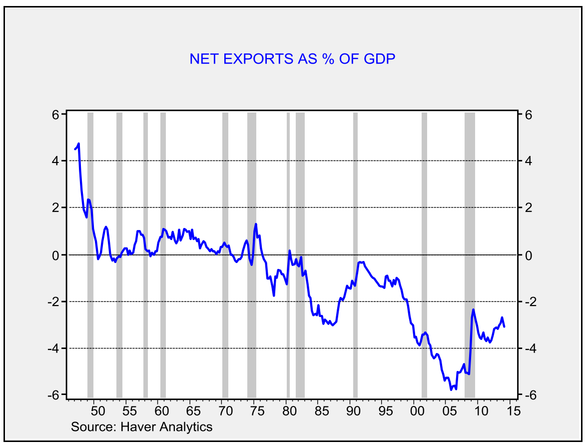
At the same time, the U.S., due to the dollar standard, had to supply enough dollars to maintain global money supply. By becoming the "global importer of last resort," the U.S. had to support high levels of consumption. Government spending was part of the process of maintaining global growth.

The below chart shows U.S. government spending as a percent of GDP. Although government spending gradually rose into the Depression, it only touched 10% of GDP by the late 1930s. Thus, all the programs of the Roosevelt administration to stem the Depression were relatively tame compared to how spending rose during the superpower period.



Starting in the 1950s, spending had hit 20% of GDP, in part due to higher military spending and in part due to a broadening social safety net. By the 1970s, in the aftermath of Johnson's "Great Society" programs, spending had moved into the 25% of GDP range.

The critical element of this process is the reserve currency. The reserve currency becomes the global currency; nations try to acquire the superpower's currency as saving. The reserve currency has become the currency in which many global goods are priced. For example, most commodities are priced in dollars. Because the reserve currency provides global liquidity, the reserve currency country must run a persistent current account (trade) deficit. If this nation ran a surplus, it would act as a global monetary policy tightening. At the same time, this deficit needs to be "manageable." If it becomes too large, it could weaken foreign investors' confidence that the risk-free asset is truly risk free.



This chart shows net exports as a percentage of GDP. Initially, after WWII, the U.S. ran a large trade surplus. However, this rapidly contracted as the U.S. carried out its role as importer of last resort. Although the trade balance tended to be positive for most of the 1960s, the U.S. was running persistent deficits with Europe, the first region to recover after the war. In the 1970s, trade deficits became more common after President Nixon closed the gold window.

From the 1980s forward, trade deficits became larger and more persistent. In addition to Europe running export-promotion policies, Japan and other nations in Asia followed the same path. Over time, the U.S. has been required to take on larger levels of debt in order to supply the world with enough dollars to maintain global liquidity. The problem of maintaining confidence in the reserve currency and simultaneously keeping the trade deficit large enough to support global liquidity is called the "Triffin Dilemma."[6] As noted above, the British and the Dutch were able to manage this dilemma through colonization.

Simply put, the acceptance of the superpower role led to major modifications to the American economy, changing it from a small government nation with a small safety net to a large government/high defense spending economy with a bias toward imports and consumption. This was a major adjustment for the U.S. and has led to major political and policy issues.

The Next Step

Next week, we will examine how policymakers coped with this new role and explain why the first program failed and why the current program may have reached the end of its useful life.

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[6] Named after the economist Robert Triffen, who noted that using a national currency would inevitably lead to a difficult tradeoff between maintaining confidence in the currency and, at the same time, running a large enough trade deficit to supply enough global liquidity.

Confluence Investment Management LLC

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