

April 23, 2018

Reflections on Globalization: Part III

This week, we will conclude our series on globalization with a discussion of how China and Russia threaten U.S. hegemony, the potential responses and close with market ramifications.

China, Russia, the U.S. and Hegemony

U.S. policymakers, heeding the Washington Consensus, assumed that developing nations would eventually adopt both market economics and representative democracy. American policy toward China was thus based on the idea that integrating China's economy into the world trading system, which was dominated by the U.S., would eventually lead Beijing to drop communism and adopt democracy. After all, a string of other nations had made similar transformations, including Japan, Germany, South Korea and Taiwan. Japan and Germany had to lose a mass mobilization war to make this shift, but South Korea and Taiwan eventually shelved authoritarian regimes in favor of democratic governments.

Based on this expectation, the U.S. gave China wide latitude in its trade policy. Although obviously mercantilist, it was generally believed that China would eventually integrate into the world economic system on U.S. terms as its economy developed. China has integrated into the world economy but not in a manner preferred by the U.S.

There was a serious flaw in this expectation. Germany and Japan were willing to adjust to U.S. demands¹ because both nations were dependent on America's security guarantee. China, on the other hand, was not necessarily protected by the U.S. Although Nixon's opening to China was partly due to China's worry about Soviet aggression, in reality, China didn't face any serious outside threats after the collapse of the Soviet Union. Its military was mostly concerned with internal control.

China is making it clear that it is a strategic competitor to the U.S. It does not want to necessarily challenge the U.S. around the world but it does not want to be beholden to the whims of American policy. In his recent work on Thucydides's Trap,² Graham Allison noted that the U.S. threatened British hegemony in the Western Hemisphere in the early 20th century. Although the British were uncomfortable not projecting power into that region, American power was overwhelming and the British faced another strategic threat from Germany. Thus, the British ceded the Western Hemisphere to the U.S. Part of the reason for taking this step was the cultural similarities between the two countries. Both were market economies and democracies, which made Britain's actions more reasonable. And, Germany was becoming a more proximate threat (and proved to be a real one by 1914).

¹ Examples include the 1985 Plaza Accord, the 1994 Halifax Accord and Japan's "voluntary" export restraint on cars in the 1980s.

² Allison, G. (2017). *Destined for War: Can America and China Escape Thucydides's Trap?* New York, NY: Houghton Mifflin Harcourt Publishing Company.

China and the U.S. are not alike. The Communist Party of China (CPC) is firmly in control of China's political system and is unlikely to give up power anytime soon. It has dictated terms on direct foreign investment, requiring firms to give up intellectual property. It is taking liberties with American hegemonic practices because policymakers have remained under the illusion that China would eventually "get on board." It won't.

The Russian situation is different in that it is really a "throwback." Throughout history, Russia has protected its central core by extending its influence south and west. Since most of Russia's geography is plains with few natural borders, Russia's defense against invaders has always included an element of forcing enemies to extend supply lines then praying for winter.³ The U.S. made a critical mistake by allowing NATO to extend clear to the Baltic States without putting up the military resources to defend them. Even though Russia was no longer communist, that didn't mean it was on board with the Washington Consensus. Russia's interests will always be to extend to the west and south. This is part of its geopolitical imperatives which cannot be wished away. There was nothing wrong with extending NATO; after all, the former Eastern Bloc nations were anxious to get out from under Russian dominance. However, not recognizing the costs involved with expanding NATO created the worst of all situations. The U.S. now has commitments to these Eastern Bloc nations but hasn't committed the resources to their defense. Russia is steadily encroaching on NATO-protected regions and each time the U.S. and

³ The two classic examples were the defeats of Napoleon and Hitler, both of which were unable to maintain supply lines and were compromised by harsh weather conditions.

NATO fail to respond, it undermines their credibility.

What is to be done?⁴

The situation facing the U.S. regarding China is not necessarily one of an alternative ideology as was the case with the Soviet Union and communism. Although China claims to be Marxist, it is really an authoritarian nation with a state-directed market economy. Some sectors of the economy are dominated by state-owned enterprises, and large private firms know they always face the potential of government interference. Still, China is not a full command and control economy; many goods and services are mostly distributed by the market.

Although China is trying to develop "soft power" by expanding cultural facilities across the world, it isn't clear that there is a universal Chinese culture. Instead, China is a nationalist power. It wants a world of nation states that deal with each other based on power and shuns universal human factors, such as human rights, democracy, etc.

President Trump is attempting to adjust the U.S./China economic relationship by contracting the bilateral trade deficit and by defending the intellectual property of American firms. So far, China's response has been to threaten tariff retaliation, targeting politically sensitive industries.

Although the president's actions against China's trade policy at least reflect the acknowledgment that China isn't going to "become just like us," there is no evidence that policymakers on either side of the political spectrum have any ideas on how to deal with China. Starting a trade war with

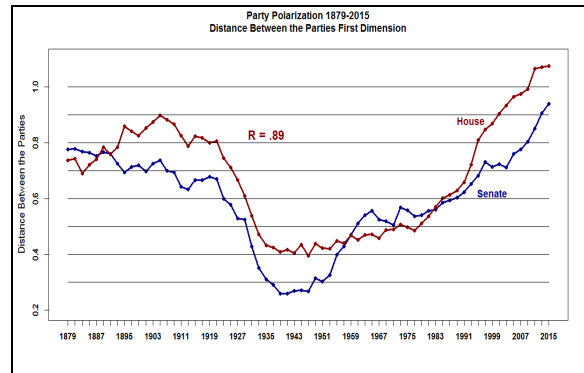
⁴ Named after a pamphlet published by Lenin in 1902.

China is probably not a good strategy and, more than anything, reflects the lack of strategy for dealing with China’s rise.

Instead, American policymakers have to decide if they are going to resist China’s attempts at regional domination or acquiesce. If the U.S. is going to contain and restrain China, it will need a military buildup and a focus on the region. The U.S. probably doesn’t have the resources to fully underwrite European security, including an expanded NATO, and stabilize the Middle East as well. There was some recognition of this from the Obama administration. The “pivot to Asia” and the Iranian nuclear deal were part of a plan to reduce America’s involvement in the Middle East. The Iranian nuclear deal was likely the beginning of efforts to normalize relations with Iran and allow it to become the regional hegemon, tasked with stabilizing that part of the world.⁵ The Trans-Pacific Partnership (TPP) trade agreement and the Trans-Atlantic Trade and Investment Partnership (TTIP) were other ways to create U.S.-centric trade policy that would have forced China, Russia, et al. to follow.

However, as part of the political backlash discussed above, trade is now seen as part of the development of globalization that isn’t benefitting much of the West’s working class. Thus, in the last election, neither candidate wanted TPP or TTIP.

Essentially, if the U.S. is going to fend off the challenges that Russia and China pose to American hegemony, the same degree of political unity seen during the Cold War is likely necessary.



(Source: https://legacy.voteview.com/political_polarization_2015.htm, Rosenthal and Poole.)

This chart shows the degree of party polarization from 1879 to the present. Note that during the Cold War there was a general trend toward bipartisanship. That unity broke down significantly after the Cold War ended and has reached new extremes. A democracy this polarized faces the problem of legitimacy; essentially, the party out of power views the government of the party in power as fundamentally illegitimate. Elections then become “life or death” contests where losing doesn’t mean simply being out of power for a period but carries the potential for political disaster. It is nearly impossible to deal with the challenges presented by China and Russia without resolving this divide. Dealing with this partisanship likely requires measures to reduce inequality, which can be accomplished in a number of ways, including higher taxes, increased regulation, trade barriers, etc.

Of course, the U.S. does have the option of simply reducing American hegemony and ceding the Far East to China. However, we doubt that either of the Korean states, Japan, Vietnam or India will simply accept Chinese regional domination. The U.S. has frozen conflicts in the Far East by resolving Japan and China’s insecurities of commodity supply by enforcing peace. Without American power, war is likely. Similarly, a rearmed Western Europe is perhaps an even

⁵ To quote one of our favorite movies, <https://www.youtube.com/watch?v=9HVejEB5uVk>

bigger threat to Russia than a reinvigorated America.

At this point, U.S. policymakers have been unable to formulate a cogent response. This has been true of every administration since the fall of communism. Perhaps this is because America, at heart, is a reluctant hegemon; our nation was born in rebellion against a superpower and thus as a country we have been sympathetic to complaints against them. However, the lack of consensus has led us to a point where America faces threats that will someday prompt a response. How that response works out remains to be seen.

Ramifications

It's difficult to offer a clear direction to investors given the tensions globalization has created. However, we can make the following observations.

Supply chains are likely to shrink: Since the end of the Cold War, supply chains have extended which means that goods and services can come from various parts of the world. In a world with multiple hegemonic threats, those lengthy chains are probably unsustainable. The complaints from Western businesses about intellectual property confiscation are part of this problem. Actual expropriation could occur as well. The same technological changes Ballwin discusses could create conditions where supply chains contract, with production being sourced regionally or domestically. That change would affect foreign economies and logistics firms that have benefited from global supply chains.

Supply insecurity of key commodities:

The creation of "just in time" inventory models is based on security of supply. That

comes, in part, from having a global hegemon that secures the sea lanes. Coupled with the rise of regional geopolitical tensions, if security of the sea lanes becomes an issue then nations, companies and households will move to "just in case" inventory models to ensure supply security. That will be bullish for commodities.

The potential reversal of efficiency: We have seen a steady march of efficiency in the global economy. Using the internet to send information that informs production, pricing, etc. is also vulnerable to hacking. War is bad for business. We are seeing new forms of war, so-called "hybrid wars," which use multiple tactics all designed to undermine the enemy but stop short of actions that trigger a military response. Russian interference in the U.S. elections is nothing new but the use of technology gives American enemies a force multiplier to increase the potential for success. Of course, we could go back to a world of typewriters, carbon paper and physical mail. These are electronically unhackable, but inefficient. For some key industries, the inability to protect data may lead to a reversal in efficiency. This development would increase costs and inflation.

While commodities and cybersecurity may benefit from globalization tensions, logistics and foreign investment may face headwinds. In all cases, inflation will likely rise which will tend to hurt the performance of financial assets. But, this is truly a "stay tuned" issue. History only offers an obscure view into what this evolving world could bring.

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