

April 9, 2018

## Reflections on Globalization: Part I

For much of recorded human history, we have seen waves of globalization and deglobalization.<sup>1</sup> Periods of globalization tend to be characterized by the emergence of either large regional hegemony or global hegemony. When these hegemony see their power wane, deglobalization occurs. Recently, globalization has come under fire. In some circles, being called a “globalist” is a slur. This new denigration of globalization should be viewed in a historical context.

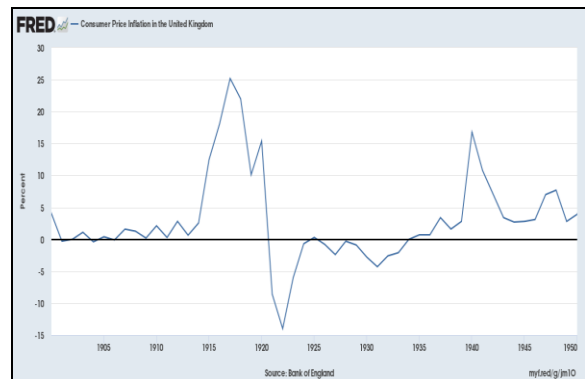
Our position has been that we have experienced the apex of globalization and a steady cycle of deglobalization will occur over the next few decades. This is the context in which we should view the current American political situation. Political pundits tend to focus on personalities, which are important in the short term. However, in the long term, it is no surprise to us that we have a president who is jaded on America's superpower role given where we are in the globalization/deglobalization cycle.

Notwithstanding, we believe there are peculiar circumstances in the current environment that offer interesting insights into how conditions may evolve. This evolution is important to investors as it will affect valuations of financial assets. Inflation is a key depressant to financial

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<sup>1</sup> A good study of this history can be found in Kevin O'Rourke's and Ronald Findlay's book. O'Rourke, K. and Findlay, R. (2007). *Power and Plenty: Trade, War and the World Economy in the Second Millennium*. Princeton, NJ: Princeton University Press.

asset values. Deglobalization will almost certainly lead to higher price levels over time. But, how that process develops is important. For example, war would likely bring a rapid increase in inflation. On the other hand, a steady contraction of supply chains and reduction in trade would lead to a much slower rise in inflation.



This chart shows British inflation from 1900 to 1950. The war years show an obvious spike in inflation.

In Part I of this report, we will discuss the end of the Cold War and the reactions of U.S. policymakers to that event. In Part II, we will begin with a reflection on markets, continue with an examination of hegemony and conclude with the expansion of globalization and the rise of meritocracy and its discontents. In Part III, we will discuss how China and Russia threaten U.S. hegemony, the potential responses and conclude with market ramifications.

## Winning the Cold War

I like sports and have followed major sports from a young age. I played sports, read

about sports<sup>2</sup> and even argued about sports with family members and friends. In the years of watching sports, I have noted that “history is written by the victors.” The winning players discuss their triumphs in such a manner that they seemed predestined. “We played harder...our game plan was perfect...we were better prepared” are the usual mantras. Rarely do you see an interview where a player or sportswriter suggests a win came just because they were lucky.

Winners in war show similar characteristics. Although serious historians will usually note the turning points in a war when different decisions or chance events may have led to a different outcome, in the popular imagination, winners are simply superior. And, by definition, losers are inferior, even if their losses occur due to accident or bad luck. To a great extent, war and sports are about probabilities. Sometimes an outcome occurs that was the result of a low probability event; thus, an inferior power can win unexpectedly.<sup>3</sup> But, the “smart money” bets on superior teams in sports or on more powerful nations in war.

Wars occur for any number of reasons. Sometimes, conflicts arise over claims of resources. Others occur due to differences in power and the rise and fall of nations (see discussion of Graham Allison below). World War I was mostly a war between a rising power (Germany) and a waning power (Britain). World War II was an ideological war in which fascism (authoritarian government with private capital) was pitted against both communism and representative democracy and capitalism. Winning WWII

<sup>2</sup> Not only did I read biographies of sports figures, but one summer I consumed all four editions of *The Fireside Book of Baseball*.

<sup>3</sup> In professional football, the term is “any given Sunday.”

seemed to resolve the fascism problem but didn’t end the dispute between communism and capitalism/representative democracy.

The Cold War was thus a battle over ideology. Capitalism/representative democracy is a system based on free markets to distribute goods and services and citizens vote in free elections to determine leaders. Communism is an economic system based on government control of the distribution of goods and services and, in its Soviet construction, the communist party appoints leaders.<sup>4</sup> Each system rests on assumptions about human nature. Capitalism assumes people are, at heart, self-interested. The only way to harness self-interest is to align against another’s self-interest.

*It is certain, that no affection of the human mind has both a sufficient force and proper direction to counterbalance the love of gain and render men fit members of society, by making them abstain from the possession of others. Benevolence to strangers is too weak for this purpose...There is no passion, therefore, capable of controlling the interested affection, but the very affection itself...<sup>5</sup>*

Adam Smith, a student of David Hume, distilled this position even further.

*It is not from the benevolence of the butcher, the brewer, or the baker that we*

<sup>4</sup> Marx wasn’t clear on how political power should be implemented. At the end of history, he expected the state to wither away. Lenin realized that the process of the state withering away was not practical in terms of revolution. As a result, Lenin created the idea of a “vanguard of the proletariat” that would manage governance until the end of history when communism was fully adopted.

<sup>5</sup> Hume, D. (1966 reprint). *A Treatise on Human Nature, Volume 2*. London, England: J.M. Dent & Sons. (p.197).

*expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities, but to their advantages...and by directing that industry in such a manner as its produce may be of the greatest value, he intends not only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was not part of his intention.*<sup>6</sup>

Hume made a famous observation which is known as “Hume’s Guillotine,” or, more commonly, as the “is-ought” problem. Should we discuss how people or situations are or how we believe they should be?<sup>7</sup> Another way of thinking about this notion is contained in a basic philosophical inquiry; what is the proper role of philosophy—to understand the world or change it?<sup>8</sup> Usually, one can do either but not both. Hume, Smith and the capitalists took humans as they saw them and tried to structure an economic system based on those realities.

Marx’s communism was designed to change human nature, to create structures that would end self-interest, not harness it. Hume, Smith and the classical economists that followed generally believe that the economic problem of unlimited wants and limited resources is best solved by self-interest. Communists believe changing human nature to end avarice is the best solution.

<sup>6</sup> Smith, A. (1776 orig. ed.). *The Wealth of Nations* (E. Cannan, Ed.). New York, NY: Modern Library. (p.197).

<sup>7</sup> Hume, op. cit., pp.177-178.

<sup>8</sup> A similar quote is inscribed on Marx’s grave: “The philosophers have only interpreted the world in various ways. The point, however, is to change it.”

Communism and capitalism are simply not compatible because they have fundamentally different views of human nature. Thus, the Cold War was a war of ideology and the conflict was filtered through this concept. Therefore, when the Berlin Wall fell in 1989 and the Soviet Union devolved in 1991, the West rightly interpreted these events as victory. In a famous article,<sup>9</sup> Francis Fukuyama opined that, perhaps, we were seeing the “end of history.” Marx had postulated that the withering of the state through communism would mark the ultimate culmination of human development, or “the end of history.” Fukuyama turned that concept on its ear by suggesting capitalism and democracy are the culmination, and history has now ended as the victory over communism proved there is no other viable development model.

Although Fukuyama’s position was not universally accepted,<sup>10</sup> policymakers essentially adopted it with what became known as the “Washington Consensus,” which argued that nations should become democracies and market economies. U.S. policymakers seemed to take the position that winning the Cold War meant that everyone should become “like us.” In other words, regardless of history or culture, democracy and open markets were the best way to govern and manage the economy.

An additional issue was that communism ended when the U.S. was a decade into neo-liberal economic policies that stressed supply side reforms.<sup>11</sup> Deregulation was a

<sup>9</sup>[https://www.embl.de/aboutus/science\\_society/discussion/discussion\\_2006/ref1-22june06.pdf](https://www.embl.de/aboutus/science_society/discussion/discussion_2006/ref1-22june06.pdf)

<sup>10</sup> A famous retort came from Samuel Huntington. <https://www.foreignaffairs.com/print/1113268>

<sup>11</sup> For historical context, see: Yergin, D. and Stanislaw, J. (1998). *The Commanding Heights: The Battle for the World Economy*. New York, NY: Simon & Schuster.

key component of this policy and supply side adjustments were key in driving down inflation, which had become a serious problem in the late 1970s. However, there has been a tendency by some analysts to ascribe the success of ending communism to these policies alone. Although they may have played a role, other factors clearly helped undermine Soviet communism, including the collapse in oil prices that occurred in the mid-1980s. Saudi Arabia's decision to recapture market share and end its cartel policy of "swing producer" cut oil prices dramatically and caused severe damage to the Soviet economy. Therefore, while it is true that supply side policies were "all the rage" in the early 1990s and this coincided with the fall of communism, it would likely be overstating the case that these economic policies were the only causal factors. But, since these policies were in place at the end of communism, there been an inclination toward the idea that there is no alternative to free markets and representative democracy, thus defining free markets as neo-liberal supply side and failing to recognize the mixed economic policies that were deployed from 1945 to 1978. This leaning has further supported the idea of open investment and deregulation that has been part of American foreign policy since the early 1990s.<sup>12</sup>

This stance brings us to our earlier discussion of sports...did the West win the Cold War because democracy and market economics are superior or was the Soviet version of communism unworkable? And, if democracy and market economics are

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<sup>12</sup> This has been part of free trade agreements as well. The tribunals in NAFTA, for example, reduce sovereignty by allowing the trade treaty to overrule domestic law. For details, see: <https://www.nytimes.com/2001/03/11/business/nafta-s-powerful-little-secret-obscure-tribunals-settle-disputes-but-go-too-far.html>

actually superior, does that mean the model is perfect? My position is that democracy and market economics are superior to communism but they are not without flaws. Democracy works not because it's efficient but because it creates conditions for peaceful transfers of power. The transfers of power in totalitarian, authoritarian and royal governments are always fraught with risk. In totalitarian and authoritarian governments, power transfers are often difficult. Leaders tend to stay until they are old.<sup>13</sup> Typically, jockeying for position occurs after the demise of the leader. In royal governments, there is hereditary transfer of power, which creates the "bad emperor problem." A good leader's DNA doesn't necessarily mean the children will be good leaders, too. Democracy and elections, regardless of their flaws, create conditions where power can be transferred legitimately and peacefully.

At the same time, democracy has the potential to dissolve into mob rule. Plato argued against democracy, suggesting it would devolve into tyranny.<sup>14</sup> In the early formation of the United States, the Federalists (Franklin, Hamilton, Jay, Madison, Washington) supported a republic with checks and balances that would reduce the power of the vote. The Anti-Federalists (Hancock, Henry, Lee, Mason) wanted a weaker central government and powerful states. The two sides remained at odds (arguably to the present day). For the most part, the Federalists prevailed, although the

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<sup>13</sup> Putin's actions to avoid term limits and Chairman Xi's recent policy change to stay in control are examples of the problems tied to transfers of power. Additional examples include earlier instances of the "gerontocracy" that afflicted the U.S.S.R. in its latter years, the long dominance of the Castros in Cuba, the Kims in North Korea and Mao's long tenure.

<sup>14</sup> See Book VIII of Plato. *The Republic of Plato*. Translated by Francis Cornford, 1945. New York, NY: Oxford University Press.

Anti-Federalists did manage to put a Bill of Rights into the Constitution, something the Federalists believed was unnecessary. The unresolved differences were one of the reasons for the Civil War that began in 1861.

Simply put, mankind has been unable to create a perfect form of government. To expect universal unity on governance is naïve at best, and dangerous at worst.

## Part II

Next week, we will continue this analysis with a reflection on markets, an examination of hegemony and a discussion on the expansion of globalization and the rise of meritocracy and its discontents.

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April 9, 2018

*This report was prepared by Bill O’Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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