

*August 28, 2017*

## **Reflections on Nationalism: Part II**

(Due to the Labor Day holiday, the next report will be published on September 11.)

Last week, we began our series on nationalism. In Part I of this report, we discussed social contract theory before and after the Enlightenment. We examined three social contract theorists, Thomas Hobbes, John Locke and Jean-Jacques Rousseau. This week, in Part II, we will recount Western history from the American and French Revolutions into WWII. From there, we will analyze America's exercise of hegemony and the key lessons learned from the interwar period.

In two weeks, in Part III, we will begin with an historical analysis of the end of the Cold War and the difficulties that have developed in terms of the post-WWII consensus and current problems. We will discuss the tensions between the U.S. superpower role and the domestic problems we face. From there, an analysis of populism will follow, including its rise and the dangers inherent in it. As always, we will conclude with market ramifications.

### **The Unfolding of History**

There were two primary tensions that unfolded from the early 1800s into WWI. The first was between the Enlightenment supporters who were opposed to empires and monarchies. The second was between the Locke wing and the Rousseau wing of representative government. Monarchies and empires continued to flourish in the 1800s. Britain, France, Spain, Portugal and the

Netherlands all still had overseas colonies. Some of these governments had monarchs that held varying degrees of power. On the continent, the Ottoman, Russian and Austro-Hungarian Empires were multi-ethnic and multi-cultural. The German Empire was formed in 1870, but prior to that the region was a mix of principalities. The British Empire included not only its vast overseas holdings but also Ireland. Within these empires there were tensions; the Serbs broke away from the Ottoman Empire but had become dependent on the Austro-Hungarian Empire for security. The Serbs expanded their territory in the Balkan Wars that preceded WWI and were wanting greater freedom from the Austro-Hungarian Empire. Russia held Poland, Ukraine and Belarus.

Wars and revolutions were common. There was a major revolution in Europe in 1848.<sup>1</sup> Germany was unified shortly after the Franco-Prussian War of 1870. One of the common themes of this period was economic disruption; the industrial revolution was moving through Europe, bringing massive changes to economies and labor. This flux created conditions of uncertainty and unrest. Job categories were created and destroyed. Massive wealth was created and inequality rose. It is worth noting that this was the period of the gold standard. As the industrial revolution led to increases in goods, the money supply was dependent on gold mining. In the absence of new gold, deflation would occur. This deflation often led to bank panics and deep depressions. The gold standard demanded nations using it to maintain their external accounts; in other words, trade deficits were

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<sup>1</sup> The Communist Manifesto was published in 1848.

“self-correcting” through rising unemployment. For the gold standard to work, voting enfranchisement had to be kept narrow, usually restricted to male property owners.<sup>2</sup>

World War I was the second industrialized conflict (the U.S. Civil War is considered the first) and it spelled the death knell for monarchies in Europe. The Austro-Hungarian and Ottoman Empires disintegrated. The Russian Empire was replaced by a communist revolution; the royal family was executed. The German Emperor abdicated just before the armistice on November 9, 1918. Ireland became independent in 1922.

At the treaty talks that ended WWI, President Wilson pressed for self-determination and the breakdown of empires into new nations. To a great extent, this part of Wilson’s plan did occur. The Russian, German and Austro-Hungarian Empires were replaced by a plethora of new nations.



(Source: BBC)

It was the spirit of nationalism that fostered Wilson’s goal of breaking up the empires and allowing self-determination to emerge. Instead of numerous groups of people being

<sup>2</sup> See Simmons, B. (1994). *Who Adjusts? Domestic Sources of Foreign Economic Policy During the Interwar Years*. Princeton, NJ: Princeton University Press (p. 27).

contained in empires, they could now build their own nations among people with whom they shared a common heritage. The map below shows the linguistic mix of the Austro-Hungarian Empire. It is no wonder that the Austrian Emperor struggled to keep the empire together.



(Source: Vox)

In addition, after the Great War, suffrage expanded. After all, restricting the privilege of voting to a citizenry that suffered profoundly during the war was difficult to justify. However, expanding the vote made it difficult to maintain the gold standard because austerity could not as easily be forced on workers who now possessed the power of the ballot box.

In the interwar period, European economies struggled. Germany was saddled with the terms of the Treaty of Versailles which created the worst of all conditions. The treaty severely handicapped the German economy but wasn’t harsh enough to lead to its collapse. In other words, it was harsh enough to anger, but not harsh enough to destroy.<sup>3</sup> Germany suffered through crippling hyperinflation that destroyed the

<sup>3</sup> For a critical but insightful account of the Treaty of Versailles, see: Keynes, J.M. (1920). *The Economic Consequences of the Peace*. New York, NY: Harcourt, Brace and Howe.

middle class, especially small business owners and workers without representation. The hyperinflation undermined social stability and arguably created the conditions that led to the rise of Hitler.<sup>4</sup>

Stagnant economic growth, attempts to maintain the gold standard that required policy austerity and an uncertain superpower situation<sup>5</sup> led to widespread frustration with liberal democracy. As economies sputtered, social unrest rose. In addition, the Great Depression led to a significant rupture in

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<sup>4</sup> Ibid, Part I, Chapter VII: "Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate *arbitrarily*; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become "profiteers," who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery...**Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency** [emphasis added]. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."

<sup>5</sup> For an in-depth discussion of hegemonic stability theory, see: Kindleberger, C. (1986). *The World in Depression, 1929-1939* (2<sup>nd</sup> ed.). Los Angeles, CA: University of California Press.

global trade and a rapid drop in growth in many countries.

Alternative government structures became more attractive in the interwar period. There were anarchist movements in the U.S.; communism had taken hold in Russia and fascism rose in Germany and Italy. Democracy, especially the Lockean variant, was rapidly falling out of favor. Adding to dissatisfaction was Germany, which had ousted the Brüning government in favor of Adolf Hitler in the early 1930s, embarking on a massive public works project that included rearmament (in violation of the Treaty of Versailles). The plan worked brilliantly; the unemployment rate fell to about 3% by 1939 as the level of unemployed fell from 6.0 mm to 0.3 mm from 1933 to 1939.<sup>6</sup> Meanwhile, the U.S., British and French economies mostly languished in the 1930s, although the economies that jettisoned the gold standard had begun to recover.

In 1939, Germany invaded Poland and set off WWII in Europe. The war was seen as one against fascism, which is a fair assessment. By 1945, fascism was defeated and the U.S. began to build a new world order based on America's particular exercise of hegemony.

### America's Peculiar Hegemony

The world has seen a parade of global superpowers. Venice, Spain, the Netherlands, Britain and the U.S. are the

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<sup>6</sup> Although this was a remarkable decline, the drop was partially manipulated. Women were restricted from the workforce and the government assigned jobs to the unemployed. Refusing to accept an assigned position led to imprisonment. After 1935, German Jews lost their citizenship and were no longer counted in the labor force. See: <http://www.historylearningsite.co.uk/nazi-germany/the-nazis-and-the-german-economy/>

most recent holders of that role. The U.S. became the global superpower<sup>7</sup> officially in 1944 at Bretton Woods, where the dollar was established as the Free World's reserve currency. The earlier holders of this role had colonies. The need for colonies develops because the superpower usually evolves into the role through rapid economic development. This process can lead to excess capacity which requires a ready market to absorb. Colonies controlled by the colonizer can provide the demand for this excess capacity.<sup>8</sup> The U.S. opted to avoid colonies mostly due to its historical experience; the American Revolution was a war against a colonial power and most Americans were uncomfortable with the idea of becoming a colonizer.

When WWII ended, the U.S. economy was by far the world's largest; U.S. GDP was nearly 36% of global GDP.



In providing the reserve currency, the U.S. needed to run trade deficits; otherwise, the

<sup>7</sup> It is arguable the U.S. shared this role with the U.S.S.R. However, the Soviets controlled a smaller part of the world both geographically and economically, and its economic power only extended to the communist bloc. America's economic influence was broader and affected the Soviets more than the reverse.

<sup>8</sup> For a deeper discussion on the economics of trade, see WGR, [Reflections on Trade](#), May 2017.

only way for the world to acquire dollars that are almost universally used for trade is through financial channels, either investing or lending. Given the American economy's relative size, there wasn't much concern about the U.S. absorbing imports or any related effects on the American labor market.

The other major difference in the U.S. execution of hegemony was the development of multilateral organizations, such as the United Nations, the World Bank, the North American Treaty Organization, the General Agreement on Tariffs and Trade, etc. The U.S. was willing to bind itself to these organizations to foster global cooperation. Although the U.S. was *primus inter pares*, it still followed the rules of these organizations.<sup>9</sup>

### Key Lessons Learned

American leadership after WWII determined the following:

1. America's decision to return to isolation after WWI was a terrible mistake and was partly responsible for WWII.
2. The collapse of trade during the Great Depression and the "beggar thy neighbor" trade policies that existed during the 1930s led to weaker global growth and encouraged war. Nations that traded with each other were less likely to go to war with each other.
3. Nationalism needed to be contained. The spread of nationalism after WWI led to a series of adverse outcomes. These included multiple states that often did not respect minority rights and created conditions of instability. Multilateralism was supported as the key organizing principle instead of nationalism. A large number of multinational organizations

<sup>9</sup> For example, the U.S. got U.N. approval for the Korean War.

and increasing free trade were seen as critical to preventing another world war.

Simply put, the American leadership concluded that isolationism, trade protection and excessive nationalism were the causes of WWII. And so, a globally integrated foreign policy, free trade and multilateralism were seen as the preventive measures to avoid repeating the experience of the early 1940s. In other words, policies that were isolationist, unilateral and protectionist were seen as destined to cause WWIII.

This position was also adopted in Europe. European leaders concluded that nationalism was a key reason for two world wars being fought on the European continent. In order to help prevent a third world war, these leaders made two major decisions. First, they agreed to build their collective security through the North American Treaty Organization (NATO). Although nations still had their own military forces, they would give up some of their sovereignty to deploy them by working within the treaty construct of NATO. In practice, after the European states gradually gave up their colonies,<sup>10</sup> NATO nations “outsourced” their defense to the U.S. With America in charge of Europe’s security, the likelihood of war within Europe was sharply curtailed. Second, although European leaders held no

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<sup>10</sup> And especially after the U.S. forced Britain and France to withdraw their forces from Egypt during the Suez Crisis of 1956.

illusions about uniting the continent politically, they decided to tie it more closely together economically by creating the European Union.<sup>11</sup> The EU, which had its beginnings with the six-nation European Coal and Steel Community in 1951, has steadily evolved into an economic union of 28 nations,<sup>12</sup> where 19 of the nations share a single currency. The idea was that although nationalism would be difficult to overcome, steady economic integration and prosperity would eventually reduce the allegiance to a particular state and create a European consciousness. The more integrated the EU became, the less likely war would occur.

And so, the political establishment in both the U.S. and Europe agreed that free trade, multilateralism and economic integration would prevent WWIII. Those who questioned these precepts were effectively indicating they were willing to risk war.

### Part III

In two weeks we will conclude this report with an analysis of the post-WWII consensus, America’s declining superpower role and the rise of populism, along with market ramifications.

Bill O’Grady  
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<sup>11</sup> See WGR, [The Revolt of the European Voters](#), 5/14/12.

<sup>12</sup> Eventually to be 27 with the exit of the U.K.

*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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