Confluence Investment Management

Weekly Geopolitical Report

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The Storm Before the Calm: A Review

(N.B. Due to the Labor Day holiday, the next report will be published on September 13.)

Although we maintain an official reading list with capsule reviews, occasionally we come across a book that we think is important enough to review as a report. George Friedman's newest book, *The Storm Before the Calm: America's Discord, the Coming Crisis of the 2020s, and the Triumph Beyond*,[1] is just such a book. Friedman is a well-known geopolitical scholar who has written numerous books. He founded Stratfor in 1996 and went on to found Geopolitical Futures in 2015.

Historical analysis tends to break down into one of two schools. The first is the "Great Man Theory," which suggests that history is dominated by towering historical figures who shape the world. The second is the "Great Wave Theory," which postulates that history is driven by broad economic, social, political, and other trends, and that people and leaders are shaped by these trends. Those in the first school believe that people shape the trends. The second school holds that this idea is nonsense, and what we refer to as "great men" are really like great surfers—they are figures who understand the world they are in and "ride the wave" to glory. Like all hard categories, neither is perfect. In reading history, it's rather clear that there have been some remarkable people. At the same time, they are often the right person in the right place at the right time, meaning that we are all, to some extent, shaped by our circumstances.

The school an analyst aligns with is important. Although history is studied for its own sake, we often study history to predict the future. A "great man" theorist is watching the principal actors to see how they will shape the world. Analysts in this school pay close attention to personalities, whereas analysts from the "great wave" school pay less attention to personalities and focus more on the conditions by which these people come to power. Great man theorists have great concern about *who* takes power, while great wave theorists are much more concerned about the *situations* in which those in power find themselves. In other words, there are fundamental differences in how analysts from either school predict the future based on history.

Friedman is a wave theorist. He doesn't believe that individuals can reverse trends that are in place and that leaders are dependent on the circumstances in which they take power. When Friedman looks at the future world through the viewpoint of history, he is examining trends to see if they are enduring or about to change.

Two Major Trends

In his analysis of historical waves, Friedman identifies two major trends, or cycles. The first he calls the "institutional cycle," which is something of a misnomer. Cycles suggest some sort of reversion; in reality, the institutional cycle is really about an arrangement outliving its contradictions and

[1] Friedman, George. (2021). *The Storm Before the Calm: America's Discord, the Coming Crisis of the 2020s, and the Triumph Beyond*. New York, NY: Anchor Books.

the need to resolve those contradictions. He argues that these institutional arrangements last around 80 years. The institutional cycle is mostly about the structure of government and how a certain structure meets the needs of the nation at a given time. The second cycle is socioeconomic and is actually cyclical. These cycles run around five decades. According to Friedman, these cycles are generated by issues in the economy.[2] Essentially, economic policies remain in place until they become counterproductive.

The reason Friedman thinks the 2020s form the "storm" decade is that, for the first time in American history, the two cycles are ending in the same decade. The U.S. is dealing with the end of an institutional cycle and a socioeconomic cycle at the same time. The termination of two cycles is leading to unusually elevated tensions; divisions on the economy, politics, and society are evident. Friedman isn't surprised by our current situation and, more importantly, suggests that as we resolve these two cycles, future conditions should improve significantly. Thus, his book, although a warning about the next decade, does offer hope that America will make its way through the current turmoil. In fact, he postulates that resolving these cycles in the past tended to bring periods of prosperity. Therefore, it is reasonable to assume that a better future is on its way.

The Institutional Cycles

The first cycle, or trend, ran from the nation's founding into 1860. The founders wanted to create a new system of government that would avoid concentrations of power and so they built one that was designed for inefficiency. Having three branches of government, with the legislature further divided, was designed as a defense against tyranny. The three branches competed with each other and acted as a brake on power.

At the same time, the country was divided at the outset. Geography allowed the South to have large farms; land was relatively flat, and the climate was temperate. The North had a harsher climate and was more attuned to manufacturing. The original documents of the United States, the Articles of Confederation, proved to be unworkable because they essentially created 13 separate nations, not one. These articles were replaced by the Constitution. The Constitution did create a nation of states but, due to divisions among the founders, the creators didn't exactly delineate the borders of federal and state power. As the country grew and created yet another region, the West, the goals of the three regions began to diverge. This divergence became impossible to manage, leading to the end of the first cycle with the Civil War.

In the second cycle, the federal government established its dominance over the state governments. The economy became increasingly interstate and the nation was expanding. It took a growing federal government to manage an industrializing economy. The U.S. completed the lower 48 states in 1912. It eclipsed the U.K. as the world's largest economy by 1870.

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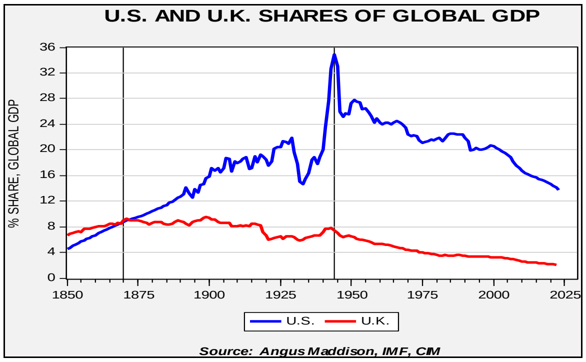
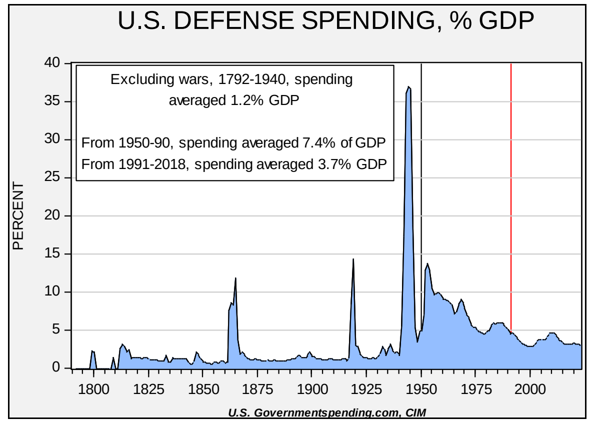
[2] Separately, in our research, we characterize these cycles on the basis of equality and efficiency. Equality cycles occur when inequality becomes politically impossible to maintain, and efficiency cycles occur when inflation becomes intolerable.



The U.S. tried, in general, to limit its international involvement, but when a nation becomes as large as the U.S. was, not just in terms of territory but in terms of economic heft, it becomes nearly impossible to avoid that outcome. The U.S. began to move onto the world stage. The Spanish-American War ended with the U.S. in control of Cuba, Puerto Rico, Guam, and the Philippines. The U.S. attempted to avoid WWI, but eventually joined the allied cause against the Axis powers. In the 1920s, America was deeply involved in global trade and German war reparations. All signs were pointing to American hegemony, but the U.S. continued to avoid the role.[3]

The combination of the Great Depression and WWII led to a wider expansion of federal power that characterized the third institutional cycle. A complicated industrial economy integrated into the global economy and coupled with the need to win WWII and the Cold War required a deliberate marshalling of resources. In other words, a big government was necessary in order to be a hegemon. Fears of a second depression meant that Americans were willing to accept government intervention in the economy. The Cold War led to the massive expansion of intelligence bodies along with a large standing military.



As the above chart shows, before hegemony, the U.S. would mobilize for war and rapidly reduce defense spending. That pattern ended after WWII.

Friedman argues that the third institutional cycle is coming to a close. We will discuss his expectations below.

The Socioeconomic Cycle

Friedman postulates that there have been five socioeconomic cycles in U.S. history. The first ran from 1783 to 1828. Although the founders were political revolutionaries, they were economic capitalists; they represented the landed aristocracy in the South and the merchant class in the North. The economy was mostly run for the benefit of these two groups. To build out the U.S., especially after the Louisiana Purchase, America needed immigrants. Germans, Irish, and Scots-Irish (ethnic Scots and Irish Protestants) came to the U.S. to improve their fortunes. Over time, they began to resent the way the founders class operated the economy. The founders class tended to conduct tight monetary policy, which benefited capital owners. A depression in the 1820s undermined the popularity of this class; the way the 1824 election denied the champion of the emerging group, Andrew Jackson, the presidency delayed the end of this cycle. But by 1828, with Jackson's win, the second cycle began.

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[3] For details, see: Kindleberger, Charles, *The World in Depression, 1929-1939*.

The Jackson cycle ran from 1828 to 1876. Initially, the goal was to expand credit for westward expansion. However, this process developed with fits and starts. Jackson was hellbent on closing the Second Bank of the United States, which he viewed as protecting the interests of the capital-owning class. Paradoxically, Jackson introduced a bimetallic standard (gold and silver) that ended up restricting credit. The money supply was dependent on mining and at times credit would become scarce. But the ultimate goal was to settle the West. Lincoln pushed that goal and presided over the Civil War. To pay for the war, the North issued greenbacks, which were not backed by gold. The South even more aggressively printed money. After the war, the successive governments tried to absorb the excess liquidity without triggering a downturn. That turned out to be impossible; the Panic of 1873 was a long depression that weighed on the economy into 1878.

The third cycle began with Rutherford B. Hayes, whose administration had an inauspicious start.[4] The election was mostly over ending Reconstruction, but the key economic issue was resolving the monetary problem. The debt overhang from the postwar period had not been resolved; the South and West wanted easy money, while the North, representing the banking class, wanted hard money. Hayes was a hard money man, and he moved the U.S. to the gold standard. Interestingly enough, it worked. Gresham's Law states that bad money drives out good. The greenbacks became used for everyday transactions, while gold notes were saved. The introduction of the gold standard brought those old gold notes back into circulation. By giving confidence to money, investment jumped just at the time that America was industrializing. Production soared and fortunes were made. The capitalist class was ascendent as corporations grew in size and in political clout.

Populist movements began to emerge to protect the debtor and laboring classes. William Jennings Bryan ran for president in 1896 on a populist platform. Although a brilliant orator, he still lost to William McKinley. However, Theodore Roosevelt adopted elements of the populist platform. He introduced regulatory bodies and antitrust actions.

Development remained centered in investment; eventually, production exceeded the ability of the U.S. to consume all the production and the U.S. became an exporting power.[5] The task of this cycle was to build the U.S. industrial base and it succeeded. The problem that developed was overproduction. WWI made that problem evident. In the aftermath, U.S. export markets struggled to recover; to compensate, monetary policy was eased[6] which led to increased debt. The debt problem and the production overhang conspired to trigger the Great Depression.

The fourth cycle begins with Franklin Roosevelt. The underlying problem that brought the Great Depression was inadequate demand relative to the productive capacity of the economy. The Roosevelt cycle ran from 1932 to 1980. Capitalism was dealing with significant threats. Communism was ascendent in Russia, and fascism was on the rise in Germany and Italy. Fiscal expansion for rearmament was leading to economic recovery in Germany, while the Western

[4] For details, see our *WGR*, "The Election of 1876: Part I" (10/19/2020).

[5] Not too dissimilar to China today.

[6] This was also due to an attempt to help Britain return to the gold standard with an overly strong pound exchange rate. To prevent a run on the pound, the Federal Reserve kept interest rates low.

democracies were mired in policies appropriate for building supply but not boosting demand.

Roosevelt embarked on fiscal expansion and debased the currency. Public works were implemented as were make-work programs. In general, they only had a modest impact. Fortunately for the world, when WWII began the U.S. had ample idle industrial capacity. Massive war spending put that capacity to work and the combination of military enlistment and war jobs reduced unemployment and gave households the wherewithal to pay down debt.

The economy was managed by technocrats in Washington. They won the war and their demand management led to prosperity. The suburbs were built, and America enjoyed its longest expansion at the time, which ran from 1961-70.[7]

However, the policies that favored aggregate demand (consumption) led to under-investment. By the 1970s, this lack of investment began to trigger systemic inflation. As inflation rose, the continued implementation of demand stimulus mostly served to further lift price levels. This period, beginning in the late 1960s, also saw significant political turmoil. Assassinations of important public figures, such as Robert F. Kennedy and Martin Luther King Jr., occurred. High levels of civil unrest, with protests against the Vietnam War and racial inequality, plagued the cities. Richard Nixon was forced to resign from the presidency. Oil prices spiked due to wars in the Middle East. For the average American, the problem of inflation became paramount.

The fifth cycle addressed the inflation problem. Although President Carter actually started the process of deregulation to address inflation and put Paul Volcker in charge of the Federal Reserve, who implemented monetary austerity, it was Ronald Reagan's presidency which marked the onset of the fifth cycle. Inflation was resolved by supply expansion that focused on tax cuts, deregulation, and globalization. As technology improved, firms automated production in the U.S. and what they couldn't automate, they offshored. The outcome was a rapid decline in inflation coupled with a hollowing out of the middle class. Stable, well-paying jobs were often eliminated, and workers were left to fend for themselves. To maintain consumption, households turned to debt; the 2008 Financial Crisis ended debt accumulation as a coping mechanism.

Where Are We Now and What Comes Next?

Friedman argues that both the institutional and the socioeconomic cycles are coming to a close by the end of this decade. The institutional cycle is spent. His thesis is that the third cycle was governance by experts. Expert management was necessary during WWII and the early stages of the Cold War. The U.S. needed to mobilize its productive assets for a specific goal and expertise was necessary. A large federal government requires specialists and the U.S. is populated with them.

However, Friedman points out that there is a problem with this arrangement. Experts tend to know a lot about very little. In other words, their expertise tends to be narrow. When these experts address a problem, it tends to have a narrow solution that often doesn't take into account factors outside the expert's area of study. The problem of narrow focus has been seen in many situations where the government was involved. During the Vietnam War, Robert McNamara used the corporate expertise he

[7] That record was eclipsed by the 1991-2001 expansion.

had developed at Ford Motor Company (F, USD, 13.08) to manage the war. He attempted to prosecute the war based on various data points, such as body counts, but there was never evidence of a reflection on whether the war should have been prosecuted.

Over this institutional cycle, we have seen the rise of regulatory bodies that issue rules and implement policies with a narrow focus that rarely acknowledge the associated costs of the policy. Friedman argues that this rule by experts has undermined confidence in government; citizens fear their government will implement policies they don't understand and lack their input. In addition, the experts seem to hold that they are non-ideological but, in reality, they have a view that the world should be run by the qualified defined by credentials.

Friedman suggests the fourth institutional cycle will be dominated by generalists. Although they may seek out the opinions of experts, the decisions will be made by those with broad knowledge. In the familiar parable of the fox and the hedgehog, where the fox has broad but not necessarily deep knowledge, while the hedgehog has intimate knowledge of a small space, we are heading toward a world governed by foxes. Largeness of government isn't necessarily the problem; instead, policy must be made by elected officials who answer to voters.

This change will be a crisis for the current elite, who value where one went to school and how much one knows. And it isn't clear from where these generalists will emerge. But it is clear, in Friedman's mind, that the rule by experts is in its twilight.

In terms of the socioeconomic cycle, the next phase will be about increasing demand. Much like the Roosevelt era, it will be about distributing the wealth that technology has created. The third institutional cycle and the experts that conducted it tended to believe in meritocracy—those who became rich deserved it because they were clever. For those who failed to prosper, it was either due to racism or other restrictive factors. In the sixth socioeconomic cycle, Friedman expects a return to a focus on class; identity will be less important than income and wealth. For this to work, education will need to be reformed, with less emphasis on where one goes to school and more on getting the necessary education. Online learning may play an important role.

What Lies Beyond

The political and social turmoil since 2008 signal that change is necessary. Friedman shows that there were similar crises before other cycles occurred. The rise of Jackson, the Civil War, the Panic of 1873, the rise of populism in the 1890s, the Great Depression, the 1970s inflation, and the Great Financial Crisis all occurred when one of these cycles was ending. They are harrowing to live through, but history shows that they do get resolved.

In Conclusion

Cyclical models of history have weaknesses; sometimes events are shoehorned in place to support the theory. Friedman may be guilty of this at times. Wave theories of history have another weakness in that they assume a historical figure will rise because one always does. However, there are also times where human failure occurs and no leader emerges.

With these caveats in mind, we still think that Friedman's book offers a likely blueprint for the next few years. The bad news is that we are likely facing another five to 10 years of disorder. The good news is that America will come through this to a brighter future. In that regard, it is a hopeful book, although the winners in the new era probably won't be those currently in control.

Right or wrong, readers would benefit from this book. Examining history and using a pattern to discern the future is a worthwhile exercise and Friedman is quite good at this sort of analysis. We recommend it highly.

Bill O'Grady
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Confluence Investment Management LLC

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