Weekly
Geopolitical Report
By Bill O'Grady

August 31, 2015

Bremmer's Choices

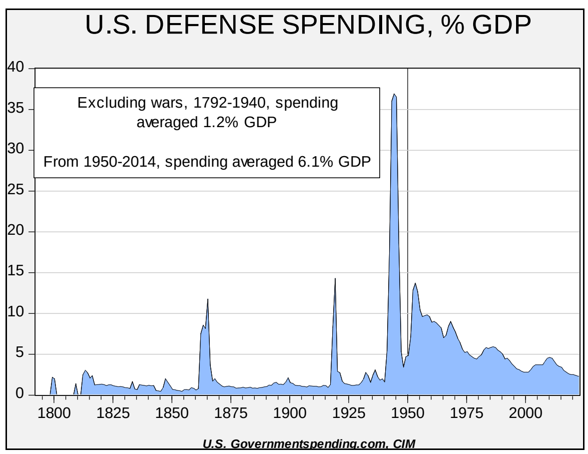
(Due to the Labor Day holiday, our next report will be published on September 21.)

Last week, we wrote our first formal book review as a Weekly Geopolitical Report. The book, *Superpower: Three Choices for America's Role in the World*, is a recently published book by Ian Bremmer in which he discusses three models for American foreign policy. In our closing comments last week, we promised to take a deeper look at Bremmer's three foreign policy models to examine their costs and benefits. In this report, we will analyze his three models of exercising the superpower role, Indispensable America, Independent America and Moneyball America. From this analysis, we will discuss which model is the most likely choice. As always, we will conclude with market ramifications.

Indispensable America

This model mostly describes Charles Kindleberger's hegemonic stability theory, which is that the world needs a single superpower to stabilize the world. We agree with Kindleberger's theory, which states that when the world lacks a hegemon, the global economy struggles to function.[1] The strongest argument for adopting the Indispensable America model is that the world needs a hegemon to provide two key global public goods. First, the hegemon builds a military that has the ability to project power anywhere in the world. This act provides global security and fosters international trade. Second, the superpower provides the reserve currency to the world and by this act becomes the global importer and consumer of last resort.

These two roles can be burdensome. The hegemon is required to spend large sums on defense, unlike other nations, and it is often called upon to provide security for nations around the world that face threats which do not directly affect the hegemon's security. Looking at the history of American defense spending, the difference between the republic and the superpower periods are obvious.



From 1792 to 1940, outside of wars, U.S. defense spending averaged 1.2% of GDP. It clearly spiked during wars, but military spending plummeted as demobilization occurred after the wars ended. Note the difference after 1950 (shown as a vertical line on the above chart). Defense spending remained elevated during this period, averaging 6.1% of GDP from 1950 to 2014.

[1] Kindleberger, C. (1986). *The World in Depression, 1929-39*. Los Angeles, CA: The University of California Press.

This level of defense spending is required of the superpower. The U.S. is the only nation on earth that can project military force anywhere. By possessing this power, it bears responsibility for keeping global sea lanes free of piracy and closure by hostile powers. A good example of this is the Strait of Hormuz in the Persian Gulf. About 20% of the world's petroleum passes through this narrow strait daily. Without the presence of the U.S. Navy, it is highly likely that Iran would attempt to control world oil prices by interfering with shipping.

The reserve currency role is perhaps the least understood superpower issue for Americans. Global trade requires a generally acceptable currency for exchange. Imagine two small nations trying to conduct trade with each other. To avoid using the reserve currency, they would need to have mutual needs; each nation would want something the other has and both could agree on a price. That outcome is very rare. With most global trade currently conducted in dollars, every nation in the world has an incentive to run a trade surplus with the U.S. to acquire dollars that they can use as a universal currency.[2] Since these acquired dollars probably won't be spent immediately, foreign nations hold U.S. financial assets as reserves.

This process of providing the reserve currency distorts the U.S. economy in several ways. First, consumption will tend to exceed optimal levels. The U.S. is the global importer and consumer of last resort; a slowdown in U.S. consumption reduces global economic activity. Second, the U.S. will run persistent trade deficits. This will put tremendous pressure on firms that compete with imports and tend to undermine domestic wages. Third, because foreign reserves are held in financial assets of the reserve currency country, there is a need for deep, liquid and broad capital markets. This necessity tends to require an outsized financial sector. Fourth, the global demand for safe assets means that there is a premium placed on the government bonds of the reserve currency nation. Foreign buyers allow the reserve currency nation to run large fiscal deficits with lower interest rates than would occur in the absence of that demand. Although this factor can be a benefit, it tends to undermine fiscal restraint. Finally, the requirements of a large military, global security and strong consumption tend to foster the growth of government. ***There is no such thing as a small government superpower.***

The U.S., being the global hegemon, has to balance its global obligations with the needs of the domestic economy. From 1945 to 1980, the U.S. accomplished this through a deeply regulated economy with very high marginal tax rates designed to create high-paying, low-skilled jobs. This model brought about large oligopolies and unions, and purposely curtailed the disruptive impact of entrepreneurship through high marginal tax rates. Unfortunately, this led to high inflation from 1965 to 1980. To counteract the inflation problem, the U.S. embarked on a policy of deregulation and globalization, which dramatically cut inflation but resulted in widening income differences. To maintain the consumption needed to supply the reserve currency, households increased their borrowing to unsustainable levels, which led to the 2008 financial crisis.

[2] Imagine a Paraguayan chocolatier needing cocoa beans from the Ivory Coast. The selling nation probably would have little desire to accept Paraguayan guarani in return for the beans and so the Ivory Coast seller demands to be paid in dollars. To acquire dollars on a regular basis (outside of borrowing or begging), Paraguay needs to run a trade surplus with the U.S.

If the U.S. is going to maintain this model, it has to create a new policy that will provide the lower 80% of the income distribution with enough purchasing power to absorb the world's imports without adding to debt. If we return to the policies prior to 1980, inflation will return with a vengeance within a decade or so.

Perhaps the only feasible way to achieve this model would be to provide a universal base income to all households (a Social Security for all adults) with a progressive, but relatively low, top marginal tax rate that would not curtail entrepreneurship.[3] At this juncture, we see no political path to such an outcome. The populist opposition discussed two weeks ago[4] tends to pine for a return to the 1945-80 economic model. Such a model would probably fail to provide the necessary global public goods required of the hegemon due to the populists' opposition to foreign trade.

The Indispensable America model is very expensive. Americans were willing to bear the costs of the model when communism was viewed as a major threat. With the Cold War over, Americans have become less willing to accept the costs. At the same time, it is politically difficult to sway Americans to walk away from this model. Rand Paul is the only candidate with established views opposing many of the superpower roles. He is regularly criticized for his stance and is struggling in the polls. We suspect Bernie Sanders agrees with much of Paul's foreign policy positions but Sanders's followers are supporting him for reasons other than his foreign policy views. Simply put, policymakers haven't been able to build a model for Indispensable America that can address the costs of the hegemon role and meet the needs of the domestic population. Until such a policy is developed, a growing element of the voting public will support positions that undermine this model.

Independent America

In this model, the U.S. should refrain from acting as "global policeman" and run America by putting its own interests first. What are the international and domestic costs of the Independent America model? If the U.S. retreats from the hegemon role, we would expect a number of important changes to occur.

1. Regional conflicts will rise. Without the U.S. providing security to weaker nations, regional powers, such as China, Iran and Russia, will try to expand their influence within their local areas.
2. Frozen conflicts will turn hot. The U.S. prevented wars in Europe and Asia from occurring over the past seven decades by essentially disarming key adversaries. In Europe, the U.S. took over security from Western Europe through NATO. In Asia, the U.S. imposed a pacifist constitution on Japan and defended it from the Soviet Union and China. By disarming these regional powers, peace was maintained. Without the U.S. providing this service, these conflicts will likely "thaw" over time.
3. Globalization will come to an end. Globalization rests on the U.S. protecting the world's sea lanes and providing the reserve currency. If the U.S. Navy isn't protecting the sea lanes and the U.S. is no longer willing to be the world's consumer of last resort, global liquidity will likely fall as no other nation appears willing or able to replace the U.S. in these roles.

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[3] To accomplish this goal, the tax code would need higher rates on top incomes with fewer deductions, raising the effective rate.

[4] See WGR, 8/17/2015, Donald and Bernie.

4. Global defense spending will soar as it falls in the U.S. Nations, when forced to defend themselves, will aggressively move to rebuild their militaries.
5. Commodity prices will rise. The supply of key commodities will become less reliable as the U.S. won't be there to ensure the shipments will arrive safely. This situation will lead to hoarding, driving prices higher.

The last time the world was "between" superpowers was 1914-45. That era saw two world wars and a depression, which is why America's leaders after WWII opted for the Indispensable America model. Roosevelt, Truman, Eisenhower, et al. feared that a return to Independent America would lead to WWIII.

Paradoxically, Independent America would probably be a rather prosperous place. Jobs lost to globalization, to some extent, would be "re-shored." The need to run trade deficits would end, allowing the U.S. to protect some industries and boost jobs. However, labor costs would likely be contained due to increased automation. Defense spending would decline, although the defense industry would do well due to exports. An unstable world would make America an oasis of stability and a Mecca for the global elite to move their talents and wealth to America.[5]

The risk to this model is that, at some point, global instability will wash up to America's shores and we will find ourselves forced into a major war. Clearly, the Independent America model is attractive. It allows America to return to its republic roots and avoid the problems that come with the superpower role. However, it also smacks of "intergenerational forgetfulness" in that its proponents only see the benefits and forget why our elders adopted Indispensable America in the first place.

Moneyball America

This model suggests the U.S. should be sly and cunning with its foreign policy. Essentially, Moneyball America is designed to conduct foreign policy with little regard for moral imperatives, using offshore rebalancing and a cost-benefit paradigm in terms of intervention. This model is initially attractive because, at first glance, it seems like a compromise of the previous two models. It suggests the U.S. could remain the global superpower but on less intensive terms and, by reducing America's responsibilities a bit, it would be easier to address domestic concerns.

It should be noted that there were Moneyball presidents during the Cold War. President Nixon, through his decision to normalize relations with China, acted in a fashion consistent with making a productive choice without adhering to the Wilsonian moral restrictions that usually come with the Indispensable Model. George H.W. Bush's decision not to oust Saddam Hussein during the First Gulf War falls into this same category.[6]

There are two primary problems with Moneyball America. The first, which Bremmer identifies, is that Americans are not comfortable with an amoral foreign policy. Americans need to believe they are

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[5] Growing capital flight and the tendency for wealthy foreigners to buy U.S. residences suggests the well-connected around the world may be expecting this outcome. See:
Frank, R. (2014, September 20). In Suburban Seattle, New Nests for China's Rich. *New York Times*.
Satow, J. (2015, February 6). Wealthy Chinese Buyers Head to New York's Suburbs. *New York Times*.

[6] It should be recognized that, before the Cold War, President Roosevelt's decision to team up with Stalin to fight the Nazis was a "moneyball" foreign policy.

in the right,[7] and a policy that is openly willing to only defend U.S. interests and not friends' is hard to sell politically. The second problem is that determining America's "true" interests in a post-Cold War world is devilishly hard. From my vantage point, I don't see anyone from either party's foreign policy apparatus capable of executing the Moneyball model effectively. I suspect President Obama believes he is actually running this model; Bremmer criticizes the president because his foreign policy is incoherent. It should be noted that it doesn't just take foreign policy skill to run this model; it also takes great political skill to sell an amoral model as moral. This was perhaps the real foreign policy genius of President Roosevelt. Consequently, it appears to me that the Moneyball America model is probably a non-starter, although if the talent existed in the U.S., it might just be viable.

Ramifications

Although I wish the U.S. would maintain the Indispensable America model, in reality, Bremmer's choice of Independent America is probably what most Americans would choose and will probably become the default choice over time. Americans have tired of the Indispensable Model and want to see their lives improve.

If that choice is made, there are two important market implications:

1. Foreign investing, regardless of emerging or developed, is going to become much more volatile and dangerous. Everything we know about foreign investing, including correlations, cyclical patterns, earnings relationships, etc. have existed with the U.S. acting as the global hegemon. Without the U.S. acting in this role, it is uncertain how foreign stocks and bonds will perform.
2. Although commodity prices are presently in a bear market, if the U.S. continues to vacate the superpower role, the security of supplies of key commodities will become uncertain. We suspect this will lead to widespread hoarding which will drive the market higher.

Thus, as we noted before, the 2016 elections will be very important. Bremmer's book offers a way of examining how foreign policy might evolve.

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[7] Obviously, this isn't unique. All nations operating foreign policy, to some extent, strive to portray themselves as being on the side of the angels.