

September 11, 2017

Reflections on Nationalism: Part III

Three weeks ago, we began our series on nationalism. In Part I, we discussed social contract theory before and after the Enlightenment. We examined three social contract theorists, Thomas Hobbes, John Locke and Jean-Jacques Rousseau. In Part II, we recounted Western history from the American and French Revolutions into WWII. From there, we examined America's exercise of hegemony and the key lessons learned from the interwar period. This week, 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. Next, we will analyze populism, including its rise and the dangers inherent in it. As always, we will conclude with market ramifications.

What Changed? The Post-Cold War Period

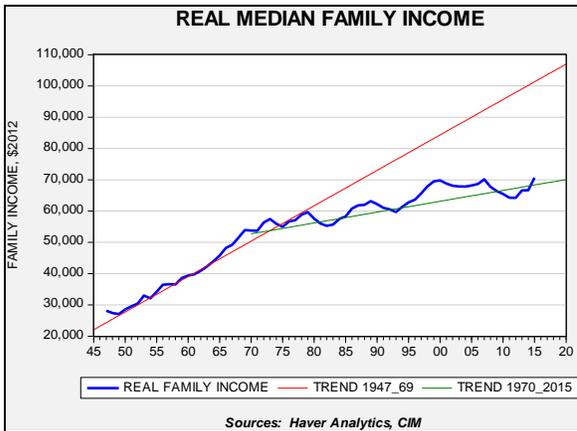
The American political establishment still holds that free trade, multilateralism and American involvement in the world is the correct policy.¹ Populists generally supported this policy until the Cold War ended. After the Cold War, the political establishment wanted to remain the global superpower, in part because it had led to world peace and in part because members of the political establishment have

¹ For an analysis of the four major political blocs in the U.S., see WGRs: 2016: [Part 1](#), 3/31/14; [Part II](#), 4/14/14; and [Part III](#), 4/21/14.

economically benefited from the policies of free trade, multilateralism and deregulation. The latter policy, deregulation, began with President Carter and was fully embraced by President Reagan.

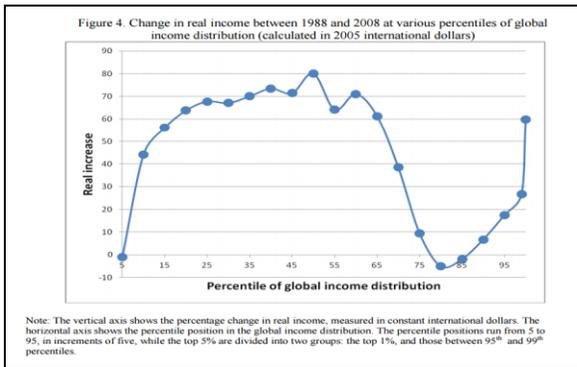
Both left- and right-wing populists were less enamored with the Cold War policies. Deregulation and globalization removed job protections; firms were free to move production out of the U.S. or easily replace workers with automation. The hegemonic wars were seen as burdensome to the populist classes, although this perception isn't necessarily supported by recent data.² However, the combination of globalization and deregulation clearly played a role in wage stagnation and inequality.

² See: <http://freakonomics.com/2008/09/22/who-serves-in-the-military-today/>. The current volunteer military generally selects from the top 60% of income brackets; this is probably because the services have rather high educational requirements (high school or equivalent is a minimum, with the Army also requiring a 2.5 GPA). However, in terms of geographic distribution, the recruit-to-population ratio shows higher numbers for the South (1.19 in 2008) compared to the Northeast (0.73). That geographic skew may account for the perception that the beneficiaries of globalization and deregulation don't bear the burden of the hegemonic wars required for that role. Of course, before the volunteer military, the draft offered a deferment for college students. This meant that most 18-year-olds who were drafted came from less affluent households that either had no history of higher education in their families or were unable to afford going to college. This situation led to the belief that the establishment sends populists to war; thus, the security arrangements during the Cold War gave the benefit to establishment households at the expense of lower income households.



This chart shows U.S. median family income. Note that the trend began to flatten as deregulation began in the late-1970s. This process has continued to the present.

This is not just a U.S. issue.



(Source: Branko Milanovic)

This chart measures real income growth for the world from 1988 to 2008. Income growth exceeded 50% from the 15th percentile to the 70th percentile and for the *first percentile*. Growth was either slower or negative from the 70th to the upper levels of income. This dip in the chart represents the Western middle class, which has borne the brunt of deregulation and globalization. In fact, the chart suggests that offshoring has probably been a key reason why the lower income percentiles have seen stronger income growth.

A Critical Point

What do nationalist policies entail? As discussed in Parts I and II, nationalism is the policy of supporting a nation state. In the early 20th century, nationalism was tied to self-determination, arguing that like peoples had the right to form governments and break away from kingdoms and empires. And so, nationalist policies, it would seem, favor an individual nation perhaps at the expense of other nations. A strong case can be made that nationalism led to anti-trade policies and the lack of cooperation among countries, which contributed to the interwar breakdown and WWII. Thus, moving toward nationalist policies may create dangerous conditions that lead to war and/or economic depression.

This picture sums up the sentiment.



Vice President Al Gore shows a picture of Hawley and Smoot during the NAFTA Debate with Ross Perot on CNN's *Larry King Live* in 1993. Source: Photo courtesy of CNN © 1993.

(Source: CNN)

During Al Gore's televised debate on the Larry King show on November 9, 1993, VP Gore debated Ross Perot about the benefits of NAFTA. Polls showed that Gore was the winner, as was NAFTA; support for the free trade deal with Mexico and Canada surged from 34% to 57% after the debate.³ Gore was able to make the case that trade

³<http://www.mrmediatraining.com/2013/11/08/20-years-ago-the-al-gore-ross-perot-nafta-debate/>

protection equated with the Great Depression and war by holding up a picture of Senator Smoot and Representative Hawley. Most economists and historians believe the Smoot-Hawley Tariff was a contributing factor to the Great Depression.

Although the U.S. political establishment of both parties has adopted the narrative that nationalism, with its characteristics of isolationism and trade protection, leads to war and economic ruin, an alternative explanation for the Great Depression and WWII is possible. Charles Kindleberger⁴ argued that the Great Depression was due more to the lack of a functioning hegemon. The British, suffering from the aftermath of WWI and an exhausted economy, were no longer capable of supplying the global public goods⁵ that the superpower provides. The U.S., the only other nation with the resources to fill that role, refused to accept the mantle of responsibility.⁶ The resulting loss of global public goods led to a collapse in the global economy, leading to the Great Depression and WWII.

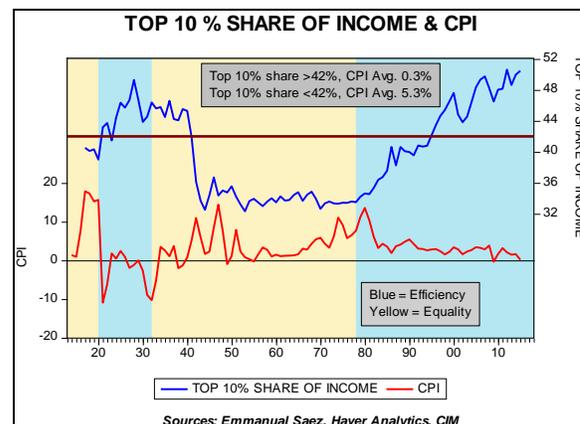
The Key Question

The key question is this: can the U.S. remain the global hegemon while running policies that will reverse the inequality of the past four decades? The U.S. was able to provide these goods from 1945 to 1978 without high levels of inequality. The problem was that inflation rose to unsustainable levels.

⁴ Kindleberger, C. (1986). *The World in Depression, 1929-1939* (2nd ed.). Los Angeles, CA: University of California Press.

⁵ Security of the sea lanes and a reserve currency are the two most important.

⁶ See WGRs: [The New World Order, Parts I-IV](#), 3/16/15, 3/23/15, 3/30/15 and 4/6/15.



This chart shows the relationship between inflation and the top 10% share of incomes in the U.S. In general, the higher the level of inequality, the lower the inflation level. However, it is obvious that there are rather long lags.

During 1945-78, the Roosevelt coalition of the center-left and right-wing populists created an economy (primarily for white males) designed to create a large number of high-paying, moderately skilled jobs. That economy was characterized by high levels of unionization, low trade penetration and high marginal tax rates. Economic disruption was designed to be low.⁷ Although foreign trade was relatively open, the U.S. economy was large compared to the rest of the world and the employment impact from imports was rather low. In addition, most nations had capital controls, meaning foreign investing was less free and thus offshoring was less prevalent.

That model would be difficult to replicate today. However, parts of it could return if other income supports were created. If regulations don't guarantee jobs as they essentially did during the aforementioned

⁷ For an interesting synopsis of this era's economy and policy, see: Galbraith, J.K. (1967). *The New Industrial State*. Boston, MA: Houghton Mifflin Company.

period, then an expansion of the earned income tax credit to lower inequality could boost economic growth. At the same time, reregulation of the economy could lead to job protection and reduce worker anxiety.

Given the increase in world trade and the steady demand for dollars (which are mostly acquired by the U.S. running a trade deficit), trade would remain an issue. Although the current narrative of the political establishment may not be completely accurate, an isolationist America will almost certainly lead to a reduction in the hegemon's global public goods and may trigger significant economic dislocation.

Nationalism isn't necessarily a bad sentiment. It became somewhat pejorative after WWII because it became associated with isolationism. However, a world in which the elites within nations have more in common with similar persons in other nations compared to their own countrymen is probably not sustainable. The political leadership in the U.S. and Europe need to realize that economic policies that support growth at home, which may lead to less trade and higher inflation, may not necessarily return the world to the 1930s. On the other hand, if the U.S. abandons its superpower role completely, it could mimic what we saw in the 1930s.

Framing Populism

In our discussion of Rousseau from Part I, there is almost a mystical attraction to the idea of the general will. It seems to know all, see all, given legitimacy to all. In Rousseau's writing, it wasn't clear how a government could gain legitimacy under conditions of the general will. And so, there is an underlying danger that a leader will argue he "represents the will of the people" in order to gain legitimacy. Although a populist leader may begin with the idea that

he will try to reflect the will of the people, power changes leaders and there is always a temptation to demagoguery.⁸

Although populist ideals are persistent, they tend to gain traction during periods of poor economic growth. Lower income groups become frustrated with their conditions and begin to look for an improvement in their situation.

At the same time, this frustration can lead to more radical solutions. We would argue that these radical solutions tend to be Hobbesian in nature. Communism and fascism are the two most common. R.H. Tawney, the British historian and socialist, called Karl Marx "the last of the schoolmen,"⁹ indicating that he had not really created a synthesis of capitalism and what preceded it but, instead, was attempting a return to a pre-capitalist and pre-Enlightenment era. The fascists are a right-wing authoritarian variant of government, calling for a similar pre-capitalist, pre-Enlightenment period. In practice, both end up suppressing individual rights in favor of supporting the whole, a sentiment that Rousseau would have favored. However, Rousseau would probably not have supported the practice of communism or fascism. Unfortunately, claiming to represent the general will without definition runs the risk of devolving into totalitarian and authoritarian solutions.

Ramifications

Franklin Roosevelt is generally credited with saving the U.S. from falling into the trap of fascism or communism by adopting enough populist policies to bring unity back to the political sphere. Although there are

⁸ This quote was attributed to Lord Acton: "Power tends to corrupt, and absolute power corrupts absolutely. Great men are almost always bad men."

⁹ The "schoolmen" refers to the scholastic theologians associated with St. Thomas Aquinas.

no guarantees, we do expect a similar outcome to emerge in the coming years. The current slow growth, low inflation, high inequality economy is probably not sustainable.

The West is seeing a steady rise in populism. There is the risk that it devolves into a communist or fascist environment. However, that outcome isn't predestined.

There are two likely market outcomes from current trends. First, inflation will likely

rise as global economic integration retreats. Second, international investing will change dramatically; the world of international investing since 1944 has relied on the U.S. providing global public goods of security and the reserve currency. If the supply of those goods declines, international investing will likely become a tactical practice rather than a strategic allocation.

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