Weekly Geopolitical Report
By Bill O'Grady

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The New World Order: Part III

In this third installment of our four-part series on The New World Order, we will examine how policymakers coped with the new superpower role. First, we will examine how policymakers attempted to resolve the tensions created between the desires of its domestic constituencies and foreign superpower obligations. There are going to be periods when the requirements of the hegemon role adversely affect segments of society within the superpower. The political class must navigate these divergences in such a way so as to keep domestic tranquility and fulfill its foreign obligations. We will offer a history of how the U.S. managed these differences, with an analysis of Roosevelt's political configuration and how the Reagan Revolution adjusted to the failures of the first program. Second, we will detail these periods with charts. Third, we will explain the capability and willingness of the U.S. to continue providing the global public goods to the world.

The Political Coalitions

As noted above, the superpower role requires political leaders to juggle the duties of providing global public goods and, at the same time, manage the changes and distortions that providing these goods causes to the domestic economy and the political system. The superpower has to run the global and domestic economies and bear an unusually large burden both diplomatically and militarily. To make this work, the political class has to create narratives to "sell" the program to domestic interests and, at the same time, create policies to meet both the external and internal goals.

From the end of WWII until 1980, the main coalition was the Managerial/Rentier class and the Right-Wing Populists.[1] The Entrepreneurial Class and the Left-Wing Populists were mostly marginalized. Starting with "The New Deal," the government created a middle class social safety net designed to help society recover from the Great Depression and WWII. This was the Roosevelt Coalition.

This political coalition created conditions that opened up a "wide road" to the middle class, which was mostly populated with Caucasian men and their families. In effect, a household could achieve financial stability with a modest degree of education by acquiring low-skilled, high-paying jobs, mostly in manufacturing. The combination of high marginal tax rates, which discouraged entrepreneurship, and onerous regulations created concentrated industries that allowed for the creation of large and powerful unions. During this period, the U.S. had one telephone company and three primary automakers. Technology was "dribbled" into the economy to avoid disrupting the job market. Much of the potentially disruptive technology was "bottled up" in the big research laboratories or in the expanding defense industries.[2]

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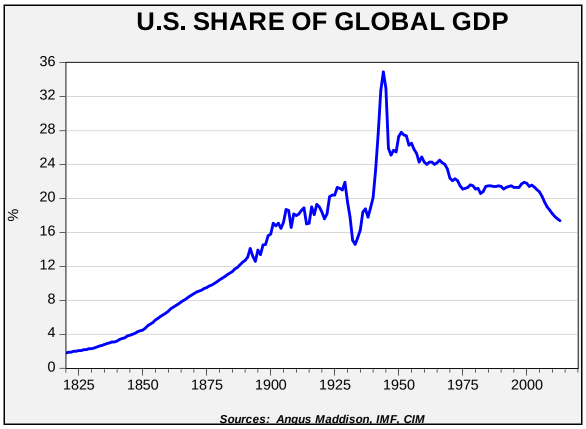
[1] See WGRs: 2016, Part 1 (3/31/2014), Part 2 (4/14/2014), Part 3 (4/21/2014).

[2] For an in-depth analysis of this period, see: Galbraith, J.K. (1967). *The New Industrial State*. Boston, MA: Houghton Mifflin.

The expanding middle class not only maintained domestic tranquility from 1945 into the mid-1960s, it also met two key hegemon goals. The steady expansion of U.S. consumption allowed the U.S. to meet the importer of last resort role, which is necessary to provide the global reserve currency. Foreign nations need to run trade surpluses with the reserve currency provider and that nation needs to buy the imports the rest of the world wants to sell. Because the U.S. economy dwarfed the rest of the world, the American consumer was able to provide the reserve currency without triggering an unsustainable trade deficit.



This chart shows the relative size of U.S. GDP compared to the rest of the world. Until the mid-1970s, the U.S. accounted for 24% or more of global GDP. In addition, the expanding labor force also provided workers for the growing defense industry.

In the late 1960s, two factors emerged that undermined this arrangement. First, beginning in the mid-1960s, inflation began to rise persistently. The inefficiencies caused by stifling entrepreneurship, excessive regulation and industry concentration created an environment for inflation to develop. Mostly stimulative fiscal and monetary policies also lifted price levels. Reducing inflation became a major concern. Second, the Left-Wing Populists, who were paid "lip service" in the Roosevelt Coalition but given little economic or political power, began to aggressively press for inclusion into the existing coalition. Redistribution, gender equalization and affirmative action policies were implemented under Johnson's Great Society program. Unlike Veteran's Benefits, various tax expenditures[3] and Social Security, which were designed for the middle class, these new programs mostly helped the poor. These shifts were not well received by the Right-Wing Populists, putting the coalition in flux during the 1960s into the 1970s.

In addition to these domestic concerns, by the 1970s, support for the Cold War was waning. Opposition to the Vietnam War led to deep societal divides that were joint to the struggles of women and minorities among the Left-Wing Populist class. The madness of the nuclear arms race,[4] the inconclusive Vietnam War and persistent inflation undermined confidence in America and called into question its ability to lead the West against the Communist threat. Nixon's decision to close the gold window in 1971 in response to excessive trade deficits with Europe and the drain of gold from the U.S. further weakened America's status. By the end of the decade, which saw the Iranian Revolution and the hostage crisis along with a second oil crisis, there was growing concern that the U.S. was not up to the task of integrating the hegemon role and sustainable economic growth.

Ronald Reagan was elected into this situation in 1980. Reagan, following in the policy footsteps of British PM Margaret

[3] E.g., the mortgage interest deduction.
[4] Reflected in the policy term "mutually assured destruction," or MAD, the policy that nuclear weapons would not be deployed if all parties believe their use would result in mutual destruction.

Thatcher, deregulated key industries, lowered marginal tax rates, expanded globalization and deregulated the economy. The lower marginal tax rates and deregulation dramatically expanded the productive capacity of the economy. Globalization encouraged firms to move production offshore to reduce costs. These policies, coupled with tight monetary policy, led to a steady drop in inflation.

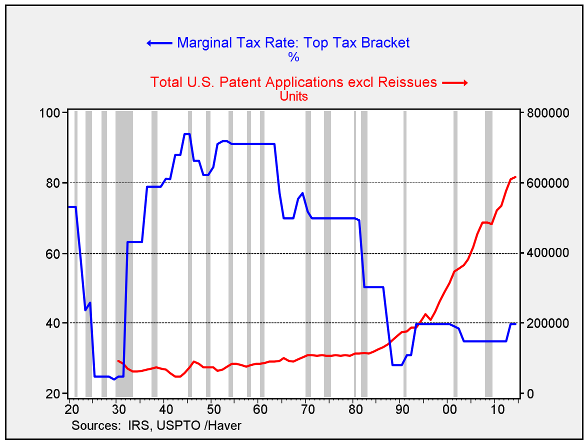
The Reagan Coalition was created by jettisoning the Right-Wing Populists and including the Entrepreneurial Class with the Managerial/Rentier Class. Since this coalition, by itself, couldn't create a majority, center-left and center-right leaders within the ruling coalition tried to attract populists to their cause. In the popular press, this is known as "attracting the base." The Reagan Coalition had no interest in creating economic policies that benefited the populist classes, which would entail reregulation and deglobalization. Instead, the ruling class tried to garner support by recommending various social policies. In practice, few of these social policies ever become law.

The current ruling coalition has greatly benefited from the current economic policy mix and is loath to change it. Unfortunately, this policy mix has not favored the populist classes at all. Since the superpower role requires that the nation be the consumer of last resort, consumption levels need to remain high in order to supply the reserve currency to world markets. The Reagan Coalition's solution to inflation led to weak income growth and rising income inequality, meaning that the hegemon's consumption requirements could no longer be satisfied by income alone. In response, financial markets were deregulated and household debt rose sharply. The Great Financial Crisis in 2008 suggests that debt-fueled consumption growth probably isn't feasible, meaning that the importer of last resort role is in jeopardy.

The Charts

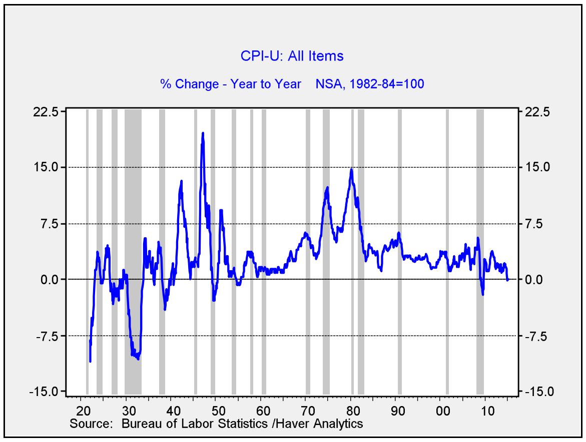
To better understand the transition from Roosevelt to Reagan, we offer the following charts.

Chart 1: Tax Rates and Entrepreneurship



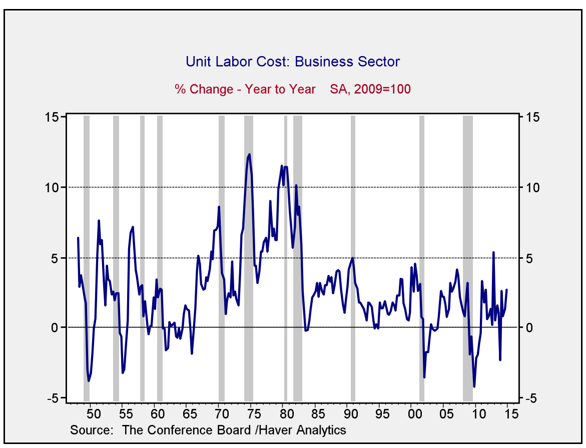
This chart shows the highest marginal tax rate along with patent applications. Although the latter isn't necessarily a perfect indicator of entrepreneurial activity, the act of applying for a patent only makes sense if the applicant believes he will be compensated for his efforts. Note that applications rose significantly after Reagan cut the highest marginal tax rate sharply.

Chart 2: Inflation



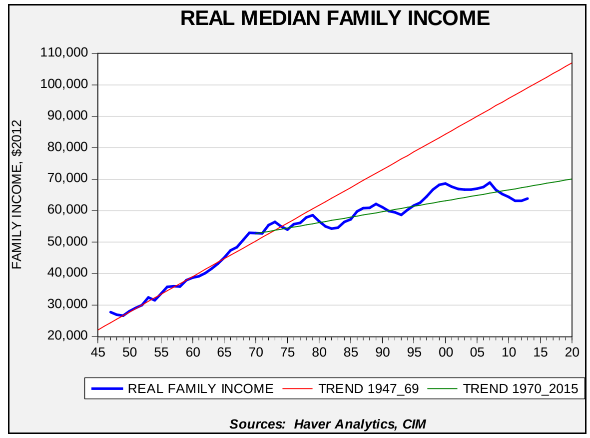
After the post-war flurry of inflation which was mostly due to the lifting of price controls, inflation remained well controlled until the mid-1960s. It began rising with each business cycle until the Reagan Revolution broke the cycle.

Chart 3: Productivity Changes



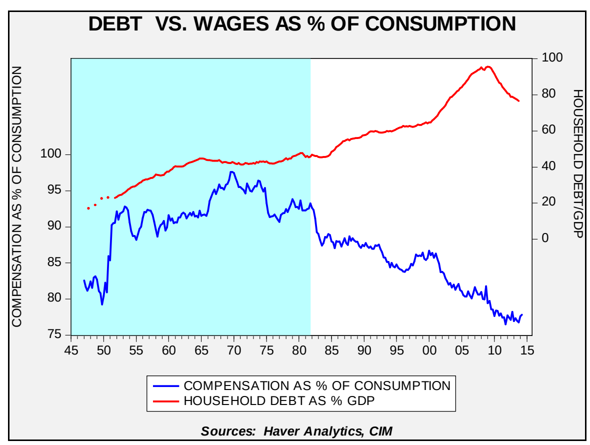
Unit labor costs are labor costs adjusted for productivity. When these costs are rising, it means that rising labor costs are not being offset by improving productivity. Note that in the 1965-1980 period, these costs persistently rose; after deregulation and globalization, they have remained under control.

Chart 4: Median Income Trends



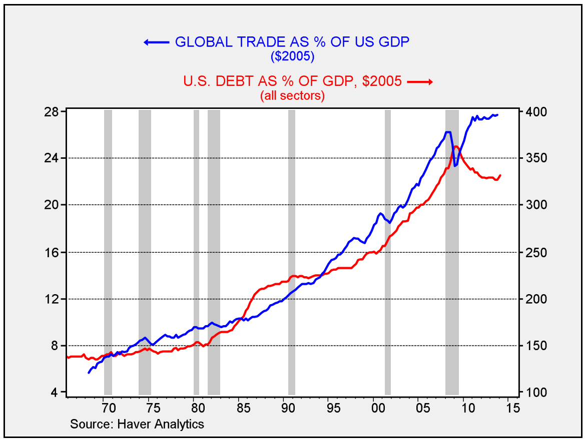
This chart shows real median family income. During the Roosevelt Coalition period, median income growth rose at a strong pace; had that pace been maintained, median inflation-adjusted family income would be approaching $100k. Instead, the Reagan Coalition's policies led to growth rates that slowed income growth dramatically, leaving the median household with less income, putting the "global consumer of last resort function" at risk.

Chart 5: Debt and Income Trends



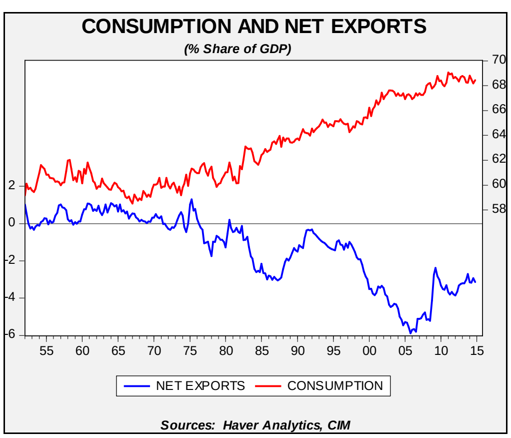
The lower line on the chart shows how much of consumption is being funded by wages. The shaded period shows the era of the Roosevelt Coalition; for most of that period, 90% to 95% of consumption was funded by wages. The Reagan Coalition led to policies that meant wages funded less consumption and the spending gap was closed by debt, shown on the upper line.

Chart 6: Debt and the Superpower Role



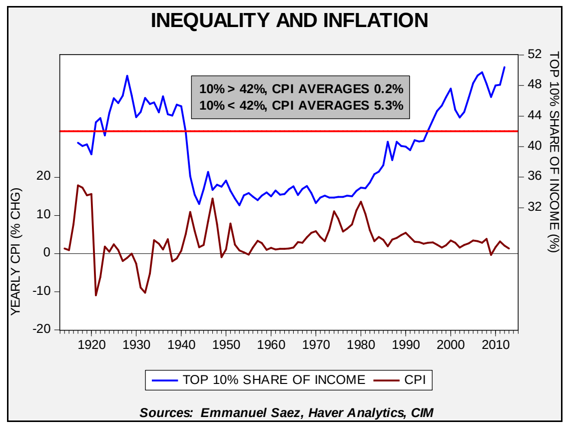
As global trade as a percent of U.S. GDP has increased, U.S. debt as a percent of GDP has also increased. Essentially, to provide the reserve currency to markets, the U.S. has been forced to accept higher levels of debt. Note that in the wake of deleveraging after the 2008 Great Financial Crisis, the growth rate in global trade has flattened, showing how dependent the world is on U.S. consumption and debt growth.

Chart 7: Consumption and Net Exports



As the U.S. share of global GDP began to fall, in part due to the success of America's policies toward supporting the global economy, the U.S. economy became overly dependent on consumption and began to run persistently large trade deficits. The main reason for this situation is the superpower role; the world needs high levels of U.S. consumption to acquire dollars, which also requires a large U.S. trade deficit.

Chart 8: Inequality and Inflation



The upper line shows the top 10% of households' share in income and the lower line shows yearly CPI. In general, periods of higher inequality, measured by a top 10% greater than 42%, tend to have lower inflation. It isn't that inequality leads to lower inflation; it's that the policies that make the economy more efficient lead to inequality. And, efficiency leads to lower inflation.

Is the Current Situation Sustainable?

Essentially, there are two conditions that must be met for the U.S. to sustain its superpower status. First, does the U.S. have the capability, and second, the willingness, to maintain the role? We believe the U.S. still has the capability to maintain the role. However, to maintain the role, the problem of debt and income must be addressed. The U.S. has used two different methods to generate the consumption necessary to supply the reserve currency and fulfill the importer of last resort roles. The first method was to create high-paying, low-skilled jobs in a highly regulated, high-tax environment. The second method was to allow for debt accumulation.

It's probably not possible to return to the Roosevelt Coalition because the superpower needs to be part of a globalized world. This coalition worked in the earlier period because America's economy dwarfed the rest of the world due to the devastation caused by WWII. Thus, in order to generate sustainable income levels for the populists that would fulfill the consumption requirements of hegemony will probably require guaranteed national income redistribution schemes and/or massive debt write-offs.

The second question is more interesting. Does the U.S. still want the job? Most Americans were willing to tolerate the expansion of government, the distorted economy and the persistent war footing to defeat communism. However, that threat ended with the Cold War and so Americans are less committed to the costs of hegemony.

In many ways, the political rhetoric points to a desire to end hegemony. The call for smaller government is a case in point; you can't be a small government superpower. Your military and financial responsibilities are too great. You can't protect civil liberties as a superpower; the costs of not knowing what your enemies are doing are too high.

Policymakers seem to want to improve the lot of the middle class; this would either require a retreat from globalization and deregulation or massive redistribution of income. There is strong sentiment in the U.S. to avoid hegemon wars; as Afghanistan, Iraq, Korea and Vietnam have proven, most of the time these wars have unsatisfying conclusions and usually require perpetual support. The U.S. managed the Cold War well. The U.S. outlasted the Soviet Union and created a prosperous free world to defeat communism. However, in the aftermath of the Cold War, many Americans want to return to a pre-superpower America. At the same time, it doesn't appear that the rest of the world is ready for an American retreat from the global stage.

The Next Step

And so, the U.S. is ripe for another phase of the superpower role. In Part IV, we will offer what we believe is the emerging new world order. The U.S. probably can't end its superpower role, but it must restructure that role in such a fashion to make it both economically sustainable and politically feasible. That will be the topic of next week's report.

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