

April 11, 2016

## **Intergenerational Forgetfulness**

As the political nominating season in the U.S. wears on, presidential candidates have been making statements about foreign policy that would signal a significant change in direction. What has been striking about these comments is a seeming ignorance about why current policies are in place and what could occur if these policies are radically changed.

We believe these calls for change are the result of “intergenerational forgetfulness.” When policymakers implement an initial policy regime, they tell their successors why such policies were deployed and guide their “children” to stay on course. The next generation becomes less aware of the benefits of that policy but is acutely cognizant of the costs. Eventually, younger policymakers reverse the policy, only to discover later why the original policy was made in the first place.

A complementary concept that goes along with intergenerational forgetfulness is policy dilemma. Virtually all policies are dilemmas. In logic, a dilemma contains two choices, neither of which is ideal. In other words, both policy choices carry significant costs and whichever one is chosen will create costs for some part of the electorate.

Unfortunately, all policies are “sold” to the public on the positive merits alone. As the costs of the policy become increasingly obvious, the political support for such policies erodes over time. At some point, the costs of the current policy will lead to a

new (and in many cases, opposite) policy direction and the cycle repeats itself.

In this report, we will examine the foreign policy predicament leaders faced at the end of WWII, their solution to these issues and the increasing disenchantment with current policy as an example of intergenerational forgetfulness. As always, we will conclude with market ramifications.

### **America, the Hegemon**

As WWII was coming to an end, the Roosevelt (soon to be Truman) government surveyed the geopolitical landscape. The most obvious problem was that an alternative economic and political system, communism, threatened to replace democratic capitalism. The communist threat had to be dealt with. In addition, there were three major unresolved conflict areas that had to be managed.

***Europe and the German Problem:*** Europe had been the site of two world wars. The reason these wars were fought is that Europe could not cope with the rise of Germany. The German Problem is based on the geographic fact that the country lies in the middle of the European continent. This position fosters economic strength as being at the crossroads of Europe fosters trade. At the same time, Germany has no natural defenses, making it vulnerable to invaders from the east and west. The leaders of Europe were never able to create a stable geopolitical structure that made Germany and its neighbors feel safe, and it became an ever-larger threat as the German economy grew. The Europeans failed to resolve the German problem; this inability led to two world wars.

***An unstable Middle East:*** The Middle East was mostly a collection of proto-states created by European colonists. The nations they created were designed for colonial control. Usually, minority groups were put in power and thus were reliant on the colonial power to remain in government. As the British and French withdrew from the Middle East and North Africa after WWII, the leaders they left in place became autocratic in order to remain dominant. This meant that there were constant threats from the majority within the nation to oust these leaders. Tensions were exacerbated by the discovery of massive oil deposits which gave these autocratic leaders the economic power to meet their fiscal budgets without taxes, thus depriving the majority a voice in government. The region became a powder keg with the potential to become very unstable.

***An unresolved conflict in the Far East:*** Japan industrialized sooner than the rest of the nations in the region and began to steadily project power. By the early 1930s, Japan had invaded parts of China and, after bombing Pearl Harbor, moved quickly to secure natural resources in other parts of Asia. American troops eventually rolled back Japanese expansionism during WWII. After the war, the potential for retribution against Japan was high as was the potential for Japan to recover and rearm. This would have set off a struggle for dominance in the Far East.

### **The Resolution**

Consequently, at the end of WWII, the U.S. faced four geopolitical problems—the communist threat, the German Problem, an unstable Middle East and an unstable Far East. The Roosevelt/Truman government and subsequent administrations resolved these problems with the following policies.

***Containing communism:*** Following George Kennan’s famous “long telegram” to the Truman State Department in 1946,<sup>1</sup> U.S. policy toward the communist bloc was to prevent it from expanding. Containment consisted of military and economic elements. Militarily, the U.S. built a series of bases and treaty organizations designed to prevent the communist bloc from expanding. Economically, the U.S., at Bretton Woods, became the provider of the global reserve currency which required the U.S. to become the global importer of last resort. This plan would foster the economic recovery of nations aligned with the U.S. However, the cost of that policy has been that, over time, the U.S. has run persistent trade deficits. Essentially, U.S. consumption supported economic development in the free world by allowing allied nations to use export promotion. This policy also exposed the U.S. economy to relentless foreign competition. The security requirements of containing communism fostered a standing military (President Eisenhower warned of a developing “military/industrial complex”) and a large intelligence apparatus which led to domestic spying. It also required government policies to support consumption, leading to persistent transfer payments and other government spending. The small government of pre-WWII America was incompatible with global hegemony and was another associated cost of the Cold War.

***Demilitarizing Europe:*** To address the German Problem, the U.S. underwrote European security. Although most of the major European nations became members of NATO, in reality, the U.S. did not want Europe to rearm itself outside of U.S. control. To maintain control, the U.S.

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<sup>1</sup>[https://www.trumanlibrary.org/whistlestop/study\\_collections/coldwar/documents/pdf/6-6.pdf](https://www.trumanlibrary.org/whistlestop/study_collections/coldwar/documents/pdf/6-6.pdf)

needed to fund most of the defense costs. Thus, American policymakers created a situation where European states were likely to “free ride” U.S. security measures. Demilitarizing Europe ensured that another world war would not emerge from the German Problem.

***Demilitarizing Japan:*** To prevent Japan’s economic recovery from evolving into a resurgent military, the U.S. followed a similar playbook from Europe. Gen. MacArthur implemented a pacifist constitution in Japan that has, for the most part, remained in place through the present. By taking over Japan’s security, the U.S. has protected Japan and assured its neighbors that they would not need to fear Japanese aggression in the future. The U.S. also ensured that another world war would not emerge from the Far East.

***Containing the Middle East:*** To maintain stability and prevent the Soviets from gaining the prize of Middle East oil, the U.S. supported autocratic regimes in the region. Most of these regimes conducted domestic policy in ways far from American ideals. However, securing the oil and keeping the region stable were considered more important goals than spreading democracy and redrawing borders.

### **Intergenerational Forgetfulness**

Global hegemony is not a natural desire for Americans. The U.S. is protected by two oceans and has pacified its immediate neighbors. Isolationism is the default position of the United States because it is possible. Other nations facing hostile borders don’t necessarily have that luxury. Nevertheless, to prevent WWII, the U.S. abandoned its natural position after WWII and became heavily involved in global affairs. Most Americans understood that the communist threat required the U.S. to make

significant sacrifices that were contrary to American ideals. However, the other three imperatives have steadily been forgotten.

Democratizing the Middle East is a noble goal. However, unless the U.S. is willing to undertake a long occupation similar to what it did in Japan and Europe, undermining the autocracies of the region are bound to devolve into the creation of more “natural” nation-states based on common ethnic, racial and sectarian affiliations. That almost certainly means the straight lines drawn by Sir Mark Sykes and François Georges-Picot during WWI would be changed. The process of changing them, as displayed by the conflict over IS, would not be smooth. Thus, the plans to oust Saddam Hussein and instill democracy in the region were fraught with risk. The refugee crisis in Europe is also a result of this change in policy.

Recent comments from some of the presidential candidates about ending our involvement in NATO or allowing Japan to have its own nuclear deterrent open up the possibility that these frozen conflicts in Europe and the Far East will “thaw” and create the potential for major wars.

### ***Winning the Cold War and preventing WWII are not necessarily the same goal.***

The latter requires American involvement to prevent these unresolved conflicts from being resolved via open conflict. Yes, free riding occurs; both President Obama and Donald Trump have complained about this situation. However, it should be noted that if we force Japan and Europe to shoulder more of their defense, they may decide to use their militaries in ways we don’t approve that may become destabilizing. The unresolved conflicts in Europe and Asia remain; the U.S. has successfully “frozen” them to prevent them from reoccurring.

The same is true for trade barriers. There is no doubt that U.S. workers face persistent competition, much of it unfair. However, retreating from the reserve currency role will create a chaotic global financial system that will undermine the global economy and disrupt the path of development for the emerging economies of the world. This instability would likely lead to broader displacement of peoples.

The complaints from politicians, presidents and the public are not unfounded. The issue is that there is a tendency to “forget” why the current policies were implemented in the first place and that changing these postwar policies will carry their own costs. If that outcome is what the country decides and it is willing to bear these costs, then, in a democracy, that is the will of the people and it should be followed. However, there is a possibility that the complaints being aired are more about the fatigue of bearing the burden of global hegemony instead of awareness that reducing America’s role in the world will make it a more dangerous place. Unfortunately, under conditions of intergenerational forgetfulness, the unappreciated benefits of a long-standing policy tend to be discounted, but the costs of changing policy will become evident in short order. In this case, a retreat from hegemony will tend to lead to a

regionalized, more dangerous world where previously frozen conflicts thaw and become geopolitical problems.

### **Ramifications**

The retreat from the world is bullish for U.S. financial assets as we become the target of global capital flight. Commodity prices will likely also rise as companies and nations scramble to secure critical supplies that can no longer be easily acquired. Foreign investing will become problematic as the U.S. will no longer be providing global public goods, such as the reserve currency and secure sea lanes which are necessary for the development model of import promotion. In addition, nations that have been free riding the American security apparatus will no longer be able to rely on that security, forcing them to spend more on defense.

There are winners and losers in policy dilemmas. The key for investors is to determine the direction of policy and favor those areas that will benefit. These trends are what we will be focusing on as the political process works out the direction of policy going forward.

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