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(Up)Turn Ahead?



After some skidding and scraping along the bottom, stocks should find traction by year end.

It doesn't feel that way now, but we are paving the way for an upturn in the stock market. The ongoing deleveraging process and oil price surge have been more severe and more protracted than markets were expecting, but the odds are that we are nearing a bottom.

We're looking toward year end, when further financial and household balance sheet repair, an easing in energy prices, a rollover of headline inflation in the U.S. and a turn in domestic nonfinancial corporate profit growth should all lead to a recovery for U.S. equities.

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Tim McGee, Director of Macro Strategy and Research, U.S. Trust

Soft Power Drives Globalization

It's ironic that the globalization of the world economy is feeding national aspirations and creating increased tensions between countries. Trade and investment across geographic and cultural boundaries and the personal interaction that comes with it help break down the fear of strangers that lies behind a lot of negative forces in international relations. The increased acceptance of foreigners, the ability to see them as like us, is a hallmark of globalization.

Nevertheless, as Fareed Zakaria notes in his book, *The Post-American World*, reviewed on page 8 of this issue, the improved living standards that globalization makes possible for the world's poorest people also allow them to shift their attention from searching for their "daily bread" to thinking more about their country or ethnic group and their role in the world, including the respect that people everywhere expect for that with which they identify.



This desire for global respect and the tension that it can generate is an especially volatile force when economic good times turn bad, causing a heightened interest in scapegoats and a lessened concern for outsiders as a natural instinct to protect one's own takes over more intensely in hard times. At the national political level, this makes the likelihood of anti-foreigner legislation greatest in times of high unemployment. The Great Depression of the 1930s is the ultimate example, where legislative and policy initiatives shut out outsiders to protect insiders. When many countries do this, the result is a depression. The phrase "cutting off the nose to spite the face" comes to mind.

"SOFT POWER" VS. "HARD POWER"

During the Cold War, international economic relations were dominated by the bipolar competition for global hegemony between the Soviet Union and the United States. This dynamic repressed a lot of latent ethnic and nationalist feelings. According to the political scientist/historian Robert Kagan¹, the resolution of the Cold War in favor of the "soft power" strategy of the U.S. and its allies, rather than the repressive "hard power" of the Soviet Union, has restored geopolitics to its more traditional unipolar framework. The bipolar model of the Cold War represented an unusual situation compared to history.

When the Iron Curtain came down, there was a naïve hope that the long history of global rivalries had ended and a benign era of peaceful coexistence had begun.² In this view, the world would naturally come to respect the West's ideas of human rights and governments that served the people rather than the other way around.

Over the past two decades, this dream has run up against a

harsher reality. National, tribal and ethnic tensions were bottled up during the Cold War, often forcefully in the Soviet sphere of influence but also on the Free World side, where the larger cooperative effort dominated international relations. In the developing world, progress was hampered by a tendency to straddle both sides of the Iron Curtain in return for aid, playing one side off against the other.

"SOFT POWER" AND GLOBALIZATION

The reemergence of a unipolar world dominated by the U.S. has unleashed many of the national, tribal and ethnic rivalries that were suppressed during the Cold War, creating a whole new dynamic in international relations that is running parallel with the forces for economic progress that broadening free markets have unleashed. The U.S. is too benignly conflicted in its own political will and, in any event, hardly powerful enough to rule the world with the iron fist that more traditional hegemony used in the past.

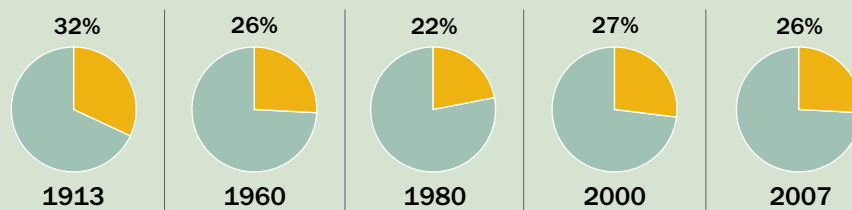
Progress in human affairs is reflected in the movement toward a "hegemony"

that wins the hearts and minds of people rather than forcefully suppressing them. That's what makes the "age of enlightenment" enlightened. In this respect, the last global hegemon, the British Empire, helped pave the way. The U.S. approach to international relations in the past half century is deeply rooted in the same, long intellectual tradition. It is not a coincidence that the U.K. and its former colonies like Canada, Australia and New Zealand share the respect for individual freedom and ethnic diversity that also characterize the U.S.

The essence of U.S. "soft power" is manifest in the dynamic of globalization. Looking around the world today, one cannot help but be struck by the increased influence of western economic and cultural trends. This is well documented in recent books on globalization like *The World is Flat* and *The Post-American World*. It is not the result of coercive imposition. It is a voluntary embrace, the preference expressed by individuals around the world. That's what distinguishes "soft power" from "hard power." The rest of the

Percentage of US share of Global GDP³

The U.S. economy has been the world's largest since the middle of the 1880s, and it remains so today. In fact, America has held a surprisingly constant share of global GDP ever since. With the brief exception of the late 1940s and 1950s — when the rest of the industrialized world had been destroyed and America's share rose to 50% — the United States has accounted for roughly a quarter of world output for over a century.* It is likely to slip but not significantly in the next two decades. In 2025, most estimates suggest that the U.S. economy will still be twice the size of China's in terms of nominal GDP (though in terms of purchasing power, the gap will be smaller).⁴



*These numbers are based on market exchange rates, not adjusted for living standards. The numbers in PPP dollars would be 19% in 1913, 27% in 1950, 22% in 1973, 22% in 1998 and 19% in 2007. The PPP numbers also show the same pattern, of American power being relatively stable at around 20% of global GDP.



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world is becoming more like us as we become more like them. This embrace of the American (and more broadly, the British) legacy to the world is not, as some maintain, the result of cultural imperialism or a prideful American exceptionalism. The reality is much simpler than the wrong-headed notion that somehow Americans figured out what's best for the world.

THE POWER OF ASSIMILATION

The answer lies in the stew that is constantly being stirred in the American melting pot. There does not exist anywhere else on the planet on the scale that exists in the U.S. such a diverse population, representing all the world's people living in relative harmony. The U.S. has an unrivaled proportion of foreign-born residents (about 12%), four times more than the global average. Of those born in the U.S., most can trace their ancestry back in the past 100 or 150 years to another country. This makes the U.S. the largest microcosm of what the world would look like if all of its people lived together in relatively peaceful freedom. The success of the U.S. melting pot is its ability to assimilate. One need only contrast the Muslim populations in Europe and the U.S. to see this assimilating power.

In a free society with significant cultural contributions from most of the world's traditions, the stew that results is spiced with what the broader population chooses to embrace. This creates tension and animosities, even nostalgia, for the less diversified culture of the past, but ultimately these tensions are resolved in a relatively peaceful way. This shows that it is possible for the world's different peoples to live cooperatively. It also explains the receptivity of the rest of the world to American culture. It is the most globally representative culture.

The ability of the U.S. and certain other countries to live with cultural diversity and rapid change at the same time is the source of global strategic advantage. The leading-edge industries of the global economy are idea based and the U.S. melting pot is peppered with the best and the brightest from all over the world, attracted by the best educational system on the planet and the freedom to pursue their dreams.

governance that falls short of western human rights standards. This latter point creates a natural defensiveness in the Chinese and Russian leadership that causes them to resist the idealism of U.S. hegemony, often by protecting other governments that refuse to respect individual rights. The recent siding of the Chinese and Russian governments against U.N. initiatives to deal with humanitarian disasters in Darfur and Zimbabwe are cases in point.

A GLOBAL DOUBLE STANDARD

The U.S. is expected to behave according to a higher standard of "soft power" etiquette. "Hard power" countries are held to a much lower standard, often because they are feared and human nature tends toward "peace at any price" rather than confrontation. More insidious, global businesses and mass media opinion makers avoid criticism to maintain profitable access to newly opened-up "hard power" countries. In contrast, the U.S. government can be criticized without fear of reprisal. So it is.

Despite this double standard in favor of aspiring "hard power" hegemons, the recent tide of history seems to favor the "soft power" hegemony of the U.S. and its cultural relatives. As Fareed Zakaria puts it: *"At the end of the day, openness is America's greatest strength."* It is a strength that the rest of the world seeks to emulate. It is why the Post-American world will look a lot like America. Where this openness sprouts, investment opportunities will flourish; where it is repressed, caveat emptor. ■

The information in this article is general in nature and designed to offer a perspective on broad economic or market trends. It is not intended to give you suggestions about your specific portfolio. No recommendations to buy or sell securities are made. Consult your relationship manager first to determine if the ideas in this article are relevant to your personal financial circumstances.

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¹End of Dreams, Return of History by Robert Kagan, 2007. ²The End of History by Francis Fukuyama, 1992 was representative of this view and time. ³Reprinted from *The Post-American World* by Fareed Zakaria. © 2008 by Fareed Zakaria. With the permission of the publisher W.W. Norton & Company, Inc. ⁴Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICs: The Path to 2050* (Goldman Sachs, Global Economics Paper no. 99, Oct. 1, 2003). Although this widely cited study is the best source for projections of this kind, it is worth noting that since its publication, the BRICs have been growing at a faster rate than the Goldman economists assumed.

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