

Hard Power of Nations

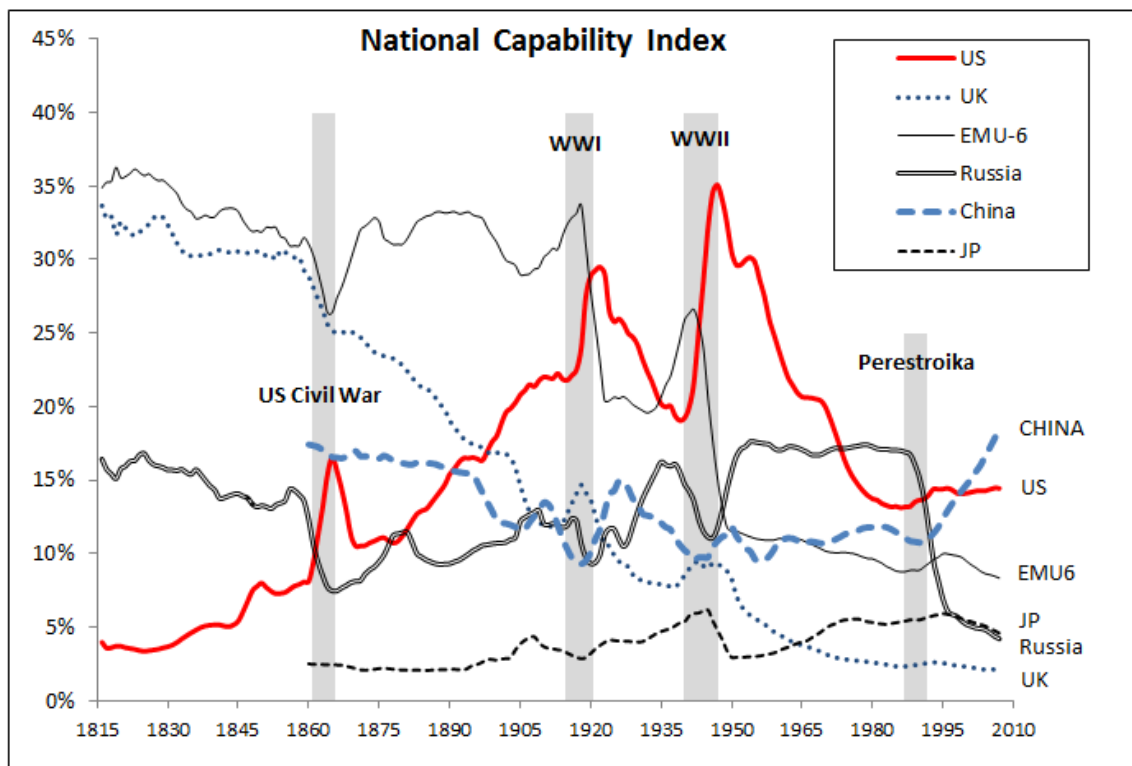
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Bottom line: In thinking about the hegemonic reach of reserve currencies and financial policies of countries, both ‘hard’ and ‘soft powers’ of nations are important. In this note, we present an index measuring hard power of nations from 1815 to now. On this particular measure, the current configuration of countries, ranked by hard power, is at the most even point during this long sample period, i.e., for most of the time in the last 200 years, there were always countries that dominated the world by a much wider margin than the countries with the greatest hard power today: China and the US. Multi-polarity of hard power has implications for geopolitical and economic stability of the world. Further, while China’s hard power, on certain measures, already exceeds that of the US, the former still lacks soft power that is needed to make its currency the dominant reserve currency in the world or its financial policies to be as influential as those of the US. Extending this distinction between the US and China, it could be argued that the lack of soft power has constrained the ability of EM countries to develop their financial markets on par with their real economies. The US is the only country with substantial hard and soft power, and that is an important reason, in our view, to expect the US dollar to remain the hegemonic reserve currency of the world. 2012 is a watershed: in PPP-terms, EM economies, in the aggregate, have become as large as DM economies. However, the EM economies’ financial markets are far from as liquid, deep, or developed as those in DM. This ‘grating of the tectonic plates’ – with the real economies of DM and EM moving past each other but with the EM continuing to rely on DM’s financial markets – will continue to create distortions and volatility in the global financial markets.

A historical view of countries’ hard power. We start with a chart. The index we use for measure a country’s hard power consists of steel and iron production, primary energy consumption, total and per capita military expenditure, total

population and urban population. This index was first introduced as the CoW (Correlates of War) database by Singer et al. in 1972, which we modified and updated.¹



Source: CoW Database and SLJ Macro Partners

Note: National capability index is a brut force power metric which uses the following variables: steel and iron production, primary energy consumption, total and per capita military expenditure, total population and urban population.

These indices add up to 100% at any point in time, i.e., they represent how dominant a country was, in percent of total for the world, at any point in time.

We find this chart extraordinary, and make some immediate observations before presenting out thoughts on how hard power relates to finance and currencies.

- **An even distribution of hard power now.** Eye-balling this chart covering the last two centuries, one sees that, right now, there is an extraordinary balance of hard power around the world, led by re-surgng China, followed by the US, the EMU, Japan, Russia, and the UK, in that order. But the dispersion of power amongst the top nations/entities in the

¹ Singer, J. David, Stuart Bremer, and John Stuckey. 1972. "Capability Distribution, Uncertainty, and Major Power War, 1820-1965." in Bruce Russett, ed. Peace, War and Numbers. Beverly Hills: Sage. We show the 5Y moving averages of these indices in the chart. EMU6 includes Germany, Austria-Hungary, France, Italy, Spain, and the Netherlands.

world is at the lowest point in the last two centuries. In the early 1800s, Western continental Europe and the UK absolutely dominated the world, making up close to 70% of the entire world's 'hard power'. Back then, the US was as un-powerful as the UK is now: with a hard power index of under 5%. Later, during the two world wars in the 1900s, the US and Western Europe absolutely dominated the world. The relatively even distribution of hard power at present has implications for the geopolitical and economic stability of the world. While the argument could go both ways, our best guess is that the lack of a dominant hard power could be bad for stability, due to a lack of leadership.

- **A sharp decline in the hard power of Western Europe and the UK.** The decline in the hard power of the UK is perhaps the most pronounced and unsurprising trend. (In retrospect, the British Empire had an immense hold on the world, considering the relatively small English population at that time.) What is perhaps more surprising is how much and rapidly the hard power of Western Europe declined after the two world wars of the 1900s: since WWI, Western Europe has lost about 80% of its hard power, despite the industrialization and reconstruction of Germany and France post-WWII. A main reason for this trend had to do with de-militarisation in the last half century, but the demographic and aging trends have also been more advanced in Western Europe than elsewhere.
- **The dominance of the US has also declined.** What is also interesting is that this index of hard power suggests that the US' hard power steadily declined between WWII and around 1990. Part of this reflected the relative rise of Russia/USSR between 1950 and 1990 and re-industrialisation of Japan during the same period. Japan, by the way, never registered a high measure on this index at any time in the last two decades, not during WWII or during the bubble years of the 1980s.
- **The rise of China since 1990.** The rise of the relative hard power of China since 1990 is very pronounced, as pronounced as the fall in Russia's hard power after perestroika and glasnost. In the chart, it seems that the rise of China did not come at the expense of the US, but reflected an opposite move to the decline in hard power of the USSR/Russia, Europe, and Japan. The steady 'market share' of the US during this period suggests that the US has not lost hard power, but rather China has gained hard power. It is also interesting to note that, while both Russia

and China embarked on policies of ‘openness’ (glasnost under Mr Mikhail Gorbachev) and liberalization of the socialist economies and politics, the economic and hard power trends in Russia and China have been polarly different. On our measure, China’s hard power is as dominant relative to the rest of the world as the former USSR’s hard power was during the Cold War of the 1980s.

- **Caveats on this measure of hard power.** This measure of hard power is of course imperfect, as the concept of hard power itself is a fuzzy one. However, arguably, hard power is relatively easier to measure than soft power, and because of signs of hard power are more visible and quantifiable than soft power, investors may be more easily impressed by changes in the components of hard power. Further, this measure of hard power says nothing about sustainability. The case of the former-USSR is clear. Moreover, while the components of the index we use reflect traditional measures of a country’s capability of waging and sustaining a traditional war (e.g., production and use of steel and iron), some concepts of soft power can also add to a country’s hard power (e.g., cyber and computing power).
- **Definition of soft power.** By soft power, we have in mind fuzzy concepts like a country’s rule of law – both how things are *de jure* and *de facto*, governance, equality, social justice and stability, economic stability and prosperity, and general happiness of the citizens of a country. Democracy – both its quality and effectiveness – is also important. Almost all of these concepts above are important but more difficult to quantify objectively than hard power.

Both hard and soft power matter for finance. We believe they matter a lot for currencies and other aspects of international finance. We make the following points.

Point 1. The distinctions between economies and capital markets. We have long warned investors not to automatically equate economic strength of a country to the buoyancy or the sophistication of its financial markets. The operative word for ‘EM’ and ‘DM’ is the ‘M’, which stands for ‘markets’, i.e., the terms ‘EM’ and ‘DM’ distinguish economies according to the level of development of their financial *markets*, not the economies. One could argue that hard power is a more important factor determining or reflecting the strength of the real economy of a country, while soft power is at least as important in the

development of the financial markets of the country in question. A good example is China. China has ample hard power that has had evident impact on its economy. Investors in general have been mesmerized by China's economic prowess. However, China does not yet have the soft power that is necessary for its financial markets to develop *commensurately* with its real economy. Since 2001, China's economy has expanded more than 10-fold, yet the A-Shares are lower than they were in 2001. We would extend this argument or critique of how investors may have over-weighted economic growth and under-appreciated the lack of commensurate developments in the capital markets of EM: i.e., EM in general, not just China, still lack the soft power needed for their financial markets to keep up with their real economies.

2012 is a watershed, in that the aggregate GDP of the EM economies, in PPP-adjusted terms, now matches that of DM economies and is on track to surpassing the latter in the coming years. This is a powerful, and gradual, shift in a major tectonic plate in the global economy. However, in terms of market capitalization, DM markets still command the bulk of the world's market share. The grating of the tectonic plates – a real economic tectonic plate on the move, against a relatively static capital market tectonic plate – is the source of many distortions in the financial markets today. For example, if the Chinese RMB were a dominant reserve currency, would AUD or CHF have been so over-valued? If more EM's financial markets were more developed and deeper, would EM central banks still rely so much on the Fed's policies?

In sum, if we were able to come up with an index measuring the soft power of EM, we would more probably find that such a chart would show EM's soft power significantly lagging their hard power. This dichotomy between hard and soft powers of EM is consistent with the different levels of development of their economies and the financial markets. Further, this dichotomy, in our view, is one major distortion in the global financial markets, and a significant source of future volatility.

Point 2. Hard power important for the reserve currency status of currencies. We are strong believers of hard power being a necessary but not a sufficient condition for a reserve currency to be the dominant currency in the world. The hegemonic reserve currency of the world needs to be able to command respect in times of extreme financial or geopolitical fear. The dollar qualifies, but the euro does not. Europe's lack of hard power is both a reason for celebration and a source of pride for many Europeans, but also one key

factor that will prevent the euro from supplanting the dollar as the hegemonic currency of the world. A few years ago, before the Great Recession of 2008, there were many academic papers arguing that the EUR was on a certain path to replacing the dollar as the dominant reserve currency. We consistently challenged this view, citing that Saddam Hussein was captured by the US with USD750,000 in US dollar bills with him, and the safe haven currency in Iran today is the US dollar, not the EUR.

In Point 1, we argued that China lacks soft power. (The same critique also applies to the former USSR.) In Point 2 here, we are arguing that Europe lacks hard power. The US is the only major country that possesses both hard and soft power. Until the balance of hard and soft power changes, we expect the US dollar to remain the supreme reserve currency of the world.

Point 3. Economic sustainability is key. Perhaps one of the most important observations of the chart above is that the US has been the only dominant country that has exhibited staying power, or sustainability. Western Europe, the UK, the former Soviet Union all failed to sustain their hard power, partly because of their inability to economically sustain their hard power in the long run. Debt sustainability, lasting economic prosperity, and other long-term considerations are all obviously important. The financial crisis of 2008 has challenged all the major hard powers of the world: the US, China, the EMU, Japan, and the UK.

(1) These countries must deal with their public debt. The debate on sustained Keynesian stimulus or fiscal austerity is partly related to one's view on what the new potential growth rate is, and whether the society is able and willing to accept a lower standard of living. Artificially propping up economic growth through sustained Keynesian stimulus – like what has been done in Japan in the last two decades – is probably not a viable option for most countries.

(2) China is as challenged by the crisis of 2008 as other countries because its decade-old growth model relying on exports and investment effectively terminated with the crisis of 2008: if the US and Europe cannot rely on financial bubbles, household dissaving, and over-leverage of banks to grow, it will be hard for China to sustain its export-centric growth policy.

(3) The peace dividend from the end of the Cold War has been very positive for the global economy as a whole, but for the workers of the West, this peace dividend has turned from being positive in the 1990s to being negative in the

2000s. The effective doubling of the global labour force was clearly good for the world, but has been challenging for expensive and unproductive workers of the West. Going forward, policy makers and the citizens of countries will need to think hard about the balance of ‘perspiration’ and ‘inspiration’, i.e., how much harder and smarter people must work. Without going into the details of what each country needs to do, we believe the policy choices countries make now will have critical consequences for the *sustainability* of their economic prosperity and hard power.

Point 4. There are serious challenges for policy makers. The muscular real economies in EM and their under-developed financial markets have created a number of policy complications. For one thing, much of EM is still reliant on the Fed’s policies, even though they are often inconsistent with the local economic fundamentals. Further, EM central banks have continued to accumulate foreign reserves, even though they have already reached excessive levels – above and beyond what these countries may need for traditional liquidity purposes. Moreover, Fed policies have considerable spillover effects on the rest of the world, which could in turn boomerang back to affect the US. Finally, DM needs to deal with supply-side shocks (e.g., cheap labour from EM) that compromise their competitiveness.

The grating of the economic-financial tectonic plates will, in turn, pose challenges for investors. Economic policies will remain unpredictable and incoherent, and their impact uncertain.

Bottom line. Both the hard and soft powers of countries matter for investment. It is important for investors to resist placing too much weight on hard power – which is more visible and quantifiable – and too little weight on soft power. We believe soft power is important for the development of financial markets, while hard power better reflects the strength of the real economy. In instances where the soft and hard powers of a country are not balanced, investors need to exercise discretion. Further, to be the hegemonic reserve currency of the world, we believe the country in question must possess both hard and soft power. China still lacks soft power; and the EMU lacks hard power. The US is the only major economy that has both hard and soft power. Finally, hard and soft power would not be meaningful if economic sustainability is in doubt. We believe the policy choices to be made in most major economies in the coming year will be consequential for their long-term economic sustainability.

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