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April 8, 2019

## When Hegemons Fade

In our Daily Comment report, a section on Brexit has become something of a regular feature. As part of keeping up with developments, we have commented on nearly every twist and turn (or lack thereof) in the Brexit process. In a recent WGR series, we discussed the Irish problem<sup>1</sup> and how it relates to Brexit.

As we watch Brexit unfold, one persistent theme has emerged—much of Brexit is about unresolved issues surrounding the end of the British Empire. Britain was the global hegemon from 1815 to around 1920 (although the nation still thought it was in charge until the end of WWII). Historians tend to view the shift from one hegemon to another as a clear, abrupt break. But, in reality, faded hegemons tend to cling to elements of former glory. Although global influence may have waned, the vestiges of power still affect policy and national self-image. For example, Spain's era as global hegemon ended around 1640 after wars with the Dutch exhausted Spain's power. Still, Spain held possessions in the Western Hemisphere until the Spanish-American War in 1896-98. That war finally ended the Spanish Empire.

There is an element of Brexit that is trying to recapture former glory. Sadly, Brexit may make it clear that Britain is no longer a major global power.

In this report, we will discuss the geopolitics of Europe and Britain. Using this geopolitical analysis, we will examine the British Empire and how it devolved. These two analyses will be used to examine the path of Brexit. As always, we will conclude with market ramifications.

### The Geopolitics of Europe and Britain

Geopolitics is the study of the exercise of political power within the context of geography. How a nation exercises its power is shaped by the physical constraints under which the political power operates.



(Source: Wikipedia)

This is a physical map of Europe. One of the great disappointments of history is that technological development has been fastest on a continent that has been impossible to unify under one government. Geography is a key reason why unification has never occurred. Southern Europe is separated by a series of mountain ranges, including the Pyrenees, the Alps and the Carpathians. Northern Europe is separated from the main continent by the Baltic Sea. The British Isles and Ireland hang off the northwestern coast, close enough to allow the British to interfere with continental geopolitics but far

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<sup>1</sup> See WGRs, The Irish Question: [Part I](#) (2/25/2019) and [Part II](#) (3/4/2019).

enough away to avoid invasion.<sup>2</sup> These physical divisions have prevented any singular power from controlling all of Europe. Of course, that didn't prevent powers from trying. European history is marked with rising states that have tried to conquer Europe, but none were able to complete the task.

Many of the wars were fought along the Great Northern European plain that runs from the Pyrenees to the Urals in Russia. A seminal event in European history was the formation of Germany after the Franco-Prussian War. The country sits in the middle of the aforementioned plain. Because there are few natural barriers to moving goods and people, Germany was destined to become a major economic power. At the same time, the lack of natural barriers meant Germany was vulnerable to invasion from the east and west. For this reason, Germany was the center of two world wars as the country tried to preemptively avoid a two-front war.

The great continental powers tended to develop land armies; being an island nation, Britain became a naval power. When Napoleon attempted to unify Europe through conquest, the British Navy blockaded the continent and weakened the French economy. Britain never had the power to dominate Europe, but it had the wherewithal to affect the distribution of power within Europe to prevent a single nation from controlling the continent. Britain wasn't the only power able to do this; the Scandinavians acted in a similar fashion at times.

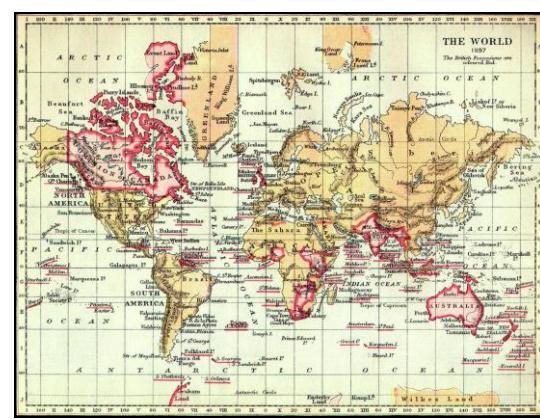
Therefore, due to geography, no European nation was able to dominate the continent; they either could not penetrate all of

Southern Europe due to the topography, or they were unable to prevent Britain or Scandinavia from intervening to thwart a continental government from dominating the land mass.

The inability of European countries to dominate the continent did not prevent them from projecting power. The countries in the region became very competitive and expressed that competition through imperialism. Britain, Spain, Portugal, France, Germany, Belgium, Italy and the Netherlands all held colonies throughout the world.

As noted above, Britain, being an island nation, focused on naval power. This factor assisted the country's imperial designs; along with being the first nation to industrialize, the Royal Navy led Britain to achieve global hegemony in 1815, following Napoleon's defeat.

By the turn of the 19<sup>th</sup> century and into the 20<sup>th</sup> century, the British Empire spanned the globe. This map was used to show British schoolchildren the extent of the empire.



(Source:

<https://www.britishempire.co.uk/maproom/pinkbits1897.htm>)

However, cracks in British hegemony were starting to develop by the early 20<sup>th</sup> century. The rise of American power made it clear

<sup>2</sup> The last successful invasion of the British Isles was the Norman Conquest in 1066.

that Britain could not defend its holdings in Canada and may not have been able to even protect its colonies in South and Central America either. Britain quietly accepted U.S. dominance in the Western Hemisphere.<sup>3</sup>

Britain accepted U.S. dominance in part of the world in order to contain a rising Germany.<sup>4</sup> Unfortunately, Britain failed to do so. WWI undermined British dominance and led to a power vacuum from 1920 until 1945.<sup>5</sup> In reality, the U.S. was the dominant power after WWI but didn't fully accept the role until after WWII.

### The Vestiges of Hegemony

After WWII, the U.S. was clearly one of the world's dominant powers. The U.S. shared global control with the Soviets, with America dominating the non-communist world. The U.S. exercised power through its control of organizations, such as the U.N., IMF, World Bank and GATT. The U.S. also pressed to dismantle the European empires and, steadily, European colonies mostly gained independence. The U.S. especially pressed to unwind the British Empire. India, the "crown jewel" of the British Empire, became independent in 1947.

But, the event that clearly showed how powerless Britain had become was the Suez Crisis in 1956. A coup in 1952 overthrew the Egyptian king, who was essentially a British puppet; this coup eventually brought Gamal Nasser to power. In July 1956, Nasser nationalized the Suez Canal and

ousted British forces that were protecting the canal. Britain, France and Israel concocted a plan to regain the canal. The U.S., which was trying to woo Nasser out of the Soviet orbit, was furious with the invading nations. Although the military operations were successful, the U.S. pressured the three nations to retreat. The Eisenhower administration threatened to dump British bonds held in reserve, which would have likely led to a devaluation of the GBP and a spike in British interest rates. The three nations backed down and withdrew. In the aftermath, the European nations were given a clear signal that they could no longer operate independent foreign policies that diverged from U.S. interests.

Steadily, Britain's overseas holdings became independent. The UAE, Bahrain and Qatar broke away from Britain in 1971; Belize followed a decade later. The Crown still maintains some overseas territories (Caymans, Bermuda, British Virgin Islands, Gibraltar, the Falklands and Turks and Caicos, for example), but, for the most part, the British Empire has devolved.

In 1973, Britain decided to join the EU. As our discussion of European geopolitics notes, the British people viewed themselves as separate. However, given its declining status, the U.K., much like its European counterparts, viewed joining the EU as a way to enhance its stature. Although joining the EU did make sense, there were always going to be underlying tensions about being part of the union.

### Brexit

Being part of the EU, like most things, comes with costs and benefits. The EU takes over a number of bureaucratic functions, including trade negotiations. Although the U.K. didn't join the Eurozone, the nations in the single currency give up

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<sup>3</sup> Allison, Graham. (2017). *Destined for War: Can America and China Escape Thucydides's Trap?* New York, NY: Houghton Mifflin Harcourt Publishing Company. Pp.194-200.

<sup>4</sup> Ibid, 58-63.

<sup>5</sup> Kindleberger, Charles P. (1986). *The World in Depression, 1929-1939* (2nd ed.). Berkeley, CA: University of California Press.

monetary policy as well. Borders are open to goods and people within the EU.

The Brexit referendum was poorly structured; it asked whether or not the voter liked the EU. However, it didn't have any guidance on what would follow in the event of a vote to leave. There is some evidence to suggest that the vote became something of a referendum on satisfaction with the status quo. Given that the vote was held during a period of austerity after the Great Financial Crisis amidst elevated immigration concerns, support for the status quo was not very high. As a result, the referendum's outcome was to leave the EU.

Since the vote, the May government has tried to create a plan that would allow the U.K. to mostly exit the EU with the least degree of economic disruption. However, that has proven to be excessively difficult. The EU has little interest in allowing a nation to treat its benefits and costs as a menu; if that practice were to become widespread, all nations would freeride the system. If the U.K. wants control of its borders on immigration then it will have to accept trade barriers, for example. As we discussed in our recent report on Irish/British relations, the border with Northern Ireland has become a major sticking point.<sup>6</sup> Although Parliament has repeatedly indicated it does not want a sudden break with the EU, which would result in economic chaos, there is no obvious way forward that guarantees this outcome will be avoided.

### **Empire Nostalgia**

A certain subset of the Conservatives appears driven to exit the EU at any cost. And, it appears some of that willingness is based on the idea that the British could "get the band back together" by rebuilding the

<sup>6</sup> Op. cit., The Irish Question.

commonwealth.<sup>7</sup> Commentators have noted how Brexit supporters harken back to the Battle of Britain when the country "stood alone" against the Nazi onslaught.<sup>8</sup> U.K. officials have used colonial ties to discuss potential free trade agreements in Asia,<sup>9</sup> which may not be the best strategy to undertake.<sup>10</sup>

There are good reasons for Britain to exit the EU. German economic policy has essentially colonized the Eurozone. The bureaucrats in Brussels do affect the domestic economy in ways that are difficult to influence. Immigration has become a severe strain on European society. However, leaving the EU will be disruptive, so it should have been carefully planned out with a thorough assessment of costs and benefits. Instead, the odds of crashing out of the EU have increased.

Part of the reason for the lack of planning appears to be based on an overestimation of Britain's status in the world. Outside the EU, assuming the U.K. does not join the Customs Union, Westminster can make its own free trade agreements. However, such agreements take a long time to negotiate and it's hard to predict how good of an agreement can be negotiated without the leverage of the EU. For example, the U.S. would likely force the U.K. to accept unrestricted agricultural trade and disadvantaged financial industry arrangements. The EU will almost certainly try to curtail London's financial industry. Eventually, if the EU breaks up, the U.K.

<sup>7</sup> <http://www.dannydorling.org/?p=5410>

<sup>8</sup> <https://www.theguardian.com/commentisfree/2018/feb/03/imperial-fantasies-brexit-theresa-may>

<sup>9</sup> [https://www.washingtonpost.com/world/2019/01/04/britain-clings-imperial-nostalgia-brexit-looms/?utm\\_term=.7be6cf9cbaad](https://www.washingtonpost.com/world/2019/01/04/britain-clings-imperial-nostalgia-brexit-looms/?utm_term=.7be6cf9cbaad)

<sup>10</sup> <https://www.nytimes.com/2019/01/17/opinion/sunday/brexit-ireland-empire.html>

would have a leg up by being the first to depart. But, in the meantime, the costs will be high.

In addition, there is evidence to suggest that Brexit was more about England than the United Kingdom. After all, Northern Ireland and Scotland voted to remain. It is quite possible the U.K. might not survive Brexit.<sup>11</sup> If the U.K. becomes merely England and Wales, that means Northern Ireland would be absorbed into the Irish Republic (an outcome that seems to be a matter of when, not if, given demographics) and Scotland would become independent

again and likely join the EU and the Eurozone. Valuing the GBP of England and Wales would be difficult, but it's safe to say that it would likely be at a lower value compared to the present.

### Ramifications

Financial markets continue to assume that, in the end, the U.K. will avoid a disruptive exit. While that is the most likely outcome, there is the potential that no good alternative develops. We expect that if a disruptive exit occurs, the GBP would fall to around \$1.10. If "muddling" continues then the exchange rate likely remains near current levels.

<sup>11</sup> <https://www.ft.com/content/e4b113f0-5552-11e9-91f9-b6515a54c5b1?emailId=5ca57ca8531b510004d1e4c5&segmentId=2201ee7-896a-8c4c-22a0-7603348b7f22>

*This report was prepared by Bill O'Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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