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Ashmore

The flipside of Turkey: America's use of soft power

By Jan Dehn

United States sanctions against two Turkish government ministers triggered the recent bout of volatility in the Turkish currency market. While Turkey was fundamentally vulnerable to begin with, due to a lengthy period of bad economic policies, the fact that volatility was so severe and spread far beyond Turkey indicates that this was not just about Turkey. It is also about the major shift in America's use of soft power on the global stage. US President Donald Trump favours discretion over rules and increasingly uses American soft power in a coercive way in pursuit of narrow short-term objectives rather than using it to reassure and support the global governance infrastructure. This particular use of US soft power confers clear benefits onto Trump, who appears strong and potent, but at the same time erodes America's stock of soft power at the fastest rate in the modern era.

The erosion of US soft power will render the world more uncertain in the foreseeable future, but exactly how long the uncertainty persists and how bad it gets depends on the US itself, how America's allies react and how quickly China overcomes its credibility deficit to emerge as the new global hegemon.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	-3.68%
MSCI EM Small Cap	10.5	–	-2.86%
MSCI Frontier	10.1	–	-1.41%
MSCI Asia	11.2	–	-3.47%
Shanghai Composite	9.5	–	-4.49%
Hong Kong Hang Seng	6.9	–	-3.92%
MSCI EMEA	8.7	–	-4.81%
MSCI Latam	11.1	–	-2.46%
GBI-EM-GD	6.85%	–	-1.79%
ELMI+	4.79%	–	-0.49%
EM FX spot	–	–	-1.17%
EMBI GD	6.51%	363 bps	-0.02%
EMBI GD IG	4.80%	192 bps	0.37%
EMBI GD HY	8.52%	565 bps	-0.43%
CEMBI BD	6.14%	331 bps	-0.18%
CEMBI BD IG	4.83%	201 bps	0.06%
CEMBI BD Non-IG	7.81%	498 bps	-0.47%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	0.66%
1-3yr UST	2.61%	–	0.01%
3-5yr UST	2.73%	–	-0.04%
7-10yr UST	2.85%	–	-0.05%
10yr+ UST	3.00%	–	-0.12%
10yr+ Germany	0.31%	–	0.29%
10yr+ Japan	0.10%	–	-0.04%
US HY	6.31%	341 bps	0.02%
European HY	3.48%	421 bps	-0.06%
Barclays Ag	2.03%	-82 bps	-0.07%
VIX Index*	12.48	–	-2.30%
DXY Index*	96.25	–	-0.15%
EURUSD	1.1420	–	0.09%
USDJPY	110.54	–	-0.14%
CRY Index*	189.22	–	-1.08%
Brent	72.0	–	-0.87%
Gold spot	1186	–	-0.62%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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"There was a dream that was Rome. You could only whisper it. Anything more than a whisper and it would vanish, it was so fragile."

Marcus Aurelius, Gladiator (the movie)

Apart from the times when the United States (US) is physically dropping bombs on other countries, American power is felt most keenly when the US imposes legal, financial, trade and other sanctions on other countries. The imposition of sanctions on two Turkish ministers a fortnight ago immediately led to significant pressure on the Lira, which in turn triggered a broader global repricing of assets including US stocks, EURUSD, VIX, US Treasuries and, of course, non-Turkey EM. The imposition of sanctions on Russia for alleged involvement in a recent UK poisoning incident similarly precipitated material Rouble volatility. Even the mighty Renminbi has weakened under the onslaught of US trade tariffs this year, although this weakness is largely mechanical.[1] The term used to describe America's ability to effect massive pressure on other countries with mere words or tweets is 'soft power'.

America established its stock of soft power during World War II, when the US successfully used its massive military might, aka hard power, to bring about a morally good outcome to the conflict. In subsequent decades, the US broadly preserved this original stock of soft power through the exercise of global economic and political leadership in the Cold War and by sponsoring the establishment of global institutions for conflict resolution.

[1] US tariffs reduce Chinese imports. Chinese imports fall. Fewer Dollars flow to China. The USD rises versus RMB.

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American soft power remains formidable. It rests with the size and openness of the American economy, the global reach of the US banking sector, control of important benchmark indices by US banks, the widespread use across the world of the Dollar in transactions and the high levels of trust vested in American legal and regulatory institutions. Soft power manifests itself in a willingness of other countries to comply with US rules even when they do not agree them, at least up to a point. They comply because business ties with the US institutions are so deep and wide that those ties ultimately matter more than relations with most third parties. Many also comply because they recognise the value of a predictable and stable system of rules, even if those rules are not always very fair.

Hard power in retreat, growing reliance on soft power

It has not escaped anyone's attention that President Donald Trump has made greater use of American soft power than recent US presidents have. Ironically, the greater use of soft power may simply reflect the fact that the US has become more constrained in terms of its ability to exercise hard power. For example, every Republican president since Ronald Reagan has gone to war in his first term. Trump may yet become the first Republican president not do so. Why has the US become more constrained in its ability to go to war? US military might is as formidable as ever, perhaps even more so, but America's ability to form broad alliances in support of military action has received significant setbacks over the last couple of decades. For example, despite the outrage of 9/11, former President George W Bush was unable to establish a Europe-wide coalition against Iraq after declaring that, "either you are with us or you are with the terrorists". Iraq had nothing to do with 9/11, so Bush's categorical statement alienated many European countries for whom frivolous application of military power is still a sensitive issue (this sensitivity is rooted in Europe's memory of the horrors of two world wars on its own soil). European scepticism about US military action deepened further when it became clear that Iraq had no had weapons of mass destruction and that General Colin Powell had told blatant lies on the floor of the United Nations. Close allies, UK and US, thus found it impossible to mount military incursions against President Bashar al-Assad after his use of chemical weapons against his own people in 2013, 2014, 2015 and again in 2017. In short, Trump is turning to the use of soft power, because it is so difficult to mount global coalitions in support of the application of hard power. Of course, the world may ultimately be safer in an era of soft power compared to an era of hard power in the sense that there are fewer US-instigated wars.

Use or abuses

Soft power, like hard power, can be used or abused. How soft power is utilised determines whether its stock increases or decreases. When American soft power has been employed in pursuit of objectives with broad global backing, US leadership credentials have tended to improve and the stock of soft power has grown. The US victory in the Cold War, the collapse of the Soviet Union, the establishment of NATO, the rise in living standards in the post-World War II era, free trade and globalisation, America's technological advances and the Brady Plan, which laid the foundations for the integration of Emerging Markets (EM) into global financial markets, all contributed to American soft power. On the other hand, the use of soft power in pursuit of goals defined from the perspective of narrow US self-interest, or in pursuit of objectives seen as contrary to values of the majority of the world, has been negative for American soft power. The loss of macroeconomic control in the 1970s with resulting high inflation and a halving of the value of the Dollar, the flawed 'Domino Theory' that ultimately led to military defeat in Vietnam, America's support for South Africa's Apartheid Regime, CIA sponsorship of coups as well as recurring financial bubbles (Savings & Loans, telecoms, DotCom and Subprime) depleted American soft power.

Diminishing returns to soft power

Today, even as Trump steps up his reliance on soft power, America's stock of soft power is eroding away at the fastest rate since World War II. Depletion is coming from three specific directions. First, the Trump Administration is applying soft power to targets, where soft power has sharply diminished effectiveness, much like trying to get blood from a stone. The recent US sanctions on Iran are not going to have much of an effect, because the more divorced a country is from US systems, the less effective the application of system levers. In the final equation, countries become practically immune to soft power, when they no longer have any ties with the US at all. Iran is extremely removed from US system levers after thirty-nine years of US sanctions, including a ban on using US dollars for international transactions. Iran is still alive and kicking. North Korea and Cuba are other examples of countries, whose regimes are still in place despite decades of US sanctions, blockades, interventions and other US measures designed to destabilise them.

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Disagreements over where to apply soft power

The second reason why US soft power is waning, is that the US government is now applying soft power in areas where America's long-standing allies clearly believe it is unwelcome. Many Europeans are sceptical of Trump's North Korean adventure, but Iran is a far more divisive issue. The Trump Administration's withdrawal from the Iran nuclear deal and the imposition of sanctions against companies in third countries doing business with Iran has pushed Europe into a direct challenge to US law.

For the EU, the disagreement over Iran is not solely about European self-interest. EU nations strongly believe, with good reason, that the Iran nuclear deal was working as intended and that it made the world a safer place. The EU believes Iran is less of a threat to world peace if its economy can be integrated into the global economy and views US withdrawal from the nuclear agreement as reckless, self-serving and counter-productive.

In the EU's eyes, the threat against European companies doing business with Iran is therefore particularly offensive, so offensive, in fact, that the EU has issued a 'blocking statute' to shield European companies involved in legitimate Iranian business from US sanctions.[2] Under the statute, EU companies can take US banks and businesses to court to recover damages arising from adherence to Trump's sanctions. In other words, the EU is threatening to do to US businesses exactly what the US is threatening to do to EU businesses. The result will be a drop in direct EU-US business and less reliance in Europe on the US legal framework and banking institutions. The likelihood that the EU conforms with US sanctions in the future is also lower.

Global governance framework under threat

The third and largest threat posed to American soft power comes from the recent withdrawal and/or outright attacks by the Trump Administration on the institutions, which form the pillars of the system of global governance. These institutions, which include NATO, WTO, UN, the Human Rights Council, TPP, NAFTA and the Paris Agreement on climate change, have widespread global support and there are no obvious replacements. Across the world, their decline is seen as posing a direct threat to global stability. In addition, there are growing doubts about America's commitment to sound macroeconomic policy following a massive fiscal stimulus at the precise point the US achieved full employment. The unilateral imposition of tariffs on key US trading partners has upended the decades' long equilibrium in trade policy. These changes may boost US economic performance in the short term, but they are unambiguously inconsistent with a stable Dollar, thus threatening the global reserve currency over the medium to long term.

Despite global concerns about American attacks on the global governance infrastructure, which America itself was so instrumental in establishing, such concerns appear to have little effect on the Trump Administration. Moreover, since the Administration appears to be responding to political considerations emanating entirely from within the US itself, there is very little reason to expect major changes in the near term. Widespread domestic discontent with the conventional political establishment in the US due to stagnating living standards and rising inequality continues to nurture a political environment in which it is politically expedient to attack establishment institutions in all their manifestations. Trump is responding to this discontent and likely to continue to do so.

Short term trumps long term

America now employs soft power in a coercive way in pursuit of narrow short-term national objectives rather than to reassure the likeminded and support the global governance infrastructure. This is a deliberate choice based on a simple political calculation, which says that it is no longer efficient for the US to incur the upfront costs of global leadership. Rather, by actively divesting the US from its global leadership obligations Trump gives the impression of wielding great power. He sells himself to voters as a man of action, someone who is taking back control, someone with great virility. Unfortunately, the actions are mainly destructive in nature. He is tearing things down rather than building anything (apart from the wall with Mexico). The dismantlement of institutions built painstakingly over decades is populism in the classic sense of the word. The private short-term benefits, which accrue to Trump, vastly exceed any short-term costs, but the longer-term implications, which are only negative, only accrue over time and affect America as a whole, not just Trump.

Costs

What are those long-term costs? The list is long and some of the risks are impossible to predict. The last time America turned in on itself Fascism and Communism, took root in Europe and ultimately led to World War II. Even if such extreme outcomes do not occur, it seems reasonable to expect less predictable international relations, which will be bad for businesses. Economic nationalism and growing discretion in policymaking increases the risk associated with engaging in business with the US. Gains from trade evaporate. Global

[2] Legitimate as defined under the terms of UN Security Council Resolution 2231, a legally binding resolution.

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financial flows shrink. The Dollar ultimately becomes less widely used and America's ability to finance its deficit is gradually undermined. Harmonisation of legal and regulatory systems falls apart. The environment suffers. Rogue states exploit the greater room afforded by divisions among the big powers. Geopolitical tensions increase. The risk of war ultimately rises. The list goes on.

Rivals appear

When then French finance minister Valery Giscard d'Estaing coined the term 'exorbitant privilege' in the 1960s, he undoubtedly did so with a twinge of envy. Other countries have long wished they could avoid the risk of currency crisis by issuing the global reserve currency of choice. China, in particular, is not oblivious to the benefits of global hegemon status. China will exploit any vacuum created by America's shrinking leadership role. China's greatest obstacle to assuming global leadership is lack of credibility. Not only is China a relatively new entrant on the global stage, the country also has a nasty legacy of Maoism, the most militant version of Communism ever known.[3] China is working to overcome these handicaps by acting in an especially mature and rational manner in the face of US aggression, including explicitly supporting the very global institutions from which the US is currently seeking to divest itself. It serves China's purposes that Trump's America is doing all it can to not lead.

The soft power 'U' curve

Due to the rapid pace of erosion of US soft power and the still formidable challenges faced by China in gaining credibility as a global leader, it seems rational to expect the global stock of soft power to decline for a time. While Europe ought to pick up the slack – a massive opportunity – European leaders have repeatedly failed to act in unison. The resulting 'U'-curve in global leadership means that the world is heading into a period, which could last for years, in which aggregate global leadership goes into decline. This period is likely to be characterised by growing rivalry between the leadership contenders until the baton has decisively changed hands. If, as appears to be the case, the US leans more on direct attacks on individual countries in a bid to demonstrate soft power, such as the recent attack on Turkey, then noise levels will spike periodically.

The role of third countries

Europe may not be able to lead, but European countries are very open, vastly experienced in the realm of geopolitics and have populations, which broadly support global governance institutions. As such, Europe can generally be relied upon to exercise boring and slow, but sensible leadership and to support constructive global initiatives. It is in the interest of the world as a whole that global leadership changes hands as quickly as possible. Europe will undoubtedly play an important part in this process as will Japan and the big EM economies. EM central banks will be important supporting actors in a transition, because they are the stewards of USD 8.5trn of FX reserves, which are mainly invested in USD denominated US Treasury bonds. The quicker Europe, Japan and large EM countries move, the sooner the new geopolitical reality comes about. Remember that change can be rapid: the UK went from the world's largest empire to IMF patient in just 30 years; when a hegemon loses the will to lead, things can change very quickly indeed.

Conclusion

America's shift away from rules towards discretion and her willingness to abandon the pillars of global stability is rooted in domestic political developments. These developments demand that America looks inwards, but introspection is inconsistent with global leadership. US hard power is already constrained and soft power is now depleting rapidly as well, aided by Trump's abuse of soft power. The US withdrawal from global leadership increases global instability and introduces hitherto unfamiliar risks associated with direct dealings with the US. Protectionism and fiscal irresponsibility pose clear risks to the Dollar's standing as global reserve currency over the medium term. Rational countries must therefore now begin to face reality and adjust. Change is scary, but ultimately good, because global leadership belongs to countries, which are willing to set aside their narrow self-interest in order to protect the pillars of the global governance structure. Today, the vast majority of countries in the world do not share Trump's vision of introversion, populism, protectionism and irresponsible fiscal policies. Instead, they strongly favour a continuation of a rule-based global system, which has delivered sustainable gains in living standards for many decades. Today, China, rather than the US, looks the most likely country to deliver this outcome.

[3] It was Maoists, who conducted the Cambodian genocide in the 1970s.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-5.82%	-9.99%	-1.22%	9.10%	4.13%
MSCI EM Small Cap	-4.38%	-11.28%	-0.11%	5.49%	3.48%
MSCI Frontier	-3.58%	-10.94%	-1.94%	3.65%	3.19%
MSCI Asia	-4.30%	-7.98%	1.53%	10.18%	7.09%
Shanghai Composite	-7.13%	-17.50%	-16.41%	-10.67%	7.65%
Hong Kong Hang Seng	-4.63%	-7.00%	1.12%	2.60%	4.52%
MSCI EMEA	-11.68%	-17.36%	-7.74%	2.16%	-2.22%
MSCI Latam	-7.17%	-9.75%	-7.62%	8.29%	-1.97%
GBI EM GD	-5.74%	-10.14%	-8.43%	2.46%	-1.94%
ELMI+	-2.79%	-5.28%	-3.10%	2.45%	-1.18%
EM FX Spot	-4.49%	-9.36%	-9.57%	-3.24%	-7.53%
EMBI GD	-1.64%	-4.40%	-2.23%	4.98%	5.26%
EMBI GD IG	-0.16%	-2.43%	-0.64%	3.87%	4.76%
EMBI GD HY	-3.14%	-6.48%	-3.98%	6.30%	5.66%
CEMBI BD	-1.10%	-2.55%	-0.90%	4.24%	4.69%
CEMBI BD IG	0.01%	-1.08%	-0.13%	3.24%	4.33%
CEMBI BD Non-IG	-2.44%	-4.31%	-1.71%	5.90%	5.14%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.36%	7.92%	19.56%	12.98%	13.77%
1-3yr UST	0.23%	0.26%	-0.12%	0.48%	0.60%
3-5yr UST	0.46%	-0.50%	-1.43%	0.57%	1.21%
7-10yr UST	0.83%	-1.73%	-2.69%	0.58%	2.36%
10yr+ UST	1.15%	-3.32%	-2.04%	1.44%	5.52%
10yr+ Germany	2.05%	4.94%	4.81%	3.36%	7.20%
10yr+ Japan	-1.13%	-0.08%	0.65%	3.93%	4.58%
US HY	0.30%	1.56%	3.51%	6.71%	5.52%
European HY	0.10%	0.14%	1.54%	4.62%	5.84%
Barclays Ag	-0.45%	-2.07%	-1.22%	2.28%	1.15%
VIX Index*	-2.73%	13.04%	-12.48%	-34.80%	-16.30%
DXY Index*	1.79%	4.47%	3.01%	0.28%	18.96%
CRY Index*	-2.73%	-2.40%	6.60%	-2.80%	-34.83%
EURUSD	-2.32%	-4.87%	-3.34%	1.58%	-14.88%
USDJPY	-1.18%	-1.91%	1.43%	-10.42%	13.64%
Brent	-3.06%	7.64%	36.53%	54.40%	-34.65%
Gold spot	-3.11%	-8.96%	-8.19%	2.94%	-13.50%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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