Notes for an address to the Group of 78

So Long, Globalization V2: The Causes and Consequences

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Abstract: Economic history since the industrial revolution has not been a story of gradual evolution. Rather it has been punctuated by disruptive changes that ushered in new episodes. The current episode is being ushered out; what will replace it? The sources of the disruption can be traced by the various economic indicators that literally went off the charts: nominal interest rates broke the "zero bound" going into negative territory; while financialization, income inequality, and the structural bias against labour and "good jobs" soared. Economic systems face economic constraints: the balance of payments must balance and savings must equal investment. But they also (eventually) face other constraints: economic outcomes must fall within tenable social, political, and environmental bounds or disruption follows. The system that is to come will respond to the pressures that brought down Globalization V2. Can we glimpse at this future?

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Economic history since the industrial revolution has not been a story of gradual evolution. Rather it has been punctuated by disruptive changes that ushered in new episodes. Since the end of the Napoleonic wars, at least five distinct episodes can be discerned. The first two combined to generate a system recognizable as Globalization 1.0, about which John Maynard Keynes marvelled[1]; the last two combined to generate Globalization 2.0, with which our generation has had a lifelong love-hate relationship and which also featured two distinct episodes – the Bretton Woods era and its aftermath. In between was an inter-regnum of economic volatility, depression, and war.

We are now at the break point that is ushering in a new era. The transitions from one episode to another are endogenous to the system – they are not some form of external "shock". Accordingly, it is important to attempt to understand the processes that drive disruptive change in economic systems.

This note provides a brief retrospective on the sequence of episodes, considers the markers that pointed to the disruptive change now underway, examines the causal factors that led to the disruption, and speculates on the consequences.

A Brief Retrospective: The Episodic Evolution of the Global Economy

Not surprisingly for an economic system based on markets, the defining factor behind the post-1820 episodes appears to have been the arrangements for international trade and finance. While the episodes were distinct, they arguably emerged endogenously, each from its predecessor.

The original exchange rates were between the metallic bases for money – gold versus silver. Sir Isaac Newton's historic under-pricing of silver in terms of gold resulted in Britain adopting the gold standard on a de facto basis. Britain's emergence as the dominant global economic power following the Napoleonic Wars made it advantageous for others to adopt the same monetary standard. Germany's conversion to the gold standard following the 1871 Franco-Prussian War was the tipping point that prompted other nations to follow suit, resulting in the gold standard era.

The linkage between gold reserves and national money supply (depletion of gold reserves was responsible for money-supply driven recessions during the gold standard era) created a natural incentive for mercantilist trade policies, since export surpluses supported growth in the domestic money supply. Mercantilism during Europe's Belle Époque equated with colonialism – colonies were captive markets – and colonial rivalries led to war: the minor diplomatic incidents that triggered hostilities in 1914 do not explain the prosecution of the First World War to its bitter and devastating end. There were much deeper reasons for the industrialized carnage that

[1] In his "Economic Consequences of the Peace", Keynes (1920) famously wrote: "What an extraordinary episode in the progress of man that age was which came to an end in August 1914! … The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth … he could at the same time and by the same means adventure his wealth in the natural resources and new enterprise of any quarter of the world."

produced failed states in Russia and Germany in the first instance, which in turn endogenously led to the second conflagration. Follow the money to see the endogeneity.

The post-WWII system emerged in an economic context radically restructured by the wars – Britain had squandered her treasure and her empire in the Pyrrhic "victory" over Germany and allowed the United States, unscarred by war and profiting from its industrial spoils, to become the global hegemon, the master of its money, and the architect of its trading system. The result was, in the first instance, the Bretton Woods system, an era defined by Keynesian demand-side management in macroeconomic policy and controls on capital flows. However, the gradual bleeding of US gold reserves led to the Nixon measures of August 1971, which ushered out the Bretton Woods era and ushered in its successor, which ultimately came to be defined by monetarism, supply side economics, and full liberalization of capital flows.

The eras were remarkable for the differences in economic outcomes and policy frameworks. Whereas the 1820-70 era featured impressive technological developments and the dismantling of trade barriers that enabled trade,[2] it did not feature widespread technological and industrial convergence; however, the gold standard era not only witnessed continued technological development and liberalization, but also featured convergence – big time (Dowrick and DeLong, 2003). Similarly, while the overall post-war era featured continuous technological advance and liberalization, the first episode (Bretton Woods) featured widespread convergence, but its successor had a very mixed record, in part because of the striking absence of global financial crises during the Bretton Woods era and the almost continuous incidence of such crises since. In terms of policy, the Bretton Woods system emphasized fiscal policy for macroeconomic stabilization, while its successor emphasized monetary policy. Exchange rates during Bretton Woods were fixed to gold; in the successor regime, this was stood on its head: any exchange rate system *except* pegging to gold was allowed.

This record allows several inferences:

- Global economic systems change abruptly for reasons endogenous to the systems;
- They are characterized by different international trade and finance regimes;
- They feature distinctly different policy frameworks;
- They feature distinctly different economic outcomes; and
- The choice of when systems change is not a collective one – the hegemon decides, in its own perceived interest, at the time of its choosing.

These inferences provide a perspective on the recent developments in the United States principally, but also not unimportantly elsewhere, that augur the dawn of a new global economic episode.

[2] "In the decades after the Napoleonic Wars, trade barriers fell dramatically, and capital and labor became exceptionally mobile. A dismantling of the byzantine tariffs, prohibitions, and regulations of the eighteenth century mercantilist empires began the process. From mid-century, the technology of iron and steam conquered distance, dramatically reducing the natural protection that transportation cost had hitherto provided." Harley (2000: 926-927).

Break Point

For the technocrats charged with writing the rules for Globalization V2, its abandonment comes as a shock. The crowning achievements – the European Union's Single Market with its four freedoms (movement of goods, services, capital, and persons), and the Trans-Pacific Partnership (TPP) tour de force of treaty drafting – represented the near perfection of the system's logic. This logic was endorsed by massive amounts of scholarship and reinforced by peer reviews through such organizations as the OECD, the IMF, and the World Bank. What's not to like?

Understanding this conundrum is crucial to understanding how to move forward.

From many perspectives, the system was not working well – a decade of stagnation coupled with deflationary pressures suffices to attest to that. However, even more troubling is that key vital signs for the system were going off the charts:

- Interest rates were breaking the "zero bound" – going below zero in nominal terms.
- There was an enormous increase in financialization (as evidenced by the ratio of international financial transactions to global GDP).
- Income disparities were soaring.
- Economic instability was growing from cycle to cycle.

These facts challenged the technical assumptions that supported the policy decisions to stay the course. Yet, these challenges were largely ignored. This is hardly surprising. The concept of "paradigm shifts" (Kuhn, 1962) invokes the idea that anomalous data tend to be ignored until they gather sufficient mass to trigger a discontinuous adjustment to theoretical frameworks – i.e., disruptive change.

The conclusion to be drawn is that the perfected system is flawed and that the "shock" is not some random event, but is instead endogenous to the system – it was in some sense "expected" in a well-specified articulation of the system.

Details aside, the economic solutions generated by the system are breaching fundamental "closures" in other dimensions – social, political, and environmental. This generates inherent tensions that result in a conflict that cannot be resolved within the system, but by rupture of the system.

For example, the economy is embedded in a natural environment and relies on the environment for "environmental services". The economy features fossil fuel companies whose stock values depend on the oil and gas in their inventories being pumped out of the ground and burned, releasing carbon into the atmosphere. The release of the carbon changes climatic parameters, which portend significant impact on the asset values of fixed investments. To get to the point, global warming means Miami will drown, Phoenix will fry, and California will go dry and continue to burn. Someone's assets will get gored – the oil companies or the cities. The economic system is not geared to reconcile this conflict – this is done through social and political mechanisms. If one only looks at event from the perspective of the economic system, it appears to be a "shock".

Similarly, the imbalance in factor markets between labour and capital created political tension. Labour faced competition with machines not just from trade and technology, but also from the subsidization of capital through monetary policy. Countries that opted for flexible labour markets kept up the job counts at the expense of quality – labour absorbed cyclical risk, tax burdens, and saw pensions and other benefits severely eroded, while wages stagnated. Countries that preserved labour security lost jobs and struggled with persistent high unemployment. The result was unhappiness and a reaction against things foreign – foreign goods, foreign investors, and ultimately foreign workers. The failure of economic policy to resolve the tension between labour and capital pushed the solution into social and political realms. Change happened at the ballot box – again, from the perspective of the economy, there was discontinuous change due to an "external" shock.

The Causes

The causes of the current disruption can be assigned to three factors: the logic of monetarism, the logic of the system of globalization, and feedbacks from these.

The logic of monetarism involves three key propositions from a practical perspective. First, inflation is a monetary phenomenon; accordingly, controlling the supply of money controls inflation. Second, interest rates control output through their influence on interest-sensitive consumption and on savings/investment. Third, flexible exchange rates avoid disruptive change, because they do not allow the build-up of price wedges between domestic and global prices. The modern inflation-targeting framework translates these principles into a simple, uni-dimensional rule to keep domestic inflation rates within a specified band.[3] If this is accomplished, money supply, real growth, and the exchange rate will take care of themselves. The technical means to hit the inflation target is fine-tuning the interest rate – the price of money.

Playing with the price of money, however, does not work very well to fine tune real economic activity when capital reserves in the corporate sector become superabundant and the problem is demand, not supply. At the same time, trying to use the price of money for macroeconomic control has pervasive unwelcome side effects on the economy.

On the first point, a decade of failure of low interest rates and extraordinary measures to further ease monetary policy ("quantitative easing") in order to stimulate robust growth should be sufficiently convincing.

On the second point, the price of money fundamentally affects the amount of debt accumulated (lower interest rates = more debt), exchange rate valuations (which drive speculative flows, including combined exchange rate/interest rate plays, such as yen carry trade[4]), asset market inflation (lower interest rates boost equity values), household income (lower interest rates = lower returns on bank deposits), and the relative cost of labour and capital (lower interest rates

[3] See for example, Clarida et al. (1999). This approach is based on Taylor (1993) who specified a systematic relationship between the target for a short-term interest rate and the deviation of inflation from an inflation target and of real output from potential output. For a discussion, see Rasche and Williams (2005).
[4] Yen carry trade involves investors borrowing in yen, which is a low-yielding currency, to fund investments in higher-yielding assets denominated in other currencies.

subsidize the substitution of capital for labour). These effects contribute – arguably importantly – to the factors that are driving disruptive political change.

As for the systemic logic of Globalization V2, it is based on the assumed scarcity of capital. This scarcity requires optimization of capital deployment. Accordingly, modern economic framework policies – which are well reflected in such trade agreements as the TPP – go to great lengths to ensure what can be termed "general freedom to operate" for multinational enterprises and to protect their assets, including the intangible assets (Ciuriak, 2016a). This works through many channels, but importantly ensures that capital has full mobility – in contrast to labour, which is extremely limited. This generates the imbalance that drives the political tension. Interestingly, capital controls, which Keynes had insisted should be a permanent feature of the postwar architecture, are now being rehabilitated by the IMF for reasons of financial instability. Here, we reach the same conclusion for different reasons.

Finally, there is the feedback loop: money is power – and power corrupts. Private money funds the media, think tanks, university chairs, tax-deductible charities, and political action groups, not to mention politicians and political parties themselves. The concentration of wealth that has emerged under the system of Globalization V2 has thus had a powerful effect in guiding the system towards rules that reinforce this concentration. One can identify various forms of "kleptonomics" that flourished under this system:

- Klepto 1.0: the leveraged buy-out schemes of the 1980s, which stripped corporations of pension funds and left them saddled with the debt used to take them over.
- Klepto 2.0: the system facilitated the avoidance of tax by the wealthy, as the Panama Papers incident underscored; this worked as a positive feedback to further widen income disparities.
- Klepto 3.0: the financial instability that emerged under the system created the need for hedges, which transferred wealth from the non-financial sector to the financial sector, and also created opportunities to make speculative windfalls from instability – enter the hedge fund and various sophisticated techniques to game the system.
- Klepto 4.0: Quantitative easing erased earnings on household bank accounts and inflated equity markets, effectively transferring wealth to the already wealthy.
- Klepto 5.0: in the knowledge-based economy, a large part of the value of corporations consists of intangible assets. Ownership of intellectual property becomes a cash cow in the hands of patent trolls, who buy up large stocks of non-performing patents, do not explore which ones actually have value, but wait for others to identify viable commercial undertakings, from which they seek to obtain rents on the basis of infringement claims. In the context of the massive proliferation of low-value patents, this becomes a viable way to skim.
- Klepto 6.0: under discussion in the United States is a corporate tax reform that involves the repeal of the US corporate income tax, which is currently levied at 35% of taxable profits, and its replacement with a so-called destination-based cash-flow tax (DBCFT) levied at 20% for incorporated businesses and 25% for unincorporated businesses. This tax features a border adjustment such that income on foreign sales is not taxed and imported production inputs are not deductible business expenses. A company that switches its input sourcing to

domestic suppliers and obtains its revenues from foreign sales could face a negative income tax and get a cheque from the Treasury rather than writing one to the Treasury.

The Consequences

Globalization V2 generated, for reasons of its own internal logic, the conditions for its own demise. One can think of this as a discontinuous shift from an untenable equilibrium to a new one. Alternatively, in the language of dynamic complex systems, we can think of the system as breaking away from a point of attraction and moving to an alternative point of attraction. If history is any guide, we are in a new episode that will have a very different look and feel to the one we have left behind.

Though Brexiters and Trump voters may have had nostalgic visions in mind for their future, the initial conditions that will shape the new episode are nothing like those that prevailed during Britain's imperial days or that gave rise to Norman Rockwell's or "Happy Days" America. Democratic market-based economies with functional social contracts and characterized by rule of law require limits on power and internal checks and balances. The disruption now underway is not creating these conditions, but unshackling naked power. The outcome is thus perverse.

Following 9/11, habeas corpus, the cornerstone of limits of power, died with barely a stir of protest. Surveillance became ubiquitous; torture was resurrected as a tool of repression; and extra-judicial assassination became routine. A new STAR has arisen: the surveillance, torture, assassination raj. This is not the seedbed for a rules-based system, but rather a power-based one. While blue collars helped elect Trump, his Administration is comprised of blue-bloods – billionaires whose interests are not aligned with Main Street America and who are accustomed to wielding untrammeled power within their corporate fiefdoms.

The Trump Administration is moving quickly to test the limits of power – if it finds none, then another indicator, which has already spiked, will go off the charts: uncertainty. Of particular concern must be the WTO and its dispute settlement understanding (DSU). The NAFTA binational panels are almost certainly going to be abolished, which raises the obvious question of whether the Trump Administration would comply with an adverse ruling from the WTO. The economic consequences of US defection from established global bargains are likely to be dire. New treaties would induce no confidence, the heightened uncertainty would be bad for business, and collective action in such areas as climate change would be undermined.

What Comes Next?

In the short-term, there is scant reason to hope that economic outcomes will improve or that the environmental, social, and political breaches that emerged under Globalization V2 will be resolved. Everything points to these various tensions being ratcheted up, not down.

However, the situation is not without hope. We are not in the ditch yet and the experience of the 1930s may serve to avoid the disasters of trade retaliation and open conflict. Meanwhile, the diagnosis of the problems that brought down Globalization V2 suggests that certain elements of system design were responsible; these may be amenable to reform.

In "Rebooting Europe" (Ciuriak, 2016b), I suggest a set of discrete actions to break Europe out of its bad equilibrium: raising interest rates to rebalance conditions of competition in factor markets between labour and capital; change the method of quantitative easing by buying up excess government debt and cancelling it to defuse the debt bomb and provide fiscal room to manoeuvre; and using that fiscal room to explore a set of investments that had been ruled out by the current industrial policy consensus – projects that are not of the horizontal, infrastructure type, which is the currently sanctioned domain for the public sector, but vertical, product- and sector-specific investments that have risk/return metrics that cause the private sector to take a pass. To this list, the present analysis suggests we must add a further measure: reinstate controls on the movement of capital. This may in any event be required in response to potential instability in international capital markets from US tax policies that are precisely aimed at driving massive capital reflow back to the United States and to raise the value of the US dollar. The IMF has already put in place some of the intellectual basis for capital controls and we always have Keynes as a source of wisdom on this point.

Globalization will not go away – technology assures that. Globalization 3.0 could look good: a technology-empowered, knowledge-based economy growing principally in cyber space and sparing the biosphere, with high capital/labour ratios supporting high wages, labour-saving technology allowing for shorter work weeks and more leisure, and the rising wealth of the economy powering the provision of public goods rather than the accumulation of massive stores of stagnant private wealth. The key is income distribution and the key to income distribution appears to be restrictions on capital. It may be just a question of system design.

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