New Agenda for Global Governance

Divergent Performance and Shifting Alliances in a Deglobalizing World[1]

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Abstract

There is a significant probability that the world economy is about to stumble into a period of financial dislocation. Exacerbated by political tensions partly as a consequence of an untethered American foreign policy, the unwillingness and/or inability of the major economic powers to confront the imbalances that led to the financial crisis of 2007–2008 have laid the basis for a historical repetition. The danger is that the confluence of slow real growth, low productivity increases, inflated asset prices (notably real estate) and higher public debt in some of the major Group of 20 (G20) economies cannot be sustained much longer. The Bank for International Settlements (BIS), among others, has been expressing its concerns that collectively we have been unable to constrain the buildup of financial imbalances, leading to a progressive narrowing of policy options. Not only are debt levels higher but we have unwittingly helped to entrench the concentration and power of large banks, spurred the development of shadow banking, encouraged a massive misallocation of capital and exacerbated income inequality via financial repression and productivity-sapping bailouts to crippled firms, which have the side effect of perpetuating unsustainable asset bubbles. It hardly seems surprising that deglobalization has become a factor in the internal politics of too many countries. It could well be that in retrospect the past 10 years will seem like a lost opportunity to address serious crisis prevention. Despite efforts to strengthen global governance over these past 10 years, the economic foundation has little resilience.

Key words: economic crisis; economic imbalances; global governance; debt; G20; BRICS

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Observing the performance of the world economy from the perspective of early February 2018, it is far from obvious to most public and private analysts that there could be significant risks looming in the immediate future. After all, the major Group of 20 (G20) economies register continuing real growth, low inflation, and lower unemployment. Moreover, asset markets are booming. The wealth effects in turn buoy consumer and investor confidence. The situation of course varies from country to country with the U.S. overdue for a correction, concerns that China is over-heating, and Europe and Japan on an upward trajectory. Politicians, notably U.S.

[1] The editorial board received the article in January 2018.

President Trump, are apt to claim credit for this perceived return to prosperity after the near meltdown of the global financial system during the great recession of 2007–2008.

However amid this relative euphoria, which is not limited to lucky investors in crypto-currencies, there is a significant probability that the world economy is about to stumble into a period of financial dislocation. Exacerbated by political tensions partly as a consequence of an untethered American foreign policy, the unwillingness and/or inability of the major economic powers to confront the imbalances that led to the financial crisis of 2007–2008 have laid the basis for a historical repetition. It is only a question of time.

Although reasonable people will disagree about risks, the symptoms of the unresolved strains in international finance are obvious. Almost all of them are linked to excessive debt, which lays the basis for the next crisis. In fact, there has been no effective deleveraging since the height of the crisis 10 years ago. Globally, debt in relation to gross domestic product (GDP) has not adjusted post-crisis. Even in the worst country cases affected by the crisis, declining private sector debt was more than offset by an increase in public sector debt.

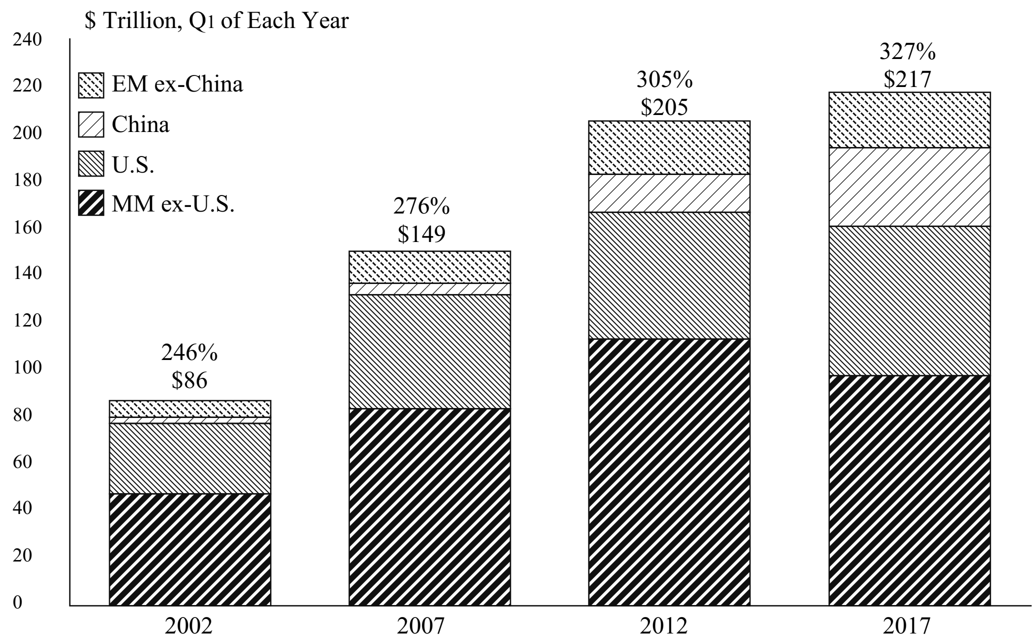

Fig. 1. Total Global Debt (All Sectors)

Source: [BIS, 2016a].

Meanwhile asset price inflation (equities, bonds, housing), seemingly unrelated to fundamentals and fueled by extraordinary central bank policies in the U.S., UK, Japan and the EU, has been the main macroeconomic driver of the new euphoria.

At the same time productivity growth has slowed, and remains too low, in all of the major economies [BIS, 2016a].[2] Potential output growth is restrained and actual growth has generally

[2] In fact, Fitch Ratings in a press release issued in New York on 29 June 2016, noted that investors' flight to safe assets following the UK's EU referendum on 23 June pushed the global total of sovereign debt with negative yields to $11.7 trillion as of 27 June.

been well below post-World War II trends. Average real wages in manufacturing, for instance, in the U.S. have been stagnant for over 20 years.

As is well known, monetary policy has been ultra loose both as regards policy rates and ballooning balance sheets via quantitative easing, at least until recently in the U.S. [OECD, 2017]. The experiment in Europe and Japan with negative interest rates marked the ultimate recourse to desperate policy innovations. By early 2018, it was estimated by the Bank for International Settlements (BIS) that over $6.5 trillion worth of sovereign debt paper was trading at negative yields (NIRP).The big surprise is that, contrary to theoretical expectations, consumer price inflation has been low.[3] In fact, central bankers and other policymakers have been determined to raise annual inflation rates to 2%, supposedly to facilitate economic activity but, in reality, to lighten the debt burden in real terms for over-extended borrowers.

There is certainly a sense of irony that central bankers, entrusted to maintain the value of their fiat currencies, have resorted to inflation targeting, not to anchor inflation expectations so much as to erode – over time – the real value of outstanding debt. This insidious process of "financial repression" is one way of addressing a serious debt overhang. Its subtlety is that most economic agents are oblivious to the intended consequences of such a policy until their savings and pensions have been effectively transferred to creditors. The political consequences for those unprotected from such an erosion of real savings could be a factor, even if unarticulated, behind the swings in public opinion toward populist policies in the U.S. and other countries.[4]

The danger is that the confluence of slow real growth, low productivity increases, inflated asset prices (notably equities and real estate) and higher public debt in some of the major G20 economies cannot be sustained much longer. Despite admirable efforts to strengthen global governance over these past 10 years, the economic foundation has little resilience. Indeed, the BIS, among others, has been expressing its concerns that collectively we have been unable to constrain the buildup of financial imbalances, leading to a progressive narrowing of policy options [BIS, 2016b]. Perhaps more worrying is that, in the aftermath of the financial crisis, Group of 7 (G7) policymakers effectively have been focused on trying to restore the *status quo ante* rather than drawing conclusions for a major reconfiguration of economic relations appropriate to the 21st century.

This approach was unlike that taken to earlier major economic crises (i.e., the crises of 1907 and 1929) which produced systemic institutional reforms. It was certainly an underwhelming response to the challenges of the most serious financial crisis in past 80 years. This was a missed opportunity that Kindleberger would have appreciated [Kindlebeger, Aliber, 2011].

A major concern is that the concerted, post-crisis efforts of the G7, abetted by the G20, to restore the prevailing liberal global economic framework have been misguided. Not only are financial imbalances now even worse but we have unwittingly helped to entrench the concentration and power of large financial institutions, spurred the development of shadow banking, encouraged a massive misallocation of capital and exacerbated income inequality via financial repression and productivity-sapping bailouts to crippled firms, which have the side effect of perpetuating unsustainable asset bubbles. It hardly seems surprising that that deglobalization has become a factor in the internal politics of too many countries.

It could well be that in retrospect the past 10 years will seem to be a lost opportunity to address serious crisis prevention. Instead of balanced growth, we have debt-fueled asset bub-

[3] As money demand has collapsed to levels not seen since the Great Depression of the 1930s in the United States. See Miles, Panizza, Reis, Ubide [2017].

[4] Note that 2% inflation would reduce the real purchasing power of a pension fixed in nominal terms by 30% in just 11 years. See, for example, Kaletsky [2016].

bles. The G20, especially at the summit level, has become an anachronistic photo op [Gilman, 2008].

At least the BRICS grouping of Brazil, Russia, India, China and South Africa may come to be seen as a useful but historically limited step in the evolution of the global economy that could lead to an eventual restructuring of global governance.

Of course it is easy to criticize what has *not* been done. No doubt many BRICS and G20 officials appreciate that the risks of future Minsky moments have not been eliminated [Curran, 2017; Minsky, 1992]. It could be that the change in administration in Washington in January 2017 has provided an incentive for the G20 and BRICS to become more assertive in the pursuit of the world's longer-term economic interests since the global hegemon is clearly distracted by domestic issues.

That change in administration in Washington underscores the urgency of addressing global financial imbalances. It certainly seems that there is an impetus in terms of institution-building by both the BRICS and the G20, where China has been playing a more prominent role.

In terms of the threats to the global economy, and 10 years after the beginning of the great recession, we remain unprepared for a Fisherian debt crisis. To paraphrase the BIS's chief economist, Claudio Borio: why almost a decade since the financial crisis of 2007–2008 does the global economy seem unable to return to sustainable and balanced growth? There may be either a failure to fully appreciate macroeconomic stability issues (i.e., dealing with financial booms and busts per Minsky) or perhaps are cognition that the political costs of confronting the looming public debt bubbles in many G20 countries are too steep.

The International Monetary Fund (IMF), while acknowledging the risks to financial stability posed by the buildup of imbalances, has been relatively complacent about sounding the alarm, unlike the BIS [IMF, 2017b]. However, since both institutions are – in the end – governed by their members, their staffs cannot stray too far in the public expression of their concerns, even if they were so inclined.

One point is clear, even among those who view current global economic conditions as part of a new normal – policy options are increasingly constrained. This is particularly the case with monetary policy where, after 10 years of exceptional, indeed experimental, attempts affecting both the price and quantity of money, there is a realization that a normalization is urgent almost no matter what the cyclical circumstances. Underlying such an inevitable policy tightening is a grudging acknowledgement that loose monetary policies, especially after the initial liquidity problems in 2008–2009, have had limited effectiveness and have had potentially counterproductive effects on productivity and growth.

As Harold James (Princeton) has observed: "Some lessons emerge from the increasingly decentralized governance of the international system. Each major challenge – the 1970s inflation and oil price shocks and the recent global crisis – produced some new approaches to multilateral cooperation and coordination: the G5 in 1975 and the G20 advanced and emerging market economies in 2008. In each case, however, a productive initial meeting was followed by a process of routinization that sapped the urgency and the capacity to generate major breakthroughs and policy improvements" [James, 2017b]. His hope is that Big Data and transparency can be the instruments to move forward with international cooperation.

Major countries need to place a stronger focus on financial, medium-term and global factors in appreciating spillover effects from even well-intended domestic policies. Unfortunately, led by the flawed example of the U.S., it appears that broader concerns about system effects, or even the impact on neighbours, are ignored. Aspects of financial and trade nationalism, no matter how well camouflaged, are asserting themselves. An increasing recourse by the U.S. and others to the use of sanctions serves to undermine the liberal, multilateral consensus of the past 70 years.

In fact, the road ahead is quite narrow. The mainstream consensus revolves around variants that perhaps the global economy could rebalance smoothly. This is probably wishful thinking. In fact there are risks of further serious financial distress. Although policy is key, there is insufficient leadership to ensure that hard decisions can be taken in time to avert serious financial disruption and economic dislocation. The priority should be to abandon the debt-fueled growth model.

Unfortunately, as we all learned as students, there are only three ways to reduce public debt: repay it in the usual way, inflate away its value in conjunction with financial repression or default in some way. Could it be that we may be heading inexorably to a "debt jubilee" in the U.S. and elsewhere in the wake of the next wave of populism as debtors (i.e., think student debt in the U.S.) confront their creditors with non-payment? However it would be masked, such steps could cause financial collapse with inestimable political damage.

Even the IMF noted already in 2017 that "rich market valuations and very low volatility in an environment of high policy uncertainty raise the likelihood of a market correction, which could dampen growth and confidence." It also mentions risks such as a more protracted period of policy uncertainty, financial tensions, inward-looking policies and non-economic factors [IMF, 2017a].

	2016	2050	
China	1	1	China
US	2	2	India
India	3	3	U.S.
Japan	4	4	Indonesia
Germany	5	5	Brazil
Russia	6	6	Russia
Brazil	7	7	Mexico
Indonesia	8	8	Japan
UK	9	9	Germany
France	10	10	UK

E7 economie

G7 economie

Fig. 2. The World's Top 10 Economies in 2050

Source: [PwC, 2017].

For the advanced economies, future problems may now intensify as the demographic structure worsens, growth slows and there seems to be little appetite for major inflation. Are we in a trap where the debt overhang enforces continuing low interest rates, and those low interest rates encourage yet more debt finance (and lower productivity)? As noted above and emphasized by Carmen Reinhardt, financial repression has been the unannounced policy imperative [Reinhardt, Sbrancia, 2015]. The U.S. Federal Reserve followed the initiatives of the Bank of Japan, the Swedish Riksbank and the European Central Bank in reducing policy rates to the lower bound (and beyond in the latter cases) while flooding the banking sector with liquidity. However, instead of reducing the relative debt burden of heavily indebted public sectors in the aftermath of World War II, it has facilitated yet more leverage: really a lost opportunity.

In a narrow sense, banks *per se* may be safer after a decade of modest expansion amidst a restraining regulatory framework. But non-banks and shadow banking have proliferated, including trading in financial derivatives. The financial system is debt-heavy and imbalanced. The test will come only in a time of economic stress, when interest rate expectations change and/or investors suddenly become more risk adverse.

Moreover, there is almost no need to emphasize how much international politics are changing as power shifts increasingly to major emerging economies. Even among the BRICS, the situation is fluid as countries like Indonesia and Mexico are set to supplant most of the remaining G7 countries in terms of GDP purchasing power parity by 2030 according to PwC [2017]. Ironically the forces of deglobalization are intensifying almost despite the global reach of the internet – as seen in areas from security, migration, taxation and trade. And de-dollarization may also accelerate as an unintended consequence of American extraterritorial policy reach. The launch in 2017 of settlement of gold contracts in Hong Kong in renminbi could be an ominous step.

Since the world is not conveniently binary, what we may face now is a U.S. hegemon that is not withdrawing inwards (in an isolationist sense) but has become an increasingly disruptive force in the global economy. The BRICS and much of the G20 will be frantic to try to salvage what they can of international economic cooperation. It will likely accelerate the development of alternative institutional arrangements.

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Различия экономических результатов и изменение альянсов в деглобализирующемся мире[1]

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Существует значительная вероятность того, что мировая экономика в ближайшее время вступит в период финансовых потрясений. Нежелание и/или неспособность основных экономических держав противостоять дисбалансам, которые привели к финансовому кризису 2007–2008 гг., усугубляемые политической напряженностью, отчасти вызванной несдержанной внешней политикой США, закладывают основу для его повторения. Опасность заключается в том, что сочетание низких темпов реального роста, низкой производительности труда, завышенных цен на активы (в частности, недвижимость) и высокого государственного долга в некоторых ключевых экономиках «Группы двадцати» не может поддерживаться и далее. Банк международных расчетов (БМР), среди прочего, обеспокоен тем, что страны «Группы двадцати» не смогли сдержать нарастание финансовых дисбалансов, которое привело к постепенному сокращению доступных вариантов экономической политики. Страны не только обеспечили рост долга, но и невольно помогли усилить концентрацию и мощь крупных банков, стимулировали развитие теневого банковского сектора, поощрили массовое нерациональное распределение капитала и усугубили проблему неравенства доходов посредством финансовых репрессий и снижающих производительность программ помощи фирмам, как побочный эффект обеспечив сохранение неустойчивых пузырей активов. Неудивительно, что деглобализация стала фактором внутренней политики значительного числа стран. Вполне возможно, что в ретроспективе последние десять лет будут восприниматься как период упущенной возможности для решения проблемы предотвращения серьезных кризисов. Несмотря на усилия по укреплению глобального управления в течение последнего десятилетия, экономический фундамент недостаточно прочен.

Ключевые слова: экономический кризис; экономические дисбалансы; долг; глобальное управление; «Группа двадцати»; БРИКС

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