

Current reality: The new mediocre

The political economy problems facing us are complex, intractable and in many cases deepening. The financial crash in 2008 has changed our political economy in ways we do not yet fully understand, but it is increasingly recognised as a watershed. The events of 2007-8 were the most serious financial crisis since 1929, and it brought a concerted policy response from governments. Every possible lever that could be pulled to avert it was used, including zero interest rates (ZIRP), quantitative easing (QE) as well as more traditional measures such as bank nationalisations and fiscal stimulus. The financial meltdown that was widely feared was averted, but at the cost of a serious recession in 2009, the worst downturn since the 1930s. It contrasted markedly with the experience of the previous sixty years during which recessions were shallow and short-lived, eighteen months on average. This time there has been no quick or sustained recovery. The slow-down in growth has lasted already for almost eight years, and emergency policies like ZIRP and QE are still in place. In the three hundred years since the Bank of England was established interest rates have never been so low, and despite a limited uplift in US rates there is no early prospect of significant change either in the UK or in Europe.

Christine Lagarde in October 2014 called the growth performance of the western economies since 2008 'the new mediocre'. The inflation trap of the 1970s has been replaced by the deflation trap of the 2010s. There are competing explanations of whether the fundamental problem is on the demand side or the supply side, whether it is the result of growing distributional inequality and a falling labour share which some economists have highlighted, or whether it is the result of the vanishing of profitable investment opportunities, despite the ever increasing pace of technological change. The international economy appears stuck in an impasse of weak growth, low productivity and high debt. So far there have been three phases of the crisis which first erupted in 2008. The banking crisis of 2007-9 was succeeded by the Eurozone sovereign debt crisis 2010-2012, and then by the crisis in the emerging market economies, particularly China and Brazil since 2014. There are increasing warnings of the possibility of new shocks ahead, precipitating a new crisis in the financial markets or in the Eurozone. Policy makers have limited room for manoeuvre in dealing with any further shocks. In the phrase used by HSBC there are no lifeboats left, and there is currently much discussion on what else might be done. Some policies being canvassed have suitably dramatic names, like helicopter money.

Since 2008 the problems of the economy have been managed with some success. There have been no breakdowns, although particular countries and sectors have come close, particularly the banks in 2008 and the Eurozone in 2011-12. The political resilience of the western governments has also been strong. Many incumbents have lost office, but they have been replaced by other mainstream parties still committed to the rules based multilateral order. Despite the rise of populist insurgencies in many countries questioning globalisation and attacking elites, none have so far successfully toppled mainstream parties. The only exception has been Syriza in Greece in 2015, but Syriza's challenge failed, and after winning a referendum to defy the EU and the IMF it capitulated. But the continuing failure to

resolve the impasse of the last eight years and the deep economic problems which have emerged in so many countries, particularly unemployment in the eurozone and stagnating real incomes in the liberal market economies of Anglo-America created the potential for major political shocks. 2016 saw Donald Trump's successful presidential bid in the United States, and the challenges of anti-immigrant, anti-globalisation parties in many parts of Europe, including France, the Netherlands, and Austria pose major potential challenges to the international order. The impact of one such shock, the vote for BREXIT in the 2016 UK referendum has already had a major impact on other European countries, threatening to destabilise further the eurozone, and even increasing the possibility of an unravelling of the EU itself. The undermining of one of the major institutional supports of the western international order risks precipitating a new economic downturn. Following Donald Trump's election in the US an election victory for one of the insurgent parties or candidacies threatened to intensify pressures towards greater protectionism, even possibly the kind of trade wars and competitive devaluations experienced in the 1930s. Another source of uncertainty is China's debt. If the Chinese succeed in engineering a soft landing for their economy, will the consequence be a permanently lower rate of growth and an economy rebalanced away from exports to domestic consumption? If the Chinese Government opts for a hard landing, however, involving a major write down of Chinese debt, that is likely to have major repercussions on the economic prosperity of the rest of the world and on political stability in China, even if it might be the best hope of ensuring a return to higher Chinese growth in the future.

Stresses and strains: the obstacles to recovery

There are three main obstacles to recovery and the creation of a new era of prosperity and expansion in the international economy. All require serious reforms and restructuring in the way the international economy works.

The first obstacle is *global governance*. The international order which has existed now for more than two hundred years has relied upon the gradual evolution of rules which encourage cooperation and mutual dependence. Such rules have been necessary to ensure deeper market integration but have always been vulnerable to the fragmentation of political authority among competing jurisdictions. The conflicts which arise have periodically threatened both peace and prosperity. In the last seventy years the economic and military power of the United States has underpinned the economic rules and the military alliances which enabled the long era of relative peace and expanding prosperity. But the continuing ability or willingness of the US in continuing to play those roles has been questioned, particularly since the 2008 crash, and the interventions in Afghanistan and Iraq. The prospect of the rebalancing of the international order through the emergence of a new group of rising powers, India, China, Brazil, Indonesia, Turkey, Mexico, and Nigeria has highlighted the need for a reform of the institutions of global governance. A start was made in 2008 with the new importance given to the G20 as a forum for international discussion, and for a time it seemed that the G7 might be superseded. One major initiative was the establishment of the Financial Stability Board, and the cooperation of the world's central banks using the authority of the G20 to put in place a new framework for financial regulation. But after the initial progress further development has stalled. In other multilateral forums, such as the IMF, reforms to give more votes to some of the rising powers, particularly China, have been blocked by the US Congress. The WTO remains deadlocked on a new overarching trade deal, and although the UN Climate Change Conference reached important agreements in Paris in 2015, most

climate specialists argue that the gains the new plans will deliver if they are fully implemented will not keep pace with rising environmental costs.

The second obstacle is *slow growth*. The aftermath of the 2008 financial crisis has cast doubt on whether growth of the old kind is still sustainable. It came to rely increasingly on a permissive attitude to increasing debt, mainly incurred by private households and companies, which was made possible by the expansion of financial services. Financial intermediation became more important across many sectors, both private and public. Individuals were encouraged to become more self-reliant and act as independent financial agents across a larger set of activities than ever before. After 2008 and the recession public debt soared as fiscal revenues plunged, and the economy shrank, making public expenditure a much larger part of the economy than before. A concerted effort to reduce levels of public and private debt commenced, but had only limited success. The difficulties of returning to pre-crash levels of growth highlighted how the past foundations of growth, whether technological innovation, rising population, immigration, or an inexhaustible natural environment had all become less reliable. Some of the reasons for this are directly political – immigration is the most obvious example, with increasing pressure to reduce immigration, even though immigration is an important element in the growth model of many economies including the UK in the last twenty years. There is anxiety that we may have entered a new age of secular stagnation. Despite the rapid pace of technological innovation productivity gains remain disappointing. The information technology revolution has not so far proved to be the kind of basic technology which in the past raised productivity across all economic sectors. This makes keeping living standards rising and generating the resources to deal with some of the big challenges all societies are facing, such as climate change, very hard, and no government is doing very well.

The third obstacle is *managing debt and inequality*. There has been a growing gap between rich and poor in the last thirty years, relatively stagnant living standards for the majority and sharpening intergenerational inequality. Ageing populations and increasing political hostility to immigration mean that dependency ratios are likely to continue to worsen with serious implications for the funding of public services. All these trends are associated with growing levels of personal, corporate and public debt. The austerity programmes widely adopted after 2008 have brought higher levels of unemployment in many countries, falling or squeezed living standards, reduced public services and sharpened struggles over the distribution of resources. The modern state is a tax state which depends for its resources on its ability to extract resources from private and corporate households, and arbitrate between the all the competing demands upon it. The legitimacy of states is crucial to their ability to raise taxes, and that legitimacy depends to an increasing extent in modern times on how well they manage and deliver public goods and public services to their citizens. They therefore have come to rely on steady economy growth and the fiscal dividend which it supplies to ease all the pressure upon them. Managing the social contract which lies at the heart of modern democratic citizenship has always been challenging, but the pressures have substantially increased since 2008, contributing to the growth of anti-system populist parties in many countries.

Four Scenarios

If these are some of the main features of the current political and economic impasse in which the western democracies currently find themselves, what are the most likely lines of development for

the future from a political economy perspective, particularly as they affect the financial markets. Four scenarios are sketched here; ordo liberal, social liberal, national protectionist, and red/green. The future is likely to involve elements of all four, although not in equal proportions. Current political circumstances make some of these scenarios much more likely to be realised than others. But political circumstances can change. The BREXIT vote and the election of Donald Trump have given new salience to the national protectionist scenario. Within the four scenarios there is much variation and complexity. To simplify the presentation each scenario is placed against two axes – interdependence/sovereignty and open/closed. The latter is further broken down into capital/trade and people. The different trajectories associated with the scenarios have been sharpened by the result of the 2016 UK Referendum on EU membership, and this is incorporated in the analysis.

	Ordo-liberal	Social-liberal	National-protectionist	Red/Green
Governance	Sovereignty	Interdependence	Sovereignty	Interdependence
Trade/capital	Open	Open	Closed	Closed
Migration	Closed	Open	Closed	Open

Scenario 1: Ordo-Liberal

In this scenario there is a very firm commitment to the maintenance of open market and international co-operation, along the broad lines which have characterised the international market order for the last seventy years under US leadership, as well as the governance of the EU, and specifically the Eurozone in the last twenty years. This means also that one of the main aims of policy will be to restore the situation that existed before the crash, with a strict separation of markets and government, and with government's role seen as freeing markets from obstacles to their full functioning. The free movement of goods, capital, services and people are the four pillars on which an international liberal economy is built, backed by a national state strong enough to enforce property rights, maintain the rule of law, and raise the resources to resolve social conflicts in ways which do not interfere in any radical way with the four freedoms.

Examples of this type of polity include the gold standard regime in the 1920s and the contemporary eurozone. For its supporters the advantage of the gold standard was that it was 'politician proof', and this is also an aspect of the governance of the eurozone. Strict rules are intended to minimise the opportunities for discretion on the part of politicians and policy-makers and regulators. Economic decisions are 'depoliticised' and governance is made to appear technocratic. The rationale for handing over decisions to experts is that they are less liable to corruption and influence from special interests, and more likely as a result to serve the public good, which is defined as upholding the rules which define the broad parameters of market/state relations. Markets supply economic dynamism and financial innovation, and states guarantee the framework in which a multitude of exchanges can take place.

As the previous thirty years showed such a framework can potentially allow a very rapid expansion of financial services and financial intermediation if the rest of the economy is also expanding rapidly. In the event of a major financial shock, such as the 2008 financial crash, the ordo liberal perspective sanctions action by government and regulators to stem market panic and restore public

stability. In an emergency no actions are off the table. But the clear expectation is that they will be temporary and that there will be a return to normal as soon as possible. This has not yet happened as noted above, but in this scenario that is the ultimate goal of policy which guide government agencies at both national and supranational levels. Debt has to be managed down, and the forces making for secular stagnation have to be overcome. Within an *ordo liberal* framework the best way of doing this is promote even more flexibility in markets, particular labour markets, and even more openness to free trade in goods and services and free capital movement. The ideal is a world without borders, held together by the bonds of trade and exchange.

The main impact of BREXIT on this scenario is that the global character of the UK economy and the policy stance of the UK government receives even more emphasis, but policy is also shaped by national protectionism, specifically on immigration. This national liberal variant of *ordo liberalism* appears to be the preferred policy of the May Government. In seeking to maintain the UK economy as a key trading and financial hub, the government might compensate for restricted access to the EU single market by pursuing policies to deregulate the British economy further and reduce corporate taxation. The regulatory burden on financial services in particular would be relaxed, and specific measures such as the proposed EU bonus cap would be rescinded. Alternatively the regaining of some sovereign powers might encourage national protectionist experiments, as occurred when Britain left the gold standard in 1931.

This scenario relies quite heavily on the reassertion of US political and economic dominance and the willingness of the US to continue to provide leadership in the governance of the international economy. The challenge of China and other rising powers would fail to materialise, and China would steadily be incorporated within the governance of the international economy, and would prove willing to be bound by the rules fashioned by the United States. The rationale for this accommodation is that China's political class is not ready to assume the burdens and responsibilities of international leadership. This concord between the largest economies and military powers in the international economy would permit an expanding role for the key central banks and specifically the Financial Stability Board would seek to preempt future financial crisis and maintain financial stability.

A return to US primacy would only work however if it facilitated a resurgence of economic growth across the international economy and a further widening and deepening of the world market. Techno-pessimists think that one of the conditions for this would be that prices of energy and other essential resources remained low. That would entail that reducing greenhouse gas emissions be downgraded as a policy objective, and much environmental legislation and subsidies for renewable sources of energy scrapped. Techno-optimists think that high energy prices could be one spur to a new wave of technological innovation aimed at reducing the world's dependence on CO₂ emissions. The hope of Brexiters is that BREXIT by 2030 will have delivered a more dynamic and entrepreneurial society, able to help the UK adjust to the higher costs associated with BREXIT. The most difficult area in this scenario is immigration, since free trade rules require free movement of people, but one of the key promises of BREXIT is that immigration is controlled and drastically reduced.

In this scenario there is a return to the trajectory of the international economy which was established in the long expansionist wave from 1992 to 2007. The importance of removing obstacles to the working of the global market would be paramount. A further enhancement of the role of financial services would be one outcome along with an increased reliance on personal and corporate debt to fuel

growth. A sustained economic recovery would reduce the burden of debt both for governments and households and make the problem more manageable, but the danger of periodic asset bubbles would still threaten financial stability and require careful management. There would continue to be tensions between prudential financial regulation and more laissez-faire regulation.

Scenario 2: Social-Liberal

The second scenario also envisages the maintenance of open markets, but much greater emphasis is placed upon international cooperation and the pooling of sovereignty. The thrust of this scenario is that the international economy can only recover and the obstacles to its growth and stability removed if there are fundamental reforms in the way capitalism is governed. At the heart of this scenario is a reconfiguration of the relationships between the state and the financial markets to promote investment, growth and higher wages. The *ordo liberal* scenario sees the return of sharp lines between monetary and fiscal policy and between governments and the financial markets. The social liberal scenario accepts the blurring that has occurred since 2008 as permanent and the basis for new relationships at both national and international levels, leading to a much more active role for governments both in setting the framework of economic activity and managing the outcomes. This reformed capitalism would see new checks and balances and new forms of democratic accountability established.

A significant feature of this process would be the strengthening of international financial regulation. The problems in contemporary global governance would be tackled through the pooling of sovereignty through the G20 and through regional associations such as the EU. A new financial architecture would be one result. Such accords would come about either through the US deciding it was in its interests, as after 1945 and after 1975, to promote a new set of rules for the international economy. The difference this time is that the United States would acknowledge that its power to impose its will was much less than in the past, and it would therefore offer concessions to gain the participation of other major players, particularly rising powers such as China. Along with new rules on financial regulation there would be agreements on tackling climate change and mitigating inequality. BREXIT is a particular challenge for the social liberal scenario because pooling sovereignty, and promoting multilateral cooperation are seen as essential. One of the conditions therefore for the social liberal scenario to be realised is delivery of the closest possible relationship with the EU after the UK formally exits in order to minimise the costs of leaving the bloc.

The social liberal scenario would also be associated with a new growth model. Financial services would be an important component of this but would no longer have the primary role they achieved in the economies of Anglo-America before 2008. The emphasis instead would be on investment in infrastructure and new technologies, and the skills required to support them. The aim of the new model would be finding ways to boost productivity and raise wages. This would require a much larger role for public agencies in promoting investment which private companies were reluctant to undertake. Opinions differ as to whether this shift to public agency would be temporary or permanent, a way of breaking the impasse of the low investment, low productivity, low wage, high debt economy of the last eight years, which would then allow government to step back. More radical versions of this scenario see

the enlargement of the government role as permanent. That would imply a much more tightly regulated financial sector, with the implicit social contract between the market agents and state agents being rewritten, requiring market agents to pursue certain specified public purposes, for example in funding particular kinds of investment, in return for their license to operate, and the guarantee of state support. In contrast with the *ordo liberal* scenario the state acts not just as enabler and the guarantor of last resort, but also creates a partnership to steer the economy in particular directions, in response to the pressures of the voters. This will mean at times, policy outcomes to which the majority of businesses are opposed. Politically the question is whether the trade-offs which emerge are acceptable, and re-establish the basis for prosperity.

The success in creating a new growth model will also determine whether or not debt can be successfully managed. In the *ordo liberal* scenario the return to growth is something which happens spontaneously, once all the conditions for it have been put in place, which include creating a fiscal balance through austerity. In the social liberal scenario the return to growth depends on active intervention, and growth is given priority over austerity. So long as higher borrowing is for investment it will be sanctioned, and austerity will be eased. Innovative monetary policies will be used to advance a broader economic and industrial strategy rather than a narrow financial strategy.

Scenario 3: National Protectionist

In contrast to the other two scenarios the national protectionist scenario is based on a closed rather than an open economy. Under this scenario countries would reject further liberalisation and globalisation and instead seek much more control over borders and over trade. There would also be withdrawal from multilateral institutions and a general suspicion of international co-operation. Ties with other countries would be mainly bilateral and would be restricted to specific issues where there was a mutual interest to co-operate. The underlying assumption about global and regional governance is that neither are reformable and the institutions which embody them should either be scaled back or abolished altogether. Such policies would not necessarily be isolationist, although they would point in that direction. Trade deals would be viewed with suspicion as limiting national sovereignty, and controls over immigration would be tight.

The implications for financial markets and financial services would be much more severe than the first two scenarios. A national protectionist scenario would signal much tighter regulation of financial markets, particularly all forms of cross border activity. Nationalisation of finance would not necessarily mean public ownership, although it could do. At the least it would imply that finance had to operate nationally and serve the national economy and the national interest. Financial markets would as a result become highly politicised, because their successful functioning would remain essential for the success of the new economic policy and therefore for the viability and popularity of the regime. A national finance model would be developed which would establish control over finance in order to direct investment. How far this would go would depend on how far the government was prepared to break ties with the international economy. There are many examples of such regimes, but few recent examples within major economies.

A range of outcomes are possible in a national protectionist scenario, reflecting the degree of closure in respect of borders and trade and the degree of protection of citizens which is sought. The

political forces driving national protectionism are quite diverse, ranging from Donald Trump in the US to the Front National in France, the Swedish Democrats, and the True Finns. How protectionist they would be in government as opposed to opposition is uncertain. Some of the parties on the left of this spectrum are both anti-globalisation and support new forms of international co-operation, building from the bottom. It still involves dismantling most of the existing multilateral institutions of international cooperation, and radical restructuring of the domestic economy.

Some national protectionist programmes, like Donald Trump's in the US, focus primarily on trade and immigration issues, and combine that with a low tax, deregulation, non-interventionist economic policy. But more common are programmes which also propose tax increases on the rich and redistribution. Budgets would be balanced primarily through tax increases rather than spending cuts, and the rentier class which has been such a feature of liberal political economies would be made a target. A common theme of national protectionist political economy is self-sufficiency and sustainability, and there is generally a political willingness to give up greater prosperity and economic growth in order to deliver that. Financial services are expected to adjust to this political choice and make the national economy work as smoothly as possible.

BREXIT offers a major opportunity to national protectionists in the UK to argue for a reform of the political economy in ways which would establish a much more closed economy, particularly in relation to trade and to borders. For national protectionists there is no trade-off between these two, because the need to safeguard borders and check free movement of people is paramount. There is a preference for trade to be bilateral where possible and tightly circumscribed. The attitude to financial markets is similar. National security and social security trump trade.

Scenario 4: Red/Green

Although less pronounced than nationalist populism another manifestation of anti-system politics has been the emergence of new socialist and green anti-capitalist movements. Bernie Sanders in the US and Jeremy Corbyn in the UK are examples of this trend, along with Podemos in Spain and Syriza in Greece, and possibly the 5 Star movement in Italy. Like the national protectionist scenario the red/green scenario is also fueled by a rejection of austerity and a rejection of globalisation. As far as capital is concerned the openness of the ordo liberal and social liberal scenarios is rejected. But where it differs from the national protectionist scenario is that socialists and greens favour new forms of internationalism, based on horizontal transnational connections and networks. Freedom of movement of peoples is a fundamental principle for many socialists.

Socialist and green movements are hostile to most of the governing institutions of the international economy and would either seek to reform them in radical ways or to dispense with them altogether. The strong emphasis on democratic accountability and of direct democracy over representative democracy means repudiation of the representative and technocratic institutions of global governance, including the EU, which led many red/green activists to support BREXIT. But they want to increase rather than diminish international co-operation, and are opposed to nationalism and isolationism. Co-operation to ensure regulation of financial regulation and global financial flows would still be necessary, but would be organised directly between red/green governments and movements, in order to keep decision-making as local as possible, rather than entrusted to supranational bodies.

The new red/green movements are deeply ambivalent about growth, since unchecked growth has created the environmental crisis. They see the environmental challenge as the biggest challenge facing all human societies, because if unchecked it threatens the extinction of the human species. Some are opposed to any further economic growth, and urge the remodeling of societies so that human beings can once again live within ecological limits. Others advocate new forms of green growth, a green New Deal, which prioritises technologies and products which help societies make the transition to ecological sustainability. This strategy would be very different from the alternative economic strategy of the 1970s and 1980s which was discussed in the British Labour party, although never fully adopted as party policy. It involved withdrawal from the European Community, import controls, planning agreements with major industries, extensive nationalisation, redistributive taxation and government control of banks. The new red/green thinking about political economy rejects this kind of centralised, top-down economic policy, advocating instead a decentralised, flat, non-hierarchical economy, made up of small businesses and mutuals, directly answerable to local communities. Such a model would get rid of the kind of financial intermediation and large global financial flows which have come to characterize the modern economy, and would be opposed to large public debt because this creates a rentier class and reinforces inequality. There would be a radical redistribution of income and wealth. Financial services would be organized to support the decentralised sharing economy. Ideas about how this would be done include crowd funding and small mutual banks. The low bond yields associated with secular stagnation is seen as an opportunity for governments to finance cheaply a Green New Deal, entailing large investments in infrastructure and technologies which may help to meet the environmental challenge.

Conclusion

What would be the broad impact on financial services of these four scenarios? They are summarised in the table:

<i>Impact on</i>	Ordo-Liberal	Social-Liberal	National-Protectionist	Red/Green
The City of London	Off-shore status maintained	International role maintained but subject to tighter regulation	Rebalancing of the economy Industrial strategy	Rebalancing of the economy Green New Deal
Regulation	Permissive Light touch	Permissive International rules	Restrictive National Priorities	Restrictive Social Priorities
Financial Innovation	Market led	Market led	National Investment Bank	Green Finance

The table considers three aspects, the impact on the City of London and its global role, the impact on regulation of financial services, and the impact on financial innovation. In the first two scenarios, ordo-liberal and social-liberal, the City of London retains its global role, although in the social-liberal scenario within a more regulated international framework. The ordo-liberal scenario is complicated because of BREXIT. Britain is planning to put itself outside the most important regional ordo-liberal framework in the international economy, but still maintain access to it. Whether this is possible will have a big impact on how financial services develop after 2020, as will whether the international economy as a whole avoids a slide into protectionism. The other two scenarios are less concerned with the international

framework and more with the rebalancing of the economy away from finance to pursue an industrial strategy or a Green New Deal. Both strategies imply a much reduced role for the City of London. It would still have important domestic functions, but its international trading would be curtailed.

For the impact on regulation there is a similar divide between the four scenarios. The first two suggest a broadly permissive approach to regulation, although this would be much stricter in the social-liberal scenario, and would be organized internationally and regionally. The other scenarios would impose much more restrictive regulation on the City, in a bid to make it subordinate to their wider programme of reconstruction. Finally, there is the impact on financial innovation. The first two scenarios assume that financial innovation will continue to be market-led, exploring in particular the opportunities being opened up by digitalization and social media. The social-liberal scenario assumes however that financial markets need quite careful monitoring, in order to intervene to avoid any repeat of the events which led to the financial crash. The National-Protectionist scenario is reliant on an industrial strategy and the mobilisation of finance to support it. The Red/Green scenario requires a much more decentralised model, built around the ideas of green finance.