

Andreas Dombret: What's the future of globalisation? What's the future of free markets? European optimism in an uncertain world

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at New York University, New York City, 11 October 2017.

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1. Introduction: Whither globalisation? Whither free markets?

Ladies and gentlemen

It gives me great pleasure to be back in New York and at NYU.

Today I want to talk about two things: chocolate and Nobel prizes.

Stay with me for a moment. Some time ago, I stumbled upon a story that connected chocolate and Nobel prizes in a way that reminds me of how we talk about globalisation nowadays. In 2012, a New York-based physician and researcher published a note in the *New England Journal of Medicine* in which he analysed the link between chocolate consumption and cognitive function.¹ While not unusual, his measurement was, let's say, creative. He measured the correlation between a nation's chocolate consumption and the number of Nobel laureates per population. It came as little surprise that Switzerland won, with the US and Germany achieving only a mediocre ranking.

While the author himself was careful not to claim that he had found a causal link, he highlighted an extremely strong correlation – indeed, his only regression graph was quite close to being a perfect line. Thus, others were tempted to debate the merits of launching a government programme to boost national cocoa consumption.

Correlation does not imply causation. Intuition is not always based in fact.

Confusing correlation with causation is amusing – but it is also disturbingly similar to what we are seeing in current political debates. Is the idea that more chocolate leads to more Nobel prizes really any different from the idea that protectionism brings back old jobs? Is it really any different from the idea that Brexit or the breakup of the European Union would bring with it increased welfare and security?

Across the globe, populism is on the rise – leading many to fear that the post-war economic order is coming to an end. What's more, even the future of the Western alliance has come into question.

My impression is that many people in the United States are still asking these questions. Political tensions still dominate. The role of global cooperation with other nations is still contested. Globalisation and free markets are still questioned.

Some of you may be wondering whether I have brought optimism with me from across the ocean.

Sadly, I have not. In my talk, I will argue that too little has been done to resolve the economic challenges that underscore populist success.

I will start in the present by giving you my take on the current state of the European Union. Much like in the US, we have not yet found the solutions to the root causes of these problems. Next, I take a look back at the past to explain that the root causes lie at the heart of our market economies – the tension between innovation and social cohesion that has been there for more

than 200 years. Finally, I will turn to the future to discuss three principles for better economic policies and several concrete policies that could serve to implement these principles.

2. European optimism in an uncertain world

So let's start with the present – with Europe's current economic and political condition.

Since the financial crisis, the pace of recovery in the euro area has been slower than it has been in the United States. Lately, however, there have been signs of a broad economic recovery.

Recent figures reveal a pleasant surprise for the euro area, with sound GDP growth of 0.6% for the second quarter of 2017. Unemployment stood at 9.1% in July, down from its peak of 12.1% in 2013.

But a recent study has shown that the labour market in the euro area is in worse shape than the official job figures suggest, with workers unlikely to see real increases in pay because of the level of underemployment.² A measure of "slack" in the labour market indicates that about 15% to 18% of the euro area workforce are without jobs or would like to work more – which is nearly double the official unemployment rate. Underemployment is even growing in weaker labour markets, such as those in France and Italy.

The still weak labour market in many regions of the euro area is one of the gravest ongoing consequences of the recent financial crisis and an indication that the recovery is still weak. This is particularly true with respect to the high level of underemployment in peripheral regions and among young people.

Thus, while the euro area economy looks increasingly healthy on average, it becomes clear on closer inspection that a lot still remains to be done to move onto a sustainable, integrative path of prosperity.

And this is one of the reasons why extreme populists are still making gains at elections. Sure, Marine Le Pen, the front woman of the far right in France, did not become the French president, and Geert Wilders, her counterpart in the Netherlands, did not become part of the Dutch government. So yes, there is reason to be a little less pessimistic.

However, two weeks ago, the German general election showed us that politics has not yet laid the groundwork for optimism, as a populist party came in third. I will come to that in a moment.

In my eyes, though, the positive outcome is one of government stability: Chancellor Merkel's conservative Union gained the majority again. But she faces the difficult task of forming a coalition, as only two options are possible. The first, which is to continue her current grand coalition with the social democratic SPD, has little chance of success as the SPD wants to go into opposition. Second, she could form what has been dubbed the Jamaica coalition with the liberal Free Democratic Party and the Green party. While all parties are willing to enter into negotiations, it will be challenging – finding common ground, will take creative political agenda-setting and political diplomacy. But I am confident that an agreement can be reached. Thus, I am confident that the stability of the German political landscape will remain intact. And with that the strong growth momentum of the German economy will also remain intact, which, in turn, will be a strong basis for continued growth of the Euro area economy.

Yet this election reveals a deeper, inconvenient truth – that we are far from having found sustainable solutions to the root causes of populist success. This is mirrored in the first far-right party entering the Bundestag since 1949: Alternative for Germany, or AfD for short. It is now the third-biggest party in the Bundestag, with almost 13% of voters supporting it.

Its supporters can be divided into three buckets: first, an established fringe group of far-right voters; second, a group frustrated with how the government handled the refugee crisis and their integration; and third, a group of economically disappointed people. About half of the party's voters are economically disappointed.

This is the economic side of why protectionism and populism still enjoy strong support. The AfD, like many other populist parties, pins the blame for economic malaise on globalisation and European integration – and demand that they be reversed.

These simple explanations offer intuitively appealing solutions to Europe's problems – they are the chocolate to Nobel prizes. And they overshadow the actual economic challenges.

If we do not solve these actual challenges, populist influence might well grow – and that would put global and European cooperation at risk. These unresolved economic tensions could become the roots of serious political conflict.

Can this really become such a problem? My answer is one word: Brexit.

In June 2016, UK voters decided to leave the EU – they had been told that they would be able to save their money and put it to better use, and that they could once again be sovereign in the global economy, all without any negative consequences. Unfortunately, the campaign was built on false anti-EU information. These intuitively appealing anti-European sentiments did find support – to a substantial degree – among economically disappointed citizens.

Where are we now? Brexit is definitely happening, and chances are it will be a hard one – by which I mean that there will be a complete exit rather than a partial one. The UK and the EU will go their separate ways in March 2019. After we agree on how to separate, we will start to negotiate the terms of our new partnership. Since negotiations have been going rather slowly, there may be a transition period of two years from 2019 to 2021 – during which the old rules would still apply and the terms of their new partnership could be drawn up. What kind of economic partnership this will be has yet to be determined. If we do not find a solution, the EU and the UK will trade under rules set by the World Trade Organization – which is in nobody's interest, but could be particularly harmful to the UK economy. I hope that negotiations will be able to strike an economic partnership that underscores the close political friendship between the UK and the EU.

Brexit shows that less integration is not the solution to the root causes of our economic problems. But a simple case of more integration is not a solution either.

The EU appears stronger today than it did a year ago. This was mirrored in Commission President Jean-Claude Juncker's State of the Union address on 13th of September, and in French President Emmanuel Macron's plan to reform the EU, as set out in his speech on 26th of September. I agree with them that a strong EU is in the best interest of all Europeans and that it can play an important role in international relations.

But I think that we should get the order right: first reform, then the next steps towards more integration. Taking economic and monetary union as an example, there remains a lot to be done to become a stable monetary union – in the case of the United States, it took more than a century of conflicts. We need to work on equalising living conditions across the widely differing economies of the euro area and on improving the fiscal rules. This will take years of political work and debate. We should take this step first before rushing prematurely into integration projects.

But let me be as clear as I can: I am a passionate European, and I want the EU to become stronger and better in the years to come.

Neither less nor more integration at any price is a panacea for the problems in our market

economies. Our problems are not that we cooperate at a European or a global level – the EU and globalisation are achievements. But they have serious side effects. These side effects give us a glimpse of the fundamental challenge that our economies are facing – and this holds, to varying degrees, for all developed market economies.

What is this fundamental challenge?

3. It's not globalisation, stupid – it's the (market) economy

It lies at the heart of our market economies: it is the tension between liberalisation of economic exchange, on the one hand, and social cohesion, on the other.

Let's take a historical look at this tension, and let's do so through the eyes of two great economists: Adam Smith explained in the 18th century that if you allowed people to work wherever they want and for whomever they want, the market would then work like an invisible hand, creating prosperity.³ The idea of a liberal market economy was born.

But this liberalisation created tension. It was the economic historian Karl Polanyi, who identified this tension.⁴ In the early 1940s, Polanyi lived in exile in Vermont. Thinking about the root causes of the rise of fascism in Germany and Austria, he realised the economic tensions that underscored the ascent of Hitler and his like. He understood that the rise of the market economy had brought with it not only unmatched prosperity but also rising social hardship and tensions.

He studied the emergence of modern market economies during the industrial revolutions of the 18th and 19th centuries. At that time, huge workforces were required to produce goods. Workers needed to be drawn away from their previous occupations into factories, and so labour came to be seen as an economic resource – one that needs to be flexible for a complex economy to function.

Industrialisation and market economy changed the social structure, as people were now relying on a macro-economic production process – and this dependence could have very negative consequences if working conditions were bad or people lost their jobs.

Thus, while the market economy created much prosperity, it did also change society. Polanyi realised that this led to a struggle that helped to explain many historic events since the industrial revolutions: liberalised markets would create change and prosperity, but the social problems that they created would lead to opposing forces. The negatively affected would then demand policies to counterbalance the negative side effects, one example of which was social security.

You can look at the history of the markets over the last 200 years through the lens of this struggle. Until the 1930s, laissez-faire liberalism led to markets being quite unconstrained, which created social tensions that contributed to the rise of fascism.

From the late 1940s until the 1970s, the developed nations experienced the glorious thirty years of rising wealth and welfare states, during which the markets were much more constrained by government regulation. This episode, however, came to an end with the decade of stagflation in the 1970s.

The response was to liberalise the markets once again. From the 1980s until today, privatisation and globalisation have been the leading paradigm.

The financial crisis, which erupted in 2008, may have been a turning point. Today's big economic debates may very well be a sign of the tides turning.

Criticism of globalisation and inequality, as well as rising populism and socialism, are symptoms

of a bigger problem of our market economy model.

Now, that was a fast ride through 200 years of economic history. And to be clear, much of this story has been simplified and I mooted many competing explanations. My point is that, at their core, our market economies are fraught with tension – the tension between free market exchange, on the one hand, and social cohesion, on the other. This tension can create social and political conflict.

We must ensure that these conflicts are mediated in a spirit of cooperation and that our economic and political model can survive.

How do we achieve this?

4. How to soften the blow: principles for a better global economy

To my regret, I do not have a master plan. That's because there are no simple, realistic, quick-fix solutions. And that's why a serious debate is needed about what we can do to make our economies future-proof.

Three principles, in my mind, should guide our discussions.

First, we need a fairer market economy. What do I mean? Markets are in principle successful in organising the complex division of labour. But they have negative externalities – in other words, others may be negatively affected by a market transaction between two individuals or firms. It might lead to the pollution of our environment, the lowering of labour standards or the loss of jobs. If these side effects become too much, they can threaten social cohesion.

To prevent this, we need to strike the right balance between two policies: policies that foster the competitive dynamics of market economies, and policies that ensure the social cohesion that is necessary for market economies and indispensable to democratic societies.

The most obvious tools are fiscal policy instruments that serve to strengthen the social security system, which provides financial compensation to individuals such as those who are unemployed.

At least as important as the provision of financial compensation is making sure that people are capable of helping themselves. To that end, we need better education and higher qualifications: countries need to promote equal access to high-quality primary, secondary and tertiary education. What is crucial to educational success in 5 to 50 years is that we increase public spending on qualified personnel. Moreover, active labour market policies are needed to support the jobless in their efforts to qualify for other professions.

The second principle is that we must tackle the hidden problems that are weakening our market economies. What do I mean? I'm talking about the problems that are complex in nature and difficult to solve – which makes them less intuitively appealing – but nonetheless pose challenges that are significant.

We need an open and honest debate about these problems, even though the debate might not be promising in terms of electoral gains. Because if we don't talk about them, the populists surely will – and once they own the debate, facts will certainly play less of a role.

Let me give you an example of what I mean: where should we take money from to fund the compensation and education measures that I just talked about – without increasing public debt? This is a difficult debate, but one important aspect needs more debate than it has received so far: financing must be tax-based rather than debt-based. And the tax base has been seriously

weakened by international tax evasion and avoidance.

This is one of the big problems of globalisation. According to Gabriel Zucman, 8% of the world's total household wealth, which is USD 7.6 trillion, was in tax havens in 2016 – according to Zucman's conservative estimates, 75% of these funds are derived from illegal tax evasion.⁵ In 2009, the G20 took action and compelled tax havens to sign bilateral treaties providing for the exchange of bank information. While this is an important first step, there is evidence that the effects are modest and that more needs to be done.⁶

Moreover, in addition to tax evasion, the public is also saddled with substantial losses due to *tax avoidance* stemming from profit-shifting strategies implemented by international corporations.⁷ The reason is simple: our tax codes are outdated and not ready for the digital age, in which it is possible to shift profits around the world. Fortunately, the first steps in the right direction are also being taken here.

OECD and G20 countries have agreed on the BEPS project – short for Base Erosion and Profit Shifting. But this agreement is toothless without effective implementation – which is the important task for all signatory countries. A promising approach is the recent initiative by ten EU member states to enhance the taxation of international corporations by updating the corporation tax codes in a manner independent of profits.

And this brings me to the third principle: we need better globalisation. We need to find a form of global cooperation that lies in between the two extreme, ideologically motivated solutions of national isolation and a borderless global economy.

A realistic middle ground would be focused global cooperation: continuing to exchange, to cooperate and to harmonise regulations, where sensible – but also focusing and improving our efforts. Focused global cooperation would also offer greater scope for solutions that respect the legitimate interests of countries wanting to run their economies independently.

An example is the global harmonisation of banking regulation. We, the Basel Committee – which includes the banking supervisors from the G20 – currently work on the final piece to complete global regulatory reforms after the financial crisis – the so-called Basel III agreement; and we are close to an agreement. That would bring global minimum standards to regulate internationally active banks.

Yet, for purely nationally active banks, there is no need to have global minimum standards. National supervisors may adapt the standards to fit historically grown national circumstances. For example, in the EU we are considering a small banking box, with less complex rules for small, non-risky, and nationally focused banks.

But let me make one thing very clear: focused cooperation and more national autonomy must not be abused to water down post-crisis reforms of financial regulation. I am concerned by such efforts, because they could be captured by the financial industry and result in a race to the bottom. Instead, we need sound minimum standards for a stable, global financial system.

5. Conclusion

Ladies and gentlemen

To my regret, more chocolate does not lead to more Nobel prizes – even if it looks that way.

Neither the US nor Europe has yet sorted out the economic problems that contribute to the success of populism. I am an optimist, so I would say that we have made progress – but we are

certainly not there yet.

Our economic policies need to strike a balance between Smith and Polanyi – enabling the competitive dynamics of market economies while safeguarding the social cohesion indispensable to democratic societies.

You may not share all of the policies discussed. But I hope we can debate on the basis of the three principles: a fair, social market economy; the need to identify and tackle hidden problems; and better globalisation through focused global cooperation.

This debate will not come easy: many must be willing to overcome their ideological convictions. It is only in this way that we can harness the benefits of market economies and limit their social costs, that we can create better market economies and a better global economy, and that we can stabilise our economies and our democracies.

And now, let's debate!

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 - [2](#) European Central Bank (2017), Assessing labour market slack. *ECB Economic Bulletin* 2017 (3): 31–35.
 - [3](#) A Smith (1776), *An Inquiry into the Nature and Causes of the Wealth of Nations*.
 - [4](#) K Polanyi (1957), *The great transformation. The political and economic origin of our time*. Beacon Press.
 - [5](#) G Zucman (2015), *The hidden wealth of nations: The scourge of tax havens*. University of Chicago Press.
 - [6](#) N Johannesen and G Zucman (2014), The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown. *American Economic Journal: Economic Policy* 6(1): 65–91
 - [7](#) G Zucman (2015), *The hidden wealth of nations: The scourge of tax havens*. University of Chicago Press.