Andreas Dombret: A stairway to heaven? The promises and limits of global integration

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the London School of Economics and Political Science, London, 8 February 2018.

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1. Introduction

Professor Goodhart,
dear Charles
Ladies and gentlemen

Thank you very much indeed for your kind invitation. It’s a great pleasure for me to be back at the LSE. For me this university represents how we can achieve a better society if we deepen our understanding of the world. London, on the other hand – with its fascinating and diverse culture – is the more joyful part of learning about the world.

I have to admit I was somewhat shocked when the majority of UKvoters chose to leave the European Union. I respect that decision, and I understand that many voters voiced their frustrations through their “leave” vote. Yet I am convinced that the UK and the EU going separate ways will be a tremendous loss for both sides. And I very much hope that during the coming months we will find pragmatic ways to establish a new, respectful, and amicable partnership.

But the formal contracts alone will not make for such a strong partnership. What it will take is civil engagement – universities are among the most important breeding grounds for this; and that is especially true of the beacons of international academic cooperation like the LSE. The teachers, professors and students of the LSE and all other universities can be – I would go as far as to say: they have to be – the basis for continued exchange to foster mutual understanding.

That is what makes my visit here today so important to me. And that is why I want to talk about the future of international cooperation, the limits of which have become so painfully obvious – not only due to the Brexit vote, but more generally in the partial rejection of global solutions and the rising support for sovereign national economic policies.

In my lecture today I will ask whether over the last 40 years global economic integration, globalisation for short, has been the stairway to heaven that it promised to be, raising overall economic welfare. I will argue that globalisation‘s performance has actually been rather mixed. From there, I will ask what we might learn for future partnerships like the post-Brexit deal. I intend to discuss a middle way between the perceptions of globalisation advocates and opponents: an approach of less comprehensive globalisation and greater national diversity. To make the case, I will apply this approach to three current policy challenges: the regulation of global trade, the regulation of global finance, and the future relationship between the UK and the EU.

2. Has globalisation gone too far?

Globalisation is good – for almost everyone. This was the mainstream judgement for a long time. But the wind has changed. More than a year after the “leave” vote and a new USadministration taking office, the discontent with globalisation seems to be almost everywhere. Do Brexit and the new US trade policy threaten to reduce overall economic welfare as they turn back globalisation? Or has globalisation gone too far? Has it created wealth for a few, while creating many losers among the broader population?

Well, globalisation is both good and bad. On the one hand, global economic integration has contributed to greater prosperity in many countries. The reduction of tariffs on trade – one particular example being the General Agreement on Tariffs and Trade or GATT for short – has increased overall economic welfare. The division of labour on a global scale has opened many channels of rising prosperity – from economies of scale and comparative advantages to global technological transfer.[1] And for the last 40 years the public debate has focused on these gains.

Then came Brexit and growing populist support around the world. This development is a reminder that globalisation has a darker side; that global economic integration of the last 40 years has contributed to two significant problems.

First, importing and exporting lead to sectoral change and redistribution, which produces both winners and losers in a society. Even though globalisation is less important than technological change for redistribution, we knew for quite some time that international trade creates winners and losers within a society.[2] There is considerable evidence that international trade pushes some people in import-competing industries out of jobs or reduces their wages.[3] Examples of what this does to societies are to be seen in the American rust-belt and northern England. There is also evidence that it heightens political polarisation.[4]

Now, a society may want to protect globalisation's losers against the negative repercussions of this redistribution, or at least compensate them.[5] But, this may be difficult – because of the second problem of globalisation: global regulatory harmonisation weakens the ability of states to sustain welfare standards and regulations that are above global minimum standards – the result can be what is referred to as the race to the bottom.

Success in slashing tariffs gave rise to the belief that ever more integration of global markets would foster prosperity growth for all participating societies. Globalisation advocates identified divergent national regulations as being the great remaining non-tariff barrier to trade. To increase the reach of the global market and to further raise prosperity, they recommended harmonising national regulations in order to reduce transaction costs. This led to trade agreements that harmonised rules far beyond reducing simple trade hurdles.

This harmonisation pressure did not come in the shape of formal international agreements alone; it also came in the shape of informal pressure to adjust to global market pressure, potentially leading a country to consider itself limited in its policy choices because it perceived the threat of firms moving to locations with more favourable conditions.[6]

At the time, wide-ranging global liberalisation and harmonisation were widely seen as a panacea. But the downside is that it limits countries in their individual policy choices. Just think about criticism levelled against CETA, the comprehensive Canada-EUtrade deal, and TTIP, the corresponding US-EU project. And also Britain's desire to set its own rules can be viewed in this light. Comprehensive, rule-harmonising agreements have the drawback of giving more influence to global institutions and international firms than is legitimate with respect to democratic principles. Moreover, they leave insufficient room for institutional, legal and regulatory diversity between countries with different histories and preferences.

And these examples show one thing very clearly: when governments and parliaments seek to regulate markets and firms freedoms – for example by taxing corporations or setting labour and environmental standards – but resist because they feel constrained by harmonised rules and global market pressures, this can undermine social contracts and lead to political polarisation.

In sum, globalisation is both good and bad. On the one hand, liberalising trade and connecting the world economy has created substantial wealth. We need to be careful not to throw this away. Retreating to purely nationalist solutions would almost certainly make things worse – for almost everyone in our societies. Yet on the other hand, globalisation might have gone too far – the dose chosen over the past 40 years probably has been too much of a good thing.

3. Accepting the limits of globalisation

What can we do about it? We need a middle way between the positions of globalisation advocates and opponents – a solution that harnesses globalisation's benefits and limits its negative repercussions. But what road can lead us to such a promising goal?

There is the populist "solution": nationalist protectionism, which might even go as far as promoting autarky. I do not wish to spend much time on this, as I deem this a short-sighted, incomplete proposal that claims to shield people from economic and societal change – without admitting that this is impossible even within a walled nation.

A more realistic, and quite prominent idea is to compensate those who lose out from international trade.[7] The welfare state does in considerable part already achieve just that. Yet the welfare state has been somewhat in retreat, as countries have attempted to strengthen their international competitiveness by lowering social costs. So there is probably some room for improvement. But this will not be enough, as it does not provide a solution to the "race to the bottom" problem; nor does it even the tilted influence of global institutions and international firms.

To understand what options we do have, I find a simple, yet powerful analysis very helpful: the impossibility theorem for the global economy. Dani Rodrik, the Harvard professor, whose work in International Political Economy has gained a great deal of attention, argues that when we set the framework for global economic integration, it is impossible to have all three tenets of the current globalisation order at the same time: we cannot have

(a) full, global market liberalisation,
(b) national sovereignty and
(c) democracy.[8]

In other words, this globalisation trilemma forces us to choose two of these three tenets and give one up. It can be any two, but it is impossible to have them all. So, if we look for a solution in our current globalisation debate, we have to decide which two central tenets we value more than the third.

While this sounds overly simplistic, I think Dani Rodrik has a valid point. Think about it. If we continue to deepen global market liberalisation and harmonisation, then the ability of countries and their sovereign people to choose their own policies becomes less and less. We could give up democracy, so that an autocratic ruler or a technocratic government could decree that everyone has to accept full market liberalisation or the globally harmonised rules that the government has negotiated. Or – if we cherish democracy and want to keep the global market – we could surrender national sovereignty to a global democracy, so that a global government and parliament would correct globalisation's failures.

Thus, if we continue to pursue a fully integrated global market with widely harmonised rules, we would have to give up either our national sovereignty or our democratic ability to oppose global rules. However, democracy is not on the table; and I think it is fair to say that Brexit and the rise of populism have taught us that our societies are not ready to renounce national sovereignty.

What remains, then, is to limit global market liberalisation. But how?

Normally, it is bad marketing to start with what your product cannot do – nevertheless, I want to clarify what limiting globalisation does not mean. It does not mean that we should end foreign diplomacy and multilateral international politics; nor should we stop fostering mutual understanding and the friendship of nations. It likewise does not exclude economic policy coordination in times of crisis – which was quite successful during the last financial crisis. And finally, it does not mean that we should resort to mercantilist policies of rebuilding tariffs around special interest groups.

So what then? The answer is that we must devise a stronger set of rules that limit the negative repercussions of free markets. This solution has a national and a global component, where greater attention has to be placed on the national approach than was the case in the past four decades. I want to emphasise three policy elements.

First, countries themselves have to decide what level of compensation they want to provide to those who lose out from globalisation.

Second, each society has to reconsider the cases in which certain limits to global markets would make sense. This would most likely result in more limits to international economic activity, and it could lead to more institutional, legal and regulatory diversity between countries with different histories and different preferences.

But there will still be substantial room for the global dimension. So the third policy element of the future globalisation framework is continued – but less, and focused – harmonisation. It is my opinion that we should focus our harmonisation efforts on certain meaningful and legitimate minimum standards.

You could call this "globalisation on a leash". I prefer the expression "focused harmonisation": sovereign countries carefully select the suitable areas and respect where other nations see their own vital interests at risk. This means that we have to ask in what areas global liberalisation and harmonisation is meaningful and how far they should go – and in many areas the answer might be that less is more; that less liberalisation and less harmonisation is better globalisation.

But when does a national policy legitimately protect its national social contract, and when does it constitute the illegitimate protection of special interest groups? Whether we can find practical answers to this question is the acid test of focused globalisation. Politicians and their advisors need to carefully decide in which areas harmonisation is meaningful and how far and deep it should go.

There is no simple answer here, but we need a more balanced benchmark than the idea of a fully liberalised global market without any legal transaction costs. Leaving room for diverse national approaches in areas involving vital elements of a country's social contract would be a more realistic course.

Now I realise that proceeding in this way takes us out of the comfort zone of our established policy principles. But innovation is always outside the comfort zone, especially since – as with all important and challenging questions – we have no readily available plan.

So the crucial question is: How can we make focused harmonisation work? Let's take the principles that I just talked about and apply them to reality in three crucial policy areas: trade, finance and Brexit.

4. What should trade agreements harmonise?

When it comes to trade, it is crucial for our societies to find innovative policies that compensate for or even prevent some of the redistributive effects of trade.[9]

There is a lot of debate going on about how this could best be done.[10] And it seems clear to me that we have to continue looking for a good policy mix that combines established ideas, like combating tax fraud and tax evasion, with new ideas. Only in this way can we hope to strengthen the social contracts which underpin our market-based policies.

But my focus today is less on the redistributive effect and more on how much global liberalisation and harmonisation is meaningful in light of these challenges. In the realm of trade deals, this brings us to the question of how many trade-related regulations and laws we should harmonise.

As the failure of the TTIP agreement shows, our approach cannot rest on the simple tenet of "the more, the better".

Instead, future trade agreements need to be focused and should respect national prerogatives. Trade agreements should be trade agreements and nothing more than is necessary to enable the global division of labour and exchange of goods. For that, we do not need transnational arbitration courts, as were discussed in the context of TTIP. What we need is a reliable legal framework, something that all developed economies can already guarantee.

If we want to do business in a society or deliver goods or services to its markets, we have to accept the rules this society deems essential, in which case a company's cost-benefit analysis will show either that compliance with said rules will still deliver an acceptable return, or that it should not engage in the business in question.

5. How much harmonisation in global finance?

Let's turn to my second example: global finance and regulatory harmonisation. Here, focused harmonisation and more diversity could also be applied.

This statement may surprise some of you, as the Basel Committee on Banking Supervision has just finalised the Basel III agreement after eight years of global cooperation to devise the complex set of rules.

And of course I would not wish to see this wheel turned back. Basel III is an important milestone; it is a global minimum standard that imposes limits on the risks that internationally active banks can take. By defining minimum amounts of equity for banks in relation to their risk-weighted assets, it seeks to reduce the international risks to financial stability.

The Basel Committee on Banking Supervision, a transnational body of supervisory authorities from 28 jurisdictions, has worked since the onset of the financial crisis to provide a global solution to problems that brought about the financial crisis. And I am a strong supporter of implementing this standard in the European Union to make it a binding reality. I am convinced that the UKauthorities will take a very similar view.

However, please note two qualifications: these are minimum standards for internationally active banks.[11]

Since Basel standards are minimum standards, a country may decide to set stricter requirements. For example, Switzerland has a higher leverage ratio. And as many of you know, the UK has ring-fencing rules in place that separate vital basic functions of a bank from the riskier ones. This policy is not of the Basel Committee's making, and the UK is free to apply it in its jurisdiction.

The second qualification of the Basel III standard is that it is for internationally active banks. As such, jurisdictions are free to apply a different set of rules to smaller, only nationally active banks that pose no threat to international financial stability. Most nations already have less restrictive rules on smaller banks in order to reduce the operational burden for them. I am a strong proponent of extending this proportionality further, because the highly complex regulatory reforms after the financial crisis were sought for global banks, and they overburden smaller, regional banks.

In sum, then, we ought to focus on truly global aspects, like regulating globally active banks, while leaving it to nation states to carry out those tasks that they are better placed to take care of, such as the regulation of locally active banks.

6. Brexit and the limits of the future partnership

This brings us to Brexit. Many of us are wondering what sort of cooperation model there will be. If no solution is found, the EUand the UK will trade under rules set by the World Trade Organization – which is in nobody's interests, but is likely to be especially harmful to the UK economy.

Politicians and negotiators are currently seeking a deal that will minimise frictions in trade and supply chains on the one hand. On the other, such a settlement must also give the UK and the EUfreedom to develop their own rules according to their own specific, historically evolved circumstances and current preferences.

And it may very well be that this new agreement is quite limited – for example, to the exchange of goods. Labour migration is likely to be excluded; at least, that seems like a red line for the UKgovernment. And free trade in services also seems less and less likely. To quote the negotiator for the EU, Michel Barnier: "There is no place [for financial services]. There is not a single trade agreement that is open to financial services. It doesn't exist […]."[12]

Thus, it is not that unlikely that there will be no free trade agreement for financial services – or other services sectors for that matter. Service providers would then have to apply for full licenses in both jurisdictions and have all the necessary elements of a fully functioning bank ready in both places.

And while this might increase transaction costs in some cases, it may bring the benefit of enabling the EU and the UK to set their own rules in an important area of economic policy. And as important as efficiency is, the ability to find national solutions, national rules to stabilise the social contract, is more important for social cohesion than economic efficiency.

And as unspeakable as this may have seemed just a year ago, it would not stop the world from turning; which is why we have been urging banks and other financial services firms for quite some time to prepare for this scenario.

Whatever political decision is taken, supervisors will not only do all they can to make the transition to a new regime as smooth as possible; they will also, in the long run, try to reduce unnecessary inefficiencies where possible. That way, we can hopefully keep the efficiency losses to the economy at a rather negligible level. Yet, one thing must be absolutely clear: relaxing regulatory standards as an instrument of economic policy is not an option. Competitive deregulation through tax or supervisory policy would erode the foundation of our future cooperation.

7. Conclusion

Ladies and gentlemen

I was born in the United States, grew up in Germany, and spent much of my life working around the world, including London. Personally, the backlash against the integration of our global community has shattered my core beliefs and worries me deeply.

But I accept that global economic integration has gone too far. Theoretically, it may be appealing to have one global market, but the reality is that it does not work. It has substantial negative repercussions – repercussions that our current approach to globalisation cannot handle well.

We need to find a new, third way; a middle way that harnesses globalisation's benefits and limits its negative repercussions. To stop a race to the bottom, national governments and parliaments will have to be more willing to go their own way rather than believing in entirely free, frictionless global markets and fully harmonised rules.

They will have to decide what level of compensation they want to provide to those who lose out from globalisation; and each society will have to reconsider where it makes sense to impose limits on global markets and internationally active firms.

However, there would still be substantial room for the harmonisation of rules, but it should be less, and focused, harmonisation with minimum standards only in carefully selected, meaningful areas. I personally will do everything I can to contribute to finding the right approach.

Ten years from now, I hope we will have adapted the multilateral system to form one that does not condemn distinct national rules as something illegitimate or inefficient, but one that combines sensible global integration with institutional diversity. Only if we become that open-minded and accept the rich diversity of human culture will we be able to sustain a close multilateral system that is geopolitically stable and enjoys the support of the clear majority of people.

We need to debate this earnestly and intensely so that we may arrive at new thoughts and ideas. On that note, I now look forward to debating with you. Thank you very much for your attention.

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2 W F Stolper & P A Samuelson (1941) Protection and Real Wages in *The Review of Economic Studies* 9(1): 58–73.

3 See, for example, for the US, D H Autor, D Dorn & G H Hanson (2013) The China Syndrome: Local Labor Market Effects of Import Competition in the United States in *The American Economic Review*, 103(6): 2121–2168; J R Pierce & P K Schott (2016) The Surprisingly Swift Decline of US Manufacturing Employment in *American Economic Review*, 106(7): 1632–62; D Goldschmidt & J F Schmieder (2017) The Rise of Domestic Outsourcing and the Evolution of the German Wage Structure in *The Quarterly Journal of Economics*, 132(3): 1165–1217.

4 See, for example, D Autor et al (2016) Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure. NBER Working Paper No. 22637; for Germany: Dippel, C, R Gold and S Heblich (2015) “Globalisation and its (dis-)content: Trade shocks and voting behaviour”, NBERWorking Paper No. 21812.

5 A Dombret (2017) Current challenges for the European economy and international trade. Speech given at the German Chamber of Commerce in Beijing, 25 May 2017

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7 A Dombret (2017) Election time(s) in Europe – Challenges on the way to economic recovery. Speech at the University of Tokyo, 23 May 2017.

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9 However, we should not forget that these social interventions in market economies are even more important with a view to the much bigger redistributive effects of digitisation and technological change more generally.

10 For example, D Rodrik (2017) Straight Talk on Trade: Ideas for a Sane World Economy. Princeton, NJ: Princeton University Press; A Dombret (2017) Election time(s) in Europe – Challenges on the way to economic recovery. Speech at the University of Tokyo, 23 May 2017.

11 A Dombret (2017) Basel III – Are we done now? Statement at the ILF Conference in Frankfurt am Main, 29 January 2018.

12 Interview with the Guardian on 18 December 2017; www.theguardian.com/politics/2017/dec/18/uk-cannot-have-a-special-deal-for-the-city-says-eu-brexit-negotiator-barnier; accessed on 23 January 2018.