# AND NOW THE ORDER ENDS

December 2017

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## Mercantilism's drive towards geopolitical entropy

Many decades ago, John Maynard Keynes warned of a fundamental flaw in the international monetary order. The post-World War II system of Bretton Woods, the British economist argued, rewarded the world's surplus countries with an undeserved level of impunity. By asymmetrically forcing deficit countries to adjust their imbalances but leaving the equally distortionary balances of creditors unsanctioned, the world faced a deflationary bias on a continuing basis.

Keynes thought that as long Pax Americana's ill-conceived monetary architecture remained in place, globalisation's already inherent disinflationary characteristics could be amplified to a dangerous degree.

Although, the Bretton Woods system of fixed exchange rates has long gone, Keynes' criticism of an asymmetrical bias still holds true. Most of today's global economic problems (inflation shortfall, growth's dependency on credit, low productivity, intensifying automation and polarised labour markets) can be traced back to a defective international monetary regime. This allowed disinflationary forces to spread for too long, fostering ultra-low interest rates and technological innovations but also rising social inequality and massive credit expansion.

### Globalisation's purpose

Although it appears to be otherwise, globalisation is not a natural phenomenon but a particular grand strategy of statecraft. It originates from a state's desire to produce "modern growth" within the confines of a "great geopolitical order". Great powers typically conceive of such grand ordering strategies after a major hegemonic war, which has regularly ensued approximately every hundred years. Compared to others, a grand strategy based on international free trade and comparative advantage is actually a very fragile achievement, despite of all its benefits. But if liberal globalisation, which constitutes mankind's highest state of peaceful economic competition, is so difficult to ignite and maintain, why did the British Empire, and subsequently the United States, care to adopt it?

To answer this question we have to go back to a period in which trade and violence were still closely intertwined. During the so-called "Age of Mercantilism" (1650-1780), no power was really dominant enough to qualify as a hegemon. And unsurprisingly, in this multi-polar world of constant disorder and conflict, Adam Smith's future arguments regarding gains from peaceful trade to all parties would have appeared ludicrous. Instead, the struggle for wealth was seen as a Hobbesian zero-sum game. Commercial activity was basically equalised with warfare, producing clear winners and losers. And so, economic growth became exclusively linked to geopolitics. Wining wars and expanding one's empire was all that mattered.

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Before and during Mercantilism, the West continued to struggle to escape the so-called "Malthusian trap" through which populations regularly outgrew the means to feed themselves.

During the end of the 18th century, however, the British (and others) started to realise that one could produce "modern growth" (ie exceeding population growth) by identifying international trade as a non-zero-sum game. Trying to assure its technological superiority through liberal globalisation, London would not only protect the "global commons" militarily but also institutionalise vital monetary and economic aspects of its order, adopting the gold standard and reinforcing it through an international network of free-trade treaties.

From now on, relative peace, achieved through this benign "shielding order", became a precondition for growth. This was in direct contrast to the mercantilist doctrine. Two pillars of "modern growth" were responsible for triggering this revolutionary U-turn. The first pillar, "Smithian growth", is achieved by igniting, on a global scale, the competitive process of economic specialisation. The less barriers international trade encounters the more prosperity is created. The second one, "Schumpeterian growth", is shaped by increases in knowledge. The unhampered concentration and refinement of knowledge across cultures results in an incessant and deflationary innovation process; the American economist Joseph Schumpeter called it "creative destruction".

Both pillars become most solid in an era of long hegemonic peace (Pax Britannica…), during which a true explosion of trade linkages and knowledge diffusion across cultures can occur. Without this modern type of political economy, the gigantic productivity gains during the 19th century "Industrial Revolution", and all later ones, would have never occurred. By fundamentally disconnecting international commerce from war, liberal globalisation had successfully engineered mankind's escape from the "Malthusian trap".

There is, however, a catch. From now on, it is not possible anymore to separate the phenomena of "international political order" and "modern economic growth" from each other. As they are determining one another, global order and growth must rise and decline simultaneously. If they fall, the system of peaceful co-operation, which has produced modern prosperity, is dashed to pieces in its entirety. To explore this fascinating dilemma of the modern world in more detail, we have to go back in time, to London, on a Monday morning, 86 years ago.

### Globalization's self-destruction

On September 21, 1931, Britain left the international gold standard, the monetary regime it originally initiated. As its current account balance had moved into deficit, Britain suspended all payments on its foreign debt and adopted protectionism, denouncing all multilateral obligations and its long cherished grand strategy of free trade. The accelerating integration of markets and cultures within the Empire's "shielding order" had lasted for a long time. But it could not last forever.

Although the British-led globalisation, through Washington's crucial support, initially recovered from the shock of World War I, its underlying economic system of organised complexity eventually and fatally overextended itself during the 1920s. The battered liberal order started to disintegrate completely, soon after 1931, and what was left from the aforementioned pillars of "modern growth" was successively destroyed in the "Great Depression" and World War II. It took until 1945 before a new "great geopolitical order", this time under US leadership, was constructed. This one was based on Bretton Woods' new monetary system, the one which Keynes ended up worrying so much about.

The main culprit for the breakdown of the international system in the inter-war period was the preceding deflationary wave. It had emerged in 1921 and originated from the much esteemed but liquidity restricting gold standard. While the 1920s gave birth to a whole new range of expanding technologies and industries (auto, electricity, and petroleum), the decade also witnessed the most severe decline in consumer prices since the 19th century's "Long Depression". This curious sequence of rapid technological acceleration during times of deflation, followed by the embracement of mercantilism to counter globalisation's excessive deflationary momentum, is not atypical.

For the past 200 years, every episode of intensive globalisation was subsequently followed by a concluding deflationary shock.

Each time, markets became increasingly more integrated in pre-crises years while disinflationary effects advanced productivity and technological innovation. But at one point, these initially beneficial outcomes of disinflation overshoot in a deflationary fashion, resulting in a destructive hyper-abundance of raw materials and manufactured goods.

The overriding disinflationary effect before and during a crisis is driven by the aforementioned two pillars of "modern growth", Smithian and Schumpeterian. Essentially, as long as liberal globalisation can force inflation to decline, factor productivity growth can accelerate most effortlessly due to the compounding of competitive pressures within the economy.

As soon as the deflationary depression hits, ultimate "creative destruction" kicks in and produces, rather counter-intuitively, the highest number of inventions for an economy.

Nostalgic political backlashes subsequently manifest themselves in reaction to this globalised economy, which has been conducive to technology but unfavourable to overall social cohesion. Thus, the arrival of a "deflationary trap" commonly signifies that the grand strategy of liberal globalisation has become too effective for its own good. A resurgent nationalism increasingly attacks, the now elitist, cosmopolitan grand strategy of open markets, open borders and open societies as the one poisoning force that prevents a return to national greatness through a revival of domestic industry. In this patriotic narrative, a vast conspiracy of foreign creditors and their complicit domestic elite, aims to keep the disenfranchised masses down.

Therefore, the more deflationary the system of liberal globalisation becomes, the likelier it is for Hobbesian politics to trump it. Not because of Mercantilism's superiority but modernity's in-built vulnerability being exposed by a deflation catalyst, like today's ill-suited monetary system. In times of globalisation's troubles, Mercantilism's "utopia of the past" repeatedly promises a return to a nation, an economy, which is less integrated, less competitive, and less complex, but at the same time saver, more prosperous, and more innovative.

The definite introduction of "fair trade" is the inevitable onset of technological impoverishment and lower real growth, leading protectionist countries to become addicted to debt, inflation, and militarism. Today's trouble is that our flawed monetary order makes it ever more likely for the "utopia of the past" to succeed once more.

### Pax americana's deflationary drift

What Keynes did not foresee is that the deflationary deconstruction of the world's monetary system would be more than two generations in the making. At first, the unilateral "Nixon shock" (1971) and the multilateral "Plaza Accord" (1985) seemed to improve on the collapsed Bretton Woods system of fixed exchange rates by forcing creditor currencies to appreciate against the US dollar. The ability of debtors to reflate, unlikely the 1930s, seemed feasible within Pax Americana's multilateral setting. But after a decade (2003-2013) of targeted currency manipulation (mostly by manufacturing exporters), the major imbalances between creditor and debtor nations re-emerged.

And although the policy responses to the great deflationary crisis of 2008 mostly circumvented aggressive competitive currency devaluations, distortionary spill-over effects nevertheless resulted. First, global markets suffered the direct impact of fixed currency pegs (e.g. China 2008-2010), and subsequently the indirect one of unconventional monetary policies. The novel tools of 21st century central banking, quantitative easing and negative interest rates, succeeded in obscuring the fact that it is actually liberal globalisation that possesses the most substantial lowering influence on domestic inflation.

An increase of, currently absent, direct currency manipulations is very likely to occur as soon as the US dollar starts to weaken again substantially. Thus, the danger of a "deflationary trap" is still with us, and the more ad-hoc manipulations and subtle distortions are going to disrupt the current monetary system in the years ahead, the more obvious the persistent globalisation headwinds will become.

Reflation, however, could be achieved in three ways. The first and most complex is to construct an entirely new system of monetary order. Basically, one of the current super-creditor's (the most likely candidate being China) would have somehow to succeed in designing an equally beneficial replacement for the order in-place. Without having the "tabula-rasa"-advantage of a major hegemonial-war just having ended (like 1815 or 1945) this seems utterly unlikely. But let's suppose China would undertake such a hypothetical redesign. What would be the obstacles?

First, China's economic power is still too small for this immense task, only representing 60% of US nominal GDP.

Additionally, Beijing has almost no alliance partners to speak of, complicating global institutional building and power projection even more. Second, until today, China's economic power is much more of a neo-mercantilists nature than of a liberal one. In the Heritage Foundation's 2017 index of trade freedom, China only ranks 117 out of 183 countries, the US ranks 18. A free trading China still has a long way to go. Third, China significantly lacks the capability to ignite Schumpeterian growth on its own, in Freedom House's 2017 index of political and civil freedom it scores a dismal 15 (with 0 being the least and 100 the most free society); the U.S. scores 89. Thus, a 21st century Pax Sinica capable of harvesting the benefits of "modern growth" via an open and stable commercial system seems unlikely to emerge any time soon.

The second and less complex way to secularly reflate would be to merely implement a quick-fix without destroying the underlying post-World War II architecture. But this seems equally very implausible as a "Second Plaza Accord" would require Anglo-Saxon debtors and European/Asian creditors to form some kind of common vision of global geopolitical order.

This leaves us with the third, and by far most damaging, way: breaking with the established monetary order completely and thereby rejecting the "great geopolitical order" which arose from it.

As we have seen, this third way became the preferred option during the 1930s. By abandoning the gold standard, countries escaped the deflationary trap but entered a maelstrom of protectionism and militarisation. In some ways, one can think of these "solutions" as a series of inflationary hyper-Nixon-shocks. Each time, reflation was unilaterally enforced, not multilaterally conditioned. Thus, it is not accidental that the recent explosion of anti-globalism was centred in the world's two major debtors (the United Kingdom and the United States), while the world's two major creditors (China and Germany) called for the reaffirmation of a global free trade system. It is exactly such a kind of ideology schism between surplus and deficit countries, that one would Pax Americana's asymmetrical deflationary drift expect to initiate. But if this widening schism does indeed foreshadow an upcoming occurrence of the aforementioned third way, what will happen to financial markets?

### Entropy rising

Throughout history, the disappearance of a "great geopolitical order" did not simply make financial markets more volatile but resulted in a rare paradigm break. That is to say, the prevailing dogma of "calculable risk" supremacy over "incalculable uncertainty" is eradicated via a volatility surge of a seminal nature. Fatal events such as massive geopolitical shocks (ie wars, expropriations, sovereign debt defaults, complete markets closures), suddenly start to happen with unexpected frequency. The future stops to resemble the recent past in the most far-reaching ways.

These periods of restless "deep uncertainty" and massive social change have been typically associated with a long hegemonic peace ending. Such transitions towards geopolitical disorder can last for decades, the Second Thirty Years War (1914-1945) only being the most recent example. But in general, as volatility surges, "deep uncertainty" translates into the rediscovery of investing as an art inspired by the historical, not mathematical, dimension.

While considering this worrying background, it might come as a surprise that financial markets have until now refused to reflect a scenario in which liberal globalisation decays all too rapidly, peaceful technological progress ends, and real economic growth subsequently suffers greatly. Instead, and rather disturbingly, markets continue to show a pristine confidence in the future, with volatility collapsing to levels unseen for decades. But accelerating political de-globalism paired with the heightened visions of Mercantilism's "utopia of the past" on one side, and a financial idyll of well-behaving markets on the other, have now produced a dangerous "disconnect" of extreme proportions. This distortion manifests itself most visibly in the extreme outperformance of bond and equity markets against "real economy" prices (most of all commodities and consumer-price-indices), since mid-2008. But what caused this "disconnect" to happen?

The main culprit has to be society's overconfidence in techno-globalisation's robustness. As before during times of inflation shortfall, markets busily constructed "utopias of the future" soon after the "Great Recession" had ended. The fact that many new companies, such as Airbnb or Uber, are simple outcomes of 2008's ambivalent "creative destruction" process was conveniently neglected. Instead, technological progress ended up being portrayed as a simple output of society's perpetual innovation machine. Technological progress appears as natural as globalisation.

Today's "utopia of the future" still rewards most handsomely the branches of industries which actively fan the economy's embers of deflation, e.g. internet retailing, software, and semiconductor companies. In contrast, all assets related to a possible reflation have sold off. Commodities, the market most linked to inflationary pressures, remains the worst-performing asset class since 2008.

Techno-globalisation's scientific approaches to life are commonly understood as objective and reasonable but universal scientific laws do not exist everywhere. Some phenomena humans encounter do not exhibit discoverable eternal truths but merely contingent trends. This small distinction is of critical importance because trends may change but laws never do. The wonderful thing about scientific laws is that they not only explain things which one was unable to explain before but they also predict them. Time and time again, this powerful capacity of natural sciences to make events predictable seduces other branches of human knowledge to abandon their original methodologies of restraint. Of course, one can make law-based predictions in fields like thermodynamics. However, social sciences such as economics or history are simply trend-based fields of human knowledge.

By confusing trends with laws, these fields of human knowledge outside the natural sciences have proclaimed progress where none is accomplished and earned trust where none is due.

Thus, investing cannot be something other than a subjective and risky exercise in guessing what reality truly constitutes. Markets do not reflect reality, they merely aim to. As investment returns can never become independent statistical outcomes, they will always link back to a specific but chaotic social environment. That is why the possible disappearance of the "great geopolitical order" is so worrisome. Today's markets of super-low volatility and ultimate confidence in techno-globalisation are most vulnerable to super-volatility shocks (devaluation, protectionism, reflation). And it is neo-mercantilism which seems predestined to provide them.

To conclude, secular inflation is most likely to return by breaking with liberal globalisation's asymmetrical monetary system first, and then with the "great geopolitical order" itself.

Sadly, reflation will not return by enhancing globalization but only by curtailing it. This upcoming paradigm break will consequently destroy the "utopia of the future" and all assets connected to it, while Mercantilism's brutal inflationary drive towards entropy will push volatility and commodity prices to new unseen highs. At this moment, Keynes' worst fears will have been vindicated.

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