

# How to Reconcile Democracy, the State and the Global Market

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## Key Points

- Nation states were the vehicle for market capitalism, but global market capitalism has freed itself from regulations imposed by nation states. A trilemma between democracy, the state and the market became an irreconcilable one, and gathered momentum.
- The post-War period has shown it is impossible to have a fixed exchange rate, free capital movement and sovereign monetary policy all working at the same time.
- To reconcile the trilemma, development banks need to cooperate or merge to finance transcontinental infrastructure projects to push up growth and employment and the World Trade Organization (WTO) should include a norm whereby countries joining it adopt the same exchange-rate regime (be it fixed or flexible).
- Without a deep reform in the global architecture, disequilibria, both economic and social, will continue to worsen, and conflicts will arise – only another ‘great depression’ will shock the international economy to induce the necessary international cooperation and joint action.

## A Matter of Choice

Since the late Middle Ages, political revolutions have aimed at implementing an individual *utility function* comprising a system of freedoms as defined by liberal thinkers: life, thought and speech, property, and equality (Locke). After centuries of struggles and wars, the Treaties of Westphalia (1648) gave birth to nation states whose sovereign *utility function* was security both

within borders and from external threats (Hobbes), and competition for power in the international arena (Machiavelli). Centuries later, under the pressure of democracy, the sovereign *utility function* at the national level included equality of opportunity or welfare (Roosevelt-Beveridge-Keynes),<sup>1</sup> yet retained the task of *balancing the power* at the international level.<sup>2</sup>

At the beginning nation states were the vehicle for market capitalism. Later, global market capitalism freed itself from regulations imposed by nation states, pushing for free movement of capital and its accumulation wherever profitable. This is where we are today.

In 1944, the Bretton Woods agreement provided a balanced solution, by imposing fixed exchange rates to avoid competition based on monetary parity adjustment, regulations (not bans) on capital movements and symmetric adjustment of balance of payments disequilibria.<sup>3</sup> Possible conflicts among these three variables could be settled through exchange-rate adjustments negotiated at the International Monetary Fund (IMF). In August 1971, the end of the Bretton Woods regime was followed by the adoption of a non-compulsory floating-exchange-rate regime and between 1989 and 1991, after the fall of the Soviet bloc and the rise of the internet, free international movement of capital became dominant. This turning point ushered in globalisation.

With globalisation, an irreconcilable trilemma between democracy, the state and the market gathered momentum. Our view is that this trilemma, known as the *globalisation paradox*, is not irreconcilable as defined in economic and political literature.<sup>4</sup> In the beginning, the state was the vehicle for democracy as it was for the market. The issue is the nature of the state, not its existence. This means that the irreconcilability of the trilemma is not built into the three institutions, but it is institutionally set. Irreconcilability is a political choice, i.e. the choice to *drift away*. A balance between democracy, the state and the market should be secured in the name of

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<sup>1</sup> W. Beveridge (1944) *Full Employment in a Free Society*. London: Allen & Unwin.

<sup>2</sup> H. Kissinger (2014) *World Order*. New York: Penguin.

<sup>3</sup> B. Steil (2014) *The Battle of Bretton Woods. John Maynard Keynes, Harry Dexter White, and the Making of a New World Order*. Princeton, NJ: Princeton University Press.

<sup>4</sup> D. Rodrik (2011) *The Globalization Paradox. Democracy and the Future of the World Economy*. New York and London: W. W. Norton & Company.

liberty, prosperity and security. This goal cannot be reached without reforming the architecture of the global economy. In this context, the *economics of the trilemma* is key.<sup>5</sup>

## The ‘Shadow Sovereign’

*Westphalian sovereignty*, i.e. the lack of authority over the state other than domestic authority, is compromised. Globalisation, the internet and the deepening and explosion of finance have caused irreparable damage to the three pillars of Westphalian nation states. *Territory* is not just a physical dimension any more – however, when it remains so, strong states sometimes grab it: see the case of Africa<sup>6</sup> – and the internet represents a growing and vulnerable part of this. *People* mix with each other because migratory waves are out of control and they abandon national languages and cultures, often adopting those of ‘rich’ countries (thus triggering a reaction against ‘westernisation’). Domestic *law* is bypassed by various forms of supranational law or *de facto practices*.

To be clear, these trends have positive sides, too: e.g. the emergence of ‘global law’ through international treaties and business praxis, and via this, the idea of *human rights* and, more generally, of an *intérêt général* for humanity as a whole.<sup>7</sup>

Now, consider the economic viewpoint. Money, financial savings, and real investments – that is, a large part of the *wealth of nations* – are all exposed to the effects of the liberalisation and of the internationalisation of capital movements. Delocalisation of capital without equally free movement of people threatens workers in advanced countries, at least in the short term, and distorts fair competition. In a globalised economy the possibility of freely choosing the exchange-rate regime also contributes to an unfair competition.

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<sup>5</sup> M. Obstfeld, J. C. Shambaugh, A. M. Taylor (2004) The trilemma in history: tradeoffs among exchange rates, monetary policies, and capital mobility. NBER Working Paper Series no. 10396, March.

<sup>6</sup> S. Sassen (2014) *Expulsions: Brutality and Complexity in the Global Economy*. Cambridge: Cambridge University Press.

<sup>7</sup> S. Cassese (2012) *The Global Polity: Global Dimensions of Democracy and the Rule of Law*. Seville: Global Law Press.

Globalisation creates jobs, but redistributes them from Western countries to Eastern ones.<sup>8</sup>

Taken together, these trends, together with deep technological innovation, expose nation states and their citizens, in particular the lower and middle classes, i.e. the bulwark of democracy, to *financial* and *social earthquakes* unseen in advanced countries since the end of the Second World War. The clock of history seems to be turning back.

The Age of Revolutions ended with subjects becoming citizens. Kings were beheaded. The *rule of law* triumphed. ‘No taxation without representation’ meant that citizens would have a voice, in the *public use* of resources as in its governance. It later meant that citizens would also have a voice in the *redistribution* of income and wealth, with democracy tempering the *commutative* laws of the market with the *redistributive* laws of the voters.<sup>9</sup>

In the twentieth century, democracy and progressive (socially oriented) policies provided a balance between democracy, the state and the market fostering freedom, prosperity and security. Yet it was still a domestic perspective, and it could not prevent tensions among nation states.

Things changed in the 1930s. With the failure of the League of Nations and the outbreak of the Second World War, Roosevelt’s four freedoms speech (1941), the Beveridge Report on Social Insurance and that on Full Employment (1942; 1944), the Hot Springs Conference (1943), the Bretton Woods Conference featuring Keynes at centre stage (1944), the rejuvenation of the International Labour Organization (1944) and the General Agreement on Tariffs and Trade (1947; later superseded by the World Trade Organization – WTO) sent a clear and consistent message to the world (to ‘everywhere in the world’, in Roosevelt’s speech).<sup>10</sup>

Today, globalisation is producing the reverse phenomenon with citizens subtly becoming *neo-subjects* of a shadow legislator or sovereign, i.e.

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<sup>8</sup> Trade in the balance. Globalisation can make everyone better off. That does not mean it will. *The Economist*, 6 February 2016.

<sup>9</sup> D. Cofrancesco (2003), *La democrazia liberale (e le altre)*, Soveria Mannelli, Rubbettino; P. Savona (2016) *Dalla fine del laissez-faire alla fine della liberal-democrazia. L’attrazione fatale per la giustizia sociale e la molla di una nuova rivoluzione globale*. Soveria Mannelli: Rubbettino.

<sup>10</sup> E. Helleiner (2014) *The Forgotten Foundations of Bretton Woods. International Development and the Making of the Postwar Order*. Ithaca, NY and London: Cornell University Press.

coordinated or uncoordinated speculative forces driven by short-term, non-productive objectives. This time kings cannot be beheaded since there is no detectable monarch. The *rule of law* is undermined by the *rule of a shadow legislator or sovereign*, sometimes in the disguised, only apparently neutral, form of the *law of the rules* (see the WTO and, especially, the European common market and the Eurozone).

In this context, we identify a major intellectual risk: the application of the ‘logic of the unmanned’ (from cars to potentially everything else) to various banking, economic, defence, political and social systems requiring human discretion and judgement, and not just algorithms (‘let “that” decide’).<sup>11</sup>

If we really want a global market, there is no alternative to ‘governing the world’,<sup>12</sup> a world still largely made of nation states. This requires reforming at least some aspects of the global architecture, by leveraging on the principle of subsidiarity, i.e. what cannot be implemented at the national level should be implemented at the international one and, ultimately, the global one. The reverse should be equally true. It should not be forgotten that structures erected to do the work of a state, while not themselves a state, not only fail to do the work, but are in themselves dangers.

### The Geopolitics of the Trilemma

Since the interwar years and, more analytically, the post-War era economists have identified various types of tension between the national and the international sovereign utility functions, along with the institutional design to cope with them.<sup>13</sup> Some other systems of tension are known as ‘trilemma’.<sup>14</sup> The ‘impossible trinity’, for instance, is a trilemma in which it is held to be impossible to have all three of the following at the same time: a fixed exchange rate, free capital movement and sovereign monetary policy.

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<sup>11</sup> G. Farese (2015) The rise of the dual culture of world development and world government in international affairs, 1930–1950. *International Affairs*, Virtual Issue, October, pp. 1–17.

<sup>12</sup> Kissinger (2014).

<sup>13</sup> J. Meade (1951–5) *The Theory of International Economic Policy*, 2 vols. Oxford: Oxford University Press.

<sup>14</sup> J. M. Fleming (1962) Domestic financial policies under fixed and floating exchange rates. IMF Staff Papers, no. 9, pp. 369–79, reprinted in R. Cooper (1969) *International Finance*. New York: Penguin. R. A. Mundell (1963) Capital mobility and stabilization policy under fixed and flexible exchange rates. *Canadian Journal of Economic and Political Science* 29, 4, pp. 475–85, reprinted in R. Cooper (1968) *International Economics*. New York: Macmillan.

The trinity suited the Bretton Woods period (1944–71) when the reconciliation was pursued by controlling capital movements and negotiating exchange-rate adjustments. The reconciliation is part of the old problem of finding a balance of power.

Our idea is that the impossible trinity is a peculiar version of the ‘irreconcilable trilemma’ created by the globalisation process, a modern kind of post-Bretton Woods and post-Cold war trinity. The dominant theory suggests that democracy, national sovereignty and deep economic and financial integration (globalisation) cannot be reconciled.

At the base of both the trinity and the trilemma there is sovereignty looked at from different institutional viewpoints: monetary and economic (in the trinity), political and social (in the trilemma). Both views of sovereignty should consider *lato sensu* Montesquieu’s separation of powers and the *rule of law* as the basis of individual freedom, in order to resist the pressure of unregulated markets and both economic and political oligopolies. ‘Fair’ globalisation requires the harmonisation of trade regulation and law across countries; such harmonisation would require either a global government or the erosion of countries’ democracies<sup>15</sup> – an example being the ‘Brexit’ negotiation – but these developments are not fully perceived by electorates and, therefore, are hardly feasible. The conclusion is that globalisation is impossible to complete and equally impossible to dismantle.

Take a look at the geopolitics of the trilemma. How it is resolved implies different forms of adaptation, and reveals underlying preferences between the three institutional pillars of the system of liberty: democracy, the state and the market.

We focus on the European Union (GDP: US\$18 trillion; the Eurozone accounts for US\$12 trillion), the United States (GDP: US\$17 trillion), and China (GDP: US\$10 trillion), i.e. the three biggest economies in the world.

China has chosen to give priority to the state and accept (at least partially) the market rather than democracy (in the Chinese view, ‘western-style democracy’). One example: in 2015 China’s securities regulator banned major shareholders, corporate executives and directors from selling stakes in

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<sup>15</sup> Rodrik (2011).

listed companies for six months, in order to stop the stock market fall. The yuan is not fully convertible. If her market is not pure, neither is her democracy.

The European Union has chosen to privilege its common market and a new form of 'inter-governmental' democracy, and impose various limitations on sovereignty (tighter for countries joining the Euro system), but refused to create a supranational state.<sup>16</sup>

The USA takes a more balanced, and flexible, stance between democracy, the state and the market. One example is the nature of its central bank, the Federal Reserve: the President of the USA appoints the chairperson and central bankers' remit includes both price stability and full employment. The federal government (the US President) is part of a complex system of checks and balances that includes the Congress ('We the people'), balancing the power of the state and of democracy (as does the European central bank system, in practice).

However, it is interesting to note that, whatever the combination, the market is never a loser, and that democracy and the state always give way – the more so when the population, the territory or the wealth of the state considered are small. The reason for this is that the market is global, while democracies and states are still national (or timidly supranational). As said, globalisation is impossible to dismantle. Can it be reformed to reconcile the three aforementioned basic institutions – or must a political community renounce one of them, as in the trinity of the Bretton Woods period?

The need for reform stems from facts. In the last few years, the world has been flooded with money by central banks trying to avoid depression. Nonetheless, liquidity has mainly fuelled finance, not the real economy, creating what the past Governor of the Bank of Italy Guido Carli called 'a paper pyramid' (now a pyramid of bits).<sup>17</sup> Having avoided another great depression, leaders declared the emergency over and returned to ordinary policies, but not in the Euro system.<sup>18</sup> The lessons of the 1930s remain

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<sup>16</sup> G. Guarino (2006) *Eurosistema. Analisi e prospettive*. Milan: Giuffr .

<sup>17</sup> M. King (2016) *The End of Alchemy. Money, Banking and the Future of the Global Economy*. London: Little, Brown.

<sup>18</sup> B. Eichengreen (2015) *Hall of Mirrors. The Great Depression, The Great Recession, and the Uses – and Misuses – of History*. Oxford: Oxford University Press.

unlearned.<sup>19</sup> The world is waiting for big infrastructure projects, which are not just means for implementing a minimum level of welfare, but are the most useful exogenous impulse for aggregate global demand. Infrastructure development could contribute to social mobility and lower extremism and proneness to conflicts.

Worse still, huge global imbalances that fuelled the great recession have not been removed. Consider current account imbalances. Today, the US current account deficit is about US\$ 450 billion yearly. China's surplus is still US\$ 170 billion. The surplus of the Eurozone (US\$ 385 billion) is concentrated in Germany (the German surplus is 8.1% of its GDP, well over 6% agreed with Eurozone countries)<sup>20</sup> Today, the idea of a cooperative, symmetrical adjustment between deficit countries and surplus countries envisaged at the time of the Organisation for European Economic Co-operation (forerunner to the Organisation for Economic Co-operation and Development – OECD), later reaffirmed in European treaties and today advocated by many, remains on paper.

Note that the idea of symmetrical adjustment advanced by Keynes,<sup>21</sup> and others (Kalecki, Meade, Schumacher), was not implemented in the Bretton Woods system *only* because a degree of flexibility over fixed exchange rates was granted. Conversely, if the fixed exchange-rate system had been adopted, the principle of symmetrical adjustment should have complemented it. Today, this is a lesson for the Euro system.

Moreover, while in the past the benevolent hegemon (the UK, the USA) created and distributed the international monetary base,<sup>22</sup> today Germany siphons resources from its partners (see its credit position in Target2, the European clearing account).

Though the USA found a solution to sustain its deficit by creating dollars that pile up in third countries' official reserves, the aggregate effect of

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<sup>19</sup> Helleiner (2014).

<sup>20</sup> Economic and financial indicators. *The Economist*, 20 August 2016.

<sup>21</sup> J. M. Keynes (1943) Proposals for an International Clearing Union, reprinted in J. K. Horsefield (ed.) (1965) *The International Monetary Fund, 1945–1965. Twenty Years of International Monetary Cooperation*, Vol. III: Documents. Washington DC: IMF, pp. 19–42.

<sup>22</sup> B. Eichengreen (1996) *Hegemonic Stability Theory and Economic Analysis: Reflections on the Financial Instability and the Need for an International Lender of Last Resort*. Berkeley, CA: Center for International and Development Economics Research.

Chinese and of European surpluses contribute to *competitive* and *currency wars*; geopolitical investment through sovereign wealth funds, often squeezing resources and workers in states with different level of welfare;<sup>23</sup> redistribution of income to exporters (between states and within states); and a *global deflationary effect* on part of the domestic demands in the short term, and on global aggregate demand in the long term. The global market operates out of full Pareto optimality, i.e. some get rich at everybody else's expense.

The resurgence of nationalism and terrorist attacks is another tragic, improper reaction to the highly complicated problems posed by the trilemma.

In this context, something must be done to avoid the fearsome risk of *drifting away* in an *unmanned society* ruled by a shadow legislator or sovereign. Though we believe that education, dialogues among civilisations and institutional pedagogy are essential, the economic issues of the problem take the lion's share in the international scenario and, therefore, a change in the global economic architecture is urgent. A better market for democracy and the state is the goal.

### Reforming the Architecture

Let us remind ourselves again that we assume that the *individual utility function* is life, free thought and free speech, property and equality; and that the *sovereign utility function* is security and welfare at the national level, and economic and military power at the international one.

Though historically equality has shown a 'fatal attraction' towards extreme welfare, reversing individual interest in favour of an elusive social interest (with government budgets of developed countries rising in developed countries from 25% to 50% of GDP in a few decades), if a balance is kept among the components of the individual utility function, a system of liberties that includes welfare produces a virtuous circle between individual and national sovereign utility functions, but they can still enter into conflict with

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<sup>23</sup> P. Savona and P. Regola (2009) *Il ritorno dello Stato padrone. I fondi sovrani e il grande negoziato globale*. Soveria Mannelli: Rubbettino.

the components of the international sovereign utility function.<sup>24</sup> At the global level, economic and military tools are becoming less and less reconcilable with both individual and (internal) sovereign utility functions and, worse still, such tools prove insufficient to confront recurrent international crises.

World government being still an ‘idea’, perhaps unworkable, if not dangerous;<sup>25</sup> what we propose are some reforms to the global economic and financial architecture. They could be introduced through an international agreement aiming at reconciling the workings of the aforementioned three institutions, and through this, the three utility functions in a globalised world.

*First*, as for investment issues, various development banks should cooperate or merge to finance transcontinental infrastructure projects, to push up growth and employment everywhere, as the World Bank did after the Second World War<sup>26</sup>. Projects could reduce uncontrolled social mobility and conflicts. Given the current excess of savings, bonds could be issued and sold globally with not expensive international guarantees.

The quasi-simultaneous birth of the BRICS’ New Development Bank (NDB), and the Asian Infrastructure Investment Bank (AIIB), both featuring China as their largest shareholder (49 per cent), do not contribute to removing the fundamentals of global disequilibria, but rather reinforce the (external) sovereign utility function (power). The world needs a truly global World Bank.

*Second*, as for trade issues, the WTO agreement should include a norm whereby countries joining it adopt the same exchange-rate regime (be it fixed or flexible). If the fixed regime is chosen, capital movements should be regulated as a consequence, not banned.

Today, more than twenty years after the birth of the WTO (1995) and fifteen years after China acquired membership of the organisation (2001), there is a less biased view of the advantages of free trade, especially in the absence of a common monetary standard.

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<sup>24</sup> Savona (2016).

<sup>25</sup> M. Mazower (2012) *Governing the World. The History of an Idea*. New York: Penguin.

<sup>26</sup> G. Farese and P. Savona (2014) *Il banchiere del mondo. Eugene Robert Black e l’ascesa della cultura dello sviluppo in Italia*. Soveria Mannelli: Rubbettino.

This leads to a deeper proposal: to complete the international monetary architecture. Strengthening special drawing rights (SDR) could provide the basis for a supranational standard for accumulating official reserves, both publicly and privately.<sup>27</sup> Being limited in scale and scope, SDR account for around 2% of central bank deposits. In this context, the inclusion of the Chinese currency in the SDR basket has mainly a symbolic value.

Global communication, environmental, health and labour policies are all equally important, but can hardly be set without fixing money, investment and trade issues globally.

To continue to push both financial and trade globalisation forward anywhere without removing the fundamental causes of global disequilibria means short-sightedness or, worse still, blindness. In our eyes, initiatives such as the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TTP) reaffirm the pursuit of national (or regional) approaches to adjustment, and the impossibility of reconciling the trilemma within a global architectural design, thus leaving rule to the global market (the shadow legislator or sovereign). This is a political choice, though one not supporting a sustainable trinity.

Without a deep reform in the global architecture, disequilibria, *both economic and social*, will continue to worsen, and conflicts to arise. There is no need for a general war to start, once again, at the point from whence we began with Keynes, Roosevelt and the others. It will perhaps need another ‘great depression’ to create a big enough shock in the international economy to induce such international cooperation and joint action.

### What Then?

Since capitalism is historically driven by financial and technological innovation, monetary sovereignty might soon be replaced by purely electronic transactions in virtual money (bitcoin being an example), with choices based on neuronal models substituting for markets’ supply and

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<sup>27</sup> M. Fratianni and P. Savona (1972) *La liquidità internazionale: proposta per la ridefinizione del problema*. Bologna: il Mulino.

demand, and algorithms processing constantly expanding ‘big data’ (much more powerful than the ‘old’ econometric-mathematical models).

The rules of such markets will be drawn outside the borders of democracies and of nation states by a shadow sovereign legislator aiming solely at faster and higher accumulation of capital, regardless of the issue of distribution of resources. Markets will continue to create wealth, but national parliaments would not be able to correct markets’ distortions. Fiscal sovereignty itself will be frozen.

The shadow sovereign legislator will ‘capture’ the three existing institutions making the system of liberty impossible. Social stability will then be lost, both at the domestic and the international level, because the shadow sovereign cannot govern phenomena like global migration.

The disappearance, not the irreconcilability, of the nation state, a competitive market and a satisfactory democracy, as we know them, will then be a sad reality. This will mark the end of an era of history, not of history, in which the three institutions worked together supporting the system of freedoms? How far are we from this grim reality? Not too far. The more we abandon the ‘culture of development’,<sup>28</sup> and the ethics of countries’ interdependence, the closer we get to chaos.

*\* This paper is the fruit of a joint work. Paolo Savona wrote paragraphs 1, 4, 5. Giovanni Farese wrote paragraphs 2 and 3. The paper is in memory of Peter Mathias, with whom the authors discussed both content and conclusions in Cambridge, UK in the winter of 2015.*

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28 G. Farese and P. Savona (2014) *Il banchiere del mondo. Eugene Robert Black e l’ascesa della cultura dello sviluppo in Italia*. Soveria Mannelli: Rubbettino.

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