

Sunday Wrap

Happy Sunday,

This will be the last Sunday Wrap before I take a summer break to devote time to a great list of long overdue books and articles to read – and to ponder more broadly. I expect to be back with the Sunday Wrap on September 1.

By then, the Fed will almost certainly have started their easing cycle (with a 25bp rate cut) and hopefully streamlined their communication. The ECB will be a bit closer to some tweaking of their instruments intended to ease their policy stance, while the broader European debate about the appropriate balance between fiscal and monetary policies (and the necessary European structures) will have moved another small step forward.

But let me leave you for the summer with some thoughts on a broader issue, which – unfortunately – means that I'll end the pre-summer series of Sunday Wraps on a downbeat note:

Multilateralism is being challenged like never before by an increasingly disruptive US, an (structurally) assertive China, a Russia apparently intent on playing spoiler around the Western world and now rapidly intensifying confrontations in the Middle East. Politicians and diplomats should obviously worry (and they do), but so should we all because not only has the risk of military confrontation increased, the creeping undoing of multilateralism will – without a doubt – lead to lower global trend growth because of the infringement of trade and investment. This is bad for living standards, particularly at a time when the world desperately needs to allocate additional resources to fight climate change. And as growth slows and resources are reallocated, it'll be more difficult for individual countries to address the need to deliver a fairer distribution of income. After all, the faster the pie is growing, the easier it is to adjust the relative size of the slices.

Consider this: Global GDP has grown by an average annual rate of some 3.5% for the past 50 years, supported by a growth rate in global trade of about 4%. Openness and multilateralism facilitated this. But more recently, growth in global trade has ease to only 2%-3% as tariffs have been raised by the US (and by the trading partners in retaliation), and as uncertainty sets in, leading to less investment. This means that global GDP trend growth could be slowing to no more than maybe 2.5%-3.0%, which would hardly keep up with global population growth.

The good news is that many global leaders, particularly in Europe but also at the world's leading organizations like the IMF, OECD and BIS are aware – and, at some level, this increases the probability of action. This past week I participated in an outstanding conference at Banque de France (“**Bretton Woods: 75 years later. Thinking about the next 75**”), organized on the eve of the G7 finance ministers and central bank chiefs' meeting in Chantilly. Without putting a too fine print on it, I cannot recall ever before having listened to – and chatted with - so many senior people expressing such a degree of concern about the global outlook, concerns all centered around the challenges to multilateralism.

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So, in today's note:

- I'll first discuss the key parameters for how to think of the possibility of a "post-multilateralism" world.
- I'll then turn to the UK, where Boris Johnson is almost certain to become prime minister on Tuesday. Rather than being a turning point for the UK, it'll likely mark one further step towards chaos and thereby a further decline in the UK's influence on global issues.

1. Multilateralism: How did it go wrong, and what are the prospects for the future?

I take it that you are aware of the immense body of work documenting the huge benefits to global growth and living standards across the world of the post-WWII system of multilateralism, and that you accept that multilateralism requires rules of engagement for all parties, including a dispute settlement system. Of course, this is not to say that the benefits of globalization were distributed entirely fairly, or that present global institutions, particularly the WTO, function optimally.

I also assume you are on top of the discussion of how the heavy skewing of national income distribution in the US contributed to the rise of Trump, and how decades of simmering struggle in parts of British society between the past and the present contributed to Brexit: In both cases, a long simmering fire, which in 2016-17 received a dose of petroleum in the form of (unregulated) social media, involvement of Russia as well as domestic vested interests. In other words – not controversially – Trump and Brexit are not the key causes of the present sorry state of affairs but primarily the symptoms. (That said, in a world in which multilateralism is being challenged, it would have been a lot more comfortable if we had leaders in the Western world committed to the values which underpinned the system that so benefitted the world through these past 75 years.)

But maybe we shouldn't be surprised about the unravelling of multilateralism. It's just over 12 years ago that Harvard professor Dani Rodrik formulated his global trilemma, namely "that democracy, national sovereignty and global economic integration are mutually incompatible: we can combine any two of the three, but never have all three simultaneously and in full." After ruling out the two first options (global federalism and maintaining nation states but making them responsive only to the needs of the international economy) for obvious practical or political reasons, Rodrik concluded his brief note in 2007 with a recommendation that we "downgrade our ambitions with respect to how much international economic integration we can (or should) achieve. So we go for a limited version of globalization, which is what the post-war Bretton Woods regime was about (with its capital controls and limited trade liberalization). It has unfortunately become a victim of its own success. We have forgotten the compromise embedded in that system, and which was the source of its success". Rodrik's 2007 article is here: ["The inescapable trilemma of the world economy"](#).

Maybe Rodrik's trilemma can be rephrased as the inherent conflict between the fact that – in a globalized world – trade and finance are global, but politics is still national (and sometime no more than local). For many years, it seemed as if this bumble bee actually could fly, to the benefit of so many, but as information – and disinformation - also turned increasingly global, problems started to arise. But it rose not from the underdogs in the US and UK (and elsewhere), who clearly had not benefitted proportionately from globalization, but from opportunistic parts of the elite: A self-proclaimed billionaire in the US and the Eton and Oxford educated in the UK appealing to people's longing for a different time when America was "great" and when the UK had its empire.

I wonder if this curious fact that nationalism is spearheaded by parts of the elite, and not the so-called common man, explains why one of the greatest injustices in globalization is only

now coming to the surface – and neither in the US nor the UK, but in Continental Europe: Not only has business turned global, tax payments of many companies, particularly the biggest ones, have turned global as well in arrangements that seem to channel huge portions of their global tax liabilities to a few miniscule countries, or even territories, attracting them with absurdly low tax rates. Not to pick on anyone in particular, but the Apple and Google stories are well known. And how can it be acceptable to British society that leading Brexiteer Jacob Rees-Mogg's company reportedly paid no UK tax at all on GBP 103mn profits during the past five years because its registered in Cayman Islands?

But if the US-led multilateralism is fading away, what will replace it? At the Paris conference this past week, Singaporean Senior Minister and Group of Thirty chairman, Tharman Shanmugaratnam, argued for the Chinese suggestion of a “network of powers” to replace the previous system, but I think it's fair to say that it didn't receive a lot of support in this forum.

Deputy Director General of the WTO, Alan Wolff, argued that international organizations, including the WTO, basically function well, even though when one of the judges for dispute settlement at the WTO retires in December, only two will be left (as the US has refused to appoint officials), bringing the number of available judges below the critical three, thereby de facto making appeals of trade rulings impossible. As far as I can see, that'll render the WTO virtually meaningless. I didn't sense a great degree of agreement with Alan Wolff either.

Former First Deputy of the IMF and World Bank chief economist, Professor Anne Krueger, thought it was time for Europe, Japan and others to simply start an alternative WTO which would exclude the US (but remain open to all), but EU Trade Commissioner Malmström (in an otherwise wonderfully direct and outspoken discussion) did not sign onto this, despite good prodding by panel moderator Martin Wolf of the FT.

I don't know what the outcome will be, but in my assessment, if Trump were to be re-elected next year, we may have the US out of the game for so long that alternative systems, less conducive to a multilateral-rules based system, might emerge. Or global anarchy takes over, ultimately leading to more serious conflict. But even if Trump is defeated next year, it's important to appreciate that no conceivable Democrat as president would sign on to the type of free trade we had become accustomed to, unfortunately.

This leaves me with the “least-bad outcome”, so to speak, namely an alternative US president who, in spite of not really being a free trader, would commit to the US' global role and alliances, a China that grows strongly enough to avoid an acceleration in its foreign assertiveness, and a “Europe that gets its act together”, as articulated by former Mexican President Zedillo at the Paris conference last week, and as spelled out in more detail by former Swedish PM Carl Bildt in this weekend edition of the FT. As Bildt writes, while praising the recent impressive trade agreements signed between the EU and South America, Japan, etc., Europe “must look geopolitical reality in the face” if it's not to risk irrelevance in the age of great power competition. His piece is well worthwhile reading in full; it's here: ["Europe risks irrelevance in the age of great power competition"](#)

It's too early to tell which of these scenarios will be closest to the coming reality, but one thing is clear, the EU – and its new leadership team - stands in front of not only an opportunity, but with its back against the wall. The good news is that Europe tends to move more swiftly on reforms when danger is in front of the door, and if the Paris conference is anything to go by, the reality of the dangers is clear to everyone.

In the ideal world, the UK would have been a key European player here, but that's not to be. Rather, the UK is now heading towards an increasingly marginal role in global affairs – because of Brexit, and because of likely incoming PM Boris Johnson this coming week. Let me explain why:

2. Why we all should worry about Boris Johnson and where the UK is heading.

The vote is about to close for the approximately 160,000 UK Conservative party members who'll decide the next Tory leader. The winner – almost certainly Boris Johnson – will enter No 10 on Tuesday as the new UK prime minister, the result of one of this great country's peculiar interpretations of democracy (“democratic deficit”, anyone?)

As much as I want to believe that Johnson could turn out to be an okay leader, I have found nothing that would justify such a prediction. Like Trump, Johnson is a nationalist, a celebrity, of questionable character (if I may say so) with no appetite or ability to grasp detail. To me, the hope that Johnson, the bumbling entertainer, will become serious once in office seems nothing more than wishful thinking. Certainly, his two years as Foreign Minister provide no such hope.

In spite of having one of the finest civil services at his disposal to brief and guide him when in office, the catalogue of his disastrous statements is long and painful. Most heartbreakingly, while speaking about the case of Nazanin Zaghari-Ratcliffe, the British woman jailed in Iran since April 2016 on claims that she was plotting to bring down the Iranian regime, Johnson incorrectly stated that Zaghari-Ratcliffe had been teaching journalism to students, a statement which was then used by Iran as justification for their claims she had been spying, de facto ending any hope of her release. In spite of multiple invitations to at least apologize for this gaffe, he has refused to do so. Other bizarre statements include his suggestion that the Libyan city of Sirte might become a new Dubai once “the dead bodies” are removed. And while on an official trip to Myanmar, he recited an offensive colonial-era Rudyard Kipling poem. Indeed, Johnson's behavior as Foreign Secretary turned out so problematic that – reportedly - Theresa May and the intelligence services withheld sensitive information from him over worries about his ability to keep information confidential.

The odds are that Johnson will join Trump in his contempt for the multilateral-rules based system – his unwillingness to criticize any of Trump's wrongdoing is telling. And when it comes to checks and balances, just as the Republican Party leadership in the US has folded under Trump (even to a degree that not even a handful of them are willing to distance themselves from Trump's latest racist comments), the UK Conservative Party, originally split down the middle over Brexit, now sees several former Remainer-ministers line up to endorse the incoming leader.

On Europe, by far the most pressing issue facing the country, Johnson's comments, both as one of the leaders of the leave campaign and after, were full of half-truths if not outright lies, all packed in his uncontrollable desire to be funny. There's the now infamous claim on the side of busses that the UK will save GBP 350mn per week once it stops paying into the EU budget (which in fact is the gross figure and, hence, takes no account of the substantial UK rebate and EU spending in the UK). Latest, just this past Monday, in a bizarre performance, Johnson brandished a kipper at the Conservative leadership meeting, claiming that EU regulations unnecessarily require kipper sellers to package their products in ice pillows for delivery – when indeed this regulation is a specific UK requirement, not an EU one. Politics is politics, but how can he possibly hope to be taken serious by European leaders?

To be sure, no one knows what a Boris Johnson government will do on Brexit, including – almost certainly – Boris Johnson himself. The few interviews he has allowed in recent weeks by serious journalists have revealed a complete lack of knowledge of even the most basic facts, with a standard answer when his ignorance was revealed: “Why this negativism?”

On the Irish border backstop, by far the most contentious part of the Withdrawal Agreement, Johnson has gone further than even many pro-Brexit hardliners in his party, backing himself into a corner. On Monday evening, Johnson said not only that the Irish border backstop must

be ditched, but that the two main compromise proposals (which, however, the EU has already refused) – a time limit or a unilateral exit clause – would not go far enough for him. Still, Johnson insists he does want a deal with the EU.

So, what are his options? This is a topic my colleague, our Chief International Economist (and chief UK economist) Daniel Vernazza and I have been talking a lot about. We think there are two:

First, once elected, Johnson may end up backing Theresa May's deal, with some tweaks to the political agreement, and use his "charm" (if that's the right term), celebrity-like status and power over a folding Tory party, to get the Theresa-May-negotiated Brexit deal over the line.

The notion that Johnson will be able to get the EU to ditch the Irish border backstop simply won't fly. The backstop is there for a reason (alternative arrangements to avoid a hard border do not exist). And, not surprisingly, Johnson has few friends in Europe, so the claim from Johnson that he will get a better deal just doesn't stack up.

But he may be able to change – or tweak - the non-binding 26-page Political Declaration on the future relationship in favor of a basic free trade agreement (à la EU-Canada) instead of the "half-in-half-out" current plan. Currently, while creatively ambiguous and vague, the Declaration attempts to be all things to all MPs, reflecting Theresa May's (telling) desire for both frictionless trade and "taking back control" – and all its inconsistencies. "Autonomy" is mentioned no less than 12 times and "independent" 8 times, while "ambitious" appears 7 times. For example, the Declaration states that the UK and the EU seek "ambitious customs arrangements that [...] build and improve on the single customs territory provided for in the Withdrawal Agreement which obviates the need for checks on rules of origin", while also stating that the UK will have an "independent trade policy". The "single customs territory" Irish border backstop is a customs union, a necessary requirement to avoid the need for rules of origin (as the EU is not going to outsource its tariff collection to the UK), and that means no independent trade policy.

The problem with this is that the hardline Brexiteers in his party, and the Northern Irish DUP, have lent Johnson their support based on him ripping up the Irish border backstop (which, as noted, the EU will refuse to do). During the leadership campaign, Johnson managed to secure broad support of Conservative MPs, both hardline pro-Brexit MPs as well as centrists, so at least one group is going to be disappointed (as Theresa May found out to her cost).

The other option is that, in addition to the above, Johnson goes back to the original European Commission proposal for a Northern Ireland-only backstop instead of the UK-wide backstop, i.e. a customs border in the Irish Sea. This is potentially fruitful as the Tory Brexiteers will be relieved that the UK is no longer tied to a customs union with the EU indefinitely (and therefore would have trade policy autonomy), although some (notably the DUP) may still block it on the claim that it would compromise the integrity of the United Kingdom. However, with a handful of Labour MPs supporting this construction, the deal could pass even if the DUP vote against it – but with inevitable consequences for the DUP's continued support of the government.

There is, however, a non-negligible risk that both of the above options fail – either because Johnson backs himself into a corner or he loses the support of the Brexiteers and the DUP. Yet, in this scenario, a no-deal break is still not automatic.

This week, Parliament voted to ensure that the next PM will not be able to suspend Parliament in the pursuit of a no-deal Brexit against the wishes of MPs. MPs will have their say, and they are against no-deal under any circumstances. As Daniel has argued, they would likely vote to request a further extension of Article 50, and if that were refused by the EU (possible) or the UK Prime Minister (who knows), then MPs would face the choice

between either: (i) accepting the deal on the table, i.e. Theresa May's deal; (ii) revoking Article 50; or (iii) a no-deal Brexit. Faced with this choice, we are fairly confident MPs would choose Option I, i.e. the deal on the table.

Importantly, however, whatever happens, a snap general election before the end of the year seems inevitable. The ruling Conservatives lack a majority on their own, they are divided over Europe, as is the main opposition, and even if Brexit could be delivered, the next PM would lack a majority to implement their domestic agenda, as Theresa May experienced. Moreover, the next PM will want to go to the electorate early on in his tenure, riding the honeymoon effect before the difficulties of government take their toll on opinion ratings. It's unclear what will come first – Brexit or a general election – but my money would be on Brexit first, simply because of the electoral threat that the Brexit Party poses to the Conservative Party should an election take place before the UK is out of the EU. But to think that once through this turmoil, an election would unify the Tory party with a majority under a business-friendly agenda does not rhyme with the fragmentation of British politics now on display.

As I have argued before, Brexit is a serious impediment to future British prosperity and its influence in the world (and a highly unfortunate event for Europe), but the real catastrophe is much more likely to play out via the destruction of the UK body politics, ripped apart by the decision to hold a simple referendum on an immensely complicated question like EU membership, with multi-generational consequences, and without assuring a properly informed debate about well-defined options.

So here we are: Multilateralism is being challenged like never before by Trump's disruptive US, China's assertiveness and Russia's games. Europe cannot prevent all this, but a coordinated value-based EU that "gets its act together" (in Zedillo's words) can cushion the blow for Europe and become more of a stabilizing player on the global stage. That the UK won't be part of the effort is a given, unfortunately, but as I discussed last Sunday, with the Paris-Berlin axes back in power, there seems to be a new wind blowing across Europe in terms of appreciating the need for further integration.

So, on that optimistic note in an increasingly troublesome world, I wish you all a good summer. I thank you for reading me, and for the many comments and interactions during the winter and spring. I'll be back in early September.

Best

Erik

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This report was completed and first published on 21 July 2019 at 14:09.

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