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# GLOBAL MACRO RESEARCH

## ADAM TOOZE: WHOSE CENTURY?

APRIL 2023



## ADAM TOOZE



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## EXECUTIVE SUMMARY

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- The pandemic highlighted how precarious the balancing act has become // 4
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# NOW IS THE TIME OF MONSTERS

We live in a time of monsters. By that I mean that everything appears to be mixed up, abnormal, a sort of hybrid, made up in weird ways. Be that Brexit Britain, where people are struggling to make sense of a new reality and digesting the consequences of a decision made long ago, or the United States, where society is deeply troubled, struggling with its sense of identity and how it can move forward cohesively. In this era, crisis follows crisis, from the shocking resurgence in inflation and macro financial turbulence of which the gilt market is a standout example, to the looming issue of political instability and our inability to fashion collective projects through democratic processes. It is living with the perpetual sense that you might be hit by a truck.

As we search for a term to bring all of this together, this sense of being blindsided by a series of shocks, the term that many of us have centered on is one that was coined by Jean-Claude Juncker, President of the European Commission back in 2015: “polycrisis”. Although Juncker coined that phrase to describe the multitude of problems that faced the European Union at that point in time, the phrase seems ever more apt to describe the situation that we face today.

As we think about how we find ourselves in such a situation, we may conclude that a bigger shift may be occurring from a grand historical perspective. This concept has previously been raised by no less than Insight’s own Chief Executive Officer, Abdallah Nauphal, with the thesis that we are living in-between times. Abdallah has sought to create an organized way of thinking about the incoherence that we face today with a diagnosis of the crisis as the world moves from Pax Americana<sup>1</sup> to a new era. In his analysis Abdallah has previously quoted someone who isn’t the sort of person you would normally expect to be quoting at a meeting of financial market participants because he is Italy’s most famous Marxist – the leader of the Italian revolutionary movement in the 1920s, who died in one of Mussolini’s jails in the 1930s – Antonio Gramsci.



The crisis consists precisely in the fact that the  
old is dying and the new cannot be born;  
in this interregnum a great variety of  
morbid symptoms appear.

ANTONIO GRAMSCI

Under Abdallah’s thesis, Pax Americana has found itself buffeted by forces of change in the form of creative destruction, demographics, de-globalization and debt saturation, and these forces are putting enormous pressure on the growth engine that has been in place since 1945. Although we can sense that this extraordinary period of growth is under threat, and the institutions that were formed around World War II are being refashioned, it is difficult to make sense of the structural shifts and patterns that we’re seeing. It’s not easy to define where we are within this interregnum period – this dangerous period in between one level of equilibrium and another.

As we attempt to navigate the path between these two points it is important to remember that we live in a time of giant governmentally driven regulatory and managerial capacity,

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<sup>1</sup> Pax Americana refers to the period of relative peace and stability that occurred throughout the area of American influence after World War II.



dedicated to crisis management and stabilization, both in the private and the public sector. Although many of these systems are relatively new in the greater context of history – the Fed didn't come into existence until 1913, these forces of stabilization are effectively in an arms race with the forces of destabilization. Perhaps the best way to think of this is one of those images from history following the invention of the bicycle, where you'd see a villager carefully balancing a huge bamboo stave, with baskets on either side and a member of the family on the front, with maybe another on the back. The bicycle is moving forward but precariously so, requiring constant intervention to remain in balance.

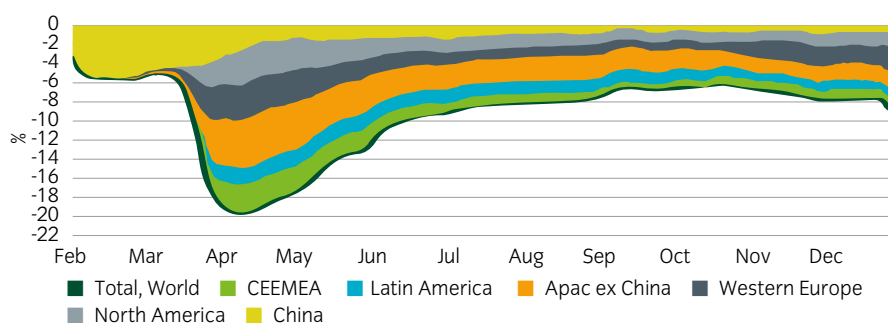
**The world that we live in not only requires constant intervention to remain on track, but the stakes have become larger and larger with time.**

## THE PANDEMIC HIGHLIGHTED HOW PRECARIOUS THE BALANCING ACT HAS BECOME

The events of recent years are perhaps a telling example of this constant balancing act as the forces of stabilization and destabilization attempt to counter each other. The pandemic caused the most savage collapse in GDP, which in turn required dramatic intervention by governments to counterbalance it. This policy, at least in part, caused the most rapid upsurge in inflation for fifty years which in turn required policy to be tightened at one of the fastest paces in history.

- **Destabilization – GDP collapsed during the pandemic:** This of course was the result of deliberate action, the intended or unintended side effect of a huge unprecedented public health attempt to prevent millions of people dying from a disease we didn't understand at the time. Figure 1 shows world GDP on a weekly basis in the spring of 2020 and this graph, which we sort of shrug and take for granted, is the single most shocking thing in modern economic history. There was a 20% implosion of global GDP in a matter of weeks.

Figure 1: Estimated impact of COVID-19 on global GDP<sup>2</sup>

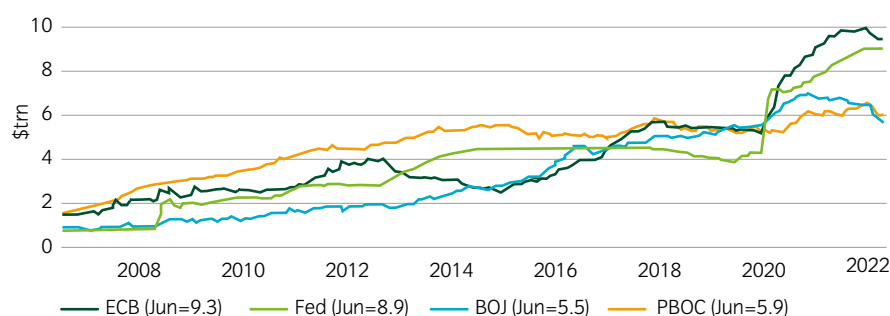


Global GDP is an enormous aggregate, it doesn't normally fluctuate by more than a percentage point here or there over a quarter. We have never seen anything remotely like this. In the worst effected economies of the great depression the United States experienced a 20% fall in GDP – but over three years, not three months.

- **Stabilization – a gigantic monetary response:** Faced with this unprecedented shock, policymakers responded with quantitative easing at an unprecedented scale (see Figure 2). In the last weeks of March 2020, the US Federal Reserve were buying \$85-90bn of US Treasuries a day as they embarked on a massive effort to stabilize dangerous signs of illiquidity in the US Treasury market – the foundation of the global monetary system.

<sup>2</sup> Source: Goldman Sachs Global Investment Research.

Figure 2: Quantitative easing programs surged during the pandemic<sup>3</sup>



- **Destabilization – surging inflation:** In due course, with as they like to say, long and variable lags, the policy response contributed to the other unprecedented shock of recent decades, namely a surge in inflation. It wasn't perhaps the main driver, but it certainly facilitated and enabled it, especially in conjunction with the fiscal policy measures that the huge surge in central bank activity helped to support.
- **Stabilization – the largest collective increase in interest rates in modern history:** Starting with the central bank of Brazil which wanted to be ahead of the curve, every single central bank around the world, more or less, embarked on monetary tightening to stave off inflation. The largest collective increase in interest rates since the beginning of the fiat money system in the early 1970s.

## THE BALANCING ACT IS MOST ACUTE IN JAPAN

As we keep trying to balance the bike, but on an absolutely epic scale, there is one place where this drama has been quietly playing out for decades – Japan.

Japan was the hub of global finance in the 1980s and 1990s, a huge surplus country that has since undergone a prolonged period of economic turmoil and recession. It's gone on for so long that it has almost been forgotten about by many in financial markets, but Japan is the country where this constant balancing act is exhibiting the greatest tensions within the monetary system. The Bank of Japan's now legendary yield curve control policy has required the Bank to purchase around US\$300bn worth of Japanese government bonds in the last few months alone. The central bank has now purchased not only a large part of the bond market, but also a large part of the equity market as well. Nowhere is this monstrous, hybridized, fully managed system more apparent than in Japan – and it doesn't just impact its domestic market. As investors search for higher yielding alternatives, so they pour money overseas and buy European and US bonds.

When we look at what's going on in Japan, we often do this through a Western lens. What we don't often do is try to understand the Japanese decision making in its own terms. To describe Japan dramatically, it is a complex, slightly odd democracy on the front line of the new cold war. Opinion polls suggest there is little support for the governing party in Japan, but that same party are making fundamental decisions about demography, technology, China, defense and about how Japan navigates the rest of the twenty first century.

Global logic concludes that Japan has to abandon its yield curve control policy. However, a shift in the monetary policy of the Bank of Japan is the last thing that anyone in Japan wants as they attempt to make profound political decisions against a backdrop of mounting tensions with China.

<sup>3</sup> Source: Haver Analytics. Data as at 31 December 2022.





# FINANCIAL REPRESSION MAY BE ONE WAY TO REBALANCE

As policymakers seek ways to make the balancing act less precarious, the monetary balance sheet question is one of the trickiest issues they have to solve. Debt has piled up from consecutive crises and its reduction is a sensitive and highly political issue because, in the end, we owe this money to ourselves.

Historically speaking, the best way of dealing with large balance sheet accumulations of this type – huge intersocietal claims on each other – is not through direct taxation. Nor is it through hyperinflation and burnouts, both of which are traumatic. It is through what we call **financial repression**: having an inflation rate that is modest and relatively stable, but above the level of interest rates such that there is a continuous reduction in inflation adjusted levels of debt. That was the playbook for the Pax Americana period of the 1950s and 1960s and both Britain and America effectively used this strategy to bring down the absolutely enormous levels of debt accrued from WW II. Perhaps a more politically acceptable term to use than financial repression is **rapid nominal GDP growth**, because all we care about is the level of debt to nominal GDP, and if you grow the denominator rapidly that ratio will naturally decline.

To some extent that is already happening. In America debt/GDP has declined by around 10% over the last 12 months due to a combination of a decline in the underlying value of debt as prices have adjusted downwards on higher rates, and rapid growth in nominal GDP. The combination of the two is rather magical but at the same time if central banks choose to pursue such a strategy it's probably quite important that they don't talk about it too much, they just allow it to happen quietly in the background.

# TENSIONS BETWEEN THE US AND CHINA ARE INTENSIFYING

## THE WAR OF WORDS IS BECOMING MORE SERIOUS

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To start the year, the Chinese Ministry of Foreign Affairs released a ten-page document on the logic of American hegemony. This was issued to all of China's embassy officials and to the journalists they deal with around the world. At its heart, it outlines the Bretton Woods Agreement of 1944 as a one-sided American decision to foist a system dominated by the US dollar on the world. In doing this, the Americans have been allowed to hoover up imports to their hearts content while paying in their own currency, creating a very unbalanced global system.

The terrifying fact about the world we are currently in is that the Americans have not responded positively, for example if the US had pointed out that the system was created for the purpose of global stability and the benefit of all. Instead, the response has been confrontational, with threats of retribution towards those not abiding by the rules. Then, rather than reverting to World Trade Organization (WTO) principles as a way to defuse these tensions, America has brought the WTO into the conflict, deciding that it is an obsolete institution whose time has come to an end.

Although this war of words is worrying enough, an increasing number of investors in South East Asia are now incorporating actual war scenarios into their financial planning for the years ahead. We now live in a world where the possibility of WW III is deep in the system and if you deal with a South East Asian counterparty, they may be including this as part of their thinking.

## AN ACTUAL MILITARY CONFRONTATION IS NO LONGER OUT OF THE QUESTION

The war in Ukraine has permanently changed the mindset of American policymakers, who were reluctant to believe that Russia would actually be willing to invade Ukraine and create the global upheaval it would bring. The American policy-making establishment is now wired to think beyond global tensions and is focused on the possibility of actual war. It was always clear that Ukraine was not part of the NATO pact and that there would be no possibility of American troops officially being put into conflict in Ukraine, but the situation in Taiwan is very different. The Biden administration has explicitly extended the American defense shield over Taiwan and repeatedly stated that American troops in the region would regard an invasion of Taiwan as a basis to engage. **This is a scenario that would be monumental in its implications for both markets and humanity as a whole. It is a source of profound alarm.**

## A NEW COLD WAR WILL HAVE CONSEQUENCES

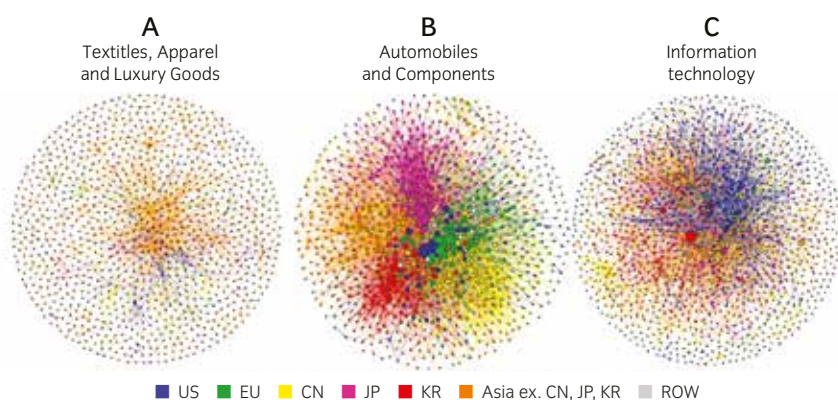
Assuming that we avoid WW III, we need to consider what the balancing act might look like that avoids this. At a minimum, it appears that the world is moving towards what is effectively a new cold war. Two blocs are forming and there will likely be a forced decoupling of relationships between them.

For some players, a global decoupling is going to be incredibly difficult to live with. For example, at a bank like HSBC, the preeminent Hong Kong based global bank, face being torn apart before our eyes. This is not just by their principal shareholders, which include mainland interests, but also internally as the interests of employees from the West, Hong Kong and mainland China collide. They could be the canary in the coal mine of the decoupling story as far as the financial sector is concerned.

Another company to watch is Apple. Although there has been much talk about the transfer of production from China to India, when you look at the actual makeup of their production it is clear there has been little progress so far. Apple, at least in part, can lay its success to Tim Cook developing one of the world's most sophisticated supply chains based in China, and it's proving difficult to change.

Thanks to the work of our extraordinary colleagues at the Bank for International Settlements (BIS), we are able to look more deeply at the potential impact of a global decoupling at a broader level. The BIS have taken 50,000 globally listed companies in a Bloomberg database and mapped their corporate connection with other members of that database<sup>4</sup>. In Figure 3 I've taken three key sectors so that we can examine how they may be impacted.

Figure 3: Global supply chains may prove tricky to untangle<sup>5</sup>



<sup>4</sup> Note this is a rough indication of supply chain relationships and is not based on actual accounting numbers.

<sup>5</sup> Source: Bank for International Settlements.



- A. **Textiles:** The concentration of yellows and orange shows that the textiles industry is totally dominated by China and Asia. Although it's unlikely that T-shirts will be labeled a national security risk, these supply chains are so deeply embedded that they will be very difficult to change.
- B. **Automobiles:** The single masses of color tell us that auto supply chains are generally regional or national. In other words, car companies producing in North America buy components from North American suppliers, car companies producing in Asia buy largely from an East Asian supply chain. The story here is clearly going to be segmentation. Deglobalisation can happen, but it will happen within corporate structures, and it isn't as explosive and disruptive as it may be elsewhere.
- C. **Technology:** The contrast of colors against each other demonstrates how interconnected the information technology sector is. US, European and Asian firms all do business with each other. This is a system that will be fundamentally ruptured by decoupling and there will be serious losses of economic efficiency as a result.

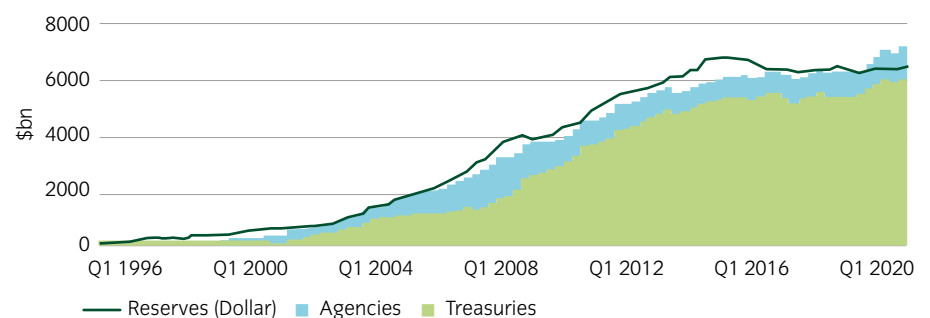
This is just the beginning of the sort of mapping exercise we'll need in order to understand the way the world is moving and the complexities of shifting supply chains in a decoupling world. The IMF has undertaken some work to estimate the scale of the impact on GDP and has concluded that there will be a loss of between one to ten percent of one year's GDP, culminated over time. This is global GDP so we're talking multiple trillion dollars – but it's not at a level which is catastrophic. Growth will continue, but at a lower trend than it was previously on.

## THE FINANCIAL SYSTEM IS ALREADY SEGMENTED AND HIGHLY POLITICAL

When we think of the world of flexible exchange rates and free capital movement, the idea that segmentation exists in financial markets may seem wrong. But, beyond the major currencies, the vast majority of the world's currencies are pegged either to a major currency or against one another. We already effectively live in a world of currency blocs and highly managed exchange rates, but it works well, so there is no need to overly politicize it. Perhaps the most important fault line in the financial world is China – the driver of global growth over the last 25 years, but with a financial system and currency that are locked to the rest of the world.

When we look more broadly, the scale of global FX reserves (see Figure 4) tells us that weaker players in the global financial system don't have confidence in a fully flexible system, as if they did there would be no need to hold reserves. Instead, many choose to self-insure, running unbalanced trade accounts to accumulate reserves over time.

Figure 4: Global FX reserves keep on growing<sup>6</sup>



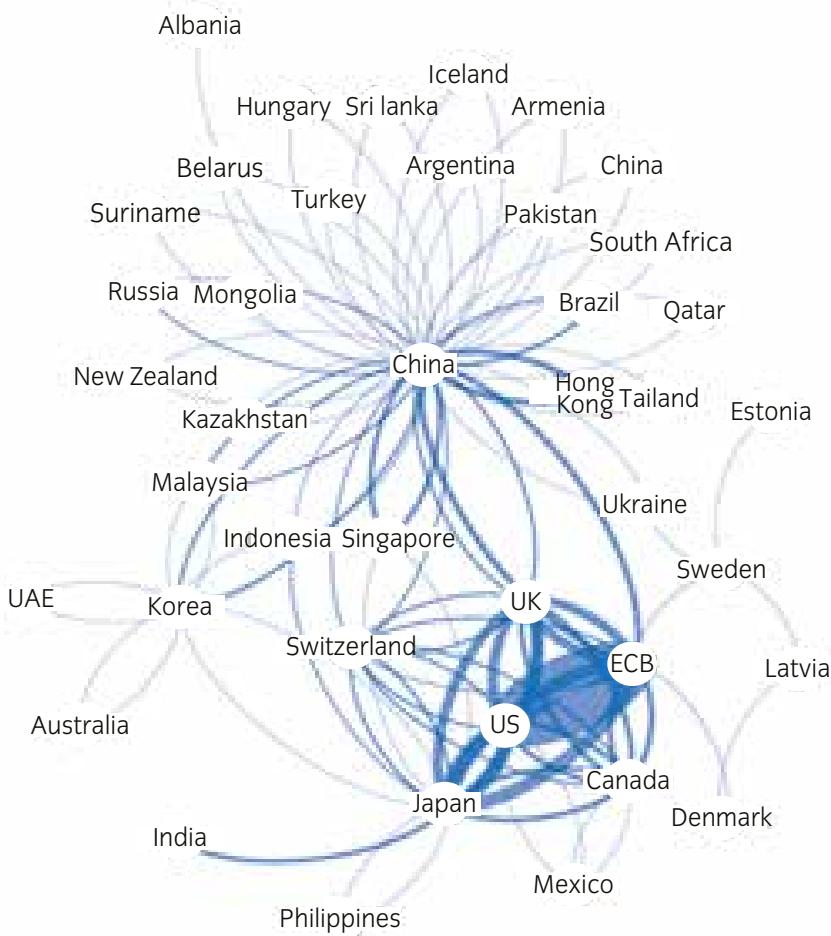
<sup>6</sup> Source: IMF/FRB/Haver Analytics.



In many ways the last forty years was never the smooth, flat perfect surface we imagined, it was always already segmented, unstable, risky and politically segmented. To really see the politics in the monetary system we need to examine the swap-line system that was put in place in 2008 (see Figure 5).

The densely woven web at the bottom, representing the largest volumes is between the European Central Bank, Fed, Bank of England and Swiss National Bank. This system allows central banks to swap currencies against one another with essentially just the other country's currency as collateral. It's entirely political. America will extend a swap line to Britain, Sweden or even Brazil because they are part of the American political bloc. We know this for a fact because India, Russia and Indonesia have all applied for swap lines and the Americans have quietly turned them down. Every time the Fed get such a request, it is the State Department that actually makes the decision. **At its core, the global financial system already has a hard geopolitical logic baked in.**

Figure 5: The global swap line system is highly political?



<sup>7</sup> Source: [www.centralbanking.com](http://www.centralbanking.com)



# CLIMATE CHANGE IS A MAJOR DESTABILISING FORCE

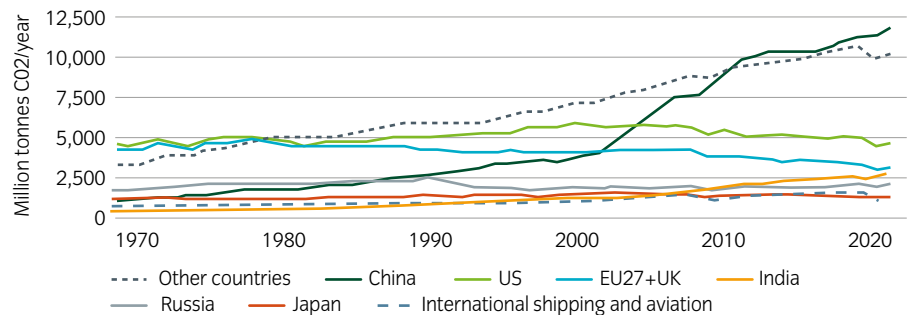
## CLIMATE CHANGE IS IN ASIA'S HANDS

In this divided world, there must surely be some issues over which we absolutely do need to collaborate – and environmental and global pandemic risks are two where perhaps we can.

However, to say we need to collaborate with China on the climate indicates that we haven't quite caught up with history. The climate problem is an Asian problem going forward – they will experience the greatest shocks. A third of Pakistan was underwater in 2022, with 30 million people displaced. Pakistan is not a small piece of the global system, it is by population the fifth largest country in the world, and it has become effectively dysfunctional as a result of politics, geopolitics, climate and financial risk.

In Figure 6 we can map out global CO2 emissions. Although Europeans and Americans endlessly argue about climate policy in narcissistic fashion, the real drivers of global emissions are now China and other large emerging markets. Emissions in China are now at a similar level to all Western economies in aggregate.

Figure 6: China will likely decide the fate of humanity<sup>8</sup>

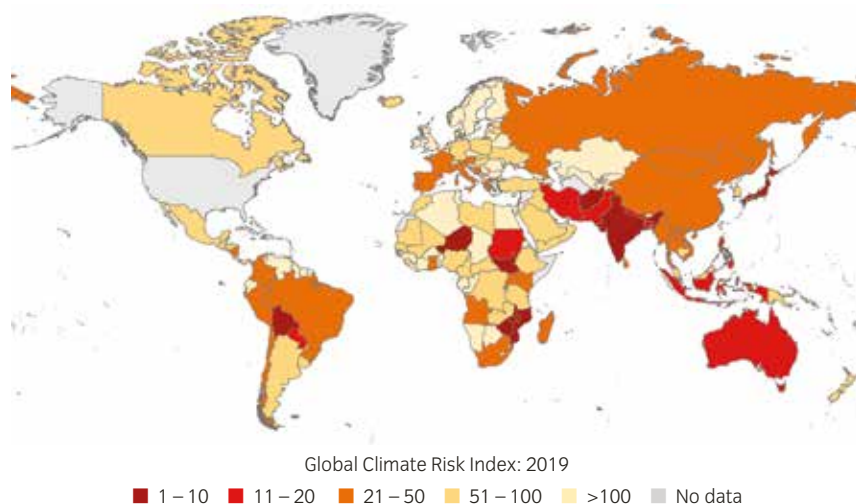


What this means is not that we need them to co-operate with us in our heroic effort to stabilize the climate – that puts it the wrong way around. Our future entirely depends on the choices they make, and we have little choice other than to wait, to see what they do. If they don't act, then nothing we do will make any difference. That is not to say we should do nothing, but we do need to wake up and realize that the battle has already passed over to them. One reason for optimism here is that the Chinese, for their own reasons, need to stabilize the climate. Stability is key to ensuring a long-lived dictatorship.

America on the other hand could be more of a problem. We can map out climate risks using the Global Climate Risk Index, which is published by UNESCO, the United Nations Educational, Scientific and Cultural Organization (see Figure 7). Although the US doesn't provide data for this index, if we assume that the US has the same risk as Canada and Mexico it immediately becomes clear why some Americans feel they can be laggards on climate change. On any objective measure of risk, they don't actually have much risk. You may not want to live in Miami or the flood plains of the Mississippi, but there are plenty of other places to live. However, climate is one area where there is a possibility of the Americans and Chinese working together going forward.

<sup>8</sup> Source: Emissions Database for Global Atmospheric Research [https://edgar.jrc.ec.europa.eu/report\\_2022](https://edgar.jrc.ec.europa.eu/report_2022).

Figure 7: Not every country will be equally impacted by climate change<sup>9</sup>



## THE BALANCE BETWEEN ENERGY SECURITY AND CLIMATE CHANGE IS HIGHLY DIFFERENTIATED

If you're a European, it's very easy to strike a balance between climate change and energy security, as renewable energy is your route to security. One problem is that solar energy is going to play a large role in this transition, and if you want cheap solar panels, you're going to have to buy them from China. Europe is likely to vindicate the story of energy security – but for the other two major parts of the global equation, China and the US, it's a much more complicated story.

In Beijing, they understand the climate crisis is their crisis to deal with, but the more we get into a geopolitical standoff, the more it will amplify the voices of the security minded energy faction who believe the exploitation of China's vast coal resources are the best option. The shift towards renewables may slow as tensions rise.

In the US it's an incredibly ambiguous story. Thinking back to the global oil market in the 50s and 60s, in Europe we were very focused on the gulf-centered system, where American and European oil majors pumped oil for export to Europe and Asia. But in America the national oil market was key – a high priced, protectionist, oil market dominated by small scale producers in Texas, and this really hasn't changed much. Americans have historically had cheap petrol not because they have cheap oil, but because they don't tax it. We now have a situation where the Biden administration are trying to exert pressure on the fracking industry to increase production, but the investment community are pushing back as they want to focus on profitability.

So one can imagine a world in which China and Europe go down a road which is centered on renewables and which ultimately leads to more stability and security, while the US and Canada have some renewables, but largely retreat into a subsidized, protected, fossil fuel driven model. Russia will likely go the same way, as might Brazil. Ultimately, if you are a major producer of oil and gas, then the balance between energy security and the use of renewables is very different than if you are a major energy importer.

<sup>9</sup> Source: UNESCO - <https://www.unesco.org/en>. Data is for 2021 which is the latest database.





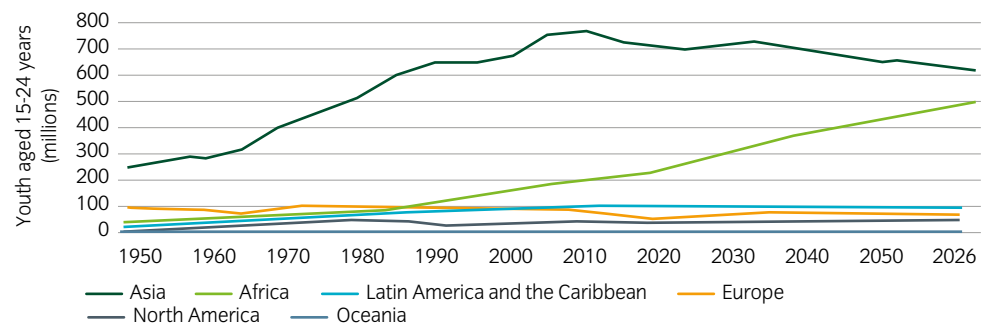
## AFRICA IS THE FUTURE OF HUMANITY

If decoupling sees the formation of two rival blocs, it could even prove healthy for humanity as a whole, as both sides race to create clean and secure forms of energy. A key beneficiary of this could be Africa.

Africa is the future of humanity. It is literally no exaggeration to say this. In Figure 8 we can map out forecasts for the number of young people in the world over the next 30 to 40 years, and we can see that demographically, Asia, Europe and America are done. The only part of the world where there is expected to be rapid population growth is Africa, and those people will need education and political capital to drive their societies to a sustainable way of life.

There is a huge amount that can go wrong and continues to go wrong in Africa's political economy. There are very few success stories at this stage but, in the long term, as inter-bloc competition increases, the process of globalization may finally incorporate all of humanity.

Figure 8: Africa is the only region with positive long term demographics<sup>10</sup>



<sup>10</sup> Source: The steady rise of Africa's youth population against world continents. Image: SESRIC SWOT Outlook 2018 for OIC Countries.

# CONCLUSION

To conclude I'd like to return to the Gramsci quote, but a different translation that I prefer:



The crisis consists precisely in the fact that the old is dying and the new cannot be born; in this interregnum a great variety of morbid symptoms appear.

ANTONIO GRAMSCI

Miraculously when the French translated this same passage it came out as “Le vieux monde se meurt, le nouveau monde tarde à apparaître et dans ce clair-obscur surgissent les monstres.” In English that translates to “The old world is dying, and the new world struggles to be born: and in this half-light monsters arise.”

Or to be succinct: “Now is the time of monsters” – which brings us back to where we started.

When Gramsci wrote this in the 1930s, he might have been thinking of Boris Karloff, famous for his portrayal of Frankenstein’s Monster in 1931. Bolted together, made of weird pieces with visible scars, unpredictable. It was an apt analogy then and ever more apt today. Globalization is becoming the Frankenstein version, still recognizable, but weird and unpredictable. Even political policies like the just passed Inflation Reduction Act in the US. A \$550bn nationalist, debt and taxpayer funded technological industrial policy which was anti-Chinese but green at the same time. A weird bolted together thing that is difficult to make sense of. These are the types of monsters we face, and which will have to face ahead as the world struggles to maintain an increasingly precarious balancing act.

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