

We are Not in Kansas Anymore: Economic and Political Shocks

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Abstract 2016 was a year of apparent political shocks from Britain's vote to leave the European Union to the election of Donald Trump. Yet whilst most analysis failed to predict these events, they were the clear product of the breakdown of the economic and political world that was in place before 2008. The breakdown of that order has produced two differing sets of consequences in relation to economic and political probability. It has, in conjunction with high-frequency trading, transformed the monetary and financial world making the financial markets the site of black swan events in terms of existing models of financial markets, leaving us in an unknown economic world. By contrast, in politics, there are historical antecedents in past crises to the kind of events that unfolded in 2016.

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2016 was a year of apparent political shocks. We seemed by the end of the year to have left a political world we understood behind and entered a new one. Put in the language of movie-culture, by the end of 2016, we were no longer in Kansas. The two developments of 2016 that have, of course, attracted most comment have been the Leave win in Britain's referendum on its membership of the European Union (EU) and Donald Trump's victory in the American presidential election. Perhaps just as consequentially, however, 2016 also saw an attempted coup in Turkey during which the US government appeared initially neutral about its outcome and the sight of Russia acting together with Iran and a NATO member in Turkey to the diplomatic exclusion of the United States to negotiate a cease-fire in Syria. Looking at this new political world, we seem to be living in a bewildering, and perhaps terrifying, political time of what could be, and are often, called 'black swan' events; these are events of low probability that are extremely difficult to predict.

Yet even without the benefit of retrospective hindsight, none of these political events in 2016 was in reality as improbable as we may have thought. Put simply, the economic and political world that was in place before 2008 no longer exists, and the events of 2016 are a manifestation of the breakdown of that old economic, political and geopolitical order. In the Middle East, the American failure in Iraq has fundamentally changed the balance of power in the region by strengthening Iran and facilitating a counter-reaction in Sunni majority-states. In this new geopolitical environment, the United States is unable to exercise power in the Middle East in the manner in which it has done since the end of the cold war, and Russia has seized the opportunity to re-enter the region. Within the EU the eurozone crisis has elevated German power and ensured that virtually all further integration will be driven by the need to recreate the institutional basis of monetary union. As a consequence, the EU can no longer function politically as it did a decade ago. Economically, the 2008 crash brought to an end the material, financial, and political foundations of non-inflationary growth in western economies and began a new era of quantitative easing (QE) and zero interest rates policy (ZIRP). The result has been a 40 per cent increase in global debt since 2007 and a radical transformation of the structural conditions of international capital flows, the relative position of creditors and savers, and the fundamental context in which monetary policymakers can judge the likely consequences of their actions.

Certainly, this post-2008 world has produced both volatility and unpredictability, most clearly in the operation of financial markets. Indeed, it may not be hyperbole to suggest that in the wake of QE and ZIRP western financial markets as *markets* with any price discovery function no longer exist. Share and bond markets in particular now have dynamics permeated to the core by expectations of what central banks, and in particular the Federal Reserve Board, will next do. For example, in May 2013, US bond markets threw what became deemed a ‘taper tantrum’ when Ben Bernanke said that the Fed planned to taper bond purchases under QE3 and in doing so pushed up sharply yields on Treasury bonds. In this new financial world share and bond markets often respond positively to the bad economic news in the real economy because poor data derails further the day when central banks can move back towards anything like a remotely normal monetary policy. As the gyrations of the financial markets over the first twenty four hours of Trump’s victory demonstrated, bond and share valuations also react with large and erratic swings to political developments, as investors endeavour to process what political outcomes will do to the likelihood of monetary change.

This increasingly surreal world generated in financial markets by QE and ZIRP has been compounded by the manner in which these markets have simultaneously been recast by high-frequency trading. Correlations between movements in different asset classes from shares to bonds to commodities and between assets in advanced and emerging market economies have become acute since 2010 with a whole range of prices driven by common external developments, not least the pronouncements of the world’s central banks, rather than anything particular to the singular fundamentals of each market. Although rising correlation was a predictable feature of periods of high market volatility in the years before 2008, the intensity of the correlation is now levels of magnitude greater than anything seen before. Meanwhile, post-2008 financial markets are producing what would have hitherto been regarded as ‘black swan’ events, flash crashes and surges of such size that should be extraordinarily low-probability occurrences according to all existing modelling of financial markets. In the context of strongly correlated markets and black swan movements in prices and yields, the risk of a systemic crisis through contagion is considerable and the avoidance thus far of another financial crisis that would dwarf anything that happened in 2008 may be considered but good fortune.

In probability terms, the apparent political shocks of 2016 are not comparable. Although like the financial black swans they would not have occurred in the pre-2008 world, at a historical level they have also been reasonably probable occurrences in the context of the rupture in the economic, political and geopolitical order that has taken place. Put differently, these supposed political black swans are the possible events that, historically, we should expect to occur at least some of the time when underlying stresses in structural fault-lines in political orders break. Certainly, the nature of the qualitative monetary and financial transformation and its fallout in terms of low-probability occurrences has not been without its political consequences, as exhibited in the direct attacks made by both Trump and Bernie Sanders on the Fed's QE programme during the American presidential election. But the monetary and financial metamorphosis since 2008 has not, at least yet, yielded anything that looks so inexplicable in politics.

In part, this relative predictability of the events of 2016 is simply the consequence of the fact that the two disruptive election results were the result of binary events in which by the time of the election one of only two possible outcomes simply had to occur. In the case of the American presidential election, we should not be surprised that one party's candidate was able to construct an electoral college victory with small margin wins in a small number of states in one particular region of the country since the number of states changing hands between the Democrats and Republicans in presidential elections from 2000 has been relatively limited and those changes have determined electoral results. The apparent low-probability event to explain in the American election is how a candidate without previous political experience and little prior attachment to the Republican Party became the candidate of the Republican Party whilst launching an outright assault on the entire political establishment in the US including the Republican Party itself. Nonetheless, even Trump's candidacy is not in probability terms as shocking as it may seem. From Rome onwards, times of crisis in republics and democracies have produced the ascent to power of an outsider member of the dominant oligarchical class, who rises by mobilising the deep discontent of a section of the populace with the ruling elite.

Trump's own relationship to the American oligarchic class, through his celebrity and the material dynamics of campaign finance that the oligarchical components of American democratic politics generate, created his political opportunity to join the race for the Republican nomination.

Once in the contest, the fact of Trump's political inexperience then allowed him to act as an effective whistle blower on the ruling political class' failures to preserve the old economic and political order, not least in regard to the failed, and exorbitantly expensive, wars in the Middle East. When the whole foreign policy-making establishment that had presided over this imperial overshoot lined up against him in the Republican primaries as if nothing had changed in relation to the United States' position in the world, it was in practice relatively easy for Trump to rally a large enough constituency of voters by pointing out that the US could no longer afford to play unsuccessfully at being the world's policeman.

In the case of British membership of the EU, a Leave result in a binary referendum was an even higher probability event from the outset. What requires more explanation in accounting for Brexit is why David Cameron first gambled on such a binary referendum to determine whether Britain would remain inside the EU when that was an outcome to which he was strongly committed, and then was unable to persuade other EU leaders, and in particular Angela Merkel, that ongoing British membership was worth significant concessions. Here again, the elucidation of these outcomes lies in the breakdown of the pre-2008 economic and political order, this time in relation to the EU. The eurozone crisis put massive pressure on the foundations of Britain's membership of the EU. In general terms, it politicised the position of London as the eurozone's offshore financial centre, it created the need for further integration of which Britain as a non-participant in the eurozone would have no part, it turned Britain into a joint employer of last resort with Germany for the periphery of the eurozone, and it magnified the differences in approach to monetary and financial matters between Britain and the other non-euro member states.

Cameron walked the path to his referendum promise in 2013 because he was unable to find an alternative way out of the political pressures these dynamics created, and he secured little in the renegotiations from Merkel in 2016 because under the conditions of the eurozone crisis British membership mattered significantly less to the future of the EU than it had done before 2008. Put more schematically, the pre-2008 centre of Britain's membership of the EU no longer held. If there was no necessary reason why any British Prime Minister had to confront that reality, or in Cameron's case to conclude that he could change it by reconstructing the domestic foundations of Britain's place in the EU through renewing democratic consent to the basic principle of

membership, there was also no path back to a world in which that centre existed. Seen from history, the departure of a large state from a confederal or federal union in which it had long been in a political minority at a time when a crisis exposed the limits of that state's political influence within the union would appear a not unlikely event at all.

The world in which Britain is leaving the EU and a political neophyte who declared rhetorical war on the American establishment is President of the United States is both unrecognisable in relation to the pre-2008 order and could have been predicted as a possible consequence of the kind of disjuncture that 2008 represents. The conjunction of developments that brought those elections to the particular binary choice at issue, which in both cases pitted attempted continuity against disruption, arose in the context of a disorder that had by definition to advantage disruption. Of course, structural advantages do not determine in politics and in particular they do not decide binary elections in which day-to-day events are highly charged and fast-moving and voter turnout is variable. Either election could have produced a different outcome if a number of contingencies had been otherwise. This is particularly true in the case of the American election where Trump's path to an electoral college victory turned on extremely small margins. Nonetheless, historical experience of economic, political and geopolitical crises and the disorder they let loose tells us that radical political change often ensues under the kind of conditions now in play, especially when, as in the United States, economic and geopolitical crises occur simultaneously.

There is a coming economic and political crisis. What history cannot predict with anything like such clarity is the future economic and political outcomes that the monetary transformation wrought by QE and ZIRP will eventually yield. There has simply been nothing in human history that looks like this monetary experiment in which central banks have created from nothing a massive volume of new money to service and expand debt whilst permeating in doing so the whole nature of financial markets. In this respect, we have indeed left Kansas behind and are living in an unknown Oz.

The Coming Crisis

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