Interview with Anatole Kaletsky, Partner & co-Chairman of Gavekal Research Ltd.

# In the Midst of Geopolitical Turmoil, an In-Depth Look at Trends in the Global Economy Could Lead to a New Capitalism

By *Japan SPOTLIGHT*

**Anatole Kaletsky, a distinguished economist, is founder and co-chairman of Gavekal Research Ltd., one of the world's leading independent providers of global investment research. He is a columnist for Reuters and the *International Herald Tribune* as well as a principal contributor to the research service of Gavekal. Before founding Gavekal, he worked for 30 years as an economic journalist and commentator for *The Financial Times*, *The Economist* and *The Times*.**

**He published a book titled *Capitalism 4.0* in 2010 on the post-crisis transformation of the global economy, an insightful analysis of world capitalism after the global financial crisis in 2008. Seven years after its publication and with some significant geopolitical crises continuing today and starting to affect the economy, *Japan SPOTLIGHT* interviewed him about the mid- and long-term perspectives for the global economy.**

**(Interviewed on Nov. 10, 2017)**

## Introduction

**JS: My first question is related to your recent book *Capitalism 4.0*. Could you please introduce this book as well as introducing yourself?**

**Kaletsky:** Of course. My book is not so recent; it was written in 2009 and came out in 2010, so it is now nearly seven years old. However, I believe it is still very relevant as it was written in 2009 after the low point of the financial crisis and was really an attempt to re-assess what was happening in the crisis and to put it in the context of the long-run development of the world economy and specifically of the economic and business system around the world.

The reason I called it *Capitalism 4.0* is that the crisis that occurred between 2007-8 was not just a crisis in the capitalist system, it was a crisis of the global capitalist system, of a kind that does not occur every five, six or 10 years like a recession in the world economy; this was a once-in-a-generation event which systemically transformed both the world economy, the relationship between countries and also the relationship between economics and politics around the world.

*Anatole Kaletsky, Partner & co-Chairman of Gavekal Research Ltd.*

In my view, this is the fourth great crisis of capitalism since the early 19th century when the global capitalist system as we know it began to be developed for the first time in England and America, and then in the rest of the world. There had previously been three great crises: the first was the middle of the 19th century and the so-called era of revolutions when Marx and Engels wrote *The Communist Manifesto and Das Kapital;* then there was the crisis of the 1920s and 1930s with the Russian revolution, the Great Depression and World War II — the deflationary crisis. Then there was the crisis of the 1970s, which really began in the late 1960s and culminated with the events in Paris, the riots in America and finally the arrival of "Reganomics" and Thatcherism — that was the inflationary crisis.

Then we had the fourth crisis of capitalism, and what struck me was that after these crises there is a long period of confusion about not just what happens next in the world economy but about the whole way the economy has to be run. After 10-15 years at the worst point of a crisis, a new form of global capitalism emerges which is still based on the principles of private property, competition and the profit motive, but each of these new eras of capitalism was very different from the one before. What came out of the 1970s was completely different from the Keynesian mixed economy of the

1950s and 1960s.

What came out of the 1930s and World War II was completely different from the *laissez-faire* capitalism of the late 19th and early 20th century, and so my argument was that what comes after this crisis — we don't know exactly what it will be — but it will be very different in terms of the management of the global economy, and the relationship between politics and economics will be very different to what preceded it.

**JS: Let me ask you about your background. You are a journalist and have been observing many political developments as well as being an economist at the same time.**

**Kaletsky:** My background was that I studied economics at Cambridge and Harvard and rather than becoming an academic economist, I was offered a job by *The Economist* magazine in London and then worked there for a few years. Most of my career I spent at *The Financial Times* both in London and in Washington and New York, and then in the early 1990s I moved to the London *Times* where I became their chief economic commentator for the next 12 years. So, I spent about 25 years as a full-time journalist dealing with both economics and public policy in Europe and America and then I set up with my partner Charles Gave (who was an asset manager) my firm, which advises financial institutions on economic and geopolitical conditions around the world.

## Assessment of Current Economy

**JS: My second question is about your general observations about the current economic situation. Many economists seem to be saying that the world economy is picking up. Would you concur with this?**

**Kaletsky:** If we are talking about where we are in the relatively short- to medium-term economic cycle, I would agree with the consensus. 2017 already was the first year of real stability and predictability in the world economy since the crisis of 2008. From the middle of 2017 onwards, we have been in a much more stable and predictable world economy than at any time since the crisis. Probably also stronger, but I think that the key change that occurred in 2017 is that it became more predictable and reliable. This situation may well continue at least for the next few years. That is what is built into the forecast by the IMF and OECD and so forth, although they have always forecasted at the beginning of each year that there will be a period of stability.

These forecasts are much more credible, but when I talk to people in financial markets there is still a lot of nervousness about a return of a financial crisis. 2017 was a pivotal year; there are three dominant parts to the world economy, namely the US, the eurozone and China/Asia. The US economy emerged from its period of extreme unpredictability about three or four years ago and has been fairly stable. However, just as the US situation was improving, the world, and in particular financial markets, were hit by a panic about Europe and the possibility of the breakup of the euro, during 2012-2014. That panic subsided in 2015 when the ECB began to do its very aggressive monetary easing. Then it came back in 2016 with the Brexit vote and the possibility of a financially driven breakup of the euro. That risk really came to an end in April 2017 with the French elections. Unfortunately, just as the European situation was subsiding in 2015-16, China began to look like the big threat to the world economy with the stock market crash and the capital flight out of China in late 2015. It wasn't until the beginning of 2017 that it became clear that the Chinese could also control their financial system — that China may have structural problems but it's not about to blow up. 2017 was the year when China and Europe stabilized; America was already sustainable, so now I think we have a situation that is sustainable for the next few years.

## Moving Away from the Neoclassical World

**JS: Your book's introduction mentions that the nature of capitalism has been transformed since 2008. Does that mean capitalism is moving towards a destabilizing phase?**

**Kaletsky:** No, that is not what I meant in my book. What I meant about the change in the nature of capitalism over many decades is mainly about the relationship between the public sector and the private sector, between politics and economics. What happened in the 1970s and early 1980s was a complete transformation between government and business and between politics and economics. In the 1950s and 1960s you had the so-called "mixed economy" in which government intervention was trusted and markets were highly distrusted by the public.

Then in the 1980s the markets were trusted and governments were distrusted, and there was this period which was sometimes called market fundamentalism, where the idea was that the government was always the problem and the market was always the solution. In the 2008 crisis, we realized that the government and the markets could both make serious mistakes. You can't fully trust either. We are groping towards a new relationship between regulation and market forces that will try to eliminate the worst excesses and instabilities that come from both.

How that will evolve will be different in each country and we don't know how successful it will be but I think if we look at politics around the world today, from Europe to China, it's about bringing about a new balance between economic and political forces.

**JS: A world that perhaps no neoclassical economist ever imagined. . .**

**Kaletsky:** If you look back at the classical economics of Adam Smith and even Ricardo, it was very much about the relationship of government and economic actors, between markets and public institutions — but you are right for the neo-classical period and again the new Thatcher-Reagan market fundamentalist period, there was this assumption that separating politics from market forces made for a better economic outcome.

**JS: I see. So in terms of economic terminology, perhaps "game theory" would be more predominant.**

**Kaletsky:** A very interesting point of view. The normal response I get is, "Aren't you just talking about a return to government interventionism and the Keynesian economics of the 1950s and 1960s?" I don't think you ever get a return to what was going on before and obviously that system failed. The point about each of these phases of capitalism is that they work for 10, 20, 30 years and then they have a crisis when they fail, so the Keynesian system failed in the 1960s and 1970s with high inflation.

The system of extreme deregulation and market fundamentalism worked very well in the 1980s and 1990s but began to fail in the last decade with the widening distribution of income, the extreme build-up of debt and then the collapse of the financial system. What will emerge will be different from the 1950s and 1960s and thus you need a much more flexible approach to unpredictable events, and this is part of the new thinking.

**JS: This reminds me of the importance of regulators as an entity in setting the rules of the game.**

**Kaletsky:** Clearly there is a return to a greater level of regulation, obviously in the financial system but also in environmental policy and in developing infrastructure — there is an understanding that the market alone cannot make these decisions. The major difference between the present phase and the postwar period is that we don't really trust the regulators now. After World War II there was this idea that the governments know what they are doing and that they know what the future holds and they are always acting in the public interest. Now there is an understanding that often the regulators a) don't understand what they are doing, and b) may not be motivated by the greater good, the interest of society as a whole — they may not be motivated by narrow bureaucratic interests or the histories of their institutions.

So we have to have a greater willingness to question what the regulators are doing as well as what the markets are doing and that is what makes the present politics so unstable around the world, because there is widespread distrust of bankers and also public distrust of the market system now. They also distrust the government, so where do we turn?

## Short-term Risks to the Global Economy

**JS: Indeed. Moving on, you said that 2018 could be a stable year. But in my understanding there are two risks: one is the rise in US interest rates and its impact on the BRICS economies, and the other is geopolitical risks such as North Korea. How do you assess these risks?**

**Kaletsky:** The geopolitical risks are very serious, they are present. I am certainly not in a position to predict what will happen in North Korea or the Middle East. And neither is anybody else. The geopolitical risks are intense; the only consolation is there are always geopolitical risks. There has never been a period in our lifetimes when there has not been some major risk. So, I would leave that aside.

On the question of US monetary policy, I have a clearer view. I think that this does not pose the kinds of risks, at least for the next couple of years, that many people worry about. The reason for that is that the very gradual increase in US interest rates — which actually began at the end of 2015 — is not yet what I would call a genuine tightening of monetary policy. It is merely a reduction in the extreme degree of monetary stimulus that we have seen since the crisis. Even after another two or three rate hikes from the Fed, interest rates in the US will be negative in real terms because I believe that inflation in the US is gradually heading towards the 2% target.

So, as long as the short-term interest rate in the US remains low or near the rate of inflation it is not really exercising a restraining influence on the economy domestically, and there is evidence that is not a threat to global economic conditions such as emerging markets. The evidence of that is that the dollar has been weakening since the Fed started raising interest rates, and may continue to do so for another year or so, and is not putting pressure on the economies of emerging markets that would be disruptive to the world economy. If we saw US interest rates go up to 3% or 4%, this would have potentially an important and destabilizing effect on the world economy; this could happen a few years from now but not in the next year.

**JS: The new Fed governor, Jerome Powell, is seen as dovish regarding raising interest rates. He is seen as more reluctant than his predecessor to raise rates very high.**

**Kaletsky:** From what I can see from the small number of speeches and statements he has given, he is very much a consensus-oriented policy maker. I'm not sure if he is any more dovish than Janet Yellen but I don't think he is any more hawkish. My impression is that he has been very close to the consensus on Fed policy for the last few years that he has been on the board. And also I think it is encouraging that he is not himself a professional economist and thus does not have strong views one way or another.

## Long-term Issues

**JS: Let's move on to some long-term issues. One**

**potential blessing for the world economy is innovation and progress such as AI, IoT, stem cells and robots. These innovations could perhaps raise the growth potential of the global economy. How do you assess their impact?**

**Kaletsky:** I think that the rate of innovation is clearly accelerating and increasing, and will continue to accelerate, and more importantly the application of innovations that have already occurred in science and technology are going to be applied to more and more sectors of the global economy in the next 10-15 years. My expectation is that the degree of economic impact of technology is going to increase in the next 10-15 years. Paradoxically, the models used by central banks and finance ministries all over the world to forecast economic activity all assume that the rate of productivity growth and therefore the application of new technology is slowing down.

This seems to be contradicted by what we see from a business standpoint from the bottom. So you might say why are policy makers around the world making these more pessimistic assumptions in their models when we can see the opposite happening in the everyday world, and the reason is that policy-making plans about how to manage the economy are always backward-looking rather than forward-looking.

The apparent degree of innovation has gone down dramatically in the last 10 years relative even to the 20 years before. This has been interpreted by a lot of academic economists (such as Robert Gordon in Chicago) as evidence that the rate of innovation has declined despite everything we see in tech and electronics and other sectors. I would rather say that the reason productivity has declined is that global economic activity generally has fallen as a result of the financial crisis, the deflationary policies or the highly restrictive fiscal policies that we have seen around the world, and we've had 10 years of very weak economic activity that is more of a demand-side rather than a supply-side issue. If we now get into a period of more stable demand in the world economy, we will now see the impact of technology and innovation accelerating which will begin to come through in the macroeconomic figures as well — but that may take several years. Policy makers are backward-looking whereas the business community and most everyday citizens are more forward-looking about technological change.

**JS: There are various views on innovation — mainly regarding speed and quality. In my understanding, some believe that there are lots of seeds of new technologies but companies fail to apply these seeds to their real business activities. Would you agree?**

**Kaletsky:** I think there is a lot of truth in that. There are tens of thousands of companies in every economy and you can't make a uniform judgment about what they are all doing. But on balance, a large part of the business community in every advanced economy has still not found ways of exploiting the opportunities that

technological changes are bringing about. There is nothing surprising about that and this also partly accounts for the falling productivity rate over the last decade. Of course, new ideas are only adopted by the minority of the business community, just like early adopters among individuals. This leads in the medium term to falling productivity growth as the leading-edge firms become highly efficient and profitable while the ones that are not at the leading edge suffer and lose business and economic activity but continue to employ the same number of people. Thus the leading-edge firms are taking business away from the lagging firms.

**JS: Do you think a more rigorous competition policy is required to encourage innovation?**

**Kaletsky:** Partly we need more time for these business models to evolve; there has been a greater recognition around the world that actually the degree of competition in the world economy has gone down compared to 15 years ago as there have been more mergers of business even at the leading edge of the technology sector where you have four or five dominant firms that are stifling competition, to the point of not allowing new ideas to develop and buying the business and closing it down before it can become a threat. So I think there is a real question mark about whether the degree of competition in the world economy has increased or diminished.

**JS: Moving to structural reform, as for European geopolitical risk, you mentioned the election in France and its stabilizing effect on the economy. President Emmanuel Macron, however, does not appear so popular now and there seems to be robust nationalism in Europe, which could cause instability.**

**Kaletsky:** I think that the situation in Europe has stabilized as a result of the French and Dutch elections but has not improved, and there is a difference. The 2017 elections in Europe were an important turning point because until then Europe's political, financial and economic outlook was deteriorating rapidly since 2008 and it was approaching a real breaking point. It looked like it would spread into the whole eurozone and the EU.

What happened in 2017 was that the process of fragmentation was stopped by politics, as it turned out there was not a will among the European electorates to break up the system. So it is stable but not necessarily improving. Will it build on this stability and improve its competitiveness? This is very much in question. The big uncertainty about Europe is whether it just stabilizes or improves upon this and integrates more closely, especially in the eurozone from a fiscal and monetary standpoint. I am confident that the nationalist breakup — the desire of a majority of voters in Europe to break it up into national subcomponents — has come to an end.

**JS: There are also independence movements in Catalonia and Scotland.**

**Kaletsky:** As you have seen, there are a number of disruptive forces. I think that the most important feature is that the sub-national breakups for example in the UK and Spain — these movements seem to have peaked. In the case of the UK, it looks like Scottish nationalism is now declining so there is a new equilibrium with a much more autonomous Scottish government. In the case of Spain, I think that the repression of Catalonian nationalism by the government was a mistake, but it looks like that situation also has reached an equilibrium.

**JS: Looking at structural reform, the most important issue in my view is labor market reform. In Japan, the administration of Prime Minister Shinzo Abe is very much trying to raise labor mobility to revitalize the economy, and in France the same thing is evident.**

**Kaletsky:** I think that the comparison between structural reform efforts in France and Japan is very relevant. In the last few years in Europe, I have been emphasizing that there is a lot to be learned from "Abenomics" and the "three arrows" approach. The important idea that Abe introduced into the discussion on economic policy is that you need to pursue structural and macroeconomic reform simultaneously. The conventional wisdom was that these are in contrast and that you need labor market deregulation and should not be connected with macroeconomic monetary policies.

That made it difficult in most economies to pursue the kind of labor market deregulation and other more competitive policies that were required because these kinds of deregulatory policies are usually deflationary and lead to a weakening of consumption and economic activity. So unless you counteract them with more expansionary fiscal and monetary policies, they are politically much harder to achieve.

And that has been the nightmare of Europe in the post-crisis period and even for the preceding 10 years, where you had in the eurozone a system of economic management imposed by the Maastricht Treaty which was extremely contradictory and imposed very tight monetary policies even under conditions where they were not appropriate, and at the same time you had a clear need for labor market deregulation, product market competition — and that was strongly resisted.

Macron is still resisted by the German philosophy of economic policy, but what he represents is the "three arrows" approach whereby you need monetary, fiscal and structural policies all moving in the same direction or you aren't going to achieve results in any of them. There is strong resistance from the German government that may prevent him from actually pursuing such a policy.

## "Happy Marriage" Between Business & Politics

**JS: I have a question related to your book. You discuss the relations between politics and the economy. Today it is sometimes pointed out that the "happy marriage" between capitalism and democracy has ended. Do you have any thoughts on this notion?**

**Kaletsky:** In the academic world, there is even a name for this idea — the "Rodrik Trilemma" — whereby you have three things and you can't achieve them all at the same time. For example, democracy, globalization and national sovereignty — you can't have all these things at the same time. So there is a real dilemma here. I think that the root of this dilemma is the fact that capitalism as it has been practiced for the last 30 years has led to a dramatic widening of income distribution. That in principle should not be a problem — in economic theory. As long as national GDP is growing then it is possible to redistribute the benefits of greater economic prosperity.

But the problem is that to achieve that redistribution you need a degree of government and political intervention, which has not happened. Not just tax and spending, but regional policies, investment in infrastructure and so on that ensures that the benefits of growth are spread. Yet for the past 30 years, the kinds of policies for this redistribution have been more necessary than ever but have been prevented by the philosophy that government and regulation should hold back. If we want the wealth generation of capitalism to continue, we need a greater degree of collaboration between the business and political sectors. If we can't achieve it, there really could be a clash between democracy and the capitalist system. I think it is moving in the right direction. JS

Written with the cooperation of Mayu Fukutani who is a freelance translator.