

New World Order: Finance or Factories?

BLINDSPOT

“Out of the crooked timber of humanity, no straight thing was ever made”, said Immanuel Kant. Human beings lack perfect knowledge and therefore, no human institution is age-proof. Our problems are not necessarily solved; they simply evolve. Every triumph is provisional in human affairs. Perhaps that’s what Faulkner meant when he quipped, “past is never dead; it’s not even past.” And every now and then we grapple with a crisis.

But some are crises WITHIN the existing system, the others crises OF the system. The former may be more frequent but less momentous; the latter much rarer but far more consequential. If the former needs reforms, the latter requires a re-ordering. Today, the world may be facing the crisis OF the system. The US, once the ‘shining city on a hill’ that underwrote global integration, peace and liberal values, is now a source of disorder. The associated USD-system is now coming undone, just like the Bretton Woods (BW) system and Gold Standard before it.

We chronicle the ‘crisis OF the system’ (or the changing world order) over the last 150 years using Dani Rodrik’s political trilemma of the world economy. The trilemma propounds that of the three desirable goals—global integration (free trade/capital flows), national sovereignty (domestic policy space) and democracy (mass voting rights)—countries must choose two, and the third takes a back seat. Different choices (synthesis) were prevalent during different phases of history.

Under Gold Standard (pre-WW1), hyper-globalisation and national sovereignty was the synthesis; democracy was rather restricted while in the Bretton Woods (BW) system (1945–75), as democracy came to the fore (as voting rights/labour unions expanded) globalisation retreated. In the USD-system (post 1980s), globalisation was turbo-charged but national sovereignty waned with the US effectively acting as a surrogate world government.

Furthermore, each phase saw the rise of miracle economies—the US during Gold Standard, Japan/Germany during BW system and China under the USD-system. They began as small economies but pursued aggressive economic statecraft or mercantilism (first laid by Alexander Hamilton, 1791) when others played by the rules of the free market system (laid out by Adam Smith, 1776). If Adam Smith was about comparative advantage guided by the invisible hand of markets, Hamilton was about competitive advantage directed by the visible hand of the state. This Smith versus Hamilton debate has played out time and again across countries. History shows Hamiltonian economies industrialised rapidly, often at the cost of others, and eventually challenged the hegemon.

Today, we may be facing the ‘crisis OF the system’ moment once again. The USD-system has hit a bad equilibrium. Internationally, the US is now an over-extended super power whose ability to deliver public good is severely constrained by bloated balance sheet, limited industrial base and lack of political will (refer: [Of Money, Material and Men](#)). Domestically, nations are confronted by record-high inequality (as a result of hyper-globalisation) and democratic accountability (populism) knocking at the door. Addressing both these would require significant expansion in the domestic policy space (strengthening of national sovereignty). In this new synthesis of national sovereignty and democracy, hyper-globalisation must retreat. What would the transition to this new synthesis mean?

- **Financialisation of the global economy may have peaked out.** The ever expanding global capital flows have fuelled the pursuit of return on capital among businesses, and reduced independence for domestic policy setting, thus hindering scale. As governments undertake industrial policies, we could see return of restrictions on capital flows and higher regulations on the domestic financial systems, including guided lending. This may not be conducive to RoEs/valuations.
- **Supply chain disruptions may become recurrent.** The US’s waning global naval hegemony amid mounting debt (much like the British Navy after WW2) means shipping routes will be less secure (conflicts, piracy?). Also states may resort to material sanctions as a geopolitical weapon. Today it is the Straits of Hormuz, tomorrow it could be something else? If so, businesses (trained in just-in-time world) and policy-makers (focused on fine-tuning demand as supply was a given) need a different type of preparation.
- **Stagnant incomes/widening inequality may come to the fore.** This is more so as speed and reach of AI technology may further skew income distribution and overwhelm the adaptive mechanisms of society. Thus, the ‘trickle-down’ philosophy may give way to redistributive tendencies (universal basic income, minimum wages?). Recall that the New Deal and the Great Society programs (1930–70) were a response to massive inequality caused by the first wave of hyper-globalisation.
- **The global monetary system may evolve from a single reserve currency system to a multi-currency competitive system**—a system more suitable for a multi-polar geopolitical setting. While the transition to such a system may not be smooth, eventually it may generate a more balanced global growth but perhaps a slower one.

- **A fiscal-monetary compact may be on the cards.** The demerger of fiscal-monetary policies that was seen as a philosopher's stone during the age of global finance, would have to be reviewed. At the same time, the inflation-targeting framework, Taylor's rule etc. which became the elegant gadgets of central banks may be seen as unnecessary irritants in the new age. When governments run industrial policies, central banks play ball. Confirmation of Kevin Warsh as the Fed Chair may mark the beginning of such an era. Indeed 'Economics' which got enamoured with the elegance and precision of mathematics needs to revert to 'Political Economy' it once was. Economists must pay heed to Keynes advice that "a master economist must possess a rare combination of gifts...he must be mathematician, historian, statesman, philosopher—in some degree."

What the changing world order means for India? If China's BoP crisis (1994) pushed it into a full-fledged Hamiltonian approach, India's BoP crises (1991, 2013) has nudged it in the Smithonian direction. Thus, the China model (see: [Hedgehog and Fox](#)) has had negative externalities on India (seen in manufacturing and trade). Surely, India shines in services, but that rarely scales up the economy. In any case, relying solely on services may not be prudent given the unfolding geopolitical and technological (AI) realities. India must build industrial base and secure critical supply chains in the coming years. Reshoring is not just an industrial policy anymore but a national security necessity. More neo-liberal reforms can attract foreign flows but that only fuels demand for foreign goods; instead, the focus should be on fixing the trade deficit itself. This will require incentivising scale over RoE (PSUs must take lead), production over consumption and fixed assets over financial assets. A scaled up PLI, a rethink on currency policy and inflation-targeting regime may be needed (see: [Of Cycles, Trend and Hysteresis](#)). Such a Hamiltonian turn may be critical to resist China, who would want to play the regional hegemon in Asia as US's hegemonic reach recedes.

In all, our big-picture point is that there may be a tide building up in global affairs. The wave of globalism, finance and unfettered markets may be subsiding, ushering in a new wave of 'materialisation'—what Eisenhower called a 'defence-industrial complex'. Today, the US has defence technology but lacks an industrial base, while Germany, Japan, South Korea have industrial prowess but lack a defence base. China is perhaps the only nation that built a vast defence-industrial base in the last half century. And the lesson is crystal clear—effective industrial policy requires some level of state control of finance; the latter is a means to an end, not an end.

Thirty years ago, the West thought that China will 'westernise' overtime; instead it's the West that may have to 'orientalise'. What was seen as the end of History in 1991 was perhaps just a holiday from history, which may now be ending. History is accelerating once again, 'rich in vicissitudes'. If the passing age got too mesmerised by the brilliance of Adam Smith, Frederick Hayek and Milton Friedman, the coming age will have to get sober with the realism of Alexander Hamilton, John Keynes and Karl Polanyi.

Scott Fitzgerald saw something about the human condition when he concluded his classic novel—The Great Gatsby—thus:

*"So we beat on,
boats against the current,
borne back ceaselessly into the past"*

“The Owl of Minerva flies at dusk”

– GWF Hegel

Introduction: Crises “OF” the system

Some crises can be seen as crises within an existing system, others are crises of the system. The former is more frequent but less momentous and the solutions are well established and well-known. The latter is rare but far more consequential, and the solutions are not so straightforward. A typical recession or even a great recession such as the Global Financial Crisis of 2008 (GFC) falls into the former category, but the collapse of the Bretton Woods system or the end of the Gold Standard are more in the realm of the latter.

Today we may be facing a ‘crisis of the system’. The global trade order, geopolitical order and the monetary order are fracturing (USD-system). The US, which was the custodian of the global order and stability since WW2, is now the source of disorder and instability. It is undercutting the very rule-based order it once established. This post-1980 USD-system was characterised by hyper-globalisation—sustained expansion in global trade, explosion in global capital flows, light regulations, just-in-time (JIT) global supply chains, a dollar-centric global monetary system and a web of US security arrangements around the world. This rule-based order worked very well in various regards, especially ensuring a long period of peace and prosperity. But as often happens, human arrangements tend to wither over time and develop chinks. History is evident of global arrangements and institutions that once served the world well at a point in time and then turning obsolete.

Below is a broad structure of what we delve into in this report:

- We first elaborate on the three different synthesis (or global systems) using **Rodrik’s political trilemma** of the world economy over the last 150 years—Gold Standard, Bretton Woods and USD-system, and why one synthesis had to make way for the other.
- We identify **miracle economies of each era** and elaborate on why such economies were far more successful than the others. Here, we contrast two approaches followed by various countries within each synthesis—one of **Adam Smith and the other of Alexander Hamilton**. These miracle economies—the US during Gold Standard, Japan/Germany during Bretton Woods and China during USD-system—industrialised rapidly.
- Third, we argue why the current USD-system has become untenable, where we might be headed, and most importantly enlist key **implications of this emerging world order** from a medium-term perspective.
- Finally, we zero-in on the risks and opportunities that this **emerging world order may entail for India**.

Political trilemma of the world economy

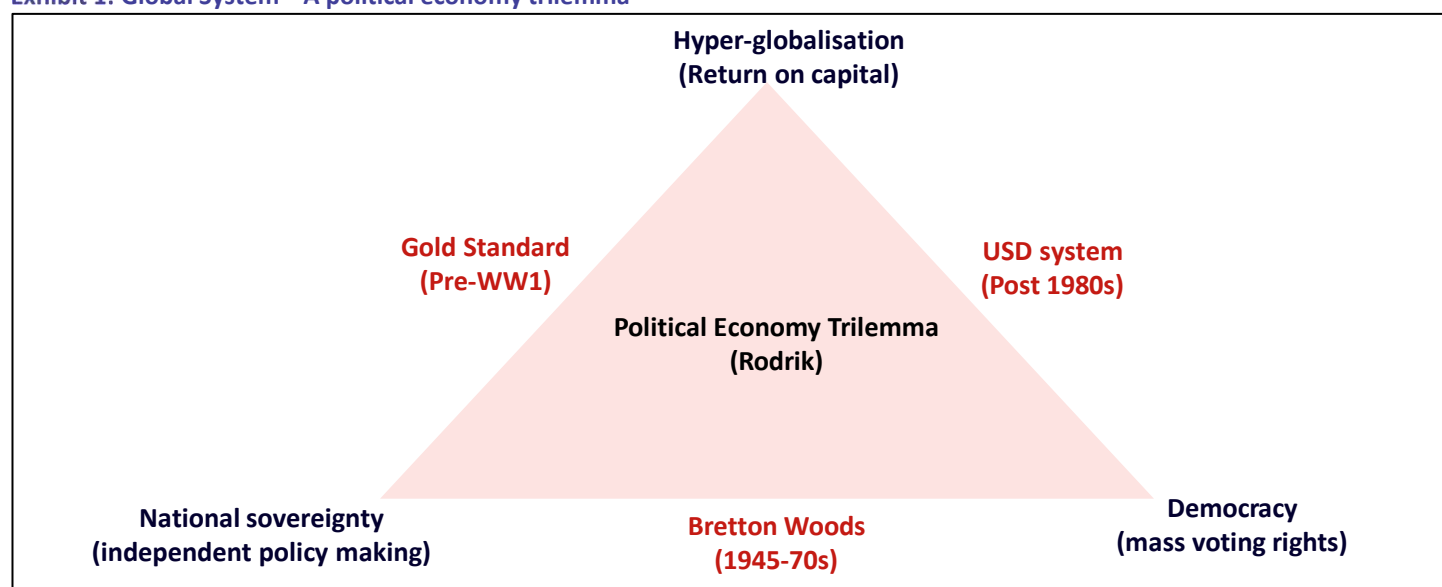
New World Order: Finance or Factories?

In our view, the best framework to understand how the international political-economy arrangements have evolved over time is Dani Rodrik's political trilemma of the world economy.

Harvard University Professor Dani Rodrik's political trilemma of world economy propounds that of the following three desirable attributes, countries can choose only two but any two; the third must take a back seat.

- **Hyper-globalisation** – This essentially means global integration through free movement of trade and capital flows and to an extent movement of labour. The underlying principle is the international division of labour based on comparative advantage, which could unleash massive efficiency and productivity gains. Under globalisation, domestic policy-making space shrinks as several critical rules of the game are set in the international arena. The underlying principle of free movement of goods and capital is the return on capital.
- **National sovereignty** – Countries have leeway/space to set their own policies with regard to the economy (fiscal-monetary policies), taxation, regulations, national security, and subsidies and so on.
- **Democracy** – Mass voting rights with citizens who can hold domestic law-makers accountable.

Exhibit 1: Global System—A political economy trilemma



Source: Nuvama Research

Countries have opted for a different set of policy choices (or synthesis) during different phases of history.

- **Gold Standard:** Hyper-globalisation and national sovereignty over democracy.
- **Bretton Woods:** Democracy and national sovereignty over hyper-globalisation.
- **USD-system:** Hyper-globalisation and democracy over national sovereignty.

But within the overarching synthesis, countries did not follow a homogenous approach. In each phase, there tended to be a major super power or a global hegemon which acted as a custodian of the prevailing overarching regime (Britain during Gold Standard, the US during Bretton Woods and the USD-system) with several countries following its lead. However, there were also nations, often smaller nations of the day, which took advantage of the prevailing regime (by pursuing economic statecraft/mercantilism) and industrialising rapidly at the cost of others. For example, the US during pre-WW1 Gold Standard, Japan and Germany during Bretton Wood system and China during the USD-system. These 'miracle' economies eventually posed a challenge to the incumbent hegemon.

At the heart of these different approaches within each synthesis lie a two-dimensional tussle: on the one hand there is a debate about the extent of the role of markets versus the government; on the other, the importance of national objectives versus international considerations. This intellectual tussle can be traced back to different approaches laid out by Adam Smith and Alexander Hamilton during the early days of capitalism in the late 18th century.

Box Article

Different approaches: Adam Smith versus Alexander Hamilton

The Smithsonian approach (laid out by Adam Smith in *The Wealth of Nations*, 1776) argued from the vantage point of a world consumer, assigned greater weight to markets versus government (invisible hand allocating economic resources) and encouraged international free trade. The idea was to generate massive productivity gains through international division of labour based on comparative advantage and guided by invisible hand of the market. This will raise living standards of the masses around the world (by driving cost of goods lower).

In contrast, the Hamiltonian approach (laid out by US's first Treasury Secretary in his *Report on Manufactures*, 1791) argued from the vantage point of a domestic producer (mercantilism), assigned greater weight to the role of government versus markets (economic statecraft) and encouraged protection of domestic infant industries through tariffs, subsidies and directed finance (competitive advantage). The idea was to rapidly build domestic industrial base that will not only provide better living standards to the citizens (through better jobs/incomes) but underwrite national security by controlling the critical supply chains. As Hamilton noted, "...every nation ought to endeavour to possess all the essentials of national supply. The possession of these is necessary to the perfection of the body politic, to the safety as well as to the welfare of the society."

Thus, if Smith prioritized global efficiency; Hamilton focused on national self-sufficiency. To be sure, these are not the struggles between the two fundamentally different systems—capitalism and communism; rather these are the two differing approaches within the capitalist set-up.

These debates, which took place in earnest at the time of American Founding in late 18th century (early days of capitalism), have been re-enacted across ages and nations ever since, whether it is the Gold Standard system of pre-1914, or the Bretton Wood system post WW2 or even USD-system of the last 50 years.

One is reminded of Cassius's prophetic remark in Shakespeare's *Julius Caesar* with regard to the tussle between the world views of Brutus (Republicanism) and Mark Anthony (Monarchy):

"How many ages hence

Shall this our lofty scene be acted over

In states unborn and accents yet unknown!"

(Act 3, *Julius Caesar*, Shakespeare)

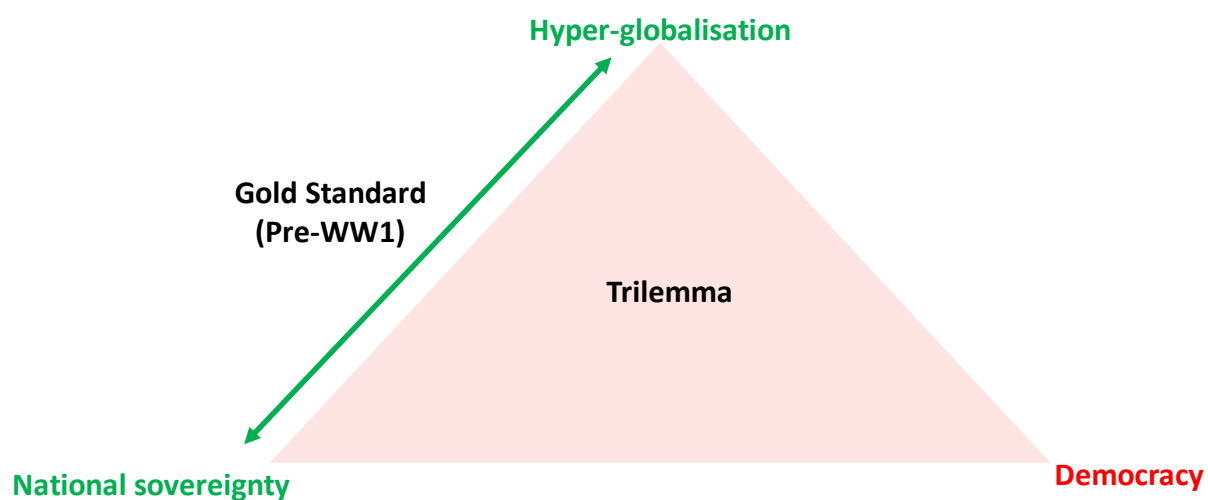


Adam Smith



Alexander Hamilton

Classical Gold Standard: Hyper-globalisation with restricted democracy



Pre-WW1, the world operated under the gold standard, where exchange rates were pegged with gold. The choices under Rodrik's trilemma were globalisation (deeper global integration through free movement of goods and capital across borders) and national sovereignty (policy-making was entirely up to the nations).

Such a synthesis was possible because democracy was highly restricted. Universal suffrage had not yet arrived and there were hardly any labour unions to speak of. Thus, national policy-makers were largely liberated from democratic accountability and could focus on adhering to the rules of the gold standard.

So, if gold standard rules so demanded, national policy-makers were ready to put domestic consideration aside, which often meant a deep and prolonged economic downturn. This is because under gold standard rules, there were restrictions on expanding money supply.

In that sense, gold standard was often seen as inherently deflationary (Keynes called it a 'barbarous relic'). For example, when American farmers were suffering from agri-deflation toward the end of 19th century and Gold Standard rules did not allow expansion in money supply.

William Jennings Bryan of Democratic Party made a memorable 'Cross of Gold' speech against the gold standard, stating

"You shall not press down upon the brow of labour this crown of thorns. You shall not crucify mankind upon a cross of gold."

Gold Standard died with the onset of WW1 and later on expansion in democratic voting rights and labour unions rendered the Gold Standard politically untenable.

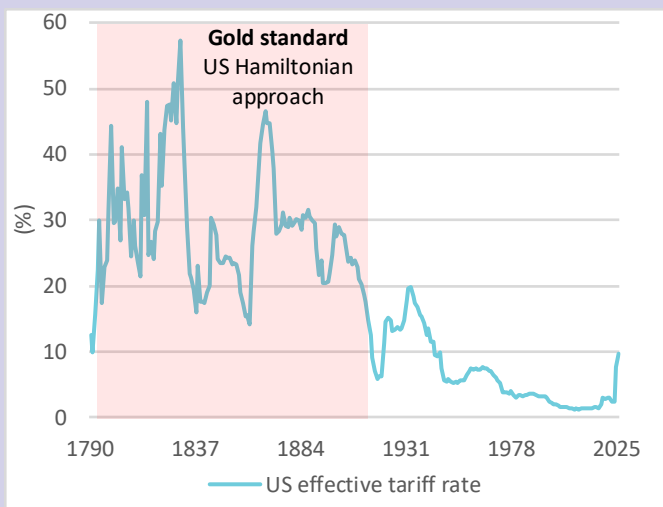
Box Article

Miracle economy of the Gold Standard era: The United States

The US was the miracle economy of this period say from 1860–1914. It industrialised rapidly, effectively following the Hamiltonian approach of economic statecraft—government intervention both in foreign trade and domestic economy to achieve rapid industrialisation.

- **US imposed high protectionist tariffs** - Anywhere between 30 to 50% through much of this period—when European nations were lowering it. For example, in 1870s, when tariff rate in France was between 12–15%, in Germany about 5% and in UK, essentially zero; the US had nearly 50% protective tariffs. Such high tariffs not only served to protect the domestic industries but also provided revenue for the government.

Exhibit 2: US's high protectionist tariffs under Gold Standard **Exhibit 3: The Tariff Men – From Hamilton to Trump**



Source: Yale budget lab, Nuvama Research



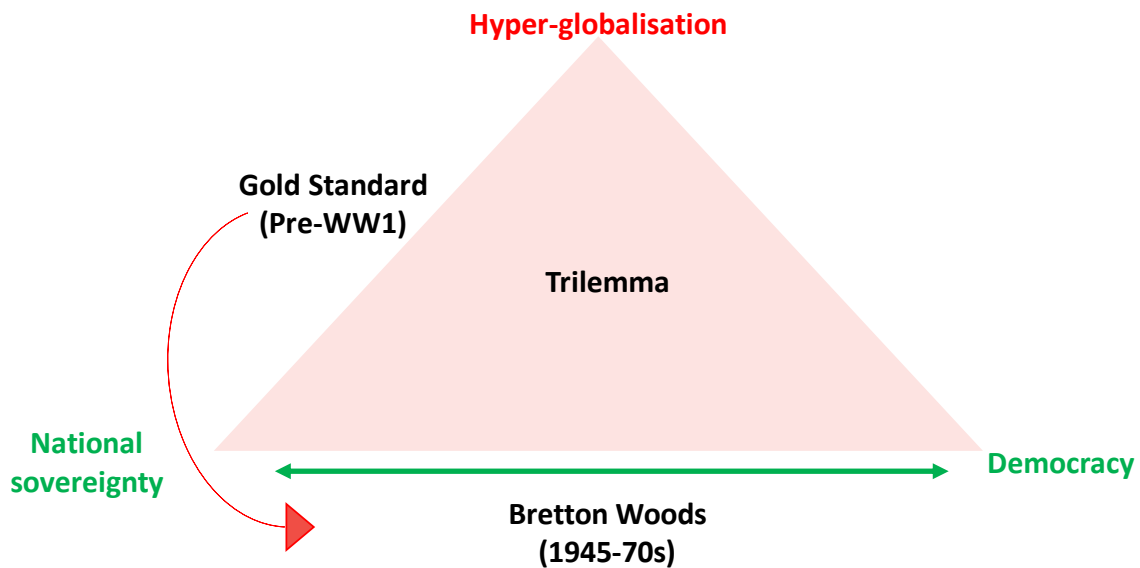
Source: Harrison Fields X account, Nuvama Research; Note: A new framed meme featuring “Tariff Men” has been placed in the West Wing of the White House. The frame includes Alexander Hamilton, Henry Clay, Donald J. Trump, Abraham Lincoln, and William McKinley (LHS to RHS).

- In addition, the US came off the Gold Standard during the Civil War (early 1860s) which led to **significant undervaluation of USD**, which also discouraged cheap imports. The US did not return to Gold Standard for another 20 years.
- In the domestic economy, **government offered production and infrastructure subsidies**. The revolutionary transcontinental railways were built with massive government subsidies in the form of large scale land grants to railway companies, rather than allocating land through any market mechanism. This was instrumental in opening up the West and spur rapid development of large scale farms, mines, factories and cities along the railway tracks. It help build economies of scale and eliminated local monopolies.
- Similarly, **land subsidies** were given in order to encourage urbanisation, setting up of colleges and universities for education.
- **Immigration was encouraged** as ever bigger industrial firms and mines needed workers. This helped to keep wages low.

Surely, the rapid industrialisation of the US during the 19th century was messy, smacked of corruption, suffered economic shocks and even led to the bankruptcy of private companies; but the American economy scaled up rapidly. The measures and government interventions listed above are by no means exhaustive but offers a glimpse into the Hamiltonian approach followed by the US through much of its pre-WW1 history and in contrast to the US’s approach in the last 50 years (which has been essentially Smith-ian).

New World Order: Finance or Factories?

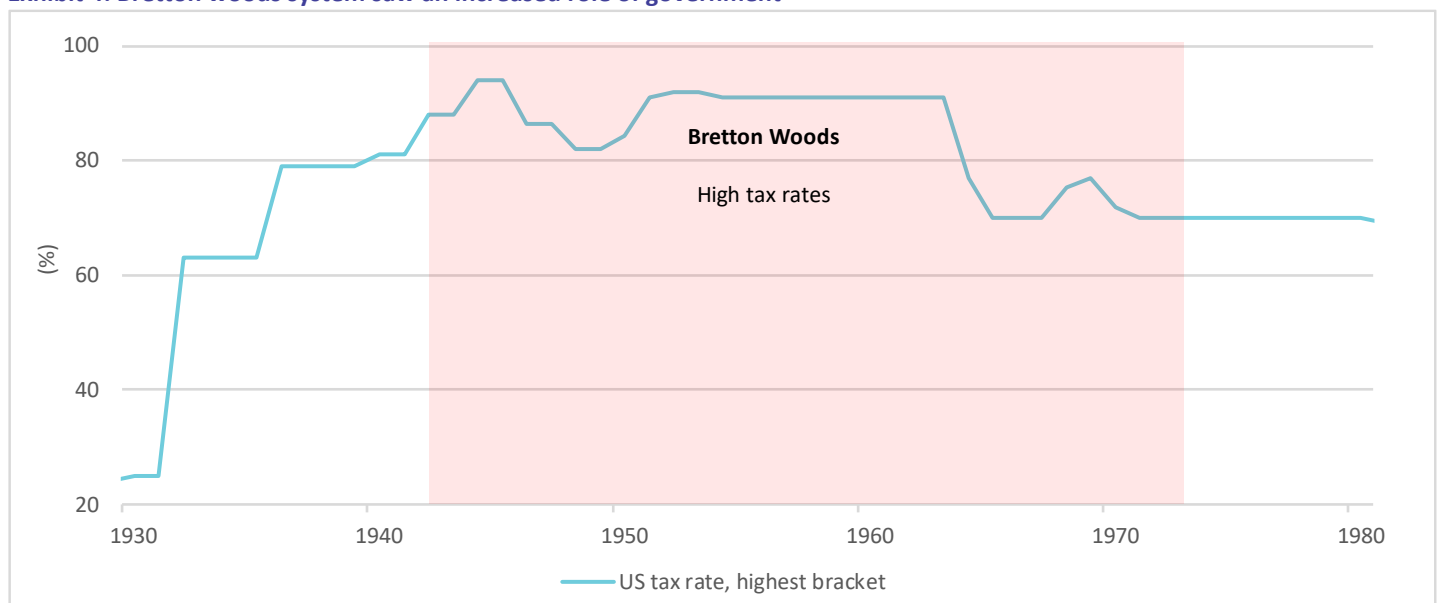
Bretton Woods system (1945–73): Democracy expands; hyper-globalisation reined in



From the ashes of the Gold Standard and WW2 emerged the Bretton Woods system. In the face of expanding democracy, nation-states needed much more leeway to respond to democratic accountability and serve domestic economic needs. If so, then under Rodrik's trilemma, globalisation had to be reined in.

The system retreated from hyper-globalisation to soft multilateralism, guided by the US. What it meant was that while trade flows were still encouraged, the financial system as well as cross border capital flows were quite restricted. One may call it thin or restricted globalisation as opposed to hyper-globalisation of the previous period. This allowed national policy-makers more wiggle room in setting their domestic policies including counter-cyclical monetary/fiscal policies (to ensure full employment), financial regulations, social safety nets, taxation and so on. Generally speaking, several countries saw the government's role increasing during this period as the West had to re-build their economies from the destruction of WW2 while the markets took a back seat.

Exhibit 4: Bretton woods system saw an increased role of government



Source: Fred, Nuvama Research

The monetary system that underpinned this arrangement was one in which the USD was pegged to gold (the US was the larger creditor nation in the world at that time) while other currencies maintained some flexibility to adjust against the dollar in order to allow room for domestic policy objectives. Meanwhile, in order to address the occasional BoP deficits for individual countries or for financing development needs, international organisations such as the IMF and the World Bank were established.

New World Order: Finance or Factories?

However, over time, cracks began to appear in the system as capital controls began to ease gradually in 1960s and the banking system too began to internationalise. In addition, the geopolitics took an adverse turn with the US getting embroiled in a long Vietnam War even as it was expanding domestic spending to build roads and highways (the famous 'guns and butter'). As a result, US's macro-balances started slipping into a deficit even as the Europeans began generating surpluses.

With the US now facing constraints of gold-peg, the direction of recycling of dollar had to be reversed. Europeans were now recycling dollar back to the US to support the gold-dollar peg. It worked for a while, but as private capital flows were progressively liberalised and the US kept running BoP deficits, the confidence in the dollar-gold peg broke down, which triggered a gold drain from the US, tightening US financial conditions.

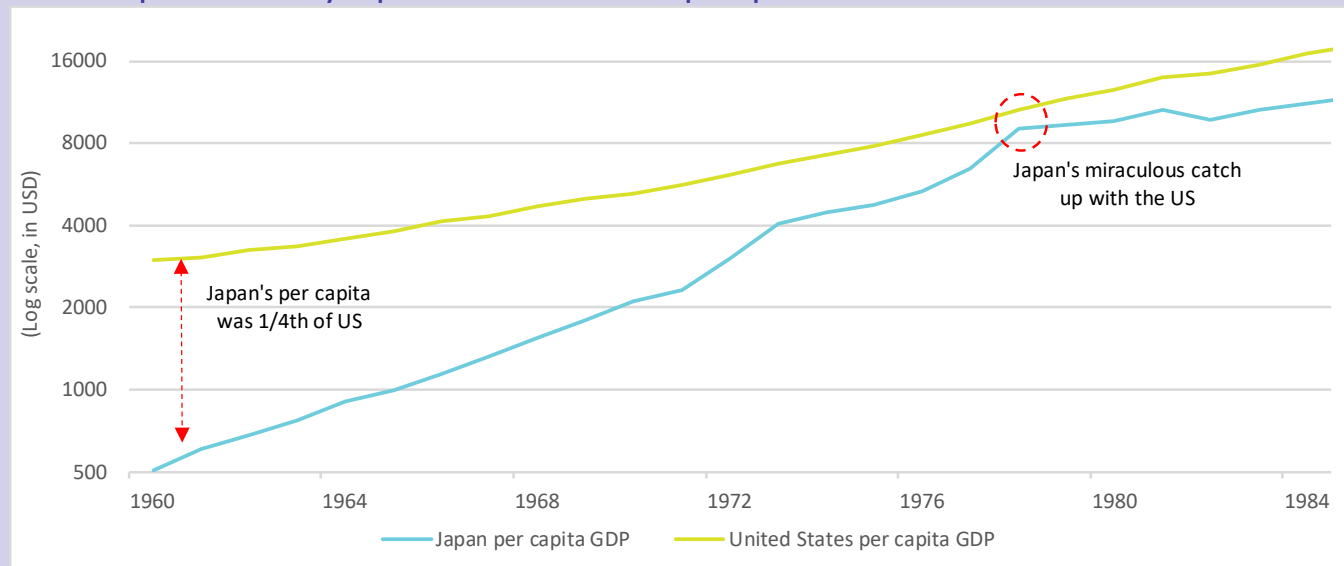
Ultimately, the Bretton Woods system became untenable for the US. President Nixon suspended the gold window in 1971 and the Bretton Woods system broke down.

Box Article

Miracle economies of the Bretton Wood era: Japan and Germany

The countries that rapidly industrialised during this phase were Japan and Germany. The model was essentially economic statecraft (Hamiltonian style) with sustained expansion in manufacturing and exports. Here, the US played a critical role in allowing Japan and Germany to take advantage of the system. For example, when European nations were confronting high inflation and dollar shortages after WW2, the US recycled its dollar surpluses back to Europe (Marshall Plan), in order to provide them funding and stabilise their exchange rates and inflation. The US also lowered its tariff rates for European and Japanese goods so that these countries can re-build their industrial base. The system worked very well for European economies. It brought financial stability to Europe, facilitated capital and allowed time for European manufacturing to get back to its feet.

Exhibit 5: Japan and Germany surpassed the United States in per capita GDP



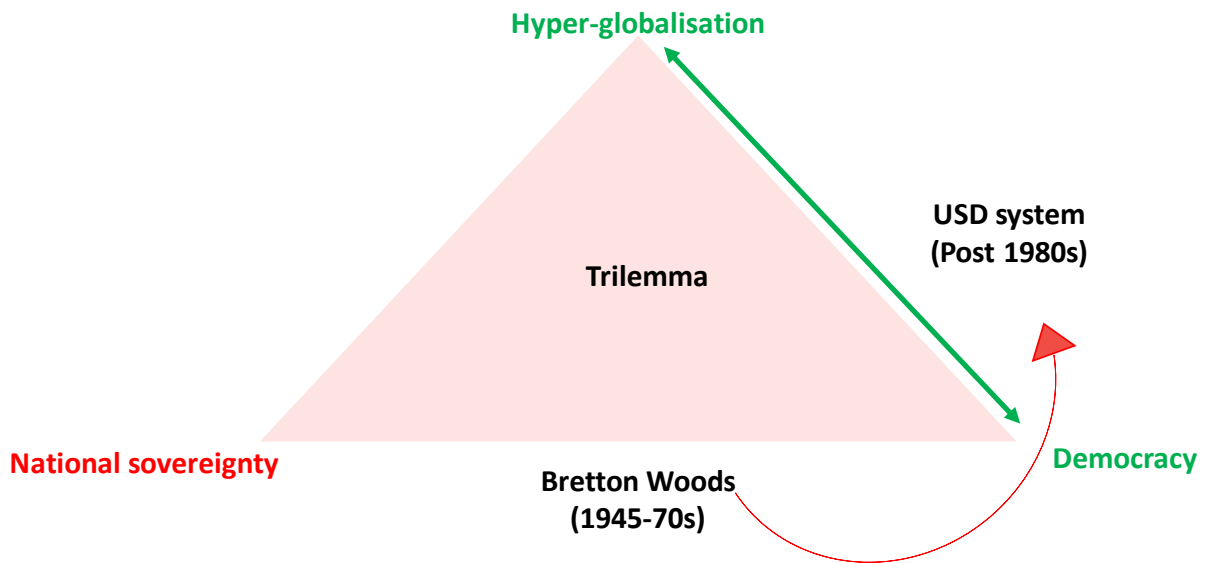
Source: World Bank, Nuvama Research; Note: In current USD terms.

Why would the US accommodate Japan and Germany?—essentially, we believe it is due to the below two reasons:

- **Learnings from post WW1 were clear** – The US learnt the right lessons from the aftermath of WW1, where excessive penalties were imposed on the vanquished—Germany and no countries were willing to play the role of organising the global system—as Charles Kindleberger put it—Britain was unable and the US was unwilling to play such a role. This had bad consequences for the peace and prosperity of the world.
- **Growing threat of Soviet Union and Communism** – The US was also cognizant of the growing risk of spread of Communism to the Western Europe.

New World Order: Finance or Factories?

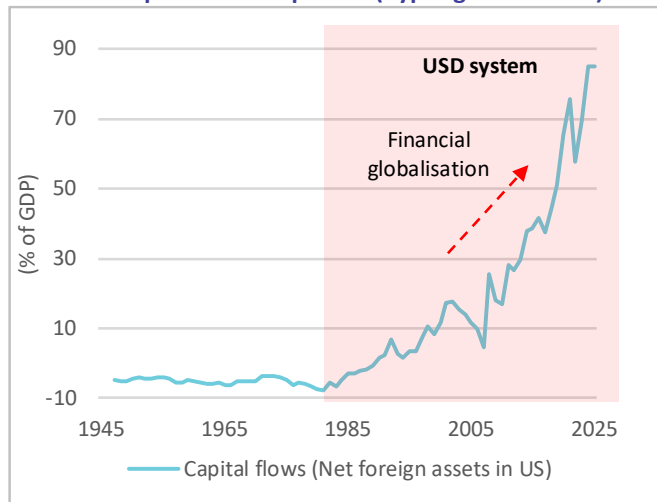
USD-system (1980-current): Hyper-globalisation returns; national sovereignty wanes



The dollar crisis and the stagflation of 1970s meant systemic change was needed again. The economic ideas were evolving too. In the US, Hamiltonian world view was giving way to Adam Smith-ian world view. Keynesian ideas fell out of favour, while Frederick Hayek and Milton Friedman emerged as the new prophets of the age. The government, which was seen as a guiding and stabilizing force, was now seen as a source of problem.

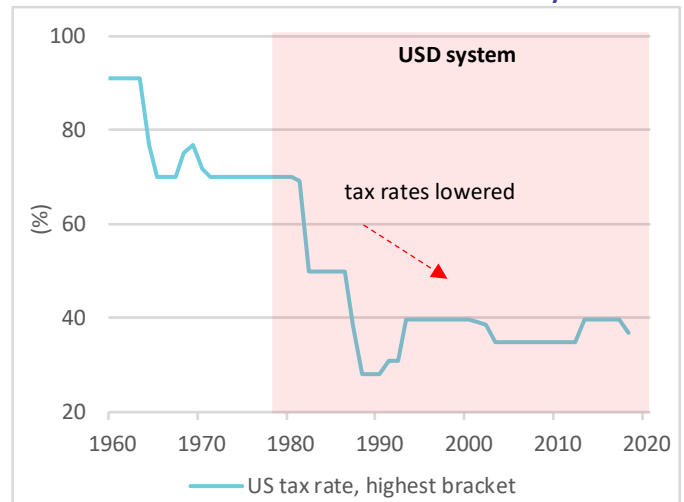
As Ronald Reagan said in 1981, “...government is not the solution to our problem; government is the problem” or as Milton Friedman noted in 1970 that the “only social responsibility of business is to maximize profits for shareholders.” Thus started the retreat of the government from the US economy. Trade liberalisation, increased capital mobility, deregulated financial system and a fiat-money monetary system without any backing of gold became the new economic consensus in the West.

Exhibit 6: Capital flows exploded (hyper globalisation)



Source: Fred, Nuvama Research; Note: US capital flows are taken as RoW (foreign) assets less of their liabilities in the US

Exhibit 7: Government role reduced in the USD-system



Source: Fred, Nuvama Research

What followed was a regime of turbo-charged globalisation or better put financial globalisation, where capital flows began to dominate trade flows, financial system expanded rapidly and shareholders capitalism was firmly established, especially in the US.

In this new synthesis of hyper-globalisation and democracy, national sovereignty had to take a back seat as per the Trilemma. The way it worked out is that several countries effectively outsourced important dimensions of national policy making (such as monetary policies, fiscal policies, regulations, national security, etc.) to the US and US-run multilateral institutions (IMF, WTO, etc.).

New World Order: Finance or Factories?

In other words, the US effectively acted as a surrogate world government, which provided necessary public goods—trade arrangements (securing shipping lines, open borders), monetary arrangements (stabilizing global business cycle, lender of last resort and so on), and security arrangements (defence guarantees) and so on. In fact, the project of European integration that started in 1960s is very much reflective of the same dynamic where the locus of the policy-making in important regards shifted from national capitals to Brussels.

At the risk of exaggeration, much of the world was behaving as if different nations are the states while the world was a country with its capital city in the US. That's how the trilemma was navigated.

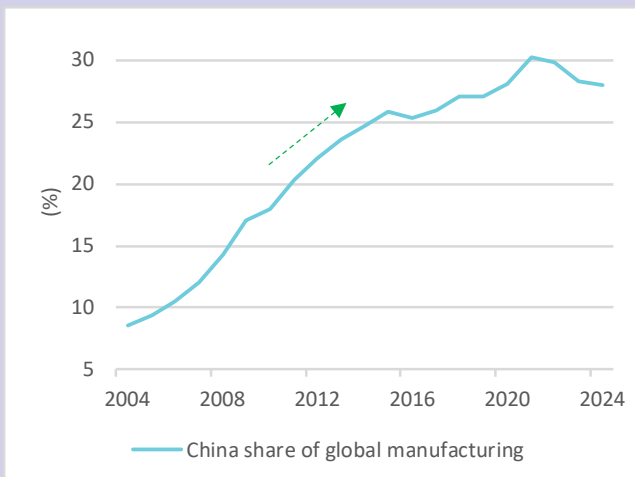
However, the USD-system is unwinding now. As we noted before (refer: [Of Money, Material and Men](#)), the US is now facing serious constraints, both financial and material, which is restricting its ability and also willingness to run the global system. Something similar happened to the British after the world wars. In fact, after being a source of stability and order in the world for more than 50 years, the US is now becoming a source of instability and disorder.

Box Article

Miracle economy of the USD System: China

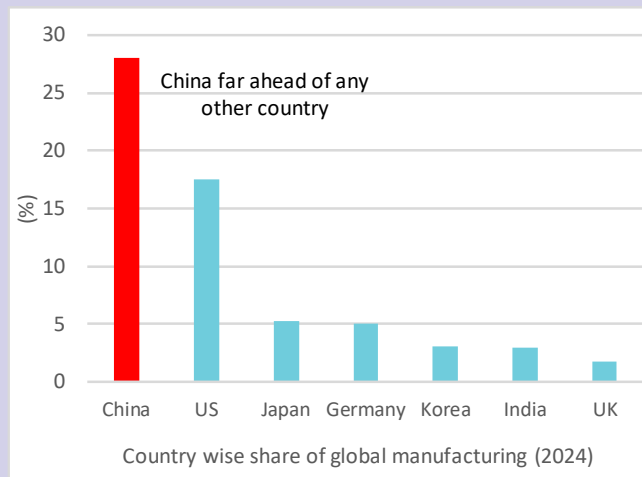
While much of the world was turning Smithonian, China turned Hamiltonian. It pursued economic statecraft as policy-makers intervened heavily in the domestic economy to turn comparative advantage into competitive advantage (on similar lines as Japan and Germany before it or the US itself in the 19th century). But the way China went about it is not so much by raising tariff barriers on the rest of the world (if anything, China lowered tariffs after its entry into WTO) but rather manipulating exchange rate or restricting capital flows. In addition, government intervened heavily in domestic economy to push financial resources into production sector and away from household sector through suppression of interest rates, implicit and explicit production subsidies and so on. The result was the rapid industrialisation of China at the cost of others. For more details on China's growth model refer [Hedgehog and Fox](#).

Exhibit 8: China industrialised rapidly under USD-system...



Source: World bank, Nuvama Research

Exhibit 9: ...and has pulled far ahead of all other countries



Source: World bank, Nuvama Research

Entering a new era: Implications

New World Order: Finance or Factories?

As mentioned above, the USD-system has hit a bad equilibrium. It is being squeezed from two sides:

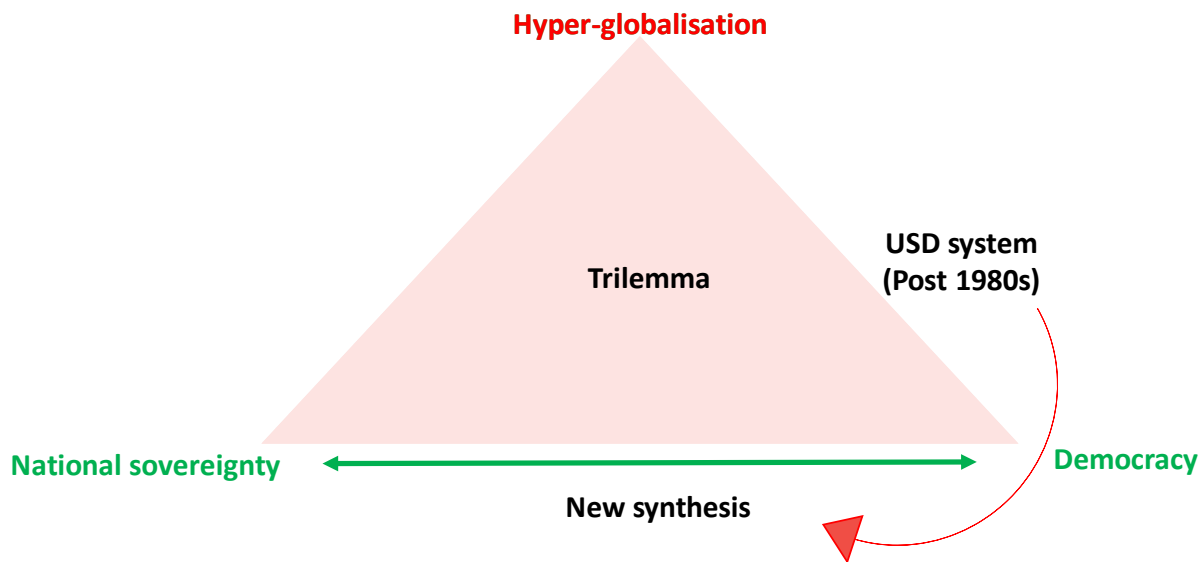
- **Internationally, the US is now an over-extended super power** whose ability and willingness to deliver public good is severely constrained by bloated balance sheet, limited industrial base and lack of political will (refer: [Of Money, Material and Men](#)). When British naval hegemony ended, there was the US to take over the hegemonic role after WW2. But now that the US's hegemony is on the wane, it is not clear who will guarantee the freedom of the seas.
- **Domestically, nations are confronting record-high inequality** (as a result of hyper-globalisation) and democratic accountability (populism) is knocking at the door.

Addressing both these would require significant expansion in the domestic policy space (strengthening of national sovereignty). In this new synthesis of national sovereignty and democracy therefore, hyper-globalisation must retreat. This does not necessarily mean the end of globalisation but certainly a retreat from turbo-charged version of globalisation where cosmopolitanism trumped nation-states and markets trumped societies.

This new synthesis is similar to that under the Bretton Woods system, but with very critical differences:

- The Bretton Woods system was designed by major powers, especially the US, and was truly an exercise in global cooperation. Nearly 730 delegates from 44 nations of the world participated in the Bretton Woods Conference in 1944. The rules of the system were well defined and the US acted as the custodian of the system. Today, no such global cooperation that too at such a scale is likely. The relations between the hegemon (US) and the challenger (China) are far from cordial. This means that the new system has to emerge spontaneously, which does not inspire confidence.
- The critical aspect of the BW agreement was USD pegged to the gold and the rest of currencies were allowed to float in a small band around dollar. If any country generated BoP deficit, IMF or even the US helped to bridge the gap. Any such currency arrangement looks difficult in the unfolding world order.

Implications of the new synthesis:



1. Retreat of global finance: From RoE to scale?

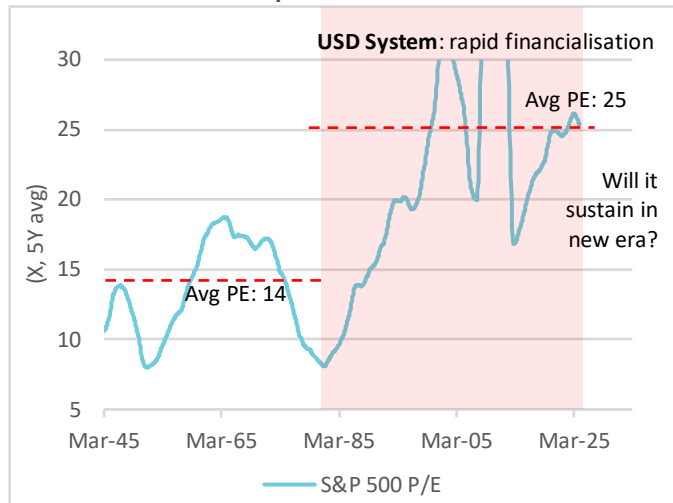
As mentioned above, under the new synthesis, globalisation will likely retreat. Specifically, it is the financial globalisation—explosion in cross boarder capital flows and deregulation and internationalisation of domestic financial systems—that could see a bigger roll-back. Both of these have worked to reduce the domestic policy space.

Volatility in global capital flows have tended to overwhelm the domestic financial conditions, especially in EM, and have often triggered macro instability. Moreover, increasing dominance of global capital (often speculative, chasing short term returns) has eroded long-term planning of countries. Effectively, return on capital (shareholders capitalism) trumped the considerations of scale building in the emerging economies.

New World Order: Finance or Factories?

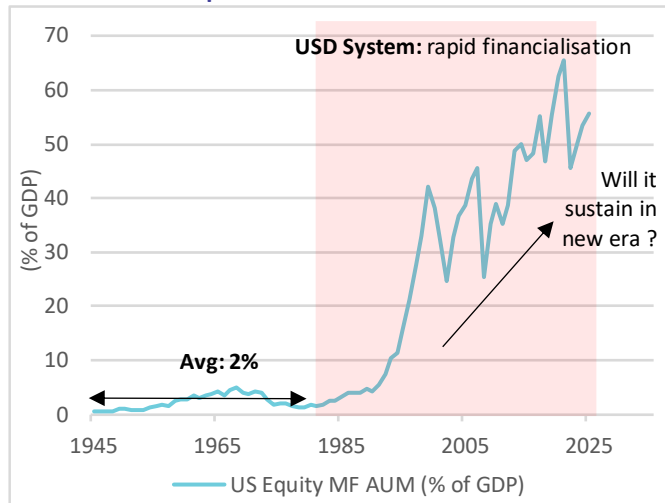
Now, if focus has to return to building scale, we think governments may have to pursue economic statecraft where financial system may be seen as a means to end rather than an end in itself. Expect some form of capital controls, increased regulation of the domestic financial system (such as directed credit to critical or strategic sectors), financial repression of banks (forced to buy sovereign debt), production subsidies and so on. Such measures, if adopted, may come at the expense of shareholders' returns (RoEs/market cap). Surely, this may be a multi-year process but such a move will be more urgent for countries which have financialised over the years and lost the industrial base.

Exhibit 10: Will PE multiples sustain in the new era...



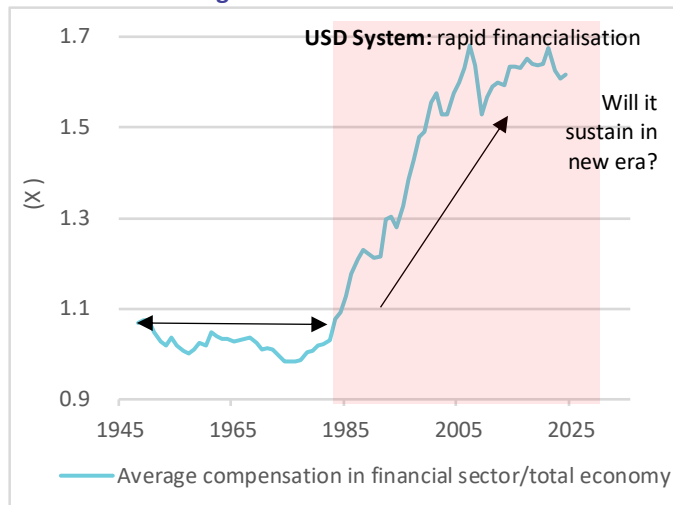
Source: Macrotrends, Nuvama Research

Exhibit 11: Will rapid financialisation continue in the new era?



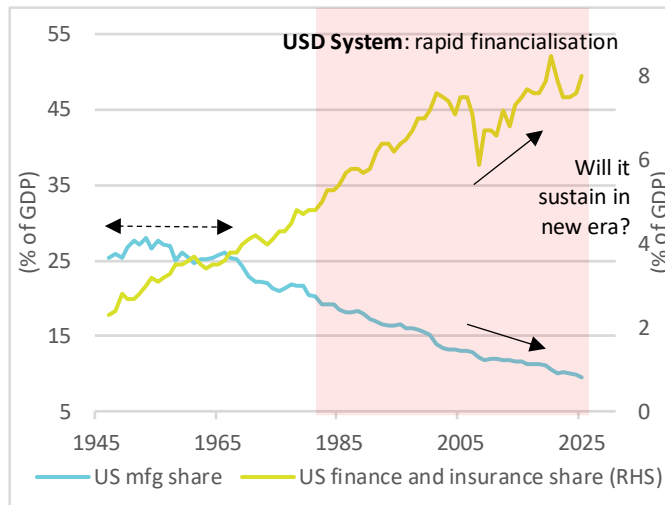
Source: Fred, Nuvama Research

Exhibit 12: Will wage differential be reined in the new era?



Source: US BEA, Nuvama Research

Exhibit 13: Back to factories under the new era?



Source: US BEA, Nuvama Research

2. Supply chains: More frequent disruptions?

In the last 30 years, policy-makers around the world focused on demand-side management through the use of fiscal and monetary policy tools; the supply of inputs/raw materials/finished goods were all seen as guaranteed and that too at the cheapest prices and in adequate quantities. This was possible, as argued earlier, as the US Navy effectively guarded global shipping lines, just like the British Navy did in its heydays. Ensuring freedom of the seas is one of the important roles of a global hegemon.

But with changing world order and the associated geopolitics, we think disruption in supply chains could become more frequent. There may be higher incidences of local/regional conflicts where sea routes could be weaponised (like Hormuz today) or countries may resort to material sanctions as a leverage against other nations, which is to say countries could restrict the supply of critical minerals/materials if the need arises. In fact China used the threat of restricting the supply of critical rare earth magnets to the US when Trump levied high tariffs on China. Thus the certainty of supply of critical components, raw materials will likely reduce. This would require a different planning by the business that has been running just-in-time supply chains in the last few decades.

3. Monetary regimes: From monopoly to competitive reserve currencies system

We think monetary regimes would likely undergo a change at two levels:

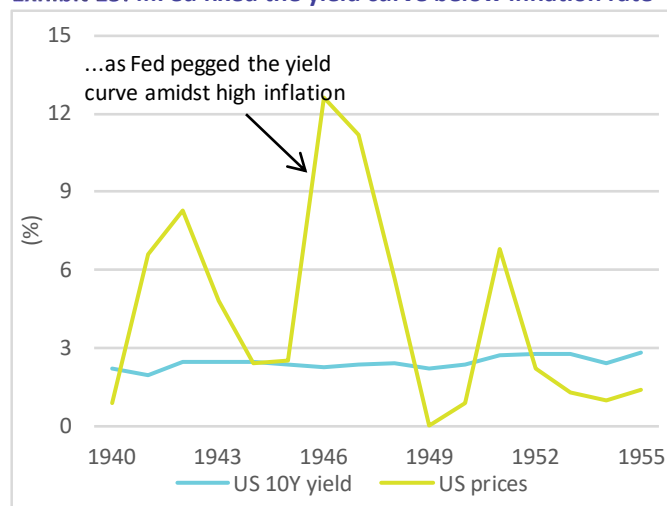
- At the global level, we think the global monetary system may be moving from a **monopoly reserve currency/reserve asset to a multi-reserve currency** competitive system with USD, EUR, JPY, CNY—all playing a role. The competitive system would ensure that no reserve currency country would be able to run huge debt/deficits consistently, something which the US could do in the last 40 years. In other words, such an arrangement could ensure that global imbalances do not grow out of proportion. Such a monetary system may be a natural outcome in a world which is moving from unipolar to multipolar.
- At the country level, we think the idea of **inflation-targeting may be past its prime**. This idea came of age in the post 1990 period when hyper-globalisation was under way and a mechanism was needed to discipline central banks or guard them against interference from elected politicians. In the emerging new world order, we might see central banks aligning their objectives to the aims of the industrial policies. Effectively, there could be a fiscal-monetary compact that feeds into industrial policies. In the US, nomination of Kevin Warsh as the new Fed Chair may be the beginning of such a trend.

Exhibit 14: Last time (WW2) US debt levels reached this high...



Source: Bloomberg, Nuvama Research

Exhibit 15: ...Fed fixed the yield curve below inflation rate



Source: Bloomberg, Nuvama Research

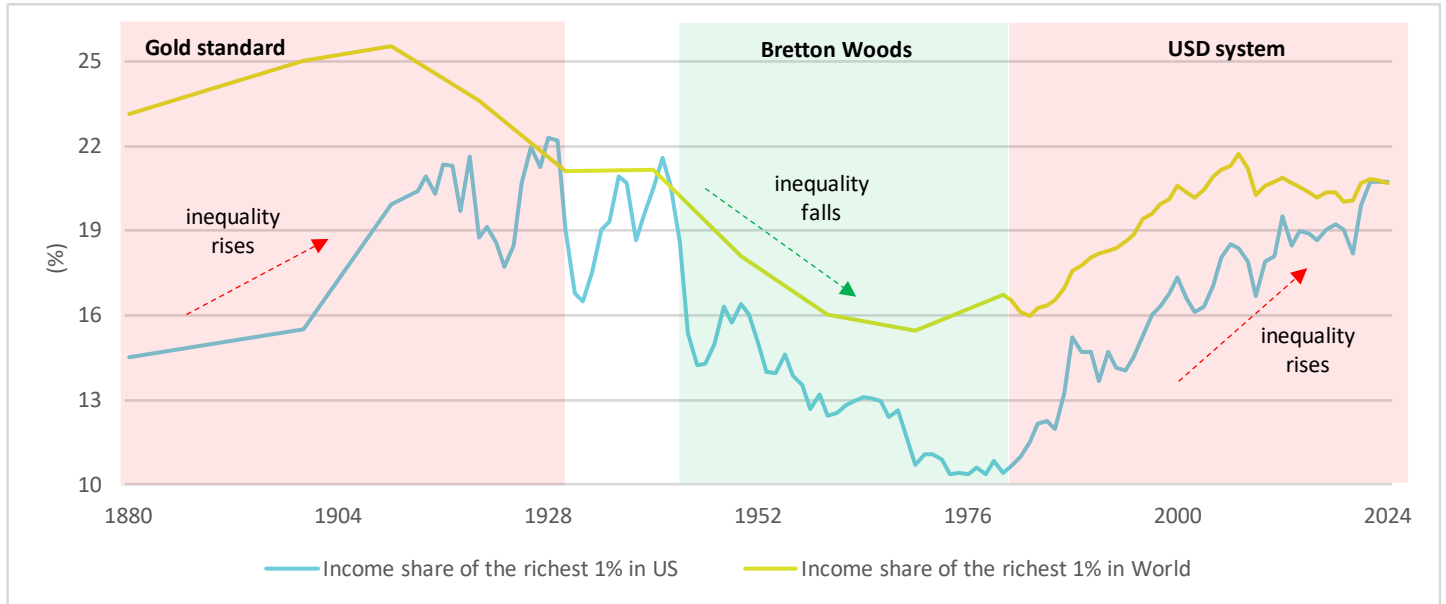
4. Addressing income inequality: Polanyi's counter-movement may take hold

One of the important outcomes of hyper-globalisation of the last 30 years has been the sustained rise in inequality in large parts of the world. At several places such as the US, real income for the bottom 20% of the population has stagnated from a long time. For example, in 1985, the top 1% of the US population accounted for 10% of the income but today it is nearly 20%. Besides, the speed and reach of AI technology may further skew income distribution and overwhelm the adaptive mechanisms of the society. Thus, the 'trickle-down' philosophy of the last several decades may give way to redistributive tendencies (universal basic income, minimum wages?). Recall that the New Deal and the Great Society programs (1930–70) were a response to massive inequality caused by the first wage of hyper-globalisation.

Karl Polanyi, the great economic historian of the 20th century in his classic study 'The Great Transformation' explained this dynamic in terms of a dialectic or a double-movement (a forward movement and counter-movement) between markets and society. The forward movement of markets tends to make society adjunct to the markets while the counter movement of the society (acting in self-defence) tends to make markets appendage to the society. In other words, there is this process of dis-embedding and re-embedding of the markets in the society. For example, under gold standard (hyper-globalisation), markets were dis-embedded from the domestic socio-economic context (domestic policy space to address local issues shrank) while the Bretton Woods (expanding democratic accountability) meant that society worked to re-embed the markets back in the society (domestic policy space expands to address widening inequality). Subsequently, the USD-system again dis-embedded the markets/finance from the domestic socio-economic context. Are we at the critical juncture once again? Time will tell. But the democratic pressures are mounting in various countries. The rise of populists and populism may be pointing toward the beginning of the counter-movement.

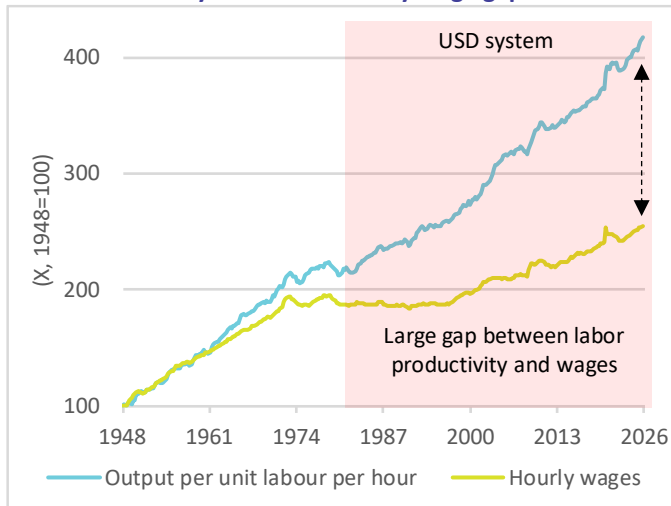
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Exhibit 16: Inequality in the USD-system rose back to gold standard levels, with potential for reduction in the next phase



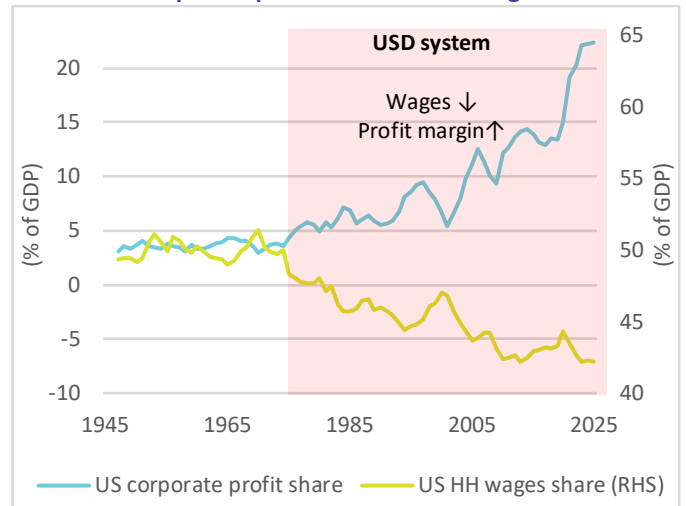
Source: World Inequality Index, Nuvama Research; Note: Income refers to national income before taxes

Exhibit 17: USD system: Productivity wage gap increased



Source: Economic Policy Institute, Nuvama Research; Note: The data cover compensation (wages and benefits) for production and nonsupervisory private-sector workers, about 80% of the US workforce. Labor productivity is measured as total economy-wide income divided by total hours worked.

Exhibit 18: Corporate profit soared as HH wages decreased



Source: US BEA, Nuvama Research

India and the new world order

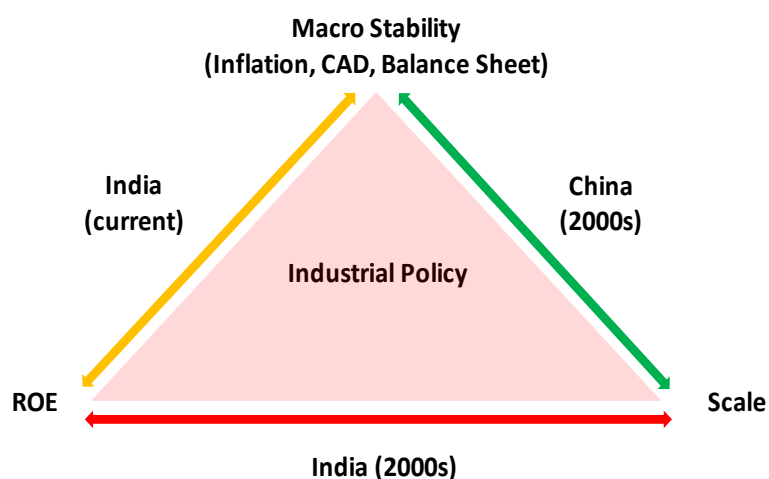
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In the early 1990s, China and India's growth model diverged. China, as elaborated above, pursued an aggressive Hamiltonian approach especially after its 1994 BoP crisis and subsequently after its entry into WTO. While it lowered its trade barriers (unlike Hamiltonian economies of the past), it heavily intervened in the domestic economy to turn comparative advantage into competitive advantage.

India took a different approach—a Smithsonian turn, one can say. While economic liberalisation started in the 1980s itself, it got a fillip after the first major BoP crisis in the early 1990s. Since then, India pursued gradual liberalisation of the economy which included incremental deregulation of the financial system and several other sectors of the economy, gradual easing of capital account restrictions, and increasing role of private sector in the economy and so on. Then, with the second big BoP crisis of 2011–2013 the reform process accelerated further. Foreign capital poured in and government increased its focus on maintaining macroeconomic stability (lower fiscal deficit, low inflation) and businesses became quite sensitive to RoE considerations.

But as our 'Growth Trilemma of domestic economy' illustrates, among the three desirable goals—RoE, macroeconomic stability and scale—countries may have to choose any two. So if India tilted in the direction of stability and RoE, scale had to take a back seat. Note that in a fully Smithsonian world, RoE and scale can achieve a good equilibrium as countries operate along their respective comparative advantages. However, since China took a Hamiltonian turn and pursued aggressive industrialisation and scale in a whole host of industries at the cost of RoE, it pushed other countries into a bad equilibrium.

Exhibit 19: Growth trilemma—pick any two



Source: Nuvama Research

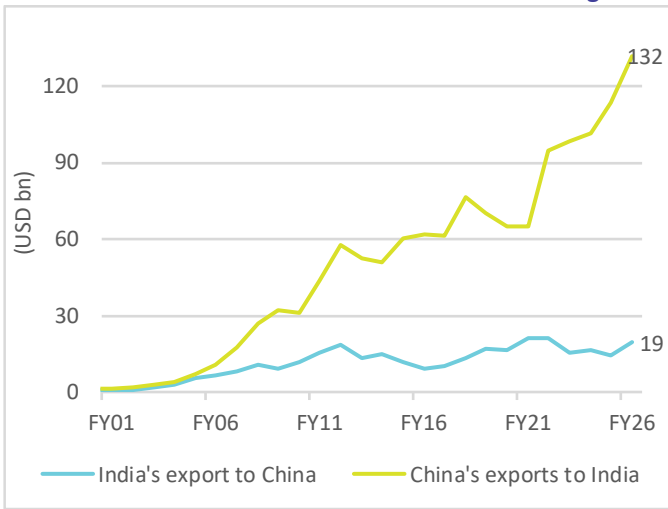
Thus India, despite having several advantages—young population, large consumption base of its own, availability of natural resources and government's economic reform push (often politically difficult)—has been relatively slow to build scale, especially in the manufacturing sector. Below, we highlight the key macro trends that point toward the economic challenge.

Trends in manufacturing and goods trade deficit

It is worth noting that India's exports to China have stagnated at around USD15–20bn for the last 15 years, while imports from China have been rising continuously and have grown three times in the last decade to ~USD130bn.

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Exhibit 20: India's trade deficit with China is widening...



Source: CMIE, Nuvama Research;
Note: Exports here refer to goods exports only.

Exhibit 21: ...with India's manufacturing share declining

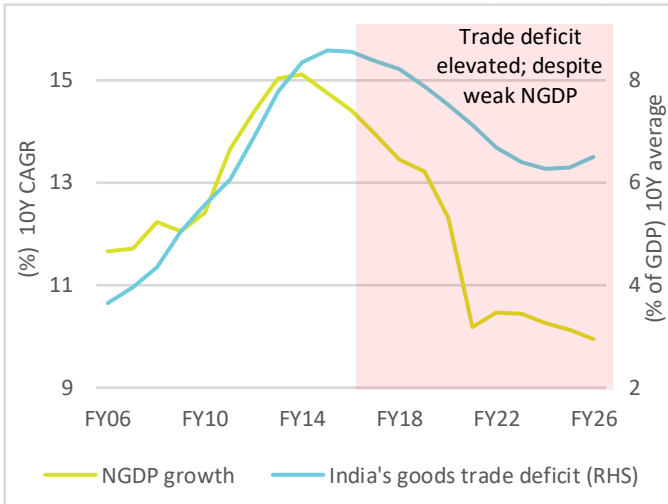


Source: CMIE, Nuvama Research

Even at the aggregate level, what is notable is that India's goods deficit remains very elevated despite relatively low crude oil prices and a trend moderation in NGDP growth in the last five years. This post-pandemic phenomenon of elevated goods deficit in India coincided with China pivoting back to the export model after the real estate bust of 2019. Even in sectors like electronics, where exports are booming, the electronics deficit of India has hardly narrowed.

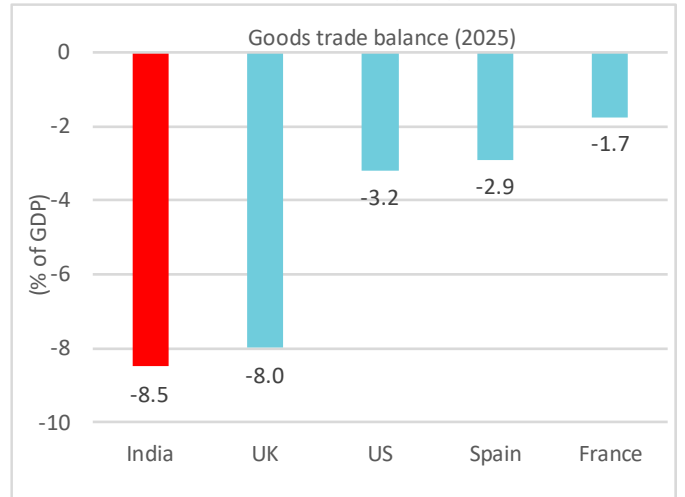
Comparing with other countries, India's goods deficit as a share of GDP stands at 8.5% in 2025, among the highest in the world.

Exhibit 22: India's trade deficit elevated despite slow growth



Source: CMIE, Nuvama Research

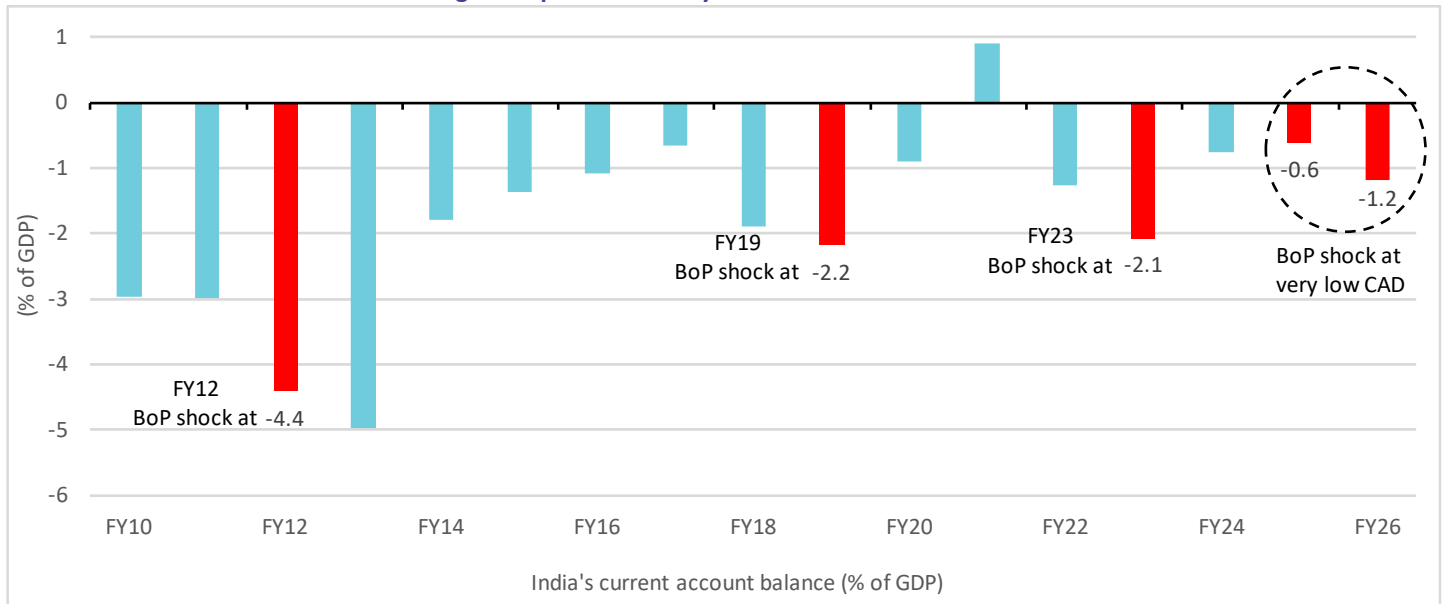
Exhibit 23: India has one of the largest goods deficit



Source: Bloomberg, Nuvama Research

Furthermore, as argued earlier, in the emerging world order, if supply shocks become more frequent, not only will MSMEs' ability to operate be hampered but the vulnerability on the CAD front could increase, which in turn can hurt stability of capital flows. Thus reshoring critical supply chains and fixing underlying CAD are critical.

Exhibit 24: India's latest BoP stress emerged despite a relatively low CAD

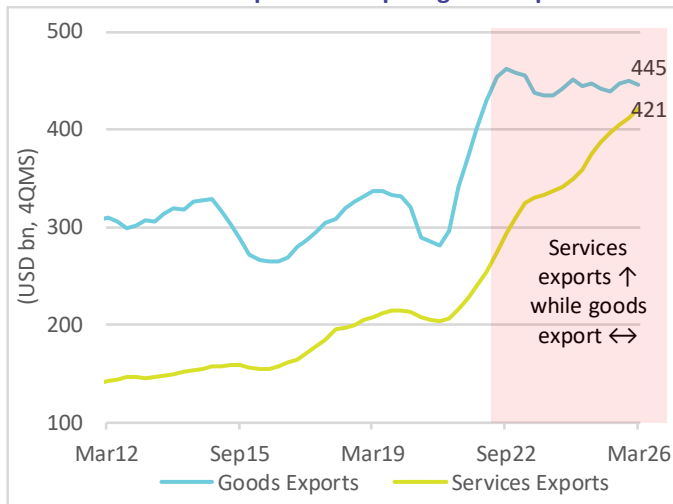


Source: CMIE, Nuvama Research

Services help but are no offset to weak manufacturing

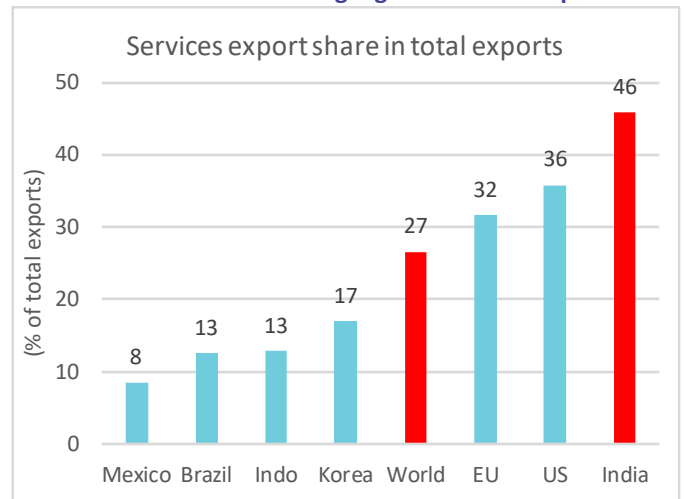
India has surely been shining in services and on the export front, with services exports now nearly equal to goods exports—an anomaly amongst global peers. Also, within services, it is the relatively medium to high-end segments (software and business services) that accounts for the bulk of exports rather than low-end tourism. But can services serve as a counterweight to manufacturing and deliver the high growth that India needs?

Exhibit 25: Services exports to surpass goods exports...



Source: CMIE, Nuvama Research

Exhibit 26: ...with India having highest services exports share

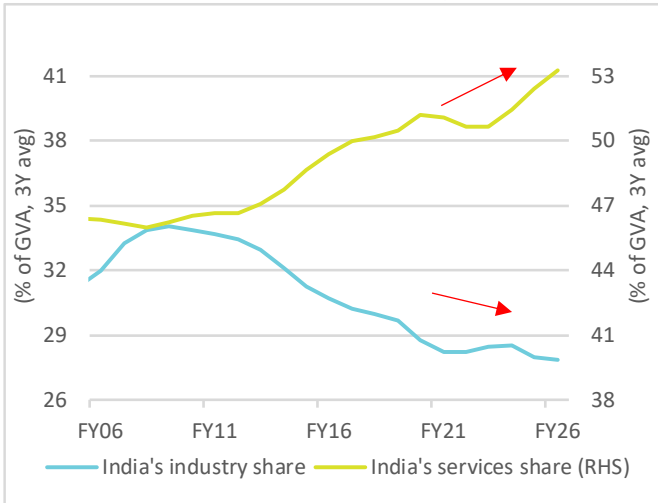


Source: WTO, Nuvama Research; Note: As of 2024

The evidence of services being able to deliver scale so far has been quite mixed. First, rise in services' share of India GDP has come more at the expense of manufacturing than agriculture. In fact, the share of agriculture in GDP has been hovering in high teens for more than a decade now. Typically, this share keeps on dropping for economies that are scaling up rapidly from low income levels. Also, 42–43% of India's labour force is still employed in agriculture, which is very high.

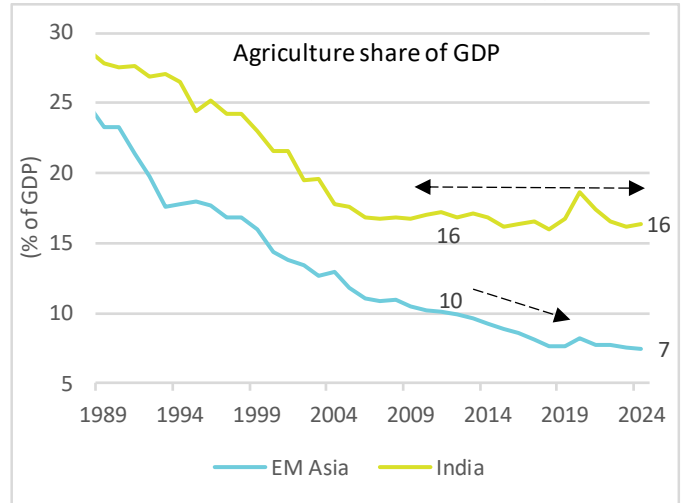
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Exhibit 27: Services increased on the expense of industry



Source: CMIE, Nuvama Research

Exhibit 28: While India's agri-share stalled at high level

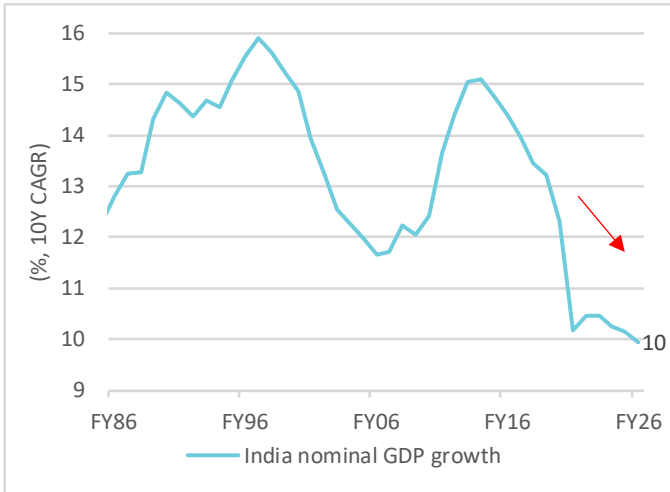


Source: World bank, Nuvama Research

Note: EM Asia includes China, Thailand, Indonesia, Malaysia, etc.

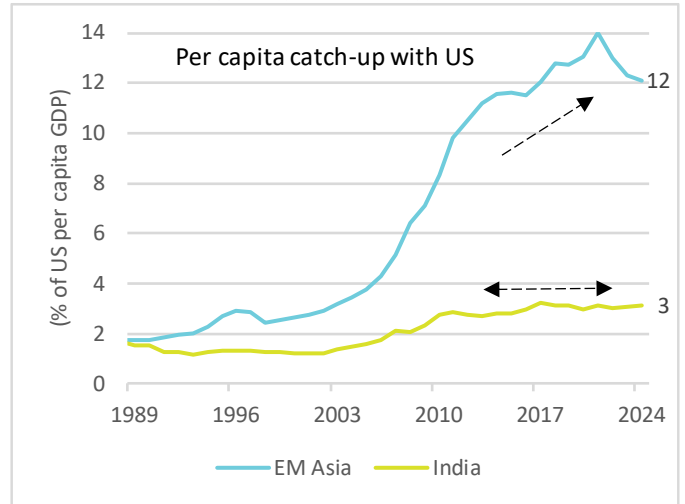
Moreover, while in the last decade the Indian economy has been increasingly led by services, India's NGDP growth trend has only slowed. Also, India's per capita GDP relative to the US, which was increasing in 2000s, has nearly stalled in the last 10 years and that too at very low levels. Even India's tax base doesn't seem to be expanding much with the country's gross tax revenue to GDP now sideways for over a decade. Note that manufacturing-based Asian economies of China and Korea have compounded at a far more rapid pace during their phases of demographic dividends. Thus, services alone may not be sufficient to build scale in the economy.

Exhibit 29: India's NGDP is growing below 10% on trend basis



Source: CMIE, Nuvama Research

Exhibit 30: India's per capita catch-up with the US has stalled



Source: World bank, Nuvama Research; Note: EM Asia includes China, Thailand, Indonesia, Malaysia, etc; GDP per capita in current USD.

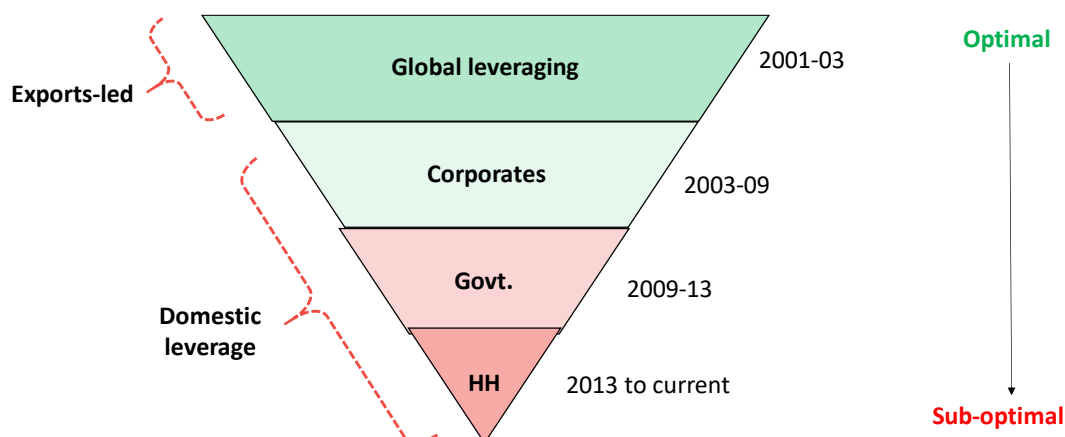
In addition to these, a heavy dependence on services may have two further limitations in the emerging world order:

- First, reshoring critical supply chains is not just industrial policy anymore, it is a national security imperative in the emerging multi-polar world. As US hegemonic reach recedes, China, the only country to build a 'defence-industrial' base over the last 30-40 years, would want to play a regional hegemon in Asia.
- Second, as the reach of AI increases, the services economy cannot be relied on generating an adequate number of jobs.

HHs: Reliant on leverage and now increasingly on state dole outs

Another important outcome of India's growth construct has been the rise in HH leverage. Balance sheet discipline among businesses and also the government has pushed leverage in the HH sector. HH debt to GDP has been rising consistently since 2012-13, only the instruments of leverage keeps shifting—from mortgages to unsecured (credit cards, MFI) to gold loans now (HH debt to GDP on the rise). But after a decade of levering up, HH leverage may be hitting diminishing returns. In fact, as we argued in our [hysteresis report](#), not all debt is equal. From building scale view, corporate debt is better than government debt, which in turn is better than HH debt.

Exhibit 31: Hierarchy of debt



Source: Nuvama Research

This dynamic of rising HH leverage and weak income dynamic is now shaping politics as well. We see more and more states now relying on populist measures. Some have gone for doles and subsidies while others are taking the route of hike in minimum wages or tightening labour laws.

Thus, India's current macroeconomic approach, which helped achieve stability, has compromised scale. It is time to reassess emerging geopolitical realities and pivot. In the next section, we outline some of the policy prescriptions for India in the new world order.

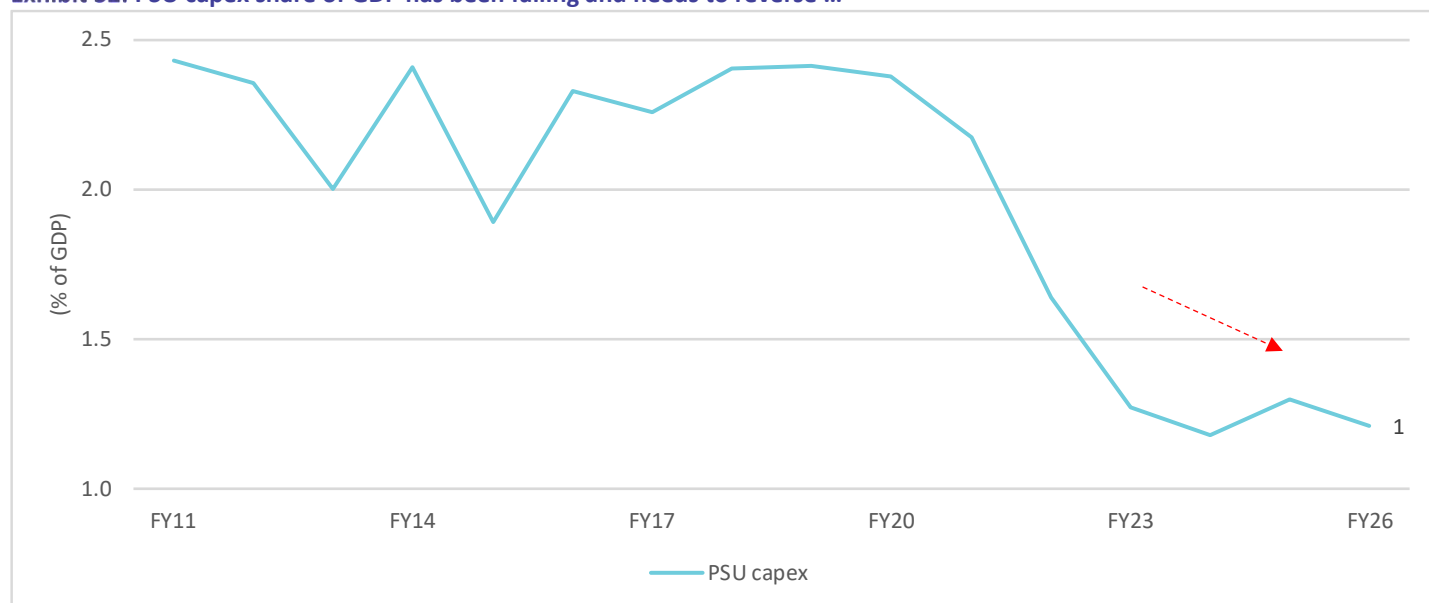
Policy prescriptions for India in the new world order

The world is changing and so does India's approach. The recent balance of payment shock provides it an opportune time to pivot. With balance sheets strong, India now needs to focus on building scale. The following measures should help:

1. PSUs: Need to focus on scale

Building scale would require investments. While the private sector may initially be reluctant to bite the bait given the relatively weaker demand and high global uncertainty, the government and PSUs may have to take the lead. Since the government is committed to fiscal consolidation, disinvestments could be accelerated to finance capex. Furthermore, the government could nudge PSUs to scale up capex; after all PSU capex as a % of GDP has dropped consistently over the last five years. If both of these measures work simultaneously, the private sector may be compelled to follow suit.

Exhibit 32: PSU capex share of GDP has been falling and needs to reverse ...



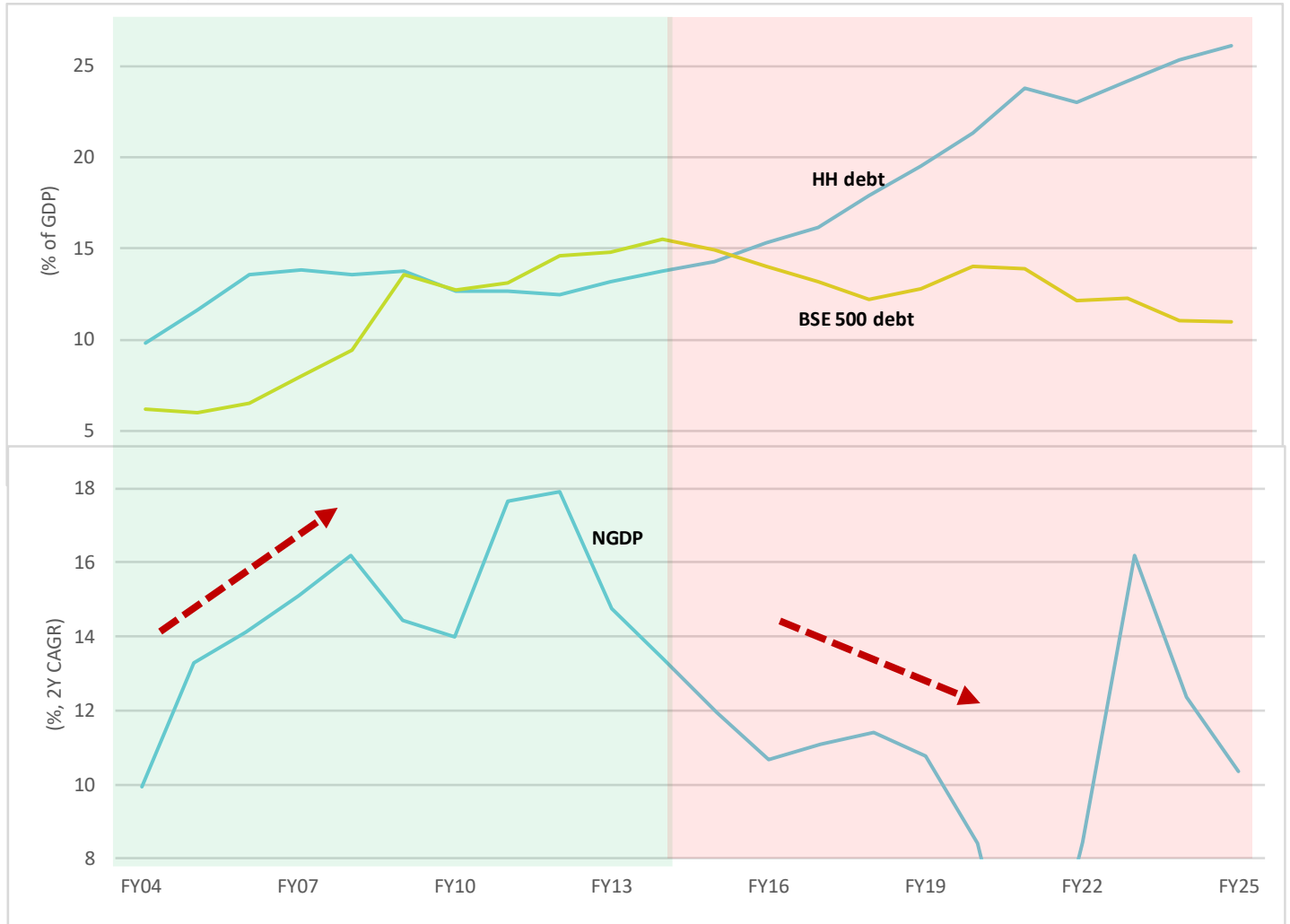
Source: CMIE, Nuvama Research

2. Credit: Should be nudged towards production versus consumption

Credit cycle too needs realignment. Regulatory framework can incentivise corporate loans (over HH credit) through appropriate risk weights and subventions. After all, corporate balance sheets are quite healthy now. In addition, taxation on equity and debt investment currently incentivises equity investment; a more balanced taxation could lower cost of debt also.

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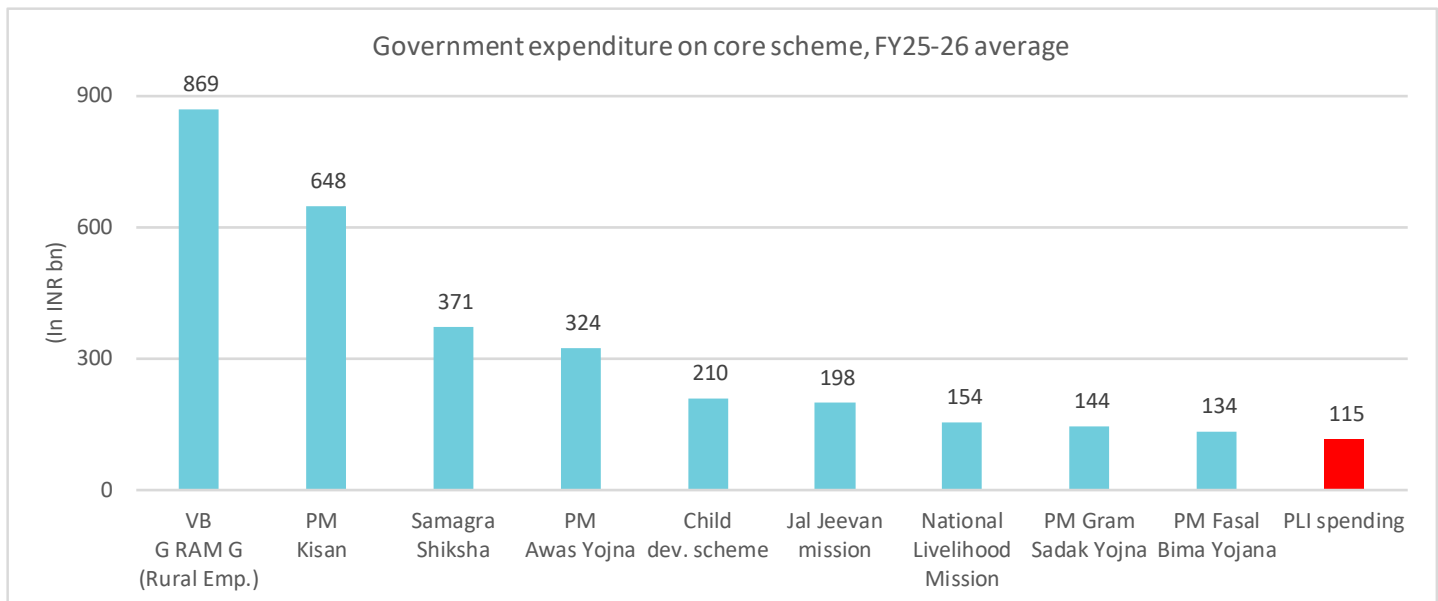
Exhibit 33: Leverage needs to shift back to corporates from households



Source: CMIE, Capitaline, Nuvama Research; Note: HH debt is Bank personal loans + HFC loans + personal NBFC loans including mortgage loans

Apart from credit, the government too must increase allocation towards production linked incentive (PLI) scheme. The current allocation for the scheme is very low to build scale. In fact, amongst the governments' core schemes, the allocation to PLI is one of the lowest with targets being missed despite the fact that the scheme has been running for more than four years for various sectors.

Exhibit 34: Government PLI allocation remains low relative to core schemes



Source: CMIE, Budget documents, Nuvama Research

3. Monetary policy: Inflation targeting regime needs reassessment

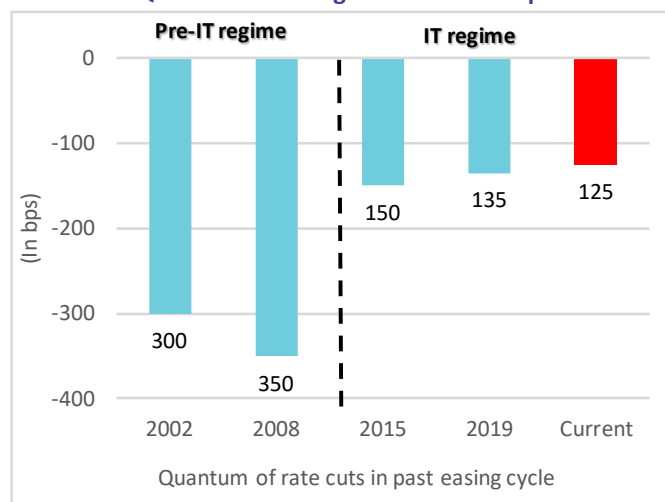
In our view, while monetary reforms were much needed after the stagflation experience, we think it is too stringent for India's needs to build scale. After all, the CPI has nearly 40–45% weight of food commodities, which are neither forecastable nor amenable to monetary policy actions.

This led to wide variations in RBI's 12-month ahead projection of inflation and the actual outcome, which in turn rendered the monetary policy sub-optimal on various occasions. But in addition to some of the problems of institutional design, there is also an issue with the way the RBI is actually running this new framework, which ended up being overly constraining from a growth standpoint. For example:

- The RBI's monetary easing post the 2013 episode has been progressively shallower, rendering real rates structurally higher.
- The RBI relied too heavily on real GDP growth and thus overestimated the strength of the underlying economy, even during periods when NGDP growth was trending lower. NGDP is a better gauge of the direction and strength of the business cycle than RGDP. (refer: [Of Cycles, Trend and Hysteresis](#))

The current regime needs reassessment, especially in a world of repeated supply shocks. Fighting a supply shock with monetary policy could be self-defeating as it has little impact on curbing inflation in the near term, while high rates disincentivise long term supply creation. We think the RBI should also consider WPI while setting rates and adjust its real rates target based on business cycle.

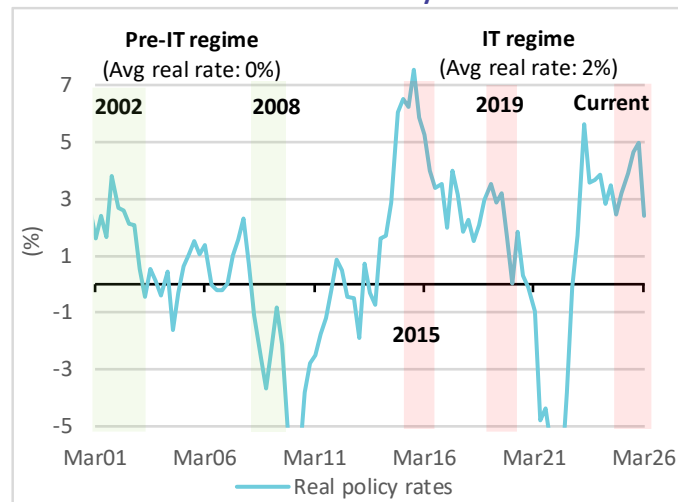
Exhibit 35: Quantum of easing has been lower post IT...



Source: Bloomberg, Nuvama Research;

Note: Policy rate pre-GFC is taken as average of repo and reverse repo; post-GFC is repo rate.

Exhibit 36: ...real rates have been very elevated



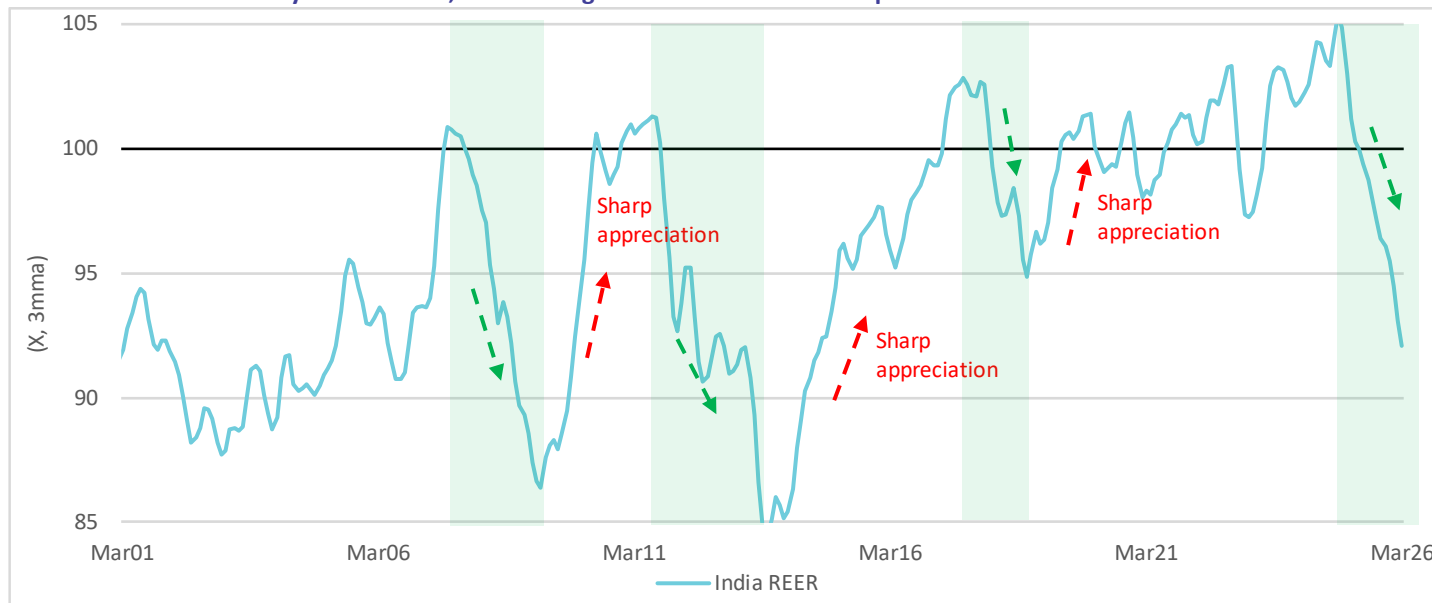
Source: CMIE, Nuvama Research;

Note: Real policy rate is calculated as the difference between the policy rate and the average of WPI and CPI.

4. FX: Need for an undervalued currency

To run an effective industrial policy, FX plays a very important role. The sharp INR depreciation over the last two years has corrected India's overvaluation. This is helpful; what would also be critical is to keep it undervalued over the long run to set expectations among businesses. Historically, gains from previous episodes of INR undervaluation (2008, 2013, 2019) were rather limited because as capital flows return, INR tended to be among the best performing currencies in the subsequent couple of years.

Exhibit 37: INR is currently undervalued; maintaining this undervaluation is important



Source: CMIE, Nuvama Research

5. Trade policy: Tariffs need to be more aggressive

Finally, the world is turning protectionist. In this era, it is important that India too adapts to the changing rules of the game. We too must protect domestic industries from the flood of cheap goods and tariff them aggressively. The government is already intervening in this direction, which is welcome. A combination of protective tariffs and undervalued exchange rate could really tilt the economy from consumption to production, and within consumption from imported goods to domestically produced goods; else, any appreciation in INR would undercut the protective tariffs.

Conclusion: A pivot toward scale

As argued earlier, reshoring and building an industrial base is now no more a choice. It may be a national security imperative given the unfolding world order. The government is already taking measures in this regard but an ecosystem-level approach may be helpful. More neo-liberal reforms can attract foreign flows but that only fuels demand for foreign goods; instead, the focus should be on fixing the trade deficit itself. This will require incentivising scale over RoE (PSUs must take lead), production over consumption and fixed assets over financial assets. A scaled up PLI, a rethink of currency policy and an inflation-targeting regime may be needed (see: [Hedgehog and Fox](#)). Such a Hamiltonian turn may be critical to resist China, which would want to play the regional hegemon in Asia as US's hegemonic reach recedes.

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