Masters and Servants in the Global Financial System:
From Trilemma Forcefields to Impossible Dilemmas?

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So sooner and not later, Eurozone governments must confront a *vox populi* demanding the use of public resources to restore popular prosperity.

If nothing changes, the best alternative is stagnation; others are isolationism and militant nationalism.

The breaking point is here:

- The Eurozone as configured cannot deliver financial stability.
- It cannot deliver transparent bank balance sheets.
- It cannot calm the financial markets.
- Its banking sector is dysfunctional and a dead weight on economics suffering from stagnation.
"Brexit means Brexit and we're going to make a Titanic success of it". Oh dear @BorisJohnson hits iceberg & sinks at @spectator awards

Boris Johnson claimed that the Tories will make "a Titanic" success of Brexit. Granted it's a long film, but has he watched it to the end?
1. Introduction
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1. Introduction

• Our focus is on exposing critical flaws in the structure of European financial governance, which cause financial instability and undercut both its member-nations’ capacity to govern and their democratic assent for their actions.

• Helene Rey, Dani Rodrik, and Wolfgang Streeck argue that replacing the outdated Mundell-Fleming trilemma lets us see how instability and the democratic deficit can be reversed.

• But the Mundell-Fleming trilemma remains central to the European crisis: EMU member-nations’ ‘solution’ to the Mundell-Fleming triad creates interlocking trilemma forcefields of bank regulation and bank behavior, which undermine governmentality in Europe.
1. Introduction

- This trilemma forcefield has limited member-states’ financial regulation when it was advisable, and now precludes them from undertaking fiscal stimulus when it is needed.  
  – The Rey and Rodrik solutions can’t be considered until this forcefield is defused.

- The European trilemma forcefield arises because of the dominant current position of the US as a post-hegemonic hegemon. Nonetheless, the US’s current advantages in macroeconomic policy, and its financial firms’ dominance, are unstable – even fragile.

- Both Europe and the US have crises of governmentality that cannot be resolved unless the market/state asymmetries that have defined the neoliberal era are overturned.
2. The Mundell-Fleming trilemma in the neoliberal era

• A useful point of entry is Mohamed El-Erien’s (2016) critical reflection that central banks are now “the only game in town” for macroeconomic policy guidance.

• Of course, the US and European central banks (the Federal Reserve (Fed) and the European Central Bank (ECB)) have similar powers, put to frequent use especially since 2007:
  – Control of baseline interest rates, designed primarily for controlling inflation (and, in the US, unemployment)
  – Shared responsibility for supervising banks, and when necessary, bank closures
  – The power to issue reserves when needed – to prevent financial-system breakdown, or (in ‘zero lower bound’ conditions) to stimulate economic activity.
2. The Mundell-Fleming trilemma in the neoliberal era

• El-Erien’s point is that more than this – stimulative fiscal policy – is needed.
• This was said on 14 March 2019 in the Financial Times.
Even as the economic outlook has been downgraded, European policymakers — with the recent exception of Mario Draghi, president of the European Central Bank — have waved off the slowdown, stressing temporary factors like dry rivers in Germany and yellow vests in France. The reluctance to discuss policy responses would be forgivable if the coyness were just an abundance of caution, a wish to not get ahead of the facts or the political consensus.

But the impulse to deny problems also reflects a deeper anxiety: that, a decade after the global crisis, Europe has run out of bullets. Fiscal stimulus is constrained by a narrative that public debt has become dangerously high in most countries. Monetary policy is constrained by an aversion to “unconventional” actions, like quantitative easing, prompting the ECB hastily to declare the programme a success and end it in December.
2. The Mundell-Fleming trilemma in the neoliberal era

- El-Erien’s point is that more than this – stimulative fiscal policy – is needed. Draghi made the same point last week.
- So why isn’t monetary policy – changing interest rates and influencing capital flows - enough?
- The Mundell-Fleming “trilemma” expressed the idea that there are tensions in the Bretton Woods system.

A nation cannot simultaneously maintain independent monetary policy, stable exchange rates, and financial integration/openness.

To fix an exchange rate is to surrender either monetary-policy control or financial openness.
Flows of economic activity
(output and expenditure)

Buyers of X’s goods and services
Sellers of goods and services to X

X
Stocks of wealth assets
(financial, real estate, etc.)

Stocks of liabilities (debt, assets owned by foreigners)

The ocean of global banks, shadow banks (hedge funds, investment funds, insurance companies, trust funds, vulture funds, etc., etc.)
Flows of economic activity (output and expenditure)

Stocks of wealth assets (financial, real estate, etc.)

Stocks of liabilities (debt, assets owned by foreigners)

The ocean of global banks, shadow banks (hedge funds, investment funds, insurance companies, trust funds, vulture funds, etc., etc.)
2. The Mundell-Fleming trilemma in the neoliberal era

• El-Erien’s point is that more than this – stimulative fiscal policy – is needed.
• So why isn’t channeling capital flows enough?
• The Mundell-Fleming “trilemma” expressed the idea that there are tensions in the Bretton Woods system.

A nation cannot simultaneously maintain independent monetary policy, stable exchange rates, and financial integration/openness.

To fix an exchange rate is to surrender either monetary-policy control or financial openness.

• The neoliberal era apparently undoes this trilemma for nations that let exchange rates float. Financial openness played to the deregulation of global-North financial systems.
2. The Mundell-Fleming trilemma in the neoliberal era

• The Fed and the ECB, along with the Bank of England, operate in nations or currency unions that have chosen flexible exchange rates, and that are financially open.
  – They have globally connected financial firms, and have pursued quantitative easing aggressively.
  – There is now a “synchronized recovery” (Martin Wolf FT 5 Dec 2017).

• So what is to complain about?
2. The Mundell-Fleming trilemma in the neoliberal era

- It looks simple: restore national autonomy, put up capital controls, regain democratic control. Rey and Rodrik’s agendas, however, ignore the reasons why monetary policy has become the “only game in town” – the global financial power that has policed its boundaries.
- They forget that the very design of the European Union and EMU are a response to the global financial forces unleashed in the neoliberal era.
- And they ignore the structurally unique position of the US in the neoliberal order.
- Considering these structures leads us to ask who is the master, and who are the servants, in this post-hegemonic moment?
3. The changing face of power

- Understand the issue of power in economics = examine the mechanisms (institutions, discourses and policies) responsible for creating and disseminating power (Foucault, 1979).

- Rise of the neoliberal rationale promotes a fundamental change in the role of the state – to ensure the effective functioning of the market forces via deregulation.

- The changing face of power: from the PE of power in the post-war to the neoliberal governmentality – *trilemma forcefield*.

- The national state becomes incapable to provide stabilizing ‘countermovements’ against the forces of the market (esp. “servant states”) (Polanyi, 2001).
3. The changing face of power

<table>
<thead>
<tr>
<th>PE of power in the PW</th>
<th>Neoliberal governmentality</th>
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<tr>
<td>Post-war world (1945-late 1970s)</td>
<td>1980s-…</td>
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<tr>
<td>• National state as the <em>locus</em> of power</td>
<td>• Market as the <em>locus</em> of power</td>
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<tr>
<td>• Systems of security to stabilize the economy</td>
<td>• Systems of deregulation to free the economy and financial systems</td>
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<tr>
<td>• State provides the controls and ‘countermovements’ against market forces</td>
<td>• State becomes the servant of the market - enables the market forces to act</td>
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4. From US hegemony to post-hegemonic hegemony

• In the Bretton Woods system the US was a global hegemon in a dollar-based fixed-exchange rate system with restricted capital flows.

• But as Kindleberger, Salant, and Lafarge (1966) recognized, the dollar standard depended on confidence, and thus required living with a contradiction.

• After the US abandoned Bretton Woods, a decade of instability in the US and Europe, combining recession and high inflation, followed.

• The US’s regulated banking system came under increasing pressure in the 1970s, losing deposit and loan customers. Finally, Paul Volcker was called to be Fed Reserve chair.
4. From US hegemony to post-hegemonic hegemony


  “It is tempting to look at the market as an impartial arbiter .. But balancing the requirements of a stable international system against the desirability of retaining freedom of action for national policy, a number of countries, including the U.S., opted for the latter ... a controlled disintegration in the world economy is a legitimate objective for the 1980s.”

- Taking over the Fed in August 1979, Volcker raised interest rates sky-high, breaking inflationary pressure, crushing commodity prices, and forcing Latin American debt default.
4. From US hegemony to post-hegemonic hegemony

- The US attacked labor rights, deregulated finance, widened its budget and current-account deficit, and made itself a global liquidity sink as the neoliberal era began.

- Meanwhile, developmental states in the global South were forced, through financial crises, to open their markets to global-North entry (especially finance).

- From the 1980s on, the Fed became the lender-of-last-resort guarantor of a TINA system of global finance in which US markets and financial firms continually expanded their reach, and other nations’ regulators acquiesced to wide-spread marketization and opening.
4. From US hegemony to post-hegemonic hegemony

- The US trade deficit led to global capital inflows, feeding Wall Street’s emerging securitization machine.
- And the Fed’s lender-of-last-resort dominance gave it no incentive to control its banks’ speculation.
  - The megabank sector became interpenetrated with a growing shadow-banking sector.
Figure 3: US Current Account Balance and Net Financial Assets Acquired, USB$, 1978-2017 (US BEA)
This paper presents preliminary findings and is being distributed to economists and other interested readers solely to stimulate discussion and elicit comments. The views expressed in this paper are those of the authors and are not necessarily reflective of views at the Federal Reserve Bank of New York or the Federal Reserve System. Any errors or omissions are the responsibility of the authors.
4. From US hegemony to post-hegemonic hegemony

- Global imbalances grew: the US had a current-account deficit and a surplus on capital account, but it’s banks lent heavily to other countries – often through ‘Eurodollar recycling’ (oil revenues from the Middle East channeled to London and then lent from there to Latin America and other places).
- When crises came (Latin America, 1982; Mexico, 1994; East Asia, 1997; Russia/Turkey/Brazil 1998; Argentina, 2001; …), the IMF was there to provide support, and the US Federal Reserve maintained the stability of financial markets.
- Governments designed policy mechanisms for disciplining themselves and attracting winning globally-mobile capital: NAFTA and the European Monetary Union.
- Developing countries built up their dollar reserves.
Currency Composition of Foreign Reserves
(percent of allocated reserves)

Note: Prior to 1999 data for euro is the sum of reserves held in the legacy currencies and ecus.

Source: The U.S. Treasury
5. European union amidst unresolved tensions

• The European Union embodied the “European project,” but also sought to create a competitive Europe in the neoliberal era. — Vis-à-vis the latter, its members agreed to a ‘single market’ guaranteeing four freedoms – free internal movement of capital, labor, goods, and services. — This State would take over duties from European member states – “More Europe” – as it matured.

• Jean Bonnet wrote in his Memoirs: “Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.” (Brunnermeier et al, 2016, 18). — Crises due to clashes between neoliberal forces and nation-state rules would, then, force member-states’ agreement about the institutions and rules of an emerging State.
5. European union amidst unresolved tensions

- Brunnermeier, James, and Landau (*The Euro and the Battle of Ideas*, 2016): there is a fundamental conflict over what this “State” should be: in a northern European view, the establishment of ironclad State *rules*; in a southern European view, the creation of a State with greater discretion to ensure well-being in Europe and to support Europe’s global role.

- To date, the State has been captured by Northern interests, as the price of their underwriting the Union in the crisis period. However, we have seen a rejection of both nation-state leadership and the “State” project in many European elections.

- Many Northern leaders see their crisis support as a one-off that only reinforces the conclusion: no rules, no Europe. So there is no State; only competing interests.
5. European union amidst unresolved tensions

- The current “Northern” resolution of State/state tension is embodied in Eurozone financial governance.
- To see this, consider two triads representing banking structure:
  - **Banking regulation triad**: Financial regulators seek control over the actions of domestic banks, and over foreign banks operating locally; and they should provide ‘lender-of-last resort’ (LLR) support in periods of crisis.
  - **Bank-behavior triad**: banks’ role in the broader economy is to perform economic functions, help finance national government, and maintain safety and soundness.
  - Banks’ economic functions: to provide transaction services, supply productive credit, and manage financial risks.
Mundell-Fleming trilemma

Fixed exchange-rate

Financial openness

Monetary policy control
Bank-regulation and behavioral triads

Bank regulation triad

Lender-of-last-resort (Crisis intervention)

Safety-soundness control of foreign banks

Safety-soundness control of domestic banks

Bank safety & soundness

Economic functionality of financial system

Bank behavioral triad

Finance government debt
6. The Eurozone’s design: a neoliberal mechanism

- These are national structures, resting on property rights defined by national laws and maintained by national courts.
- Vis-à-vis Mundell-Fleming, the banking regulatory triad is fragile under financial openness.
  - How regulation is operated depends on whether the monetary authority has lender-of-last-resort capacity.
  - How bank risk-taking is managed depends on the market context and the powers of the financial regulator.
- A nation-state’s ‘choice’ vis-à-vis the Mundell-Fleming triad sets up three critical areas in the micro-macro financial structure.
A micro-macro framework for financial structure

Fixed exchange-rate

Monetary policy control

Lender-of-last-resort
(Crisis intervention)

Bank safety & soundness

Finance government debt

Financial openness

Safety-soundness control over foreign banks

Safety-soundness control over domestic banks

Economic functionality of financial system
A micro-macro framework for financial structure

- Fixed exchange-rate
- Financial openness
- Safety-soundness control over foreign banks
- Safety-soundness control over domestic banks
- Monetary policy control
- Economic functionality of financial system
- Lender-of-last-resort (Crisis intervention)
- Bank safety & soundness
- Finance government debt
6. The Eurozone’s design: a neoliberal mechanism

• The Eurozone then was set up as a regional compact that followed the “rules” of the neoliberal era:
  – Global financial firms can freely invest in locations with the best combinations of liquidity, profit, and flexibility.
  – Nations or regions must compete for “globally scarce (globally empowered) capital.”

• The Eurozone created a bank-regulation trilemma for its members.
  – In the European Monetary Union, regulators lose control over foreign banks’ activities, and lose LLR capacity (due to introduction of the Euro).
  – But regulators are responsible to intervene in crises of domestically-chartered banks.
National policy design in the Eurozone

Fixed exchange-rate

Financial openness

Monetary policy control

Lender of last resort
(Crisis intervention)

Safety-soundness control over foreign banks

Safety-soundness control over domestic banks

Bank safety & soundness

Economic functionality of financial system

Finance government debt
**Intended policy forcefield in Eurozone design**

- Fixed exchange-rate
- Financial openness
- Monetary policy control
- Lender of last resort (Crisis intervention)
- Safety-soundness control over foreign banks
- Safety-soundness control over domestic banks
- Bank safety & soundness
- Economic functionality of financial system
- Finance government debt
6. The Eurozone’s design: a neoliberal mechanism

- Eurozone regulators without lender-of-last-resort power should encourage prudence by domestic banks.
- But Eurozone financial regulators govern markets that can be freely entered by overseas banks they do not regulate.
- Prudent regulation of domestic banks would disadvantage them in head-to-head competition in Europe and globally.
- Consequence 1: Nations entering the Eurozone facilitated many defensive mergers, often creating national-champion banks that could survive Europe’s “one market” (including the City of London).
- Consequence 2: Deregulate, let them compete. If a banking crisis comes, use tools other than LLR.
So in the EU, the regulatory layer that should exist between fully-mobile global financial flows and the domestic banking system has been disabled through an architectural flaw.

- What is the origin of this flaw? The assumption that access to (scarce) foreign financial capital is crucial, and openness to this capital will both discipline domestic banking and ensure prosperity.

- The problem of the UK being inside the single market but not under the auspices of the European Central Bank provoked this response.

- In practice, domestic regulators fought the consequences of openness by using defensive mergers to create national champions. This only created banks across Europe that are “too big to save”
7. Forcefield trilemmas in the Eurozone crisis

- The Eurozone crisis arose in part because of inadequate financial regulation in Europe, as there was in US (subprime lending and shadow banking)
- As US megabanks and shadow banks took increasingly large, leveraged risks – creating, off-loading, and betting on collateralized debt obligations, European banks followed them.
- With the subprime crisis in 2007-8, some Euro banks failed (Fortis, RBS); Euro money/bond markets froze.
- European banks with EZ sovereign debt came under speculative attack just as the crisis forced EZ nations to require borrowing. The Eurozone crisis was a banking crisis.
7. Forcefield trilemmas in the Eurozone crisis

- In the crisis, EZ central banks could not freely provide liquidity to their domestic banks. They focused on saving their national champion banks; it became impossible to maintain an economically functional banking sector.
- When the ECB finally provided liquidity for the markets, it helped banks to survive, but not to renew lending. The focus now in Europe is on recapitalizing and restabilizing megabanks: this deepens economic stagnation.
- In sum, Europe’s banking systems have failed to perform their core economic functions at the moment of their nations’ greatest crises.
Policy forcefields in the Eurozone crisis

- Fixed exchange-rate
- Monetary policy control
  - Lender of last resort (Crisis intervention)
- Bank safety & soundness
- Finance government debt
- Financial openness
- Safety-soundness control over foreign banks
- Safety-soundness control over domestic banks
- Economic functionality of financial system
Policy forcefields in the Eurozone crisis

Fixed exchange-rate

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Safety-soundness control
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Safety-soundness control
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Economic functionality
of financial system

Finance government debt
7. Forcefield trilemmas in the Eurozone crisis

Brexit deepens the contradictions.

• First, it threatens to remove the City of London as a global counterweight to Wall Street.

• It has induced Paris, Frankfurt, Luxembourg, Dublin, to propose themselves as new European hubs. They will want to offer freedom of movement and contract to the financial markets they host.

• This is a trap, because “ring-fencing concerns” led to “bail-in” provisions to be triggered when banks fail.

• This reasserts the rule-based State (the ‘independent’ ECB), not a discretionary State independent of the ortholiberal Northern powers that dictate the European agenda.
7. Forcefield trilemmas in the Eurozone crisis

- EU-level regulatory response following Eurozone crisis: 2012 banking union initiative; currently consists of two pillars:

**Single Supervisory Mechanism (SSM)**

- Banking supervision system: authority shared between ECB and national regulators; direct ECB monitoring of ‘large’/‘significant’ banks
- Participation compulsory for Eurozone states; other countries may join by signing a ‘close cooperation agreement’ (none so far)

**Single Resolution Mechanism (SRM)**

- European Commission: the purpose of the SRM is ‘to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the real economy’
- Applies automatically to all SSM countries
- Bank resolution managed through an EU agency, the Single Resolution Board (SRB); promotes bail-ins, and, only as last resort, the use of the Single Resolution Fund (SRF); SRF financed by the banking sector, currently being set up (process started 2016, expected to take 8 years to reach target size of 1% of deposits of all banks in participating countries)

Plus politically contested Commission proposal for a European deposit insurance scheme (introduced in 2015 and not implemented)
7. Forcefield trilemmas in the Eurozone crisis

- Limitations of SSM: no supervisory authority over banks outside EZ, nor over shadow banking; unclear division of responsibilities between ECB and domestic regulators encourages regulatory arbitrage; how to reconcile ECB price stability mandate with financial stability?
- Therefore, problem of lack of control over foreign banks operating domestically, as well as over domestic banks, remains
- Limitations of SRM (still in early stage): limited funds; bail-ins and SRF not an adequate substitute for LLR capacity – only a Central Bank has the necessary credibility to act as LLR (de Grauwe, 2011)
- Effectiveness of banking union called into question in summer 2017 – failures of Banco Popular (questions over supervision), Veneto Banca and Banca Popolare di Vicenza (saved using taxpayer money)
- Overall: still missing regulatory layer; continued culture of financial permissiveness
% of allocated reserves

Source: IMF; last data point Q4 2017
Deutsche Bank’s woes force boss to explore Commerzbank merger

Shares in banks rise as Christian Sewing considers options for German lender

Christian Sewing (left) of Deutsche Bank and Martin Zielke of Commerzbank

Olaf Storbeck in Frankfurt MARCH 11, 2019

Deutsche Bank’s chief executive Christian Sewing has dropped his opposition to exploring a multibillion euro merger with German rival Commerzbank after persistently low interest rates and investor pressure over its grim performance
8. Rodrik and Rey: escape from the trilemma forcefield?

• Dani Rodrik imagines that ending the Eurozone will restore democracy and national autonomy in Europe.
• But it will mean the end of the “European project”, whose centrality is clear (even while it’s not part of the conversation).
• There would be a re-establishment of national central banks, charged with being “the only game in town.”
• And these nations’ national-champion banks will want financial openness.
10. The crisis of democracy in Europe, and Brexit

• We see challenges to the ‘European project’ in many countries now – leaders in many countries are ‘populist’ – anti-Europe, or anti-European Commission.

• Brexit represents an effort to break away from ‘European controls’ – not to be a ‘vassal state’.

• The demands of global capital for uniform financial practices – the Capital Markets Union – are pushing forward more entry of global banks.

• The pressure is on!

• Let’s put this in the trilemma story…
Democratic consent: public services or public bailouts?

Job creation, pro-housing, pro-security public programs

Perceived and real character of federal-government action:

Vox populi: Democratic consent

What is public in public debt?
It is said that the first round of QE (Bank of England-sponsored temporary purchases of bonds from the private sector) that started in March 2009 has not been as successful as expected. Indeed, this has been a thorny issue for the policymakers. The claim was that this round of QE would help to reduce the risk that the economy would fall into a deflationary trap. However, the Bank of England has been criticized for not believing in the time trend measure, then you also will not be inclined to argue for more expansionary fiscal policy.

Blog entry of Jagjit Chadha, Professor of Economics, University of Kent
A micro-macro framework for financial structure

Fixed exchange-rate
Monetary policy control
Lender-of-last-resort (Crisis intervention)
Bank safety & soundness
Finance government debt
Public financial bailouts

Financial openness
Safety-soundness control over foreign banks
Safety-soundness control over domestic banks
Financial econ. functionality
Pro-job, pro-housing, pro-security public programs
Democratic consent

Pro-job, pro-housing, pro-security public programs
Democratic consent
Europe’s micro-macro financial structure

Fixed exchange-rate

Financial openness

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- Pro-job, pro-housing, pro-security public programs
- Democratic consent
11. Conclusion

- The US megabanks have profited from financial instability. Costs of monetizing their losses are borne globally; nation-state support leads to cuts in popular programs.
  - Varoufakis (2017) points out that European taxpayers paid for European banks’ losses in the EMU crisis.
  - EMU member-states of the EMU have much less policy space than the US when they must take on the obligations of failed banks.
- Eurozone governments are confronting a *vox populi* wanting democratic voice and a secure economic life.
- The crisis of financial governance is among the motor forces that have pushed the limits to Europe’s governmentality to the breaking point – and if the ‘populist’ revolt continues, soon beyond the breaking point.
Where do Europeans draw the line?

Why is there a European Community and a Eurozone but no Eurozone European Community?

• What if the EIB were like Brazil’s BNDES?
• What if there was universal health care across the Eurozone?
• What if Eurocitizens stood with African and Asian immigrants to demand justice?
• What if Europeans demanded European human rights?

11. Conclusion
• So sooner and not later, Eurozone governments must confront a *vox populi* demanding the use of public resources to restore popular prosperity.

That time is NOW.

• If nothing changes, the best alternative is stagnation; others are isolationism and militant nationalism.

Change will not be easier if we do or say nothing NOW.