

INTERVIEW WITH THOMAS I. PALLEY

LookingGlass: What is your explanation of the crisis and what does it mean for the global economy in the near future?

Thomas I. Palley: The financial crisis is the logical outcome of the “neo-liberal” growth paradigm that has guided US policy since 1980. Before 1980, US growth was driven by a combination of full employment and rising wages based on rising productivity. That combination created a virtuous circle in which full employment and strong wage-based consumption created an incentive to invest, which in turn spurred productivity growth and higher wages.

After 1980 the US abandoned that paradigm. Wages stagnated and growth was instead fuelled by debt and asset price inflation. This pattern lasted a long time - much longer than expected. Financial innovation was very important because it kept growth going by enabling more debt and fuelling speculation that increased asset prices.

However, as the neo-liberal model slowly cannibalised the economy by undermining income dis-

tribution and accumulating debt, the economy needed larger speculative bubbles to grow.

The flawed US model of global economic engagement also accelerated the cannibalisation process by undermining wages and investment through outsourcing and off-shoring, and by creating a huge leakage of spending out of the economy through the trade deficit.

These developments eventually created need for a huge bubble that only housing could provide. However, when that bubble burst it pulled down the entire economy because of the bubble’s massive dependence on debt.

The US is now going to struggle to restore growth because the neo-liberal growth engine is broken. The era of increasing debt and asset price inflation is over, and the US needs a new engine of growth. That is the issue we should all be debating, but my sense is that the US policy-making establishment has not recognised the problem. It still views the recession as a temporary blip and thinks we will be able to return to the way things were.

The global economy is also going to stagnate because it was an accomplice to this model. First, much of the global economy adopted an export-led growth model that relied on US consumers. The prospect of sales to the US market also attracted foreign direct investment. With the US consumer now bankrupt, that pattern of growth is also over.

Second, many countries accepted wage suppression and rising income inequality as a way of gaining export competitiveness. That produced ugly internal economic patterns but the effects were obscured as long as countries could rely on export-led growth. Now, the chickens will come home to roost and countries are going to have a hard time reviving growth because of worsened income distribution.

The bottom line is this was a global growth model in which there was a co-dependent relationship between the US and the rest of the world. The US provided the engine of growth, but that engine is now broken. This means the global economy faces permanently lower growth until it develops a new growth strategy with new engines of growth.

LookingGlass: Is the implication of your analysis perhaps that the US will no longer be the global player it has been and that the crisis of 2007-2008 is a turning point, after which the global economic power will shift to China?

Thomas I. Palley: China has been a big indirect contributor to the global financial crisis. That is because it has been a huge contributor to the US trade deficit and off-shoring of jobs and investment from the US, which weakened the US econ-

omy and contributed to drawing the curtain on the US neo-liberal growth model.

Chinese policymakers have pursued their national self-interest, which is why they refused to appreciate their exchange rate. US policymakers (Clinton, Rubin, Summers, Bush, Cheney) bear the primary responsibility for the unbalanced state of China - US trade. They put the US in this position by signing up for a disastrous form of globalisation and then refused to take corrective action for fear of offending Wall Street and their multi-national corporate sponsors.

However, what happens in China is still very unclear. Remember, China has relied on export-led growth and foreign direct investment to drive its economy. That model is broken and it is not clear China can create a new model.

A few years from now we may see grave economic difficulties in China. Corruption remains terrible and the ability to direct investment to productive use remains weak. That means a significant amount of bank lending is either stolen or unproductive, which sets the stage for a future Chinese financial crisis.

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There are also major political problems. Slow growth will mean rising unemployment, which will create political struggle. That political struggle is likely to create economic policy difficulties and could cause very disruptive inflation. China

is not the sure-thing that many economists and corporate leaders seem to think it is.

LookingGlass: What is likely to happen if a new paradigm is not found?

Thomas I. Palley: Absent a new growth paradigm we will have slow global economic growth and far higher unemployment everywhere.

Given all the international leakages (trade, jobs, wage competition, investment flows, financial capital flows) that globalisation has created, individual country governments are not in a strong position to fight economic weakness. That calls for globally coordinated action, but we do not have the institutions to do that.

Individual country governments face strong incentives to free ride and not cooperate. For instance, they may resist expansionary fiscal policy and instead seek to and rely on the expansionary policies of other countries. Or they may try and devalue their exchange rate, but that just appreciates another country's exchange rate.

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We may also be entering a period of international financial instability. On one hand countries are growing apprehensive about holding dollars. On the other hand they are still trying to export to the US in the absence of other markets. That's a contradiction. They want to reduce their dollar hold-

ings at the same time that they have to buy dollars to keep the dollar strong in order to export to the US. That is an unstable situation and carries the risk of a financial crisis that pushes US interest rates higher, thereby further weakening growth.

Politically, my fear is that this decade could turn out a lot like the 1930s. Deep prolonged economic stagnation releases political demons. We have to solve the “jobs problem” quickly, which will require new economic thinking.

Unfortunately, I am not optimistic about this. There are strong vested interests that will block change in our economic thinking. The economics profession is a big part of the problem. Economics has been captured and now serves neo-liberal interests, blocking space for new ideas and approaches. Politicians, journalists, voters have all been schooled in neo-liberal economics for thirty years and that makes it very hard to get new ideas into the public realm.

I am repeatedly disappointed by Social Democratic politicians who resist grappling with the question: “What is the economic foundation needed to support social democratic aspirations?” That is the key political challenge. Social Democrats must push that question to the front of public debate and they must break the neo-liberal monopoly on providing answers. That is the only way we will escape prolonged stagnation. If they do that the crisis will not have been wasted. Instead, it will have become the cause of progressive change and renewal.

Sadly, too many Social Democrats are content to accept existing thinking and try to patch the existing system. That has transformed the social dem-

ocratic project into one of poverty alleviation rather than a project aimed at addressing deep-seated social and economic inequality and creating a better society.

LookingGlass: You characterise America's engagement with globalisation as flawed and point to the fact that it has exposed the country to a three-fold hemorrhage. You also state that companies should work for national wellbeing. Does that mean that companies need to be reined in, kept within national fences?

Thomas I. Palley: Globalisation and the technological developments of the past thirty years have fundamentally transformed the relationship between corporations and country.

In the 1950s "Engine" Charlie Wilson, CEO of General Motors, could proclaim with some justification: "What's good for General Motors is good for the country." It was not because Wilson was more altruistic than today's CEOs. Instead, it was because GM's economic interest coincided more closely with the national interest.

That has changed. Companies have gone global, have global production networks, and are capable of supplying markets in one country with production from another. That is good for company profits and shareholders. The way to maximise a company's profits is to maximise its global profits. But maximising global profits is not the same as maximising national income.

Globalisation weakens the over-lap of interest between corporations and countries. What can be good for corporations can be bad for country. Shifting investment offshore can raise corporate

profits but it may lower national income and growth.

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That sets up a fundamental policy challenge, whereby we must try and re-establish alignment of corporate interests with the national interest. That is an enormously difficult policy challenge, but we will not solve it until we are aware of it. Right now, we are in denial of the problem.

LookingGlass: The accusation of protectionism is often used to block any discussion of the relation between globalisation and equality, but it is a question that must be dealt with. Some French writers, like Emmanuel Todd and Jean-Luc Gréau, argue for a European protectionism to keep wages and demand up. Would something similar be an option for the US?

Thomas I. Palley: In many regards, "protectionism" is an antiquated concept that applies to the earlier era of trade when production was fixed and goods moved between countries. Today's challenge is globalisation, which is about global production networks and the mobility of production. Trade is part of globalisation, but globalisation is much more than trade.

What we need are policies that address the mobility of production and ensure that the mobility of production does not create a race to the bottom. This will include policies that realign corporate

behaviour with national interests, tax coordination, labour standards, international coordination of exchange rates, and a new development strategy for poorer countries. That is a different agenda from protectionism. If put in place, such a progressive international agenda will create policy space for progressive national economic policy.

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LookingGlass: Are we entering a phase of deglobalisation? Might it also have some positive aspects?

Thomas I. Palley: I am not sure if deglobalisation is the right way to characterise future developments. What we can say for sure is that the bloom is off the corporate globalisation rose.

Looking to the future, we need to change the direction and character of globalisation. That means globalisation will expand in some areas and contract in others. One place where we need more globalisation is global regulation, but the goal of that regulation should be to create space for more national choice.

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In the short-term, activities like the level of trade and foreign direct investment are likely to remain down due to the prospect of economic stagnation in the US and the end of export-led growth.

The fact that trade has fallen as much as it has in the current recession also suggests it has quite small marginal benefits. That means the globalisation production model may shrink.

The environmental challenge also creates pressure to shrink the globalisation production model. The environment can be thought of as an input in to the production process, and the globalisation production process is a very heavy user of the environment. So far the environment has been treated as a free input. Now, the environmental crisis forces us to begin charging for using the environment. If that happens (a big if), it will raise the costs of the globalisation process, likely causing a contraction in the process.

The environmental challenge illustrates the likely change in the nature of globalisation. On one hand it could permanently contract trade in goods that add little value. On the other hand it could expand globalization by promoting global regulation.

Lastly, the world will continue globalising in terms of increasing culture mix and cross-border exchange of ideas.

LookingGlass: Why was the paradigm that worked so well after 1945 abandoned?

Thomas I. Palley: Explaining the abandonment of the post-1945 paradigm is a complicated matter, involving multiple social and political reasons.

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One reason is that the economic thinking underlying the post-1945 paradigm was never fully accepted. That made it vulnerable to a counter-revolution, which Milton Friedman and his Chicago School of Economics effected.

A second reason is the success of the post-1945 paradigm. That success made us come to believe we had permanently solved the economic problem so that we did not need the institutions and policies (like trade unions and regulation) that had enabled us to solve the problem.

A third related reason, particularly relevant in the US, is the Cold War. During the Cold War the West was engaged in global geo-political competition with the Soviet Union. The West pushed capitalism, while the Soviet Union pushed central planning. That competition meant the West tended to intellectually deny the limits of capitalism and over-state its capacities as a self-regulating system that can deliver full employment and shared prosperity. In turn, the West may have come to believe its own Cold War rhetoric.

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Putting the pieces together, we lost our understanding of capitalism and forgot our history. In place, we bought into an idealised version of capitalism. When we ran into economic difficulties in the 1970s, rather than working through those difficulties and the challenges they posed, we abandoned the post-1945 paradigm and shifted back to

the neo-liberal paradigm that had never been fully discredited and was waiting in the wings.

This abandonment was accelerated by the collapse of the Soviet Union, which removed political pressure to soften and humanise the market. Additionally, instead of being interpreted as proving the failure of extreme central planning, the collapse of the Soviet Union was interpreted as proving the case for laissez-faire extremism.

Economics, economic ideas, and the economics profession play a critical role in this historical narrative. That is why it is so important to crack open the economics profession and economic debate to allow a greater range of economic ideas on to the table. Ideas really matter and they have tremendous consequences.