

LOOKING GLASS

by Glasshouse Forum

NO. 2/2009, SUMMER ISSUE

NEW PUBLICATION

NOW WHAT?!

GLASSHOUSE FORUM DRAFTS SCENARIOS:
THREE POSSIBLE ECONOMIC TRAJECTORIES

INTERVIEW WITH GEORGE SOROS

THEME

THE RETURN OF THE STATE AND PROTECTIONISM

ADDITIONAL INTERVIEWS WITH JAMES K GALBRAITH AND DEAN BAKER

INTRODUCING LOOKINGGLASS AND GLASSHOUSE FORUM

Glasshouse Forum has the pleasure of presenting the fourth issue of *LookingGlass*, a newsletter written by Glasshouse Forum's secretariat and fellow researchers. Its aim is to present and discuss topics taken up within the framework of Glasshouse Forum's work and to provide an arena for critical reflection on the merits and problems of capitalism.

LookingGlass contains in-depth reports, short interviews, essays and book reviews. You will also find presentations of recent Glasshouse Forum publications. The content will in a flexible way mirror the themes on which Glasshouse Forum is running projects, while *LookingGlass* also enables explorative analysis of issues surrounding capitalism.

Glasshouse Forum, founded in 2007, is a network of researchers and intellectuals – to date about 50 active contributors – from different disciplines, mainly from Europe and the US, but also from China and Russia. The forum is politically inde-

pendent and does not engage in lobbying activities, or make policy recommendations.

The following projects are running within Glasshouse Forum 2009:

- The return of the capitalist-authoritarian great powers
- A consumed society?
- Short-termism in the long run
- Globalisation and the middle class in the West

Glasshouse Forum publications to date

Glasshouse Forum has, to date, published eight titles. The first seven were presented in *LookingGlass* 1/2008, 2/2008 and 1/2009:

Is There a China Model? A combined report and film from the China-West Intellectual Summit that was held in Paris in February 2009.

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An Edited Transcript from a Round-Table Conference on Authoritarian Capitalism, 2008, 128 pp.

White Whale or Red Herring? – Assessing Sovereign Wealth Funds, Daniel W. Drezner, 2008, 24 pp.

The Limits of the China Model, Johan Lagerkvist, 2008, 24 pp.

Tolerance and Democracy in Liberal and Authoritarian Market Economies, Sten Widmalm and Sven Oskarsson, 2008, 40 pp.

Towards an Hourglass Society? Income Differentials and the Fate of the Middle Class, Kay Glans and Johanna Laurin (eds.), 2008, 144 pp.

An Edited Transcript from a Round-Table Conference on Short-Termism, Kay Glans and Johanna Laurin (eds.), 2008, 92 pp.

The latest publication is *Alphabet Soup: The Political Economy of the Great Recession*, by Daniel W. Drezner, 2009, 32 pp. The report is presented in this issue of *LookingGlass* (see page 6):

All Glasshouse Forum publications can be downloaded from our website: glasshouseforum.org.

Upcoming Glasshouse Forum event:

12–13 November 2009: Inequality in a Time of Contraction – a Glasshouse Forum-Stanford University two-day international conference at Stanford

Although there has been extensive discussion of the financial dimensions of the crisis, to date

there has been far less written about the distributional implications. The goal of the conference is to bring together scholars from the social sciences, such as economics, sociology, and political science, to deepen our understanding of the link between globalisation (of both financial and real markets) and economic inequality. In this way we will be in a better position to understand and perhaps predict the consequences to inequality of the current economic turmoil.

Among the topics to be discussed:

- Have past financial crises reduced inequality or increased it?
- Who are the main winners and losers in this crisis?
- What international comparisons and benchmarks are useful in understanding the consequences of the crisis and how public policy might address it?

Those who have confirmed their participation include: **Sir Anthony Atkinson**, Oxford University, **Philippe Aghion**, Harvard University, **Orely Ashenfelter**, Princeton University, **David Card**, UC Berkeley, **Thomas DiPrete**, Columbia University, **Maria Guadalupe**, Columbia Business School, **Jim Heckman**, Chicago University, **Enrico Moretti**, University of California Berkeley, **Stephen L. Morgan**, Cornell University, **Robert Frank**, Cornell University; on leave at NYU Stern School's Program in Law, Ethics, and Markets, **Richard Blundell**, University College London, **Richard Freeman**, Harvard University, **Jonas Pontusson**, Princeton University, **John Van Reenan**, London School of Economics/GSB Stanford University, **Jesper Sorensen**, GSB Stanford University, **Daniel Waldenström**, Research Institute of Industrial Economics,

Bruce Western, Harvard University, and **Kim Weeden**, Cornell University, Mike Hout, UC Berkeley, and **Timothy Smeeding**, University of Wisconsin-Madison.

Glasshouse Forum in the media

2009–05–26:

“Beware the Beijing model”. *The Economist* reports from Glasshouse Forum's China-West Intellectual Summit and the film “Is There a China Model?”.

2009–05–22:

“Meeting the Chinese new left at the Glasshouse Forum”. The *Financial Times* chief foreign affairs columnist Gideon Rachman writes on his FT blog about the Glasshouse Forum film “Is There a China Model?”.

2009–05–14:

“Democracy: Europe needs to unite in order to be able to influence China” (“Demokrati: Om Europa ska påverka Kina krävs enighet”). Op-ed by Henrik Berggren in the Swedish daily *Dagens Nyheter*, reporting from the joint Glasshouse Forum/ECFR public seminar entitled “The Impact of the Global Crisis on EU-China Relations” including the screening of the Glasshouse Forum film “Is There a China Model?”.

2009–02–25:

“Chinese views of the crisis”. The *Financial Times* chief foreign affairs columnist Gideon Rachman writes on his FT blog about the Glasshouse Forum “China-West Intellectual Summit” in Paris 23–24 February.

2009–01–04:

“Capitalism without democracy?”. Op-ed in the Swedish daily *Uppsala Nya Tidning*, referring to the Glasshouse Forum report Tolerance and Democracy in Liberal and Authoritarian Market Economies.

2008–11–04:

“Wake up Left, you've won!” Article in the arts and culture pages of Sweden's largest daily newspaper *Dagens Nyheter* by Kay Glans, Glasshouse Forum's editorial coordinator.

2008–09–23:

“Swedish development assistance put out of the running by capitalist dictatorships”. Opinion piece in *Dagens Nyheter* (the debate page “DN Debatt”) by Sten Widmalm and Sven Oskarsson, based on the Glasshouse Forum report Tolerance and Democracy in Liberal and Authoritarian Market Economies.

2008–09–22:

Interview about Glasshouse Forum with Daniel Sachs, CEO of Proventus and chairman of the Concerned Capitalists Foundation, in the business section of *Dagens Nyheter*.

ALPHABET SOUP: THE POLITICAL ECONOMY OF THE GREAT RECESSION

A NEW GLASSHOUSE FORUM SCENARIO STUDY

Alphabet Soup:
The Political Economy
of the Great Recession
Daniel W. Drezner

Glasshouse Forum

Glasshouse Forum's executive summary

The current global economic crisis, which began as a subprime crisis and developed into a general credit crisis, is the deepest since the Depression of the 1930's. There are many signs that we are now facing the beginning of a structural sea change. But what will it be like?

To get a better understanding of the medium-term effects of the crisis, Glasshouse Forum asked Daniel W. Drezner, Professor of International Politics at The Fletcher School, Tufts University, and author of the Glasshouse Forum report *White Whale or Red Herring? – Assessing Sovereign Wealth Funds*, to draft scenarios and make qualified estimates based on as much objective data and historical parallels as possible.

One structural cause of the crisis was the extent to which savings/investment balances were

skewed beyond historical norms. Will the crisis force Americans to save more? Will capital exporters – Germany, China and Japan – consume more? How will these changes affect the global economy?

An immediate effect of the crisis has been to vastly expand the role of states in key sectors of the global economy. In the USA, the government has already taken on an expanded role in the finance, housing and automobile sectors – with healthcare on the horizon. How permanent will the state's role be in the post-crisis economy?

It is easy to envisage how the crisis could lead to populist outrage at the finance sector, or globalisation more generally. Will there be political support for continued trade liberalisation and economic globalisation, or will the course be reversed? Will the crisis lead to greater macroeconomic policy coordination, or a return to beggar-thy-neighbour policies? Will there be a rise in instability, diversionary war, or other forms of political violence?

Based on the evidence to date, Drezner sees three possible economic trajectories: paths “U”, “L” and “W”. Which path the economy follows will have profound effects on the macropolitical variables of concern.

In the “U-style” recovery, where economic growth rebounds fairly quickly, there would be a reverse of the deglobalisation trend, and therefore a decrease in the likelihood of greater political violence.

In an “L” economy, growth stays feeble or flat for several years to come, and there is no return to

pre-2008 output levels. An L-shaped economic path would increase both protectionist and fiscal pressures on many states. The incentive to pursue beggar-thy-neighbour policies would increase, decreasing interdependence and lessening the constraints reducing interstate conflict. On the other hand, an L-shaped economic path is also somewhat more predictable. The lower the level of economic volatility, the more the likelihood that state elites can retain control without resorting to extralegal measures.

The most likely scenario, according to Drezner, is the “W” economy. The global economy could get stuck in a “policy uncertainty trap” and we would see several mini-booms and mini-busts as government officials try to calibrate their responses. The severity of the crisis, combined with the magnitude of the government response, could lead to an increase in overall volatility. This path has the opposite effects to those of an L-shaped path. Periods of economic growth would be likely to lessen protectionist pressures. On the other hand, economic volatility would be likely to trigger greater domestic instability – which could, potentially, spill across borders. There would also be an increased demand for expanded government insurance programmes and state regulation. Savings would increase to hedge against sharp downturns.

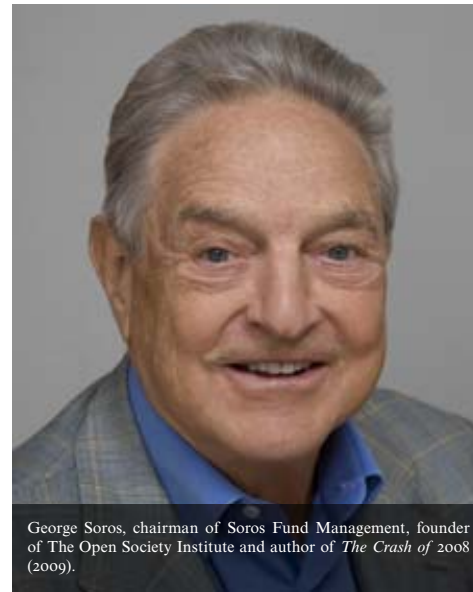
This study touches upon other Glasshouse Forum projects, particularly “A consumed society?” and “Globalisation and the middle class in the West”.

In this summer issue, *LookingGlass* takes a look at the role of the state in the economy and the rise of protectionism as a response to the global crisis.

We have interviewed George Soros, James K Galbraith and Dean Baker.

MARKETS ARE BUBBLE-PRONE

The fact that the authorities have intervened whenever US prosperity has been threatened has reinforced the misconception that financial markets should be left to their own devices, says George Soros.



George Soros, chairman of Soros Fund Management, founder of The Open Society Institute and author of *The Crash of 2008* (2009).

Which role has mainstream economics – and perhaps also the business press – had in the onset of the global crisis? Both categories failed to predict it.

I think it was possible to recognise the possibility of a world financial crisis as early as three years ago, but of course this was not what most analysts were expecting. I have always taken a different view of the market and actually predicted that a global financial crisis would come much earlier than it did. I cried wolf first with *The Alchemy of Finance* in 1987, then with *The Crisis of Global Capitalism* in 1998. Only recently did the wolf arrive.

Mainstream economics has so far been very successful in silencing opposition and marginalising different perspectives. Will the crisis lead to fundamental changes for these professions?

“Had financial authorities succeeded in containing the subprime crisis, this would have been seen as just another test passed instead of the reversal point.”

Since market fundamentalism is built on false assumptions, its adoption in the 1980s as the guiding principle of economic policy was bound to have negative consequences. Indeed, we have experienced a series of financial crises since then. Whenever a crisis endangered the prosperity of the United States – such as the savings and loan crisis in the late 1980s, or the collapse of the hedge fund Long Term Capital Management in 1998 – the authorities intervened, finding ways for the failing institutions to merge with others and providing monetary and fiscal stimulus when the pace of economic activity was endangered. These crises served, in effect, as tests that reinforced the misconception that financial markets should be left to their own devices. Had financial authorities succeeded in containing the subprime crisis, this would have been seen as just another test passed instead of the reversal point.

Your “new paradigm” has profound consequences for both economists and investors. The ability to predict outcomes by rational analysis is much more limited than most want to admit. The future of prognosis looks bleak. But still most of us find it hard to manage without at least some idea of what will happen. Is there some workable compromise between a justified scepticism concerning the ability to predict and the need to have at least some scenario of the near future? As an investor you must have confronted this problem all the time. So what is your general advice to all of us?

We are facing a period of greatly increased uncertainty where the range of possible outcomes is much broader than in normal times, so firm predictions are out of the question. However, we can make some firm predictions of what the future will not look like. The post-World War II period of credit expansion will not be followed by an equally long period of credit contraction. Boom-bust processes are asymmetric in shape: a long, gradually accelerating boom is followed by a short and sharp bust. Consequently, most of the credit contraction can be expected to occur in the near term and the resumption of credit expansion is unlikely to occur at the rates to which we have become accustomed.

I developed my own theory of financial markets and published it some twenty years ago. This theory has guided me throughout my investment career and it has enabled me both to anticipate this crisis and to cope with it. Let me briefly state the two propositions on which my view of financial markets is based. First, financial markets do not reflect prevailing conditions accurately: they provide a picture that is always biased or distorted in one way or another. Second, the distorted views held by market participants and expressed in market prices can, under certain circumstances, affect the so-called fundamentals that market prices are supposed to reflect. This two-way circular connection between market prices and the underlying reality I call reflexivity.

Now that equilibrium theory has shown itself to be a failure at both prediction and explanation, the idea that reflexivity introduces an element of uncertainty into financial markets in particular must be given some credence. The theory of reflexivity is different in character from equilibri-

um theory: equilibrium theory claims to be a scientific theory offering universally valid generalisations that can be used reversibly to provide determinate predictions and explanations. The theory of reflexivity offers no such claim. It contends that, whenever it occurs, reflexivity – through simultaneous interplay between facts involved and the participants’ biased perception of them – introduces an element of indeterminacy into the course of events; therefore it would be inappropriate to look for theories that provide determinate predictions.

“... it would be inappropriate to look for theories that provide determinate predictions.”

Concerning the philosophy of investors, could you describe the role that Karl Popper’s philosophy has played for you as an investor?

Indeed, my most pervasive influence, other than my father’s, came from Karl Popper. It was the philosophy of Karl Popper that made me question the assumptions on which the theory of perfect competition is based, in particular the assumption of perfect knowledge. Nearly sixty years ago, I began to think about reflexivity, an idea I arrived at while examining footnotes of Karl Popper’s *Open Society and Its Enemies* dealing with the problem of self-reference: people’s understanding is inherently imperfect because they are part of a reality and a part cannot fully comprehend the whole. I subsequently came to understand that market participants cannot base their decisions on knowledge alone, and their biased perceptions have ways of influencing not

only market prices but also the fundamentals that those prices are supposed to reflect. Decisions are based not on the actual situation confronting the participants, but on an incomplete understanding, or perception, of that situation. Reflexivity seeks to illuminate the relationship between thinking and reality, and my understanding of reflexivity has guided me in both financial markets and in my philanthropy.

It seems clear that the crisis has altered the position of the market both in a practical sense (the state having intervened on a large scale) and in a theoretical sense (market fundamentalism having lost much or most of its credibility). Will it also change the perception of the state? I am not only thinking of its role as a regulator, but also of the fact that state-owned or state-controlled companies play an increasingly important role in the global economy. Will the shortcomings of the market that have become manifest with the crisis alter the view of the state as an economic actor in this respect?

The interesting thing is that what needs to be done in the short term is almost exactly the opposite of what needs to be done in the long term. When you have a collapse of credit, there’s only one source of credit that is still credible, and that’s the state. Then you have actually to inject a lot more leverage and money into the economy; you have to print money as fast as you can, expand the balance sheet of the Federal Reserve, increase the national debt. And that is, in fact, what has been done, which is the right thing to do. But then once this policy is successful, you have to rein in the money supply as fast as you can.

I think it’s right to extend government credit to

replace the collapsing credit. When the flow of credit restarts, suddenly there will be a flip-flop where the fear of deflation will be replaced by the fear of inflation. The pressure for interest rates to rise will be very, very strong, and the rise in interest rates could choke off the recovery. And so we are facing a period of stop-go, or stagflation similar to but more severe than what we faced in the Seventies. But that is a favourable outcome compared to what would have happened if we hadn't done what we are doing.

"I contend that markets are imperfect but I also recognise that regulators are even more imperfect. They are not only human; they are also bureaucratic and subject to political influences."

About regulation, we have to start by recognising that markets are actually bubble-prone. They create bubbles. Therefore, they have to be regulated. I want to make it clear that I am not an advocate of over-regulation. I contend that markets are imperfect but I also recognise that regulators are even more imperfect. They are not only human; they are also bureaucratic and subject to political influences. Having gone too far in deregulating markets there is now a natural tendency to go overboard in the opposite direction. Now is the time to re-examine the broad principles that should guide regulation, but excessive regulation should be resisted.

How much of a force will state-owned or state-controlled economic actors become in the global economy in the near future?

We can expect that government, particularly in the United States, will play a disproportionately large role in the economy because it is almost the sole source of new financing. It will come to own a significant part of the banking system and, through the banks, a significant stake in commercial real estate. It will also have a major say in the motor industry, but hopefully not too many others.

China's economy has in some ways benefited from strong state influence; when the government says lend, the banks lend. If last year's stimulus programme proves inadequate, China is also in a better position to apply additional stimulus. This puts China in a strong position to recover from the recession, and that is in fact what is happening. As a result, we can expect China's power and influence to grow.

DEGLOBALISATION IN A MULTI- POLAR WORLD

The world economy is contracting and states are trying to save and protect national companies. Companies are tending to retreat to their regions of origin. This could be the beginning of a new multi-polar world order.

Do companies still have home countries?

For thirty years the bearing idea in the West has been that the state should step back and make room for the market forces. The state has been characterised as a dinosaur, constantly outshone by the flexible, rational market. Regulation simply impedes the progress of the market towards the optimal solution.

The evolution of this view was made easier by the fall of the Wall in 1989. The collapse of communism seemed to show that planning – the more central, the more dangerous – led to ineffective-

ness and inflexibility. Neoliberalism was also given ammunition by thinkers who from different standpoints questioned social engineering.¹ If the critique of reason in post-modernism was correct, then planning was an impossibility anyway.

There have been many variations on this theme. The nation-state is said to have had its day in the global economy. Companies no longer have home countries, it has been said, since both ownership

¹⁾ See for example Zygmunt Bauman, *Modernity and the Holocaust*, 1989.

and production are international. To an increasing degree, saying that a car is manufactured in a certain country means that components from all over the world are assembled there.

However, in 2007–2008 another Wall fell – Wall Street. On the home turf of the market economy – the USA – the state has stabilised the financial sector with massive cash infusions and has in effect nationalised companies. Prior to that, the economy was upheld by household consumption, which was largely based on indebtedness. Now, households are saving, but the state is running up huge deficits to stimulate the economy. One could also call it the nationalisation of indebtedness.

The state has received a new mandate as a regulatory body. It is not only because of the crisis. Behavioural scientists have questioned the image of the rationally choosing individual. People need the support of institutions – one of which is the state – to be able to deal with the options, say Richard Thaler and Cass Sunstein in the book *Nudge* (2008). Significantly, Sunstein was recently appointed by Barack Obama as Administrator of the Office of Information and Regulatory Affairs, aka the “regulation czar”.

The visible hand of the state

China’s development too gives cause for renewed reflection on the role of the state in the economy. Several of the Chinese state companies that ten years ago were considered doomed are today major international players. Successful state companies are showcased as the cornerstones of a “socialist market economy”. In Paris last February, at the Glasshouse Forum seminar “Is

there a China model?”, Zhiyuan Cui from Tsinghua University in Beijing asserted that strong state companies do not preclude the development of the private sector.² Profitable state companies enable lower taxation and reduced public indebtedness, which also provides favourable conditions for business. As has been shown by among others Yasheng Huang in his book *Capitalism with Chinese Characteristics* (2008), the role of entrepreneurship has been overestimated in China. The state has constantly played a proactive role, and this has been reinforced in recent years.

State capitalism, in which the state is the leading economic player and uses the markets mainly for political gain, is taking an increasingly dominant role at global level.

The developing countries that have not followed the recommendations of the Washington Consensus to deregulate and downsize the state have fared better. The position of the state perhaps also gives better prospects of handling the crisis. Wei-Wei Zhang at the Centre for Asian Studies in Geneva and Fudan University in Shanghai stated at the Glasshouse Forum seminar that China would be the first major economy to emerge from the crisis. When Chinese exports drastically slumped, many were quick to reject the notion of decoupling – that Asia, and above all China, generated so much of its own drive that it was no longer so dependent on the economic cycle in the West. However, as the Chinese economy is gaining momentum after the enormous economic stimulus package, increasing numbers are begin-

ning to feel that there is something in decoupling (see *Financial Times*, 11 June 2009, “Decoupling gains new group of cheerleaders”).

Naturally, they want to maximise the return, but that can be political as well as economic.

As Ian Bremmer has pointed out in his essay “State Capitalism Comes of Age” in *Foreign Affairs* (May/June 2009) the state’s strong hand in the economy signals a strategic rejection of the free market doctrine. State capitalism, in which the state is the leading economic player and uses the markets mainly for political gain, is taking an increasingly dominant role at global level. Governments own the biggest oil companies and control three-quarters of the world’s energy resources. Sovereign wealth funds represent one-eighth of global investments today. Through the crisis, their net value had fallen to USD 3 trillion in 2008, but that is more than all the world’s hedge funds combined. The value of sovereign wealth funds is estimated to increase to USD 15 trillion by 2015. Naturally, they want to maximise the return, but that can be political as well as economic. Such systems can strive in a long-term perspective for political and economic growth.³

State capitalism and deglobalisation

Previously, we have experienced deglobalisation once in Europe: when it replaced internationalisation before the First World War. It was intertwined with the first and second world wars. There is nothing to say that deglobalisation must

have such destructive consequences. Then, the Western world was predominant, whereas today we seem to be heading for a multi-polar situation. What shape will possible deglobalisation take in a multi-polar world? When the West faces powerful state players who incorporate a political agenda in their economic doings, is it not necessary to respond with a similar pooling of resources?

Politicians automatically say that they will divest themselves of the companies they have nationalised as soon as possible, but if one does not acknowledge the dichotomy between incompetent state and smart market, there need be no such deadline. As Daniel W. Drezner points out in his report for Glasshouse Forum *Alphabet Soup: The Political Economy of the Great Recession*, interventions create their vested interests wanting to retain ownership.⁴ Obama’s administration seems to find it increasingly expedient to have greater control over Fannie Mae and Freddie Mac.

There is also a basis for evaluating the privatisations that have been carried out in the West, for example in energy, transport, schools and health-care. An example: in *La trahison des économistes* (2008), the French economist Jean-Luc Gréau points out that the deregulation of the US energy market has actually brought *higher* prices and

2) See Glasshouse Forum’s website, http://www.glasshouseforum.org/news_film_chinamodel_teaser.html

3) In his report for Glasshouse Forum, *White Whale or Red Herring? – Assessing Sovereign Wealth Funds*, Daniel W. Drezner found no examples to date of their being steered by a political agenda.

4) The report is presented in this issue of *LookingGlass*, see page 6.

that when dealing with competing companies, consumers are in a weaker negotiating position than when dealing with a state monopoly. The European Commission has also decided to investigate the electricity market now that it has become apparent how deep dissatisfaction runs among consumers (*Financial Times*, “Brussels to probe electricity market”, 1 February 2009).

Public purpose or private profit?

Even though the left and right with combined efforts have both conjured up the image of a state in retreat, that is not what has been happening in the last 30 years. The state still exists, at roughly the same size; what has changed is the *way* in which it exists. State intervention is not always identical to public purpose.

The USA is characterised by a discrepancy between image and reality that is reminiscent of the East European communist states, says economist James K Galbraith in the book *The Predator State – How Conservatives Abandoned the Free Market and Why Liberals Should Too* (2008). The ideology of the US right has long since become a myth; it does not steer actions but still sets the framework for the debate. The right has tiptoed away from its attempts to liquidate the state and is concentrating on benefiting from it.

The USA is not a free market society with an underdeveloped state sector.

How can we know that the programme of the right is a myth? One need only look at the institu-

tions, says Galbraith. Those created under periods of public action in the history of the USA – the New Deal in the 30s, the Great Society in the 60s – are still intact. The USA is not a free market society with an underdeveloped state sector. The armed forces, farming, healthcare, continued education, housing, pensions and social security represent almost 40 per cent of the total consumption of goods and services in the USA. As regards middle class welfare policy, Reagan did not fundamentally change reality on the ground.

The myth about the withdrawal of the state acts as a screen behind which oligarchs can exploit it.

What has changed is who can channel and take possession of public resources. Even the USA has oligarchs, says Galbraith, a powerful class with good connections. This circle has no interest in shrinking the state, since they earn money from it, but they have no loyalty towards a nation, only towards the interests of their own group. Former IMF economist Simon Johnson makes the same observation in his essay “The Quiet Coup”: the ties between the financial sector and the state are extremely strong (*The Atlantic*, May 2009). The myth about the withdrawal of the state acts as a screen behind which oligarchs can exploit it. The question is whether companies’ sudden recollection of their home countries is a device to access public funds or whether it represents a genuine change of scenery.

(See further discussion with James K Galbraith, page 20.)

Murky protectionism

The implementation of a kind of protectionism through aid to banks and car manufacturers does not stop almost everyone publicly lauding free trade. The term protectionism is used as a tool to silence people. Free trade has become a key weapon in the fight against the status of labour and the workers, Galbraith thinks. Global competition presses down pay in the developed countries. When companies are threatened by global competitors, the negotiating position of the workers is also undermined.

If there really was free trade in this field, then the pay of American doctors would come down to European levels, and the cost of medical care would be dramatically reduced.

Free trade puts pressure on labour, but not all types of labour. In a discussion related to Galbraith’s, Dean Baker, co-director at the Center for Economic and Policy Research in Washington, states that it is only unqualified labour that is exposed to global competition (see *The Conservative Nanny State. How the Wealthy Use the Government to Stay Rich and Get Richer*, Center for Economic and Policy Research, 2006). By increasing access to a less trained workforce and limiting the supply of qualified workforce, it has been possible to achieve upward redistribution of welfare within the income pyramid. This appears to be natural way for the market to operate, and it is difficult to ascertain how much protectionism there is that is protecting the well-educated. For example, there are a number of obsta-

cles to overseas doctors becoming established in the USA. If there really was free trade in this field, then the pay of American doctors would come down to European levels, and the cost of medical care would be dramatically reduced. Regardless of whether this is a consequence of a conscious strategy, Baker is describing a reality: it is above all those with a shorter education who feel the pressure of globalisation.

(See further discussion with Dean Baker, page 23.)

War of subsidies

The alternative to removing the protection of the well-educated would be to increase protection for the less qualified. It is evident that governments all over the world are now pursuing different forms of protectionism.⁵ This is above all in the form of different aid measures, and is known as murky protectionism. It is more or less a cast-iron law of politics that aid measures are followed by attempts to favour domestic players rather than overseas players. If the tax payer’s money is used to save national banks or companies, then it is just a short step to demand in return that they favour the taxpayers in the country in question. This quite easily happens at the expense of others in another country, in particular when there is over-capacity.

To take a fresh example: the German government negotiated an agreement that saved most jobs at Opel in Germany. It meant that a plant in

5) See Jagdish Bhagwati and Arvind Panagariya, “Legal trade barriers must be kept in check”, *Financial Times*, 11 June 2009.

Belgium had to be closed down. (See *Financial Times* 7, June 2009, “Time to safeguard Europe’s single market”.) It is hardly unthinkable that the Belgians in turn will take countermeasures. In “Bailouts: how to discourage a subsidies war”, Simon J Evenett and Frédéric Jenny argue that there is a risk of subsidies war which can burden state finances and in addition lead to incorrect allocation of resources.⁶

If the global economic currents were to slow down, then according to this supposition we would see a series of contractive phenomena.

But have we not been in such a subsidies war for some time now, and will it not be exacerbated by the progress of state capitalism? The Chinese government is criticised in *A Power Audit of EU-China Relations* (2009) from the think tank European Council on Foreign Relations, ECFR, written by John Fox and François Godement, for exploiting the openness of the EU and at the same time hampering the establishment of overseas companies on the Chinese market. Authorities have for example made demands on the car industry that within five years at least 60 per cent of the components in new cars shall be manufactured in China, and there are similar demands for the railway industry. The EU and USA are preparing to bring China before the WTO because Beijing is giving domestic manufacturers access to raw materials at below market prices, which is making it difficult for overseas companies to compete. (See *Financial Times*, 13 June 2009, “China faces WTO action on raw materials”.)

The question is whether Western countries have any choice if they are subjected by state capitalism to murky protectionism and other forms of protectionism. The process is reminiscent of the arms race logic. It has turned out that we still live in a world of nation states and that these collectives, their cooperation notwithstanding, are competing. We have been so fixed in the perception that free trade is a win-win situation that it is difficult to absorb the fact that one nation can weaken another in a co-ordinated way by driving its companies out of business.

Decoupling and regionalisation

We do not know for sure which forms deglobalisation can take, if it really is such a persistent pendulum movement we are facing. Reactions have a tendency to generalise, since we like to live with cohesive pictures of the world and avoid too much dissonance. If the global economic currents were to slow down, then according to this supposition we would see a series of contractive phenomena: more emphasis on the local or regional, perhaps a division of the world into spheres of interest which reflect the multi-polar power relations.

If we are facing a multi-polar world with different values and political systems, a division into such spheres of interest is fully possible.

One such example is Russia’s sudden decision to withdraw its application to join the WTO, instead to concentrate on building a bloc of former Soviet

states. Moscow is assuming that regional power blocs will grow in significance when the power of the USA declines. If we are facing a multi-polar world with different values and political systems, a division into such spheres of interest is fully possible. If decoupling actually gains momentum, it can for example mean that China will successively carve out its sphere and become less dependent on the West.

Contraction and contract

Naturally, there is contraction in Europe too. It is clear from the newly published report *Re-inventing European growth* by Marc Lhermitte of Ernst & Young that companies in the West are retreating to their countries of origin and historical markets.⁷ At the same time as company leaders are of the opinion that China has the greatest capacity to deal with the crisis, they have become more restrictive in localising projects there. China is increasingly seen as a trade partner, more attractive for its buying power than for its workforce. The companies also see Europe’s flexibility as a resource in a crisis. It stabilises both consumption and the political situation. What were previously highly charged issues – labour market flexibility, different types of obstacle to business, as well as high social charges and restrictive work hours in France, have faded away. Only 2 per cent are today demanding greater labour law flexibility, compared to 42 per cent in 2008.

The internationalisation of the economy tends to lead two reduced differentials between countries but increased differentials *within* countries. So can the slowing internationalisation of the econo-

my in fact make it easier to create equality within countries and relatively homogeneous regions? Is there in other words a connection between contraction and social contract? This is a sort formulated among other things in the French debate by among others Emmanuel Todd and Jean-Luc Gréau.⁸ They argue for European protectionism that will prevent European workers from competing for example with Chinese workers causing a fall in pay levels. If Chinese companies want to export to Europe, they would mean to set up factories here that pay European salaries. In the long run this would also be good for companies, according to the argument, since many jobs, and well-paid ones, would keep demand at a higher level. In that perspective, constant cost-cutting would appear short-sighted: it would perhaps satisfy the shareholders for the moment but in the long term would saw off the branch they are sitting on.

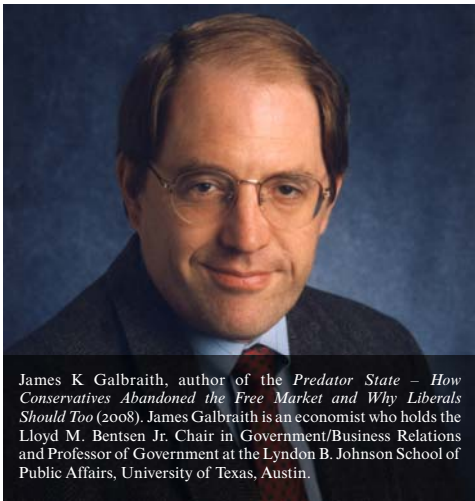
6) In the e-book *The collapse of global trade, murky protectionism and the crisis: recommendations for the G2*, ed Peter Baldwin and Simon Evenett.

7) The report may be downloaded here: <http://www.kht-tarkastaja.fi/UK/en/Newsroom/News-releases/EAS---09-06-04---European-inward-investment>

8) See Jean-Luc Gréau, *La trahison des économistes* (2008) and Emmanuel Todd, *Après la démocratie*, 2008.

PROTECTIONISM WILL NOT HELP THE WEST

Low wages are not the secret behind China's competitiveness, says James K Galbraith. If the West keeps neglecting its educational system, it will lose the advantages it still has.



James K Galbraith, author of the *Predator State – How Conservatives Abandoned the Free Market and Why Liberals Should Too* (2008). James Galbraith is an economist who holds the Lloyd M. Bentsen Jr. Chair in Government/Business Relations and Professor of Government at the Lyndon B. Johnson School of Public Affairs, University of Texas, Austin.

We have seen the nation state bail out banks and car companies etcetera. So perhaps the state is still very powerful and perhaps companies still have a national identity in the global economy? Or is this just another example of mythmaking in order to tap the resources of the state?

States are still very powerful, and companies depend on them. The depressing revelation of the crisis is that companies look on the state as a final source of funds, to be tapped when the market will not provide. And yet they accept no responsibility, no accountability – they deny that the state has any autonomy or any legitimate role in regulating their activities. And, as their allies control the state, they get away with it.

China's development sheds light in an interesting way on the role of the state, perhaps not just in developing economies. The state is and has been very dominant as director of the economy and as owner of the largest companies – some of them very successful on the global market today. You point out that the concept of state planning has largely been discredited in the West. Will this crisis help change the view of the state also in the West, not only as regulator but also as owner of companies and as central planner of the economy?

In my view, as a former adviser to China's State Planning Commission (as it was then called), state planning is far from being the central element in the Chinese model. Far more important is the structure of ownership of light manufacturing, which includes firms owned by the state, by provinces, by townships and villages, by cooperatives and joint ventures, in great numbers – and therefore highly competitive in the final marketplace. These firms earn very low or no profits in the domestic marketplace, and their losses are covered by loans from the (state-owned) banking system. This, and not low wages, is the essential element that gives them the chance to implement the continuous quality improvement that makes access to export markets possible. Also very important is the structure of land ownership. The fact that municipalities own their commercial land means that they earn ground rents, which are a substitute for property and sales taxes, and which give them ample funds to finance infrastructure development. And this is the key to the visible aspects of Chinese urban development.

If these features were understood in the West, they might help change our view of the state, vis à vis both banking and land ownership. But they

are not understood at all, so Western observers tend to attribute Chinese success to low wages or to state planning, and in both cases they mislead themselves pretty comprehensively.

We now also are at least in a better position to evaluate the privatisation programmes in the West when it comes to for instance energy, communications, education and healthcare. Is it possible to tell whether some sectors are better run by the state than by private companies?

"Insurance is clearly better run by the state, for the simple reason that universal coverage is always cheaper to administer than cherry-picking."

Insurance is clearly better run by the state, for the simple reason that universal coverage is always cheaper to administer than cherry-picking. So state-run social security systems are always administratively much less expensive. This is the clearest case by far. In some others, like communications and cable television, whether private provision is acceptable or abusive depends on the capacity of a state regulator to prevent the abuse of monopoly power. Which it obviously does pretty poorly.

You say that the rise of trade is a potent weapon against the status of labour. Some Europeans, like Emmanuel Todd and Jean-Luc Gréau, argue in favour of a European protectionism with the aim of protecting labour from competition, above all Chinese competition. Would such a policy make sense and be possible?

What those who make this argument fail to realise is that in real terms, and by Third World standards, Chinese real wages are not low at all. A visit there and inspection of the urban population and its living standards will confirm this at a glance: the population is well-dressed, well-fed, decently housed, and it has leisure time which it enjoys. Standards in manufacturing are relatively low, but the workforce is intrinsically low-wage, consisting to a great degree of young rural women, who typically stay for a few years, save some money, and return home. There is nothing so very wrong with this, and it is not for the West to tell China that consumer electronics should be made by older men with families.

“...nothing will stop the Chinese from producing and marketing the goods, nor consumers from seeking them out.”

It is true, of course, that the Chinese model is very cost-competitive, but the real source of this is the low price level for wage goods inside China (food, clothing and lodging cost very little, and for \$300 a month in wages a family lives quite well). The reason for the low price level is the competitive conditions inside China, including the admirably low domestic profit rate. Protecting against this is not justified by appealing to some concept of a just wage. It is also a bit like trying to stop the tide: nothing will stop the Chinese from producing and marketing the goods, nor consumers from seeking them out.

The task in the West is to find things to do that the Chinese economy cannot quickly emulate. Employment in universities, healthcare, elderly

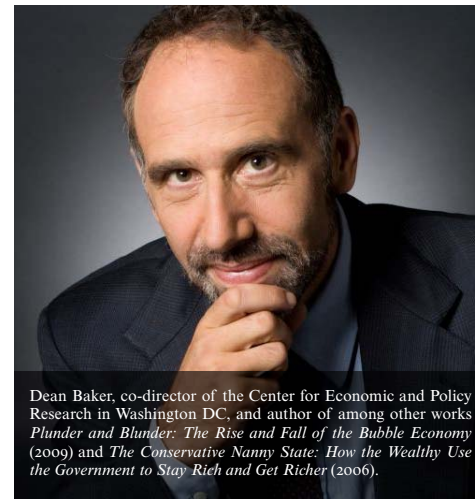
care, the arts, conservation and environment, research institutes, new technologies, and so forth: that's what we should be doing with our labour forces. Not making shoes.

The Chinese will do many things but they are not supermen, and their research institutes lag behind the West for the moment. Of course, the fact that the West has an advantage does not mean it will maintain it. If Western governments continue to starve their universities and their scientific and technical development, this will change. But the Europeans, in particular, who are obviously grossly neglecting higher education, as almost any visit to a European university these days will confirm – will have no one to blame for that but themselves.

It would be far more useful for Western commentators to focus on this problem – the gross neglect by the West of its own most promising sectors – than to keep prattling on about protecting “labour” from China, when in almost every case, the real interest behind protectionism of low-grade manufacturing is to protect the profitability of less-competitive firms in relatively backward sectors.

TRADE WILL DEVELOP ALONG DIFFERENT PATHS

We are not witnessing the end of free trade, says Dean Baker. But the USA will be a far less significant trade partner and the exporting countries will look to regional markets instead.



Dean Baker, co-director of the Center for Economic and Policy Research in Washington DC, and author of among other works *Plunder and Blunder: The Rise and Fall of the Bubble Economy* (2009) and *The Conservative Nanny State: How the Wealthy Use the Government to Stay Rich and Get Richer* (2006).

In *The Conservative Nanny State* you point to the fact that privileged strata in the USA have been able to use the state for their benefit. Has the present crisis confirmed this tendency?

The response to the current crisis is certainly consistent with my view of how the wealthy use the federal government. They managed to quickly arrange financial bailouts that saved several major financial firms from collapsing and allowed many of the executives who effectively bankrupted their firms to stay in control. There is genuine public interest in preventing a financial collapse and in that sense the bailout was helpful. However, it could have been designed in ways that did not reward the people who brought on the cri-

sis. As it is, there were few checks put in place to ensure that the bank executives did not profit hugely off the taxpayers.

Will this crisis lead to a long-term change of the role of the state also in the US, as regulator, as owner of nationalised companies? Are there certain sectors that would actually benefit from being run by state-owned companies?

We need some clear thinking on where we want the market and where we want the government. In many cases, the government will certainly be more efficient than the private sector. For example, in the case of social security and guaranteed student loans, the government can provide these services at a much lower cost than the private sector. On the other hand, it is likely that the private sector will generally be more innovative.

This creates a situation in which we may want the main actors in some sectors to be public as a way to keep down costs and raise efficiency. On the other hand, some things are best left to the private sector. For example, it would be good if Fannie Mae and Freddie Mac stayed as public corporations. They perform a very routinised task.

“I would say that the crisis has helped push more towards the idea that companies are genuinely global.”

When taxpayers’ money is used to bail out banks, it is hardly surprising that taxpayers want loyalty in return. However, a very popular idea recently has been that companies no longer have a homeland, a national identity. Their owners are often

international, and the components of any products are often made all over the world. Has the crisis shown that this idea is at least partially false?

I would say that the crisis has helped push more towards the idea that companies are genuinely global. This was most clearly seen in the case of the AIG bailout. The Treasury paid off tens of billions of dollars to foreign banks. The government had no legal obligation towards these banks. My guess is that it was done to maintain the credibility of US capital markets, however it shows that there cannot be a commonality of interest among banks across national boundaries.

There are many signs that protectionism is on the rise globally, often but not only in the form of subsidies. Recently for instance the government in China introduced a “Buy China” policy, partly perhaps as a response to US policy. Russia recently refrained from applying to join the WTO and declared its intention to create a regional bloc of former Soviet republics, convinced that the world economy with the waning of US power will reconstruct itself in large regional blocs. Are these temporary measures or are we actually beginning to see a kind of deglobalisation occurring?

These measures are ad hoc, but it is likely that we will see trade develop along a different path in the years ahead. The United States is likely to be a far less significant trade partner in the future in a large part because its imports are sure to fall, to eliminate the trade deficit. The countries losing export markets in the US are likely to look to regional markets to replace them. This hardly means the end of free trade. It just means that our trading partners will be looking towards other countries to be their markets.

You point out that highly qualified groups in the US are protected in many ways from global competition and you show what the benefits would be, to healthcare for instance, if this protectionism were abolished. Would it be possible to move in the other direction, and extend the protection to less qualified workers? Some thinkers in Europe – Emmanuel Todd and Jean-Luc Gréau in France for instance – argue for European protectionism to avoid the downward pressure on wages caused by global competition. Could such measures also be relevant for the USA?

“If we allowed anyone who wished to work here to enter the country then we would have even more downward pressure on the wages of tens of millions of workers.”

There is already some protection for less-educated workers. We don’t allow free immigration in the United States. If we allowed anyone who wished to work here to enter the country then we would have even more downward pressure on the wages of tens of millions of workers. But I don’t think it would be economically desirable, or politically realistic to open the door to all immigrants. So we have and will probably continue to have a somewhat protected labour market by virtue of restrictions on immigration.

In the USA, there will be limits to how much state policy can be explicitly redistributive. This is why it is likely to be easier to achieve gains in living standards for the bulk of the population by changing the rules so that the middle and bottom segments benefit from market outcomes, rather

than those at the top. I am not sure that we will see much policy pushing toward this end in the next couple of years.