

# LOOKINGGLASS

by Glasshouse Forum

NO. 2/2008

---

NEW REPORT ON INCOME DIFFERENTIALS IN THE WEST

**TOWARDS AN HOURGLASS SOCIETY?**

---

# THE FALL OF BABYLON LONDON

HOW THE FINANCIAL CRISIS HAS CHANGED OUR NOTION OF CAPITALISM

---

ESSAY

**GERMANY IS RUSSIA'S NATURAL ALLY**

INTERVIEW

**IS THE MIDDLE CLASS SLIDING AWAY FROM THE MIDDLE?**

# INTRODUCING LOOKINGGLASS AND GLASSHOUSE FORUM

---

Glasshouse Forum has the pleasure of presenting the second 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 longer 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 those themes on which Glasshouse Forum is running projects, but *LookingGlass* also has the opportunity of being explorative on questions of 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

Russia and China. The forum is politically independent and does not engage in lobbying activities, or make policy recommendations.

The following projects are running within Glasshouse Forum 2008/2009:

- 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 six titles. The first four were presented in *LookingGlass* No. 1/2008:

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

EDITOR OF LOOKINGGLASS:  
KAY GLANS

PUBLISHER OF LOOKINGGLASS  
AND HEAD OF GLASSHOUSE FORUM:  
JOHANNA LAURIN

GRAPHIC DESIGN:  
SANDRA PRAUN / DESIGNSTUDIO S

GLASSHOUSE FORUM  
BOX 1719  
SE-111 87 STOCKHOLM  
SWEDEN

[INFO@GLASSHOUSEFORUM.ORG](mailto:INFO@GLASSHOUSEFORUM.ORG)

VISIT US ON  
[WWW.GLASSHOUSEFORUM.ORG](http://WWW.GLASSHOUSEFORUM.ORG)

*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.

The latest publications are presented in this issue of *LookingGlass*:

*Towards an Hourglass Society? Income Differentials and the Fate of the Middle Class*, Kay Glans and Johanna Laurin (eds.), 2008, 144 pp. (see page 6):

*An Edited Transcript from a Round-Table Conference on Short-Termism*, Kay Glans and Johanna Laurin (eds.), 2008, 92 pp. (see page 16)

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

#### Upcoming Glasshouse Forum event:

China-West Intellectual Summit:  
China as a model for an alternative modernity?

As a follow up to the first round-table conference on authoritarian capitalism, Glasshouse Forum will bring together prominent intellectuals from the West and China for a “China-West Intellectual Summit” in Paris on 23–24 February 2009.

China is rising as an economic force with great

global weight. The assumption among many western observers that China will have to adopt a liberal democracy as it develops is not as convincing as it seemed earlier. Maybe China is developing an alternative to the Enlightenment Euro-American paradigm, finding a path to becoming an economic and political superpower without adopting a liberal democracy of the western model. If so, will it then become a model for other parts of the world as an alternative path to modernity? Will it have similarities with earlier western attempts at creating alternative modernities? Will it change the international political system and also influence the political climate within the West? Even if downright copying seems farfetched, we cannot rule out a more subtle inspiration emanating from a successful China, changing for instance the way the role of the state is perceived also in western societies? If Asian/Confucian traditions will be central to a Chinese model, will that also have an impact on the way the West looks at its own relation between tradition and modernity?

The China-West Intellectual Summit aims at exploring China’s search for a modernity of its own as an alternative to the logic of the Euro-American modernity and capitalism. It will discuss whether China is, or has the potential of becoming, a model for such an alternative modernity and which consequences might follow. How can different cultural and political value-system coexist on the global arena?

Participants are **Timothy Garton Ash**, Oxford University, **Daniel A. Bell** and **Zhiyuan Cui** of the Tsinghua University in Beijing, **Azar Gat**, Tel Aviv University, **G. John Ikenberry**, Princeton University, **Susan Shirk**, University of Cali-

fornia, **Vivienne Shue**, Oxford University, **Shaoguang Wang**, Chinese University of Hong Kong, **Feng Zhang**, The Foreign Policy Centre in London, and **Yongnian Zheng**, National University of Singapore. The summit will be moderated by **Gideon Rachman** of the *Financial Times*.

#### Glasshouse Forum in the media:

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*.

# TOWARDS AN HOUR-GLASS SOCIETY?

## A NEW GLASSHOUSE FORUM PUBLICATION ON INCOME DIFFERENTIALS AND THE FATE OF THE MIDDLE CLASS

**Towards an Hourglass Society?**  
Income Differentials and the Fate of the Middle Class  
Edited by Kay Glans & Johanna Laurin

Glasshouse Forum

### Table of content:

#### Preface

Kay Glans and Johanna Laurin

#### 1. Introduction: Towards a New Paradigm?

Kay Glans and Johanna Laurin

#### 2. Reflections on the Consequences of the Financial Crisis on Income Differentials and the Middle Class

Authors and Interviewees

#### 3. Is Globalisation Widening or Narrowing the Gaps?

A Progress Report from a Research Minefield

Lars Magnusson

#### 4. Globalization and American Income Polarization

Gary Burtless

#### 5. Income Distribution in Sweden Since 1990

Daniel Waldenström

#### 6. The Era of the Ever-Expanding German Middle Class has Come to an End

Interview with Stefan Hradil by Kay Glans

#### 7. The Changing French Model

While Top Incomes Skyrocket the Middle Class Fears a

Downward Social Slide

Interview with Camille Landais by Lisa Irenius

About the Authors and Interviewees

Contemporary capitalism – although at bay at the moment<sup>1</sup> – is unrivalled as regards the creation of material affluence. But this is apportioned increasingly unequally. The gap between rich and poor has widened in most developed countries<sup>2</sup> and much evidence points to the fact that, in the long term, things will get a lot worse for the middle class in the West, as the new phase of globalisation with “tradable skills” means that, to a completely different extent, the middle class competes with labour in Asia.

It is also noticeable that social mobility is diminishing. The class into which you were born more and more determines the course of your life. We have a new class society, partly structured along ethnic dividing lines. In the USA it is the blacks and Hispanics who dominate among the poor; in Europe immigrants dominate the alienated groups. At the same time demographic developments, with a rapidly ageing European population, demand that Europe succeeds in integrating more immigrants.

Who are the winners and who are the losers in this development? What will the consequences be of socio-economic stratification, and why does it arise? Is it the more or less inevitable consequence of the new phase in globalisation, or are there alternatives? Social gaps of this kind are not politically legitimate in a democratic age, and, if the differences become permanent, this will give rise to strong political reactions.<sup>3</sup> Historical experience shows that societies with large income differences are not politically stable.

Glasshouse Forum begins its project on the middle class in the Western world with the publication *Towards an Hourglass Society?* containing a re-

view of trends in income differentials between and within countries, and country-specific reports and interviews about the US, Germany, France and Sweden. Since the summer of 2008, when these texts were written, we have witnessed dramatic developments in the financial crisis. In order to put the researchers’ analyses into context we have asked them to reflect upon recent developments and the repercussions for the middle class. You will find their answers in chapter two of the book and on page 11 in this issue of *Looking Glass*. In the book’s introductory chapter we have attempted to investigate the relation between the expansion of the financial sector and income inequality and short-termism.

In chapter three, economic historian Lars Magnusson reviews the research into changes in income differentials between and within countries, establishing a basis for further discussion and country specific reports. He draws some tentative conclusions – nothing else is possible as research stands:

- The gap between the poorest and richest countries has increased since the 1980s. This is due

1) See *The Economist*, October 16, 2008.

2) See for example Lars Magnusson, “Is Globalisation Widening or Narrowing the Gaps? – A Progress Report from a Research Minefield”, in *Towards an Hourglass Society? Income Differentials and the Fate of the Middle Class*, Kay Glans and Johanna Laurin (eds.), Glasshouse Forum 2008, and *Growing Unequal?: Income Distribution and Poverty in OECD Countries*, OECD 2008.

3) See for instance the review of David Rothkopf’s book *Superclass – The Global Power Elite and the World They are Making*, in *LookingGlass* No. 1/2008,

[http://www.glasshouseforum.org/newsletter\\_1\\_bookreviews.html](http://www.glasshouseforum.org/newsletter_1_bookreviews.html)

above all to the slow growth in sub-Saharan Africa and Latin America. The number of impoverished people in the world however has diminished by 300 million in the last 30 years, mainly due to the progress in China and India. Regional patterns for income gaps are stable.

- There is no uniform trend in changes in income differentials within countries. In the USA and Great Britain, differentials are increasing significantly. In countries like Austria, Finland and Australia, there is an increase but not on the same scale, while in Germany, France, Canada and Sweden the gaps on the contrary decreased up to the year 2000.

- The downward pressure on lower incomes which many had predicted as a consequence of globalisation is as yet difficult to detect. Increased differences are not due to the lowest strata losing ground, but rather the upper stratum outrunning them. Above all in the USA and Great Britain, but also in other countries, the rich are getting richer. There is much to indicate that this trend will continue.

- In general, differences between individuals within a country are due more to domestic factors than to globalisation. National traditions regarding the welfare state and labour market organisation have not been eradicated. On the contrary, global competition may lead to a strengthening of welfare capitalism to overcome citizens' anxiety.

In the following chapters this overall picture is complemented by two more in-depth studies on the situation in the USA and Sweden and two interviews on the German and French trends in income differentials.

It is a central question whether the Western world is converging on the Anglo-Saxon model, so that other countries follow US trends in income differentials. In chapter four, "Globalization and American Income Polarization", Gary Burtless at the Brookings Institution in Washington DC, discusses the causes of the increasing gap between rich and poor that has been particularly striking in the USA. Until the beginning of the 1990s, the proportional income gap between Americans increased at the top and bottom of the income distribution. Then the inequality trends changed course. The trend toward lower earnings in the bottom ranks of the wage distribution came to an end in the mid-1990s. While the gap between high-income Americans and the middle class continued to grow, the gap between middle class Americans and those at the bottom narrowed. Wage gains at the very top far outpaced those of ordinary workers.

The trend during the 1980s can be partially explained by competition from low income countries affecting low skilled workers. The subsequent differences are more difficult to explain as a consequence of increased globalisation. The widening gap is due above all to top earners outdistancing the others: if it were due to increased economic integration, we would see the same trends in Japan and France, which as yet we do not see.

Salary income trends are just one factor behind the widening gaps. Changing family patterns are also of big significance. The number of Americans who live in married-couple families is diminishing, and the number of children growing up in single-mother families is increasing. In the upper income brackets, the position of families has been

strengthened because women work and earn well. At a guess, only half the increasing income differentials between households in the USA is due to salary trends.

Lars Magnusson holds in his research review that it is difficult to discern a uniform pattern in the trend in income differentials. In some ways, Sweden is a contrast to the USA, because it has such a strong tradition of equality and is one of the world's most dedicated welfare states. Has the national tradition of equality been affected by global market exposure? Are low income earners losing ground due to competition from the low income countries? Or has the middle class fallen behind the highest earners, as is happening in many other countries?

In chapter five, "Income Distribution in Sweden Since 1990", Daniel Waldenström, specialist on Sweden's income structure, looks at what has happened since the beginning of the 1990s. Developments in Sweden over this period were investigated as regards both labour income and disposable income, to differentiate between developments on the labour market and those due to political measures.

The vast majority in Sweden have enjoyed increases in real income, which sets Sweden apart from many countries. The increase has however been greater at the top than at the bottom, partly because unemployment has been higher in the latter stratum. Those who have been on the labour market have marginally lost out relative to the middle of the income distribution. Relations within the upper half of the income distribution have been relatively stable, in particular as regards dispersion of reported labour incomes.

If one takes return on capital into account, the picture is a different one. The upper stratum has experienced a large increase and has increased its lead. Some of this return can however be disguised salary. In this increased concentration of income to the top stratum, Sweden is following an international trend.

In addition to the reports from the US and Sweden, we have taken the pulse of the two of the great economies in Europe – Germany and France – through two interviews on the change in income differentials and the situation of the middle class.

In chapter six, "The Era of the Ever-Expanding German Middle Class has Come to an End", Stefan Hradil at the Johannes Gutenberg University in Mainz is interviewed by Kay Glans about Germany whose "co-ordinated capitalism" is often cited as an alternative to the Anglo-Saxon model. Here, primary income distribution (the income that people get from the labour market, assets etcetera) is becoming more unequal. Secondary income distribution (income after redistribution by the welfare state) is also becoming more unequal, but very moderately so. The reason behind the growing income inequality is not globalisation but technological development, which demands that people have more and more qualifications. Globalisation only accelerates this process.

The welfare state is able to moderate the growing income inequality, but this also has negative consequences, for instance in the lower strata. If you place emphasis on minimum wages and equalise in the lower income bracket, you risk a relatively high level of unemployment. In Germany 25 per

cent of low qualified people are unemployed and a new kind of lower class is emerging.

The German middle class was growing in the 1970s and even 1980s, especially among qualified personnel in the service sector. The integration of society was to a considerable extent enabled by this growing middle class. It bound society together. People could move upwards and they had the impression that it was a just society. But there has been a dramatic decline in the German income middle class, from 62 per cent of the population in 2000 to 54 per cent in 2006. Even in the core middle class of the information society – qualified professions in the service sector – one can detect stagnation since 2000. As the middle class is shrinking, the chances of upward mobility for the lower classes are diminished. Social mobility is blocked and disintegration becomes a real political danger.

Chapter seven, “The Changing French Model – While Top Incomes Skyrocket the Middle Class Fears a Downward Social Slide”, contains an interview by Lisa Irenius with Camille Landais, researcher at the Paris School of Economics. His research shows that top incomes have increased

substantially in France over the last eight years, whilst average and median incomes have only shown a slight increase. This indicates that the situation in France may come to resemble that in the Anglo-Saxon countries. In France there are social and fiscal restrictions. CEO salaries have, for example, incurred the same social security contributions as other salaries, which has prevented large salary increases. But these restrictions are now disappearing. CEOs will pay less tax and there is a greater knowledge of what top bosses in other countries earn, which is added in order to force up salaries.

The French middle class has not developed very much in recent times. In France salaries have been very stable over the past 20 years, apart from top salaries. Nor has there been any major change in redistribution of wealth. On the other hand, low-income earners have begun to catch up with the middle class, at the same time as one can see a major increase in top salaries. This may create a feeling of inequality.

Download the publication on [www.glasshouseforum.org](http://www.glasshouseforum.org)

## REFLECTIONS ON THE CONSEQUENCES OF THE FINANCIAL CRISIS ON INCOME DIFFERENTIALS AND THE MIDDLE CLASS

### Q&A WITH THE AUTHORS AND INTERVIEWEES

Since the summer of 2008, when the texts in *Towards an Hourglass Society?* were written, we have witnessed dramatic developments in the financial crisis. In order to put the researchers’ analyses into context we have asked them to reflect upon recent developments and the repercussions for the middle class.

**Have the recent dramatic developments in the financial crisis in any way affected your conclusions? If you were to write the report/give the interview about the trend in income gaps today, what, if anything, would you have written/replied differently?**

**Lars Magnusson:** As a matter of fact they haven’t. Mine is a more long-term analysis and there is every indication that it is essentially correct. This autumn, the OECD published an analysis that indicates increased income differentials in the way I described in the essay.

**Gary Burtless:** No. The goal of my essay was to examine the probable contribution of globalization to widening U.S. income polarization. The financial crisis does not affect any of the conclusions I draw nor does it shed new light on trends in U.S. or world income inequality.

**Daniel Waldenström:** My report is a representation of recent years’ trend in income distribution in Sweden and since there are no reliable data for the period following 2006, it would still be impossible to analyse the effects of the crisis. At the same time it is clear that the report in its forward-looking analysis should have mentioned that the financial crisis would probably moderate the trend in recent decades of a distinct growth in top income shares.

**Camille Landais:** It is undeniable that the recent economic downturn will in the short-run slow down the surge of top incomes, at least in the US, where the financial industry, which accounts for an important portion of the increase in top income shares according to Kaplan and Rauh, has been badly hit by the crisis. But it is difficult for the moment to say in what sense the overall picture of income inequality will be affected.

**Based on your research – or if you are permitted to speculate a little – and in the light of the financial crisis, is it possible to say anything about the future concerning developments among the lowest income groups, the middle groups and the top earners?**

**Lars Magnusson:** I don’t think the financial crisis

will affect these differences in the long term. One can however note that 1) the imminent downturn in the real economy will probably affect income distribution in that the gaps will widen when (the presumed!) unemployment rises. Perhaps one can also 2) speculate over whether the super-rich will become less rich due to the combined effect of the financial crisis and the downturn together with the political interventions that slash the most generous of the bonus programmes.

**Gary Burtless:** The financial crisis will cause income losses for people in all ranks of the U.S. income distribution; though many folks at the bottom of the distribution – who have neither labor earnings nor capital assets – will escape largely unscathed (people who live on government transfer payments don't have much to worry about). Low income workers are likely to experience big percentage losses in income, mainly because their work hours and employment rates will be hurt by the recession. Middle income workers will be hurt, but based on previous recessions their earnings losses will be smaller than those of low-wage, low-skill workers. That's because a smaller percentage of them will lose their jobs altogether. Workers with high wages will lose mainly because bonuses and other performance-linked pay will fall sharply (in fact, it has almost certainly fallen sharply already). The workers who do not face much risk of unemployment and who do not receive performance-linked pay are likely to see the smallest losses in real earnings.

Bear in mind that middle- and high-income households have already suffered massive losses in wealth as a result of the crisis. In inflation-adjusted dollars, stock market prices fell about

46 percent between October 31, 2007, and October 24, 2008, even taking account of reinvested dividends. This has probably wiped out USD 8 trillion in household wealth, most of it held by high-income families but some of it also held by middle-income families (mainly in their retirement accounts). The loss of housing wealth has also been massive, especially for families who had big mortgages (in relation to the value of their homes) in 2006 and early 2007. Many families with large mortgages now have negative net worth – their debts are larger than the value of their financial and nonfinancial assets, including their homes. It is very likely that the percentage drop in income (compared with incomes in 2006 and 2007) is bigger at the very top of the distribution than it has been for middle income households. See what happened to the incomes of Americans in the top 1% of the income distribution between 2000 and 2002 in Figure 1 of the essay I submitted to you [published in this volume, p. 87]. My guess is that the proportional loss in top-end income will be even more massive in 2008–2009.

**Daniel Waldenström:** So far it is difficult to overview the ultimate effects of the financial crisis on the financial sector and the real economy. Here are some plausible scenarios.

The rich will be affected most of all, and in negative ways. The dramatic depreciation of the finance markets hits their particular assets and income flows, which are mainly based on different forms of capital. In Sweden the richest tenth owns more than 90 per cent of all stock market shares, and if their value is halved, the income of the wealthiest will be slashed. In this way the financial crisis will lead to a levelling-out, albeit short-term, in both incomes and assets. One argu-

ment why top income shares will be restrained even in the long term is that belief in bonus systems for directors and other top earners has been shaken among both economists and the market players themselves. Many have even asserted that these bonus systems were the reason why the financial crisis has occurred. And if these systems are scaled down we can see a more tenuous link between economic growth and top incomes, which generally leads to a greater income distribution.

The middle class is probably the group least affected by the crisis. Their financial assets are protected by state deposit guarantees. In the short term the crisis reduces their pension assets and the present value of the pensions is today less than it was. For those whose retirement lies far ahead, however, this is not significant since we will probably see a recovery of these assets in the long term. For those who are pensioners today or soon will be, the downturn will be more noticeable. At the same time, this particular age group has benefited from decades of rising house prices, and many therefore can afford this setback.

Low-income earners are also protected by different welfare systems and neither will they notice much of the crisis, at least not in the short term. Nevertheless, the Nordic welfare model is under strain and perhaps there will be no return to the re-distribution levels of the past. If today's financial turbulence has long-term tangible effects, e.g. in the form of a persistent economic downturn that is perhaps exacerbated by a structural transformation in which the car industry practically disappears from Sweden in the same way as the shipyards thirty years ago, then unqualified low-income earners will suffer.

**Camille Landais:** In the short term, it is pretty certain that the economic downturn, implying rapid growth of unemployment rates and higher credit constraints, will affect low-income families. Concerning top incomes, it is much more difficult to say whether, apart from a short-term effect, the rising concentration of income will be stopped by the new economic environment. Our understanding of the forces at work behind the increase in top incomes is still too limited to predict the evolution of top incomes in the near future given the financial crisis. If we believe that rising inequality is just a superstar effect combined with some skill-biased technological change, then it is unlikely that the crisis will affect the trend of rising inequality in itself. On the contrary, if we think that institutional factors have played a major role (cf. for instance Levy and Temin's paper "Inequality and Institutions in 20th Century America"), then these factors may be reversed by the crisis.

**Will there be changes in the discussion on convergence towards Anglo-Saxon development (with increasing income gaps)? If so, in which direction?**

**Gary Burtless:** Absolutely. The lack of regulation and close supervision of industrial and financial activity, which is a hallmark of the recent Anglo-Saxon model, will appear much less attractive to policymakers, both inside and outside the Anglo-Saxon countries. Tough government regulation and closer government supervision of private businesses will seem like more attractive policies. In the U.S., I hope this is accompanied by better relative compensation for the public officials charged with regulation and supervision. The huge increase in earnings inequality was almost entirely concentrated in the American private

sector. This trend, combined with insane restrictions on the pay of top federal government officials, made it much less attractive for the best and brightest in the younger generation to accept careers in the civil service. Consequently, the private sector got smarter at evading government supervision and the top public sector civil servants were placed at disadvantage in their relations with private sector miscreants. To give you a random example: I have a young friend who did well in law school and clerked for one year with a U.S. district court judge. At the end of this very brief apprenticeship and at the age of 28, he went to work as an associate for a big, well-known New York law firm. His starting annual compensation, including expected bonus, is higher than that paid to the Chief Justice of the U.S. Supreme Court, who is the highest ranking judicial officer in the world's richest country. When first-year private attorneys are paid more than the most important judges, you know our country has a problem.

**Will “the return of the state” change developments in some way (e.g. more distribution policy, more protectionism which is expected to lead to protection of the vulnerable on the labour market)? Do you see signs of a new political climate?**

**Lars Magnusson:** I have for some time predicted a kind of increased state activism, more regulation and perhaps also more protectionism. Of course, the US elections are crucial to this. But I think that we are going to see more state presence in the economy for a while. The problem with volatile pension funds etc. has been with us for years and demands for increased stability (particularly with regard to return on pension capital) have been voiced in the USA for a few years.

**Gary Burtless:** I have long urged improvements in social protection of workers who lose their jobs as a result of globalization, technical change, or shifts in consumer tastes. I think the improvements should emphasize two main aspects of employment: Giving re-employed workers partial insurance to replace the earnings they lose when they must accept lower-paying jobs; and reforming the U.S. health insurance system to protect low-pay and unemployed workers against the loss of health benefits. I hope a new administration takes up these two issues. We'll see.

**Daniel Waldenström:** I don't think we will be seeing more protectionism or more far-reaching distribution policy in Sweden. However, in the national sphere we may see more market regulation and state control over people's everyday lives. This is not so much due to the financial crisis as the general trend even among right-wing politicians to see taxes as an instrument for control, the regulation of public utilities, etc. This development is especially noticeable at global level, where transnational coordination is becoming increasingly common when dealing with existing problems. The joint initiatives by national banks during the financial crisis are an example; another, the way in which tax havens have been constrained in a way that nobody thought possible a few years ago. Perhaps the most important explanation for this trend however is not the financial crisis, but the global threat to the environment that has prompted governments in different countries to act in unison. We will see more of that type of increased degree of state control, both at national and global level.

**Camille Landais:** If we take as an example the situation that followed the Great Depression in

the 1930s, it is truly likely that, as a reaction to what happened, taxation of top incomes will increase. In the 40s and 50s, top marginal tax rates were for instance raised to 90 per cent in the US! It therefore seems more than plausible that tax progressivity will increase in most countries in the years to come, which may undeniably affect the distribution of earnings.

**Do you think that the trend towards widening gaps will change with the new US administration? If so, in what way?**

**Gary Burtless:** If the downturn is deep and prolonged, there could be a change in both social policy and in the pay-setting norms of private companies. As a result of the Great Depression and World War II, the bargaining power of low- and middle-rank workers was greatly expanded, both as a result of worker solidarity and more generous public policy. In addition, the arrogance and irresponsibility of wealthy business owners and managers was curbed, partly as a result of strongly redistributive federal tax policy and partly as a result of new social norms inside the biggest U.S. businesses. This could happen again. We'll see.

# AN EDITED TRANSCRIPT FROM A ROUND-TABLE CONFERENCE ON SHORT-TERMISM

**A NEW GLASSHOUSE FORUM PUBLICATION  
ON THE QUESTION WHETHER DECISION MAKERS  
ARE NEGLECTING LONG TERM VALUE CREATION**

What proof is there that short-termism really exists? What drives the development? Can we see a convergence on an Anglo-Saxon model of shareholder value? What consequences does short-termism have for businesses, employees and society at large?

The general perception is that short-termism has gained ground and become increasingly dominant in the world of business as well as in society as a whole. But we need empirical evidence. Which is why Glasshouse Forum, within the framework of the project “Short-termism in the long run”, brought together a group of researchers from different disciplines and countries for a round-table discussion in Stockholm on June 16-17, 2008.

General conclusions from the discussion are:

1. The definition of short-termism is unclear; the concept needs to be defined more precisely. What is, for example, a short or long time horizon respectively?
2. The problems of measurement are many and in part major. It is, for example, difficult for an outsider to prove value destruction as a result of short-termism. But if one wishes to influence business one has to be able to quantify.
3. Short-termism is a multidimensional phenomenon created in an interaction between a large number of actors, for example owners, managers, the media, analysts, professional valuers and rating institutions. What the interaction between them looks like, however, remains to be studied.

A number of themes of significance for the spread of short-termism and its causes crystallised out:

1. The significance of the institutions in different eras and models of capitalism.
2. Cyclical changes.
3. Types of owners and change of ownership.
4. The rapid tempo of the media.
5. Paradigms, the dissemination of dominant ideas and herd behaviour.

Lennart Schön began with an economic-historical perspective relating short-termism to two important processes: globalisation and the ICT

revolution, which have both involved major changes as regards capital, labour and natural resources. An important similarity between the 19th and 20th century globalisation processes is that both saw industrial revolutions as tending to recur with a certain regularity, 80 or 90 years apart. One can distinguish two phases, an initial phase characterised by intensive technological and economic innovation, and a subsequent phase dominated by the formation of institutions. An industrial revolution sets off many processes of technological, economic and social change, but they take a long time to mature and the rapidity of today is somewhat illusory. We see cyclical change today with the credit crunch. Such a crisis on a global scale may turn trends into new directions, but the outcome of such a crisis is not

**An Edited Transcript from  
a Round-Table Conference  
on Short-Termism  
Edited by Kay Glans  
& Johanna Laurin**

Glasshouse Forum

automatic. Historical experience indicates that the tide may turn towards longer term perspectives within the next decade. But we need new institutions which provide greater security on the global market and reduce the uncertainty which causes a rise in the price of long-term investments leading to a shortening of time horizons.

Paul Windolf, who is also interested in the significance of the institutions, tested the hypothesis that explanations of short-termism are to be found in the deregulation and deinstitutionalisation in all markets (labour, financial, products) on a global level. Institutions create path dependency, which reduces uncertainty and makes it easier to forecast the future. When institutions are destroyed, the volatility of the markets increases, and one would assume that a rational reaction of the risk-averse investor is to prefer short-term investments. But a comparative study of the volatility of the Dow Jones Index, with its basis in the deregulated liberal American market economy, and DAX in the German coordinated economy, shows that this connection is weak. Xavier Ragot pointed out nevertheless that you can understand short-termism as the economic outcome of excessive volatility of financial markets according to the simple logic that, when the music is playing fast, you have to dance fast.

Paul Windolf instead pointed to another possible explanation: the type of owner and change of ownership. What we see today is a "financialisation", a gradual shift towards an increasing proportion of institutional owners, and a parallel increase in turnover rates; today it is only one year, that is to say an institutional owner retains his shares on average for a year before he sells them. The reason is that the market is segmented

and there can be considerable competition between owners for higher rates of return.

Lars Magnusson, who has studied the role of pension funds in short-termism, did not fully agree. There are different theories and views as to whether pension funds act in the short term, but a considerable proportion of the literature says that it is not necessary that these institutions should be more short-term than other investors. Without a long-term perspective they would ruin their owners. On the other hand strong incentive systems for managers might encourage short-term behaviour, just as may certain irrational and herd-like behaviours on the part of financial analysts and professional valuers. Shivaram Rajgopal presented a survey of American CFOs, aiming to provide credible evidence on whether short-term concerns cause value destruction. The survey showed that CFOs will give up some long-term value just to be able to meet an analyst consensus earning forecast. This is ultimately a career concern problem; CFOs are expected to stay in the job for only four years, and will therefore make decisions with a short-term focus.

But Lars Magnusson reminded us, the relationship between managers and owners is very complex, and a discussion that has been carried on over the last 15 years about returns for the owners, the decline of managerial capitalism and the rise of shareholder capitalism, is often oversimplified.

Xavier Ragot also emphasised different types of owner as an important explanation for why the time horizons are shifting, and introduced two dimensions of shareholder: time horizon and control. French capitalism is moving from passive shareholders towards more active ones. The ques-

tion one is now asking oneself is: Will this change in the strategy of shareholders continue after the financial crisis? It is clear that French capitalism is going to evolve towards a new model. But will it be a German, a US or a UK model?

Gregory Jackson underlined the fact that shareholders are not a heterogeneous group with the same motives and time horizons. Shareholder value is, therefore, a myth. For example, private equity, pension funds and hedge funds acquire completely different values when one measures the short-term versus long-term portfolio turnover of investors. What is more, a discussion on the consequences of short-termism for businesses, employees and society must take into account "varieties of capitalism", that there are different models of capitalism. A cluster analysis of the effects of different forms of ownership on the labour market and for employees produces two major clusters: the first includes all of the English-speaking countries with market-oriented capital markets and market-oriented employment systems. The second cluster is the rest of the world and that is heterogeneous.

The causes of short-termism may also exist in the dominant ideas created in the interplay between the media, PR consultants, analysts and businesses. The greater tempo in journalism helps create and reinforce short-term economic behaviour (Maria Grafström). Media reporting of quarterly reports is an institutionalised production of news, providing little scope for new angles of approach and contextual or long-term perspectives. The analysts are producers of a message which is in tune with, or beyond, expectations, and is being produced extremely fast (Jaan Grünberg). Public debate helps create and diffuse

ideas, but it also spreads information about the strategies adopted by other actors, which also influences the willingness to conform and to follow what others are doing. Geny Piotti's research shows, for example, that public debate encourages off-shoring by emphasizing short-term arguments (e.g. cutting costs).

#### The following people participated in the discussion:

**Rachel Briggs**, Moderator, Director of the charity Hostage UK, freelance researcher and writer and Member of the Glasshouse Forum Advisory Board, UK. **Kay Glans**, Editorial Coordinator of Glasshouse Forum, Sweden. **Maria Grafström**, Dr., Department of Business Studies, Uppsala University, and analyst at the media intelligence company Cision, Sweden. **Jaan Grünberg**, Dr., Department of Business Studies, Uppsala University, Sweden. **Gregory Jackson**, Professor of Business and Society, School of Management, University of Bath, UK. **Johanna Laurin**, Head of Glasshouse Forum, Sweden. **Lars Magnusson**, Professor in Economic History, Vice-Rector of Uppsala University, Sweden. **Geny Piotti**, Dr., Researcher at the Max-Planck-Institut für Gesellschaftsforschung, Germany. **Xavier Ragot**, Associate Professor, Paris School of Economics, France. **Shivaram Rajgopal**, Professor in Accounting, Michael G. Foster School of Business, University of Washington, Seattle, USA. **Daniel Sachs**, CEO of Proventus and Chairman of the Concerned Capitalists Foundation, Sweden. **Lennart Schön**, Professor of Economic History, Lund University, Sweden. **Paul Windolf**, Professor in Sociology, University of Trier, Department of Social Sciences, Germany.

# THE FALL OF BABYLON LONDON

The large financial sectors in the USA and Great Britain have been hit hard by the financial crisis. *LookingGlass* asks why these financial sectors grew so big in the first place, and whether their expansion might have contributed to widening income gaps and short-termism. This crisis also marks the end of the deregulation era and the beginning of a new political paradigm.

*The broad wall of Babylon  
Shall be levelled to the ground,  
And her high gates  
Shall be burned with fire.  
The peoples labour for nothing,  
And the nations weary themselves only for fire*

Jeremiah 51:58

The atmosphere has changed in the European capital of finance, London, in connection with the financial crisis. The *Financial Times* notes

that exuberance has given way to a new austerity (18/11 2008). The old indebtedness culture, which means servicing one's old debts by taking new ones, is said to be dead. The spirit of the age is more frugal and restrained with regard to conspicuous consumption. Those who still have money refrain from provoking them who have just lost theirs. Even shoplifting is showing signs of the new austerity. The British supermarket chain Tesco reports a 36 per cent increase in shoplifting. People are not stealing luxury items but to meet more mundane, practical needs.

The financial crisis is hitting London hard. According to the Centre for Economics and Business Research, the financial sector in Great Britain will shrink from a peak of 353,000 employees last year to 291,000 by 2009. The same source estimates that bonus payments will fall from 8 billion GBP in 2006 to 2.6 in 2009.

So it is not just a rumour that Babylondon, the financial capital that dwarfed the real economy, has fallen. The expansion of the financial sector in recent decades has been concentrated above all to the USA and Great Britain, that is, the metropoli of New York and London. In the USA, financial services in 2004–6 constituted 20–21 per cent of GDP, while manufacturing represented 12–13 per cent. In the USA and Great Britain, the financial sector accounted for 35 per cent of corporate profits in 2005 (see *Financial Times* 15/11 2008). British manufacturing today provides 13 per cent of the GDP.<sup>1</sup>

Quite recently the City appeared to be the right place to be at. Today it is of no use to be skilled at handling the mathematical formulae of financial innovations: another type of calculation is on the way. Now we will be hearing all the questions surrounding the expansion of the finance sector that should really have come before the crisis, and which in some cases did, although with limited impact.

The American writer Kevin Phillips, a fervent and persistent critic of contemporary Anglo-Saxon capitalism, claims in his new book *Bad Money – Reckless Finance, Failed Politics, and the Global Crisis of American Capitalism* (2008) that one sign marking the start of a nation's decline is when people become too absorbed with

moving money around instead of manufacturing and moving products. There are many examples throughout history of countries that have lost control of their financial sector and gradually lost their position. Significantly, this phase often follows an extended period of affluence. Phillips mentions Spain under the Habsburgs, Holland in its imperial phase, and the British Empire. There is a heavy foreboding in the air due to fears that that the present crisis marks a turning point – the American century has ended and from now on the economic and political influence of the USA will gradually diminish.

Financial crises are much more frequent than most people would think. Based on more complete data than research has previously had, Carmen M. Reinhart and Kenneth S. Rogoff have shown that financial crises have been a constant feature in the international economy over the past eight centuries. Waves of increased mobility of capital are often followed by a series of national bank crises. The crises have often emanated from the financial centre and in that respect the American subprime crisis of 2007–2008 is not at all unique.<sup>2</sup>

Nor is criticism of the financial sector a new phenomenon, and it can easily take on a demagogic quality. To set actual manufacturing against abstract financial activities is a rhetorically suggestive method. To differentiate between

1) See "The return of manufacturing in Britain", *Prospect magazine supplement* October 2008.

2) See Carmen M. Reinhart, Kenneth S. Rogoff, "This time it is different: A panoramic view of eight centuries of financial crises", *NBER Working Paper* No. 13882, 2008.

manufacturing (German) and financial activities (Jewish) was prerequisite to the combination of pro- and anti-capitalism in modern anti-Semitism. One finds this polarity fully developed as early as in the German economist Werner Sombart's *Die Juden und das Wirtschaftsleben* ("The Jews and Economic Life") (1911). Naturally, this historical background does not preclude criticism of the financial sector, but one should be aware that there are powerful magnetic forces under the surface which easily take hold of arguments and order them to their own patterns.

The financial sector has been a golden calf, above all to the USA and Great Britain, and to certain strata. (However, many must help pay the piper.) Nevertheless, as pointed out by George Soros among others, it is not in fact clear why the financial sector has become so big or for whose sake. There is also reason to wonder whether several of the problematic tendencies in contemporary capitalism that Glasshouse Forum wishes to spotlight in its project "Globalisation and the middle class in the West" and "Short-termism in the long run" are linked to financial sector expansion and influence on the economy and society.

For example, to what extent is the unequal distribution of prosperity a consequence of the development of the financial sector? Glasshouse Forum's investigation of the growth of income differentials in the Western world shows that differentials have grown most dramatically in countries like USA and Great Britain, which also have the largest financial sectors. It is striking also that the uppermost stratum in income distribution is accelerating ahead of other groups. Is it a coincidence, or are the generous salaries in the financial sector a significant factor in this context?

Steven N. Kaplan and Joshua Rauh at the University of Chicago in their paper "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes" have tried to estimate the contribution of the financial sector (Wall Street) to the increasing income differentials in the USA. Their focus is on the topmost level in operations and income distribution. They then compare this with developments in Main Street (non-financial top executives). By Wall Street they mean the investment banks, hedge funds, venture capital, private equity fund and mutual funds investors. There is considerable uncertainty in the estimates since many financial players are not required to disclose the number and size of individual payments, but the authors are certain that their estimates are on the low side.

This sector has grown dramatically in recent times and so has remuneration to those operating there. The top 25 individual hedge fund managers in the U.S. earned a combined total of 5.2 billion USD, 6.3 billion USD and over 9 billion USD respectively in 2003, 2004 and 2005. Kaplan and Rauh find twice as many players from Wall Street as players from Main Street in the top 0.5% and the top 0.1% of the AGI (adjusted gross income) distribution. They also find that Wall Street constitutes a greater proportion of the top 0.01% than Main Street, an equally large proportion of 0.001% and a substantially larger proportion of 0.0001%. Many of the richest citizens of what the journalist Robert Frank calls Richistan receive their incomes from the financial sector.<sup>3</sup>

Will the trend towards greater inequality be moderated by the financial crisis? The kind of impact you expect depends, as Camille Landais points out in his commentary on page 13, on how you see

the origin of the differentials. The American economist Frank Levy of MIT is among those who consider that changes in social norms play a vital role. In an essay written together with Peter Temin, he points out that if an American business leader in the 1960s had received remuneration of the kind which is commonplace today, it would have been an issue for the then President. It was quite simply not accepted under the social norms of the time.<sup>4</sup> Glasshouse Forum asked Frank Levy whether the wheel has turned a complete revolution now. Politicians are criticising the generous remunerations in business, and companies have begun to block bonuses for the year 2008, for example the Swiss bank UBS. Seven leading Goldman Sachs executives plan to waive their bonuses. Perhaps this will set a trend. Perhaps a social norm is being re-created, that will put a check on this type of remuneration.

"The economics writer Robert J. Samuelson made an interesting comment on that paper and the point you quote", says Frank Levy. "He said that in this country, businessmen had come out of the Great Depression with a generally bad reputation and this was reinforced by World War II when there was some spirit of overall sacrifice (and occasional congressional hearings on war profiteering). So it would have looked very bad for CEOs to start taking huge salaries, even if they had the economic power to do so, and it would have been very popular for politicians to attack such power."

"This attitude changed in the 1980s – i.e. nothing wrong with being very wealthy – and as long as totally unregulated markets appeared to be bringing general prosperity that was likely to stay. But now that the activities that generated extremely

high financial incomes seem to have brought the economy to the edge of disaster, that attitude may well swing again."

---

**"You will see a more regulated and, therefore, a smaller financial sector with somewhat more modest salaries."**

**Frank Levy**

---

"My guess is that in the last decade in particular, high incomes depended in part on the lack of regulation of certain kinds of financial instruments which allowed firms to take on enormous leverage – i.e. huge amounts of borrowing given their capital base – and it was the extent of the borrowing that generated much of the high incomes. Now that that has blown up, I think going forward that you will see a more regulated and, therefore, a smaller financial sector with somewhat more modest salaries. This won't affect the broad based inequality between, say, high school and college graduates – that was much more a supply/demand phenomena – but it will reduce some of the extreme upper tail inequality."

It appears probable that a downsizing of the financial sector in combination with stronger social norms will moderate the tendency for the uppermost stratum to outdistance others as regards income, something seen not only in the USA and Great Britain but also for example in

---

3) Robert Frank, *Richistan. A Journey Through the American Wealth Boom and the Lives of the New Rich*, 2007.

4) "Inequality and Institutions in 20th Century America", *NBER Working Paper* No. W13106 2007.

France and Germany, although in a less marked form.

Why then has the financial sector grown so dramatically? The so called efficient market hypothesis has no problem with this. Growth is quite simply a consequence of efficiency. According to this hypothesis the collapse that has now occurred cannot in fact occur, since market mechanisms quickly create a new equilibrium. This view has lost much of its credibility now that the financial sector has destabilised itself with dire consequences to the real economy. Nor is it particularly convincing as an explanation for the expansion of the financial sector.

A completely different approach to the financial sector is put forward by the British economist Paul Woolley of the London School of Economics. He has a background both as an assets manager and IMF economist. Woolley's formative professional years were during the IT bubble, when his company lost customers because it did not follow the trend, but insisted on a more sober and traditional valuation. (They later returned.) One of his initiatives was to start, and fund, The Paul Woolley Centre for the Study of Capital Market Dysfunctionality, which has quite recently issued a report that has caused quite a stir: "An Institutional Theory of Momentum and Reversal", written by Woolley and Dimitri Vayanos.

Irrational motives are often invoked in order to understand the bubbles and the almost inexplicable vagaries of the stock markets, both in the form of shares rising far more than is justified and suddenly falling in them for reasons equally difficult to explain. For example, Robert J. Shiller in his new book *The Subprime Solution. How*

*Today's Global Financial Crisis Happened, and What to Do about It* (2008) speaks of contagion, in a social sense, a concept that is reminiscent of the classical sociologists. Woolley is critical to this tendency and considers it a scientific dead-end. These phenomena are not due to irrationality among the players, but are the result of the interaction between the investors and those who manage their money.

"You don't have to blame irrational exuberance for bubbles", says Paul Woolley to Glasshouse Forum. "You can actually get bubbles in a perfectly rational framework because of the agency problem and momentum and short-termism that go along with it. My co-author and I explain bubbles and collapses and reversal in a formal, rational expectation framework. It seems to me if economics is going to be treated as a science, it needs as far as possible to explain things in rational terms."<sup>5</sup>

It is above all the money managers' role that Woolley deems of crucial importance to the growth and actions of the financial sector. Through their preponderance of information – reinforced of course by financial innovations, they can to great extent dictate the conditions for the traffic. Since these managers of other people's money earn on each transaction they benefit from an increase in the turnover rate. In 1965 the annual turnover of British equities was worth 10 per cent of the nominal GDP, and in 2007 almost 300 per cent (*Financial Times*, 15/11 2008). Woolley illustrates the fact with the following example: we have the manager of an actively managed pension fund with a 100 per cent turnover of holdings per year. Over a 25 year period, he will exchange the same equities with other managers for no collec-

tive gain. The end value of the fund falls by 25 per cent. But the manager himself earns by it. It is a kind of taxation to which the managers expose the savers.<sup>6</sup>

The actual prerequisite for this is that there is asymmetry of information in the relations between the banker, fund manager, broker etc; and the end investors. These players have an enormous preponderance of knowledge over the end investors and use this to benefit their own prosperity. This preponderance has been reinforced by financial innovations which are beyond the comprehension of a good many players.

---

**"I regard the size of the financial sector as a function of the inefficiency of markets. If markets were efficient, as the academics have preached for many decades, the financial sector wouldn't have grown to such a ridiculous size."**  
Paul Woolley

---

"I regard the size of the financial sector as a function of the inefficiency of markets. If markets were efficient, as the academics have preached for many decades, the financial sector wouldn't have grown to such a ridiculous size. It's only grown to account for about 35, 40 per cent of corporate profits in the UK, the US and some other countries, because it is fundamentally inefficient. Inefficient is too weak a word. Inefficient suggests mispricings of a minor degree or of a systematic degree, but in fact what we have is a propensity for dysfunctionality, sometimes on a gross scale", says Woolley.

"Practitioners have enjoyed the situation and have exploited the agency problem to the full with the endorsement of the academic community, and indeed with the encouragement of governments who see the finance sector as a source of tax and employment and foreign exchange."

"But it's like a tumour and nobody has really realized that. I find it totally extraordinary that the only academic papers that have looked at the size of the financial sector have done so with regard to developing countries and they said that it helps to provide growth. If something is efficient, you don't expect it to be ballooning like that. It's a tax on the productive sector of 40 per cent."

Woolley considers also that the financial sector has had major significance in the spread of short-termism. It is in the interests of the financial players to increase the tempo, since they earn on each transaction.

"One of the most serious aspects of the financial sector is the short-termism or momentum effect in stock markets. The trouble we're in now internationally derives from the technology bubble in the stock markets in 1999–2000, and then the policy response of the central banks to keep interest rates too low too long which stoked the real estate and debt bubble, which is now collapsing. Low rates promoted not only the bubble but also the

---

<sup>5</sup> Editors' note: Agency problem is a conflict of interest arising between the creditors, shareholders and management because of different goals, for example when managers and stockholders have conflicting ideas of how the company should be run.

<sup>6</sup> See also Jonathan Ford, "A greedy giant out of control", *Prospect*, November 2008.

carry trade and the hedge funds with high leverage. What we've seen now is simply the unwinding of that. The origins of the crisis lay in the short-term momentum-driven investment strategies adopted in the tech bubble and then pursued again in response to the low interest rates that prevailed in the early 2000s."

"You only have to look at the level of turnover in equity markets to realize how short-termist we've become around the world in our investment strategies. For an equity portfolio you typically have 100 per cent turnover per annum, which means the holding period is a year. And the hedge funds have even shorter holding periods on average."

Even if the financial sector is temporarily under pressure and will probably shrink, one of its basic preconditions is still in place and will perhaps lead to new bubbles in the future. The stratum of managers has of course been dependent on the capital that has been made available from pension funds, insurance companies and similar, and which is in search of returns. This will not decrease in the future. Simply consider what Asian pension savings can lead to when its population, such as in China, quickly begins to age. So the task for the future is to develop strategies so that the capital managed by institutes will not be exploited in the same way.

"That's obviously the key question," says Woolley to Glasshouse Forum, "and unfortunately all people are doing now is trying to patch up the system. The great danger is that lowering interest rates to zero will just set the stage for the next great bubble without actually addressing the fundamental problem."

"There are fundamental problems in the way that the finance sector works. Adam Smith's dictum that 'everybody pursuing their own self-interest leads to the highest utility for all' doesn't work in finance. The agency problem gives rise to mispricing which misallocates capital and can have huge macroeconomic implications. The other problem is that it also captures increasing chunks of the return from productive investment. That's what we've seen over the last 20 years. Now the profits are down, but look at the damage that's being done and the costs to society. We're just paying for the finance sector by a different route now, instead of their profits."

"And frankly, the finance sector actually benefits from volatility of the system. They won't see it as them benefiting now, but there will be huge gains made when they rebuild the private sector entities over the next 10 years. They've benefited not only from the volatility of prices of stocks and bonds. They will benefit from the volatility of the infrastructure itself. An efficient, smooth-functioning, stable market is death on wheels to them."

"I think the absolutely prime thing is to understand that finance doesn't work like everything else. The agency problem creates these two major problems of mispricing and capture of the rents. It's handled in the contracts between pension funds and their managers, their agents. It's handled by getting a focus on medium- and long-term investment. It can be resolved by trying to reduce moral hazards among agents by extending the period over which performance is measured, and thus bonuses and performance fees and so on."

"Principals and end investors and trustees must change the way they act. There's nothing wrong

with active management, it's just that the fee structure is ridiculous. The argument is that it's irrational exuberance and we are just paying the price for that and that all you need are a few more instruments to hedge risk – in that way, you're just pandering to the finance sector and making it even bigger. The scale of the derivatives markets was simply a function of the fundamental inefficiency of the underlying equity markets."

---

**"We should focus on the old fashioned idea of investing for dividends and investing for the medium and long term."**  
Paul Woolley

---

"Jane Austen, when she described somebody's wealth, she very rightly described the eligibility of a bachelor in terms of his annual income, not his mark-to-market value. And we should focus on the old fashioned idea of investing for dividends and investing for the medium and long term."

It is perhaps time now to rejoin Jeremiah and the sermons of retribution about Babylon and the triumph at its fall. There are overtones of such Old Testament indignation in the debate about Babylondon. It is difficult to resist temptation. One stratum has, with the help of other people's money, known as financial innovations, and the goodwill/compliance of politicians, succeeded in favouring itself by taking risks which in many ways are handed over to the man on the street, both through taxes and through the downturn which is now due to hit not only Wall Street but also Main Street.

The opinion of David Goodhart, for example, in *Prospect*, is that there may be such a thing as

a good recession, which allows us to see things more clearly.<sup>7</sup> It would among other things encompass a reduction in income differentials, renewed interest in major political issues and the political institutions, and strengthened focus on the middle stratum instead of as now the upper and lower strata. This middle Britain has nothing at all against seeing the kings of finance humiliated a little, Goodhart thinks.

It is too early to declare winners and losers, because we do not know how deep the crisis will be. It may well be as Jeremiah says:

*The peoples labour for nothing,  
And the nations weary themselves only for fire*

Intellectually and politically it is somewhat easier to identify winners and losers.

That which we usually call Washington Consensus has used up its credibility, now that the market has destabilised itself in this fundamental way. The idea that the solution to the problem was deregulation and rolling back the state has been a dominant idea for almost exactly 30 years, the space of time that in the past was called a generation. As pointed out by José Ortega y Gasset among others, history often turns out to have a rhythm created by this type of generation hand-over. Completely new climates appear with these intervals; that which was – if not impossible to imagine, then at least difficult to gain support for – suddenly becomes something worth discussing. That which was the rearguard suddenly becomes the vanguard. George Soros asserts that a market

---

<sup>7</sup>) *Prospect*, November 2008.

ideology that rejected regulation has been a basic cause of a super-bubble built up over decades. Now the state must act to regulate the market tendency toward instability.

It is no coincidence that at this time people are remembering a maverick among economists, Hyman Minsky, whose theory of the instability of the financial market has become the object of renewed interest.<sup>8</sup> Minsky held that the capitalistic economy is inherently unstable and that disequilibrium and unemployment are so to speak a normal condition. Its own driving forces sooner or later create a transition from robustness to fragility and if the state does not intervene, a boom-bust cycle arises, to which the banks contribute by meeting credit needs in an increasingly aggressive way. The unsustainable boom, which is characterised by speculative financial action, is corrected by the creative destruction of the depression.

Creative destruction is one of the things that are much more fun to talk about than to live through. The costs for society generally become far too great and it is therefore important for the state to intervene with Keynesian measures. In that sense Minsky was a follower of Keynes. But he went a step further and formulated what Gary Dimski and Robert Pollin have called “the Minsky Paradox”. Interventions maintain an existing fragile financial structure which would otherwise have been corrected through a depression. When borrowers and lenders realise that there is a safety net, their inclination to take risks and debts increases. This means that attempts to combat economic depressions will be less effective over time, according to Minsky. It is such a paradox we are living in right now: the financial markets have

shown themselves to be intrinsically unstable and state intervention ultimately risks underpinning the behaviour it aims to deal with. It would not seem a reasonable political solution for the state to intervene in order then to give back the reins to the market forces. The state will remain present, for a generation or two, however long a paradigm lasts.

Another cornerstone in the philosophy of neo-classical economics is the notion of the rational actions of homo economicus. Its reasoning assumes that the individual makes rational decisions after having systematically absorbed information. All one needs to do is create a maximum of individual freedom of choice, and rationality will dominate. This perception is undermined from various angles. Robert J. Shiller shows in *The Subprime Solution* the ways in which contagion disabled rational thinking during the housing bubble. All the explanations of why house prices should continue to rise lack foundation. There is nothing to support the fact that raw materials – or land – should become scarcer. One problem is that we do not measure inflation correctly and therefore we do not understand the extent to which property price rises are an illusion. The action programme which Shiller above all recommends is democratisation of financial advice, so that people in general understand what they are investing in. Additionally, there are indications that in recent years there has been a particular focus on for example the elderly to get them to make fateful decisions.

From elsewhere too, well planned death blows are dealt to the notion of the rationality of market players. Richard Thaler and Cass Sunstein summarise a good portion of behavioural science

research in their book *Nudge* (2008) which quintessentially holds that we as individuals are very bad at choosing, and need constant support from what they call choice architectures. The neo-classical economy’s conception of homo economicus, who makes decisions with icy rationality, is completely unrealistic. The creature of flesh and blood that actually exists acts in a far less rational way. There is no need for a guardian of the old-fashioned sort, but rather a companion to encourage this creature through friendly nudges in the right direction. Glasshouse Forum asked Cass Sunstein whether right now we are going through a paradigm shift. What is known as the Washington Consensus, which was essentially a question of deregulating and letting market forces have their way, and was based on the conception of the rational human is being replaced by – what?

“Decades of work have shown that people are not fully rational”, says Sunstein. “We are biased in our assessment; for example, many people are unrealistically optimistic. We use mental shortcuts, or heuristics, that create serious problems. For example, recent events have a big effect on us. If a disaster has occurred in the recent past, we think it will recur, even if statistics suggest that it won’t.

“A new paradigm is indeed emerging. It includes ‘libertarian paternalism’ – an approach that respects freedom of choice but that is likely to move people in directions that will improve their welfare. We should expect to see a lot of libertarian paternalism – or ‘nudges’ – in the future.”

Indebtedness has not only characterised the financial elites of the state. Generally speaking,

we live in a debt culture that encompasses more or less every class. Sociologist Daniel Bell stated in his classic work *The Cultural Contradictions of Capitalism* (1976) that the credit card was a far greater change than we realised and that the mentality it brings will in time undermine capitalism. It encourages infantile behaviour which basically feels that immediate gratification is a little too slow. But the background is that American real incomes have stagnated and that households are increasingly compensating for this by becoming indebted and by using their homes as a kind of cash dispenser to finance consumerism. There is much talk of the US national debt, but it is quite small compared to private debt. The indebtedness of American households has increased from 680 billion USD in 1974 to 12, 873 billion in 2006.<sup>9</sup>

Cass Sunstein says that both state and companies must make commitments to prevent people falling victim to temptation. Glasshouse Forum objects that when it comes to companies it would be rather like asking a wolf to watch sheep, since it is in the nature of the market to tempt and arouse needs.

“A good question. But some companies do try to counteract temptation; consider green products (trying to get you to consider the long term) and those who sell especially healthy foods (trying to get you to think about your future). Markets often tempt, but some companies try to work against temptation, and they sometimes do really well.

8) Hyman P. Minsky, “The Financial Instability Hypothesis”, 1992.

9) See US Federal Reserve’s Flow of Funds Accounts of the United States, “Debt Outstanding by Sector”, September 17, 2007.

For financial services, companies might well start to say: Consider the long-term risks!

---

**“We need to have a new set of social norms, so that people start planning for their future, and realize that the long-term is crucial.”**

**Cass Sunstein**

---

“We need to have a new set of social norms, so that people start planning for their future, and realize that the long-term is crucial. It’s not too late to stop borrowing and to start paying off your debts, if you possibly can.”

The American economic miracle, the long economic boom, has been largely fuelled by over-consumption, a consumption bubble. The USA has lived beyond its resources and in that capacity has kept the world economy going, supported by China. These two great powers have been in symbiosis: one under-consuming, and the other over-consuming. Such constellations do not usually last. As a Western company leader recently said when visiting China: “When a country gets into such large debt, it is very likely to lose a lot of its political power also” (*Financial Times*, 21/11 2008). It may be the case that the financial crises will be the catalyst for the relocation of the power centre to Asia as many predict, even though China seems hesitant. It is quite clear that the economic policy requires basic reforms so that domestic Chinese demand takes off. If that is successful, then the shift in the centre of gravity will accelerate dramatically.

What will happen with the openness of the world and with globalisation if such a transfer of influ-

ence becomes marked? So far it has been possible to sell globalisation to the broad masses in the West with the argument that everyone benefits in the long run. It is more difficult to do so today, and perhaps the loss of manufacturing jobs will be seen in a new light as the financial sector shrinks.

A sceptical attitude towards globalisation is not necessarily based on narrow-mindedness. It also applies that equality and social responsibility are not always completely compatible with mobility. It is difficult to make demands on capital when it always has the option of moving elsewhere. It can even be difficult for business leaders themselves to take a social responsibility if they have that option. The German sociologist Wolfgang Streeck illustrated this by invoking the famous reasoning by Karl Marx in *Das Kapital* regarding child labour in England. The individual capitalist could be well aware that child labour in the long run could damage both society and him, since the workforce does not procreate sufficiently. Nevertheless it could be difficult for him to refrain from it, since it would make him less competitive. Therefore he could welcome an intervention by the state with regulations making the conditions the same for everyone.

This has parallels to this day, according to Streeck. A capitalist should realise that he is dependent on positive demographic development and that there is therefore a need to organise working life so that giving birth to children is encouraged. In the same way, he should further the interests of capitalists that people should not burn out by the age of 35, but manage to work until their seventies to reduce the consequences of an ageing society. To an individual capitalist, it is

perhaps not possible to bear the possible costs for this if it impairs competitiveness, so that in principle a societal intervention should be welcome. But today’s mobility makes such an intervention more difficult, since the companies can lay claim to the population of another company by relocating, in particular to Asia.<sup>10</sup>

There are parallels to what happened during the last wave of globalisation, the one preceding 1914. Then, as Jeffry Frieden has shown in *Global Capitalism* (2006), the world was in many ways more globalised than today. National governments gave higher priority to their credibility with international players than listening to the demands of their own populace. This was possible among other things because the majority of the population had limited influence. But the wave of globalisation gave way to a back-slide with strivings for autarchy in many cases. Naturally, this must be seen in the light of the First World War, but also of the crises that followed in the 1920s and 1930s. The populations saw globalisation as a threat, as a source of insecurity. Acceptance of globalisation has always been dependent on its ability to create and spread prosperity, writes Frieden.

It is not difficult to find examples of recent reactions to globalisation. Listed Japanese companies began to protect themselves against takeovers last year through poison pills. The French President Sarkozy has argued for a European sovereign wealth fund which could buy up important European companies in the event of a recession – in other words so that they do not end up in foreign hands. European companies that previously turned to China have to a greater extent begun to locate production to Eastern Europe, which is

known as near-shoring. It is also possible that the multipolar world that is taking shape in the political sense will form a catalyst for the erection of barriers between different blocs. Glasshouse Forum asked Jeffry Frieden how he thinks the current crisis will affect people’s attitude towards globalisation.

“Over the course of the 1980s and 1990s, there was a strong tendency for governments to reduce their direct involvement in the economy”, says Frieden. “Much of this trend was undoubtedly justified, as there were many countries and many markets in which government involvement was counter-productive. However, it is almost certainly the case that this trend went too far – especially in financial markets.”

“The current crisis will almost certainly lead to a swing of the pendulum in the other direction, toward more government regulation of markets. I think there are likely to be two dimensions of this new focus. First, national governments will attempt to monitor the activities of their financial institutions more closely, and will probably try to limit some of the more exotic financial instruments. This can be justified because some of these exotic instruments reduce the transparency of financial operations to borrowers, lenders, and other investors.”

“Second, national governments – especially of the principal financial centers – will try to work together to develop collaborative approaches to regulating international financial transactions.

---

<sup>10</sup> Wolfgang Streeck: “Industrial Relations Today: Reining in Flexibility”, *MPIfG Working Paper* 08/03.

We have long understood that well-functioning financial markets require some forms of government involvement in order to operate smoothly: regulation, oversight, lender of last resort facilities. It is now clearer than ever that we have global financial markets, and this means that some form of global financial regulation is desirable. We are unlikely to see a global financial regulator emerge very soon – we still live in a world of nation states – but there is a broad and deep desire for international cooperation to provide a higher level of global financial oversight.”

“The current crisis will almost certainly give rise to demands for assistance from those hardest hit by the economic downturn. And this is fully justified. Up to now, many governments have focused their attention on those who have benefited from globalization – helping the winners. Most governments have paid too little attention to providing a social safety net for those who do not benefit, and may indeed be harmed, by international economic integration.”

“National governments need to pay attention to the social effects of economic trends, and try to alleviate some of the suffering that adverse eco-

nomie conditions can cause. Otherwise, we are likely to experience a very serious backlash against involvement in the world economy – something that would probably lead to policies that would be bad for overall economic growth.”

---

**“If governments chose to turn inward in a major way, they could do so. I think that this would be a bad idea, but the option is still there.”**

**Jeffry Frieden**

---

“Contemporary technologies have spurred some of the developments that have tied international markets together. It would be much more difficult to impede the flow of funds – not to speak of information – across borders today, in the age of the internet, than it was in the nineteenth century. However, governments have enormous powers, and retain the ability to restrict the economic activities of their citizens. So there is little technological barrier to a turn away from the world economy. If governments chose to turn inward in a major way, they could do so. I think that this would be a bad idea, but the option is still there.”

# GERMANY IS RUSSIA'S NATURAL ALLY

In *LookingGlass* No. 1/2008 we examined the relationship between Germany and Russia from the German perspective. Now we take a look at it from the Russian perspective. Germany and Continental Europe are considered as the natural partners and allies of Russia. For the Russian elite, the true enemy is the Anglo-Saxon world.

By **Fyodor Lukyanov**, editor of *Russia in Global Affairs*.

After Vladimir Lenin (who died in 1924), Vladimir Putin was the first top leader of Russia who spoke a foreign language. It was German, which the then KGB officer mastered perfectly during the years of service in East Germany.

It so happened that Gerhard Schröder did not speak fluent English. So Putin was the only leader of a great power with whom the German

Chancellor could speak absolutely freely and confidently, face to face, without fear of being misunderstood.

The personal factor in politics should not be exaggerated, yet it should not be downplayed, either. The relationship between Putin and Schröder went beyond the traditional contacts between the leaders of major states, especially those that are

not allies. As a matter of fact, Gerhard Schröder's career after he left the post of Chancellor has confirmed the uniqueness of the situation – he was the first Western politician of such a high rank to receive a well-paid job in a Russian state-owned company.

Of course, the language factor would not have played such a role, if there had not been such a profound mutual gravitation between Russia and Germany. It was not destroyed even by the fact that the two countries were on opposite sides of the frontline in both world wars, nor during the Cold War by the fact that the divided Germany itself had become a field of confrontation. How deep are the roots of these “special relations”?

Perhaps they began in the years of Peter the Great who viewed Europe, above all Germany and Holland, as a model for Russian modernisation. Or, in the second half of the 18th century when a German princess ascended the Russian throne as Tsarina Catherine the Second (later called the Great) since at the time, there was actually no Russian blood left in the veins of Russian tsars. By ethnicity, all her successors were German, and dynastic marriages were arranged mostly with German princesses.

The second half of the 19th century saw the development and prosperity of Russian capitalism. German businesses, which always tended to expand eastwards, also sought to actively tap the rich potential of the Russian market.

After the First World War, Bolshevik Russia and the defeated Germany were two European outcasts, and this factor once again caused them to seek rapprochement. The “romance” between the

two totalitarian regimes, which peaked during yet another division of Poland in 1939, lasted until June 22, 1941, when Hitler attacked the Soviet Union. Incidentally, the Soviet Union kept supplying trainloads of grain and equipment to Germany until the day of attack, even though many Soviet people had long believed that war with Germany was inevitable.

During the Cold War, East Germany served as the most convincing evidence of the untenability of the Communist system. First, because it was a pure experiment: one nation, two systems. Communist East Germany completely lost out to Capitalist West Germany.

Second, because the failure in East Germany could not be ascribed to lassitude or inability to work – the qualities that for example many believed the Russians to have. The German mentality implies complete devotion to whatever one does; therefore Communism in East Germany was perhaps built with more dedication than in any other Soviet satellite.

In turn, West Germany – even at the height of the Cold War – began to become a leading economic partner of Moscow in Europe. *Ostpolitik* by Chancellor Willy Brandt laid the foundations for the reconfiguration of almost the entire European geo-economics not of the Cold War, but rather of the post-Cold War period. Starting in the early 1970s, the two countries – and the whole of Europe – were linked by inseparable ties in the shape of gas pipelines. Actually, it was in those years that the paradigm of the modern Eastern policy of Europe and the European policy of Russia was born. One can speak at great length about the need to diversify supplies and

purchases, but neither Russia as supplier nor the European Union as customer have real alternatives in their energy cooperation.

Today's passions over energy security and the politicisation of this issue are not unique in recent history. So far, the economy has always overcome political prejudice. One can recall that the foundations of the in-depth energy cooperation were laid in the late 1960s-early 1970s, even though the political atmosphere in Europe following the suppression of the Prague Spring and the invasion of Czechoslovakia by Soviet troops left much to be desired, to put it mildly.

The next stage began in the early 1980s – an era of bitter confrontation between the United States and the Soviet Union. German Chancellor Helmut Schmidt and Foreign Minister Hans-Dietrich Genscher convinced the Reagan administration that broader gas cooperation with Moscow would do no harm to the security interests of the West. The US agreed despite Reagan's deep, in fact religious belief, as his former aide Richard Pipes recalled, that the Soviet Union was an "evil empire".

Since I was a student in Germanic studies in the Gorbachev era and visited West Germany at the time, I can testify to the admiration which Russians could enjoy there. And nobody was as active in sending humanitarian help to the rapidly decaying Soviet Union as the Germans, who inherently knew what it means to witness the collapse of a whole nation and set of ruling ideas. Today's Russians are very unwilling to remember that period summed up by Vladimir Putin as "the greatest geopolitical disaster of the 20th century". The Germans' sincere wish to ease the eco-

nomie suffering of Soviet people is seen now as "thirty pieces of silver" paid for a "perfidious" decision to allow a "smooth" re-unification of Germany. Many people in Russia believe that the unification of Germany the way it happened was the result of naivety or even treason on the part of Mikhail Gorbachev. It is widely believed that Moscow gained nothing for that huge geopolitical concession.

The friendship between Boris Yeltsin and Helmut Kohl was a vivid symbol of the diplomacy typical of the 1990s – "meetings without ties" which were intended to demonstrate that even after its defeat in the Cold War Russia remained an important and respected player in world and European politics. The real role of Moscow at that time was very modest, but "friend Helmut" eagerly gave "friend Boris" the illusion of belonging to a very narrow circle of world leaders.

---

**Last century was the time of the triumph of ideologies – first the Communist ideology, and then – in the last decade – the liberal one.**

---

Even such a cursory review of the political history shows the commonality between the two countries, which has stood the test of time. One of the reasons for that may be Russian political philosophy. The Russian elite have a world outlook based on the principles of Realpolitik. The ideas about invariable geopolitical interests of great powers as the driving force of international development were somewhat pushed into the background in the 20th century. Last century was the time of the triumph of ideologies – first the Communist ideology, and then – in the last decade – the liberal

one. The Communist ideology looked for patterns of world politics in the idea of class struggle, while the liberal ideology declared "the end of history" and the coming of a new era of universal cooperation on the principles of free trade and politics.

---

**In the first decade of the 21st century, it has begun to seem that "good old" geopolitics in the spirit of Karl Haushofer which Russians actually never ceased to believe in has returned and that the rivalry between states continues.**

---

Subsequent developments refuted both Communist and liberal dogmatism. In the first decade of the 21st century, it has begun to seem that "good old" geopolitics in the spirit of Karl Haushofer which Russians actually never ceased to believe in has returned and that the rivalry between states continues. Russia, now seriously disappointed with the results of the democratic transformations, is experiencing a renaissance of thinking in the spirit of the 19th century.

The established view that the Anglo-Saxon world (or, in modern terms, the Atlantic world) is the true enemy of Russia has existed since the 19th century and, apparently, stems from the fierce geopolitical rivalry that the Russian and British empires pursued in Central Asia and the Middle East. Another explanation is that the ideology of liberalism, which had its roots in Britain, has always been viewed in Russia as attempts to undermine the foundations of the conservative consciousness and world order.

Russia has never been in direct military con-

frontation with Britain (the Crimean War of 1854–56 was an exception due to a special combination of circumstances in Europe). Moreover, in both world wars, Russia and Britain fought on the same side against Germany. Yet, it is Germany that is viewed by Russia as the base of Continental Europe and as its natural partner and ally. In Russia's view, Continental Europe, united by common interests and opposed to seafaring Britain and the United States, is a guarantee of the security and influence of Russia and the whole of Eurasia. Of course, this is a very simplified description, but it can serve as the pivot of Russia's world outlook. For example, some Russian conservative writers hold that the cataclysms of the 20th century occurred because Britain and France involved Russia in the war against Germany, which ran counter to Russian interests.

One can easily find a reflection of these theoretical discussions in modern politics, too. The year 2003 nearly became a year of serious division in European politics. The division of Europe into those who supported the US action in Iraq and those who opposed it demonstrated that the former trans-Atlantic monolith no longer existed. But even more important was the new position of Russia. For the first time in more than 80 years, it was not against the West but on the side of one part of the West, the so-called Old Europe, against its other, US-oriented part.

Subsequent developments showed that Paris, Berlin and Moscow were right to strongly oppose that war. At the same time, the leaders of each of the countries that formed the core of the coalition against the Iraq campaign were guided by personal considerations. For Jacques Chirac, it was

another opportunity to affirm the independence of France and its claims to European leadership. For Gerhard Schröder, it was a way to win additional votes at elections, whose outcome was not obvious. For Vladimir Putin, it was to all appearances a chance to gain an entirely new position for Russia in Europe.

The presidency of Vladimir Putin cannot be described as successful in view of his initial plans and the results he achieved in foreign policy. Putin's initial aim was not at all to turn Russia into a latent threat, as it began to be viewed by the end of his presidency, but to make a "big deal" with Europe on the basis of asset swapping – that is, access to Russian energy resources in exchange for Russia's access to European markets and technologies. He spoke about that, in more or less explicit terms, almost throughout his presidency – from the famous speech in the German Bundestag (he delivered it in German, which made an indelible impression on the audience) to the no less famous speech in another German city, Munich. Considering the interests of German businesses, Germany was assigned a special role in this strategy.

This approach had two culmination points. One was in 2005 when Putin and Schröder signed an agreement on the construction of a North European gas pipeline. The other was in 2007 when Putin, speaking to Chancellor Angela Merkel, proposed that Germany be the main distributor of Russian gas in Europe.

However, these efforts have not produced the desired results. Unlike the late 1960s or the early 1980s, now there have emerged transit nations between Germany and Russia, which are not

ready to remain passive observers of large-scale projects launched by great powers. The words by Radek Sikorski, the then Minister of National Defence of Poland, that the North European gas pipeline is a reincarnation of the Molotov-Ribbentrop Pact, represented a landmark statement that outlined the limits of the individual geopolitical capabilities of Russia and Germany. And the generous proposal outlined to Angela Merkel already had no chance of being implemented – such a manifest establishment of "special relations" would not be met with understanding by any of Berlin's allies, and Germany knew that very well.

---

**The European Union does not have a unified political identity and will hardly have it in the future.**

---

Russian-German relations today are an excellent illustration of the state in which Europe finds itself. On the one hand, the European Union does not have a unified political identity and will hardly have it in the future. On the other hand, large countries, however influential they may be, are bound by commitments to their allies and cannot pursue the independent policies that they would consider the most advantageous to themselves.

This is why Moscow's policy of pragmatic integration, with reliance on key partners – Germany, France and Italy, failed to produce the desired result. Russia did not think of any other model for rapprochement, while as of the second half of the 1990s, Moscow was no longer interested in integration according to EU recipes, that is, integration based on gradual adoption of EU norms and principles.

Germany will continue to maintain a special position toward Russia anyway, as German businesses are keenly interested in broader contacts with this country. However, the polarization of attitudes toward Moscow in the European Union is increasing, so now it is pointless to speak of any geopolitical constructs that involve Russia.

The political reputation of Gerhard Schröder after he concluded the contract with Gazprom was delivered a heavy blow – as well as his ability to efficaciously perform the functions of a North European gas pipeline lobbyist. Nevertheless, Schröder's efforts to achieve rapprochement with Russia – no matter what motivated them – were a bold move from a historical point of view.

---

**There are many arguments to support the possibility that in the 21st century the centre of global influence will shift from the Euro-Atlantic space to other parts of the world, most likely to the Asia-Pacific region.**

---

There are many arguments to support the possibility that in the 21st century the centre of global influence will shift from the Euro-Atlantic space to other parts of the world, most likely to the Asia-Pacific region. Neither Russia, nor the "Old World" have any chance, taken separately, to play a central role in future world politics. However, the pooling of their potentials can essentially increase the capabilities of both parties.

To date, neither Russia, nor Europe are ready for serious discussions on their common future. Attempts to speed up rapprochement – like those made by the EU in the 1990s or by Russia in the

2000s – fail. "Special relations" with individual European countries, patterned after "holy alliances", are impossible – as is Russia's incorporation into some supranational union.

---

**Germany will play an important role in building new relations with Russia when Europe becomes aware of the need for a further merger of the Russian and European potentials.**

---

Germany will play an important role in building new relations with Russia when Europe (the whole of Europe, not just the European Union) becomes aware of the need for a further merger of the Russian and European potentials. After the Second World War, Germany, along with France, was one of the authors of the most fantastic political project in history – the gradual unification of former arch-enemies in a close alliance. Turning Europe into a truly safe and stable place requires plans for its further integration that would be comparable in intellectual boldness to the project of the late 1940s. And then "special relations" would really be established between Russia and the whole of Europe, not just Germany.

# IS THE MIDDLE CLASS SLIDING AWAY FROM THE MIDDLE?

The large middle class in Britain is still feeling quite good, but nearly all economic growth has been at the top. If the middle class is going to be hit hard by the crisis, we will probably see a lurch towards conservatism, says Polly Toynbee.

By **Rachel Briggs**, Glasshouse Forum advisory board member.

Who are the British middle classes? Angus Maude summed it up nicely when he commented, “it might perhaps have been held that the middle classes were composed of all those who used napkin rings.”<sup>1</sup> Maude’s irreverence belies a clarity that others have struggled to find in answering this question. For the middle classes are not defined just in socio-economic terms, although it has been historically correct to assume a fair degree of correlation between income and class. Neither are they defined solely in relation to how they spend their money, where they live or their educational background, although general rules can be observed. Instead, the vital ingredients are a set of shared attitudes, values and behaviours that together encapsulate the British middle classes: aspiration, financial security and prudence, voluntarism, and a commitment to the family as the main social unit. But after the large scale process of upward social mobility that took place in the 1950s and 1960s, Britain is left with a “middle class” that incorporates around 70 per cent of the population. On this measure, just how useful is the term, especially as we try to understand how the current economic crisis will impact on them?

*Guardian* columnist, Polly Toynbee, has written at length about class in Britain, focusing in particular on the poorest in society. However, her latest book, *Unjust Rewards*, looks at those at the other end of the spectrum; the super rich. As someone who has chronicled the rich and the poor, I wondered what she would make of the majority in the middle and their plight as the effects of the credit crunch starts to be felt.

**In your book, you say that class in Britain is just as embedded as it ever was. Does it still have the same impact on people’s lives?**

“When I started out in journalism in the late 1960s, we had a society that was two-thirds manual, working class, blue collar, non-home owning. Now we have moved to a society that is two-thirds white collar, middle class, home owning and that has been a huge social change. One-third of society went on a large upward mobility curve. But this stopped at about the end of the 1970s. In the early 1980s during that terrible recession, right across Europe – but particularly badly felt in Britain and America – there was a sudden falling off where the poorest just got much poorer; the bottom third who were left behind became much worse off. The effect was that, at the end of the 1970s, only one in seven children was in a family living below the OECD poverty line, but by 1997 when Labour took power it was one in three children. Also in the mid 1980s, there was the great financial boom in which the lid was blown off the very top, helped by the huge reduction in the top rate of tax. The growth in poverty at the bottom, the explosion of wealth at the top, and a much more unjust tax system led to this big social change.”

**Given the scale of the shift you describe, do you think it is still useful to talk about working, middle and upper classes? Especially when the features that characterise the so-called “working class” are worklessness and transient work, as opposed to any particular type of manual labour.**

“The culture and language of class has changed, but the reality not very much. You could say we have a 70 per cent middle class society if you

<sup>1</sup> Quoted in *Middle Class: Their Rise and Sprawl* (2002), Simon Gunn and Rachel Bell, p. 4.

include all the home owners, although in this downturn you may find that the bottom home owners fall out again. I think it's reasonable to say you are middle class if you are a salary earning, white collar home owner. It's true that to describe the rest as working class doesn't describe them at all, but I think also that not to talk about class is to disguise what's really going on. Yes, nobody has to doff their cap to someone else, we don't have feudal lords, we don't have a sense of deference, and we don't have class warfare anymore. But it's a bit like taking you into a room full of lottery winners and saying 'here are lottery winners, look anyone can win, it could be you'. The answer is that of course it could be you, but what matters are the odds, and they are very low indeed."

**But if as many as 70 per cent of Britons can now be described as "middle class", is that a useful and meaningful term?**

"I think it's a useful term as they would probably self-identify as being people who had made it, who have their own home. For many, their parents could never have imagined that it would be possible to own a house that was worth £250,000. So they identify themselves upwards, but within that group there is incredible disparity. There is a myth of growth, and GDP per capita is an entirely mendacious and useless average. I think the description that we're doing so well has been very politically damaging because people can't point to the figures and they don't know where they stand on the earning spectrum, but they just know it doesn't feel that way for them. The latest Office of National Statistics (ONS) report about incomes showed that in the last 3-4 years the bottom half have had no increase at all. What's more, the bottom-third have actually fallen back in real

terms over the last five years. When you look at the bottom 80 per cent, most of them have had not very much growth. Nearly all of the growth we have seen has been in the top 20 per cent, within that nearly all of it within the top 5, and heavily distorted towards the top 2 per cent."

**If the middle classes are no longer that affluent, that surely leaves us feeling somewhat disorientated. Have we lost our sense of perspective on income and class structure?**

"Our political leadership has failed to give people a sense of who they are and where they belong. There is a 'Hello culture', where people see footballers and others making mega money and they look at it with either wonderment or anger. They know there are a lot of poor folk but they assume they must be slackers because they think there is full employment. And there is a very uncertain middle. If you ask people in the top echelons – which we did in our book – they haven't a clue where the middle is. There is a sense that politicians have not presented a true picture back to people so they can make sense of what is happening."

**One of the most dramatic social changes of recent times has been the explosion of the super rich; a new class of people at the top of the socio-economic ladder who are self made, who have not inherited their wealth as the upper classes did. Why and how did this happen?**

"The Americans started. Under the rubric of globalisation, the top swathe of executives within companies have managed to con everybody that globalisation meant that we had to keep up with the Americans in everything, including these

astronomical salaries that all the research tells us bears no relevance to performance. The system of remuneration committees actually served to inflate pay as everyone could then look at everybody else's and compare their salaries much more easily. It requires regulation to stop it."

**Why do you think it is something we should be concerned about?**

"Because it caused disaster; huge mergers and acquisitions, huge borrowing, anything that you could do to inflate your company's share price over a very short period of time, that's what the board told you to do, and if you did you were rewarded with a bonus. It's turned out that it was that bonus culture that led to the massive under-capitalisation and over-leveraging of borrowing that led directly to the crash. When we wrote our book, if we had said that the bonus culture would bring capitalism to its knees in a way we have never seen before, we would have been laughed out of court. But it's happened. And yet, I see no real sign of the government demanding an end to that culture, even though if they did they would get good support."

"The other reason that we should be concerned is because of the effect it has on the rest of the social fabric. We now have chief executives of quite small cities or health authorities demanding to be paid £200,000 – more than the prime minister is paid – because they are trying to keep up with what's going on outside. The same thing is happening within companies; senior managers are trying to keep up with the board, and the middle managers are trying to keep up with the senior managers, and all the time a bigger gap is emerging between the shop floor and the board. This

breeds resentment and makes for very unhappy organisations."

**So, despite it becoming the main shareholder in many of these failing institutions, you do not think that the government will be brave enough to stamp out those practices?**

"I think it will breathe down their necks to do things like lend more so they don't just build up the capital for shareholders and they might grumble a bit about bonuses, but it doesn't look like they will step in and do anything. They get so bamboozled by people in the city telling them what they can and cannot do, but it is all nonsense. People won't leave Britain; nearly everyone working in the financial sector in the UK is British, and not in danger of being poached as far as anyone can see."

**So you don't think that the current financial crisis will create the climate, language, and political leadership you talked about that are essential in tackling the problems at both ends of the economic spectrum?**

"It might do. I don't think yet that the shock has been great enough, and already within two weeks of near economic collapse the Tory papers are saying that we must be very careful that we don't over-regulate. They are all back at the same old game. In fact, I don't think anyone has changed their mind – I haven't changed mine – and I don't think any of them will either. Now is our chance, say both the left and right, to do whatever it was we wanted to do beforehand. I would like to say it's a new dawn, but I've got a bit suspicious of new dawns."

**Specifically, what kind of impact do you think this economic crisis will have on the middle classes?**

It is difficult to get a proper sense of how the middle classes feel and how the current economic woes will affect them. Right now, middle England is feeling good; interest rates are at an all time low which means that mortgage payments – the main outgoing for most households – have fallen dramatically, and food and fuel prices are finally coming down. This is creating a short term feel good factor for the average family. What will happen if and when the economic crisis spreads is anyone's guess. If I am right, the middle classes will be hit hard and we are likely to see a lurch towards conservatism – socially, politically and economically – as Middle England hunkers down.

What is clear is that the plight of the middle classes will have an enormous impact on the mood of the UK. With the middle classes now accounting for almost three-quarters of Brits, Charles Masterman's words of 1909 are even more relevant today: "England...is the tone and temper which the ideals and determinations of the middle class have stamped upon [it]. It is the middle class which stands for England in most modern analyses."<sup>2</sup> Whether they are a cohesive group or not, the middle classes deserve a lot more of our attention than they have commanded of late.

---

<sup>2</sup> Quoted in Gunn and Bell, p. 1.