

# LOOKINGGLASS

by Glasshouse Forum

NO. 3/2009, AUTUMN ISSUE

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NEW PUBLICATION

## “CROSSING THE RIVER BY GROPING FOR STEPPING STONES”

CONTINUING THE DEBATE ON  
THE NATURE OF THE CHINESE SYSTEM

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REPORT

## NEO-LIBERALISM FAILED TO CREATE DEMAND IN THE US

INTERVIEW WITH THOMAS I. PALLEY ON THE ORIGINS OF THE RECESSION

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# INTRODUCING LOOKINGGLASS AND GLASSHOUSE FORUM

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

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

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

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

**The following projects are running within Glasshouse Forum 2009:**

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

**Glasshouse Forum publications to date**

The two latest publications are *A China Model? Understanding the Evolution of a "Socialist Market Economy"*, by Orion A. Lewis and Jessica C. Teets, 2009, 25 pp, and *Alphabet Soup: The Political Economy of the Great Recession*, by Daniel W. Drezner, 2009, 32 pp. These reports are presented in this issue of *LookingGlass* (see pp. 6 and 8).

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

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

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

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

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

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

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

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

#### Upcoming Glasshouse Forum event:

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

Although there has been extensive discussion of the financial dimensions of the crisis, to date there has been far less written about the distributional implications. The goal of the conference is

to bring together scholars from the social sciences, such as economics, sociology, and political science, to deepen our understanding of the link between globalisation (of both financial and real markets) and economic inequality. In this way we will be in a better position to understand and perhaps predict the consequences to inequality of the current economic turmoil.

Among the topics to be discussed:

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

Those who have confirmed their participation include: **Sir Anthony Atkinson**, Oxford University; **Orely Ashenfelter**, Princeton University; **David Card**, UC Berkeley; **Thomas DiPrete**, Columbia University; **Enrico Moretti**, University of California Berkeley; **Philippe Aghion**, Harvard University; **Robert Frank**, Cornell University; **Richard Blundell**, University College London; Richard Freeman, Harvard University; **Jonas Pontusson**, Princeton University; **Luis Garicano**, London School of Economics; **John Van Reenan**, London School of Economics/GSB Stanford university; **Jim Heckman**, Chicago University; **Bruce Western**, Harvard University; **Kim Weeden**, Cornell University; **Mike Hout**, UC Berkeley; and **Timothy Smeeding**, University of Wisconsin-Madison.

#### Glasshouse Forum in the media

2009–05–26:

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

2009–05–22:

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

2009–05–14:

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

2009–02–25:

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

2009–01–04:

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

2008–11–04:

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

2008–09–23:

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

2008–09–22:

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

# A CHINA MODEL?

GLASSHOUSE FORUM CONTINUES THE DEBATE ON WHETHER THERE IS SUCH A THING AS A “CHINA MODEL” AND TRIES TO GRASP WHAT “SOCIALIST MARKET ECONOMY” IN FACT MEANS.

**A China Model?**  
Understanding the Evolution of  
a “Socialist Market Economy”  
Orion A. Lewis  
Jessica C. Teets

Glasshouse Forum

In February 2009, Glasshouse Forum convened leading academics from China and from the West to a China-West Intellectual Summit near Paris. The starting point for the discussion was that 20 years have now passed since Francis Fukuyama launched his renowned theory on the end of history. Liberal democracy on a capitalistic base had triumphed over its rivals. Those who did not adopt this system would be hopelessly outdistanced. The country that most clearly refutes this hypothesis is China. It has seen unparalleled economic development at the same time as the regime has retained its grip on society and the economy.

Can one speak of a Chinese model, an authoritarian capitalism, which may even inspire others, in particular when the crisis emanating from the USA is leading many to look critically at the West? In the video documentation *Is There a China Model?* we can follow the occasionally tense debate on the issue of whether there is such a

model and whether the rest of the world, including the West, might have something to learn from it.



The film *Is There a China Model?* and a written summary can be downloaded on [glasshouseforum.org](http://glasshouseforum.org).

It was manifest that the Chinese participants considered China well positioned to handle the global economic crisis. There was some uncertainty however over how to characterise the system in China and how one might theoretically describe the major changes that have taken place in recent decades. Representatives for the new Chinese Left underscored the socialistic element, but it is not easy to grasp what “socialist market economy” in fact means. How should one define the Chinese economic model? What are the differences and similarities in the state’s role in the market and welfare provision when compared to American liberal capitalism, the European social model and the Scandinavian welfare model?

There was no really satisfactory answer to these questions during the China-West Intellectual Summit, and Glasshouse Forum therefore asked the American political scientists Orion A. Lewis and Jessica C. Teets of Middlebury College to try

to clarify matters in a comparative perspective, and to discuss the implications of the global economic crisis on China’s socialist market economy.

In their report *A China Model? Understanding the Evolution of a “Socialist Market Economy”*, Lewis and Teets suggest that part of the difficulty in understanding the Chinese market is that it attempts to bridge the state-market relationship under a command economy with one under a market economy. The relationship between the state and the market follows a gradual evolutionary path, where policy constantly adapts to changing political and economic obstacles to further reform. The slogan “crossing the river by groping for stepping stones” most accurately describes this economic process. Instead of emulating a specific model of capitalism, Chinese leaders desire to promote a uniquely Chinese model of development.

Lewis and Teets contend that the development of the socialist market economy is shaped primarily through the elite debate over the appropriate relationship between state and market, and resembles an ad-hoc series of compromises between neo-liberal reformers on the right and the socialist left rather than a coherent “China model” of development. Neo-liberal market reformers dominated economic policy during the post-Tiananmen period of the 1990s, pushing through reforms to downsize the state-owned sector and transition to more of a regulatory state. However the “new left” – critical of neoliberalism and advocating greater social welfare – has emerged as an important political force in recent years. The current global economic crisis amplifies this trend, creating important implications for understanding China’s future economic policy.

# DRAFTING SCENARIOS: THREE POSSIBLE ECONOMIC TRAJECTORIES

## A GLASSHOUSE FORUM STUDY ON THE POLITICAL ECONOMY OF THE GREAT RECESSION

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

Glasshouse Forum

Readers of *LookingGlass* no. 2/2009, our summer issue, may already be aware of Daniel W. Drezner's scenario study. However, we are in no less need now of understanding the medium-term effects of the current global economic crisis. There are many signs that we are now facing the beginning of a structural sea change. But what will it be like?

In *Alphabet Soup: The Political Economy of the Great Recession*, Daniel W. Drezner, Professor of International Politics at The Fletcher School, Tufts University, and author of the Glasshouse Forum report *White Whale or Red Herring? – Assessing Sovereign Wealth Funds*, drafts scenarios and makes qualified estimates based on as much objective data and historical parallels as possible.

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

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

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

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

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

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

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

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

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

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

The report can be downloaded from our website: [glasshouseforum.org](http://glasshouseforum.org).

# LOW WAGES THE ULTIMATE CAUSE OF THE GLOBAL RECESSION

The global recession is a crisis for the neo-liberal paradigm, says the Washington-based economist Thomas I. Palley. It has led to stagnating wages and a growth fuelled by debt and asset price inflation. What we need, says Palley in an interview with *LookingGlass*, are policies that ensure that the mobility of production does not create a race to the bottom.

How deep is the global crisis which manifested itself in 2007–2008, and what will its long-term consequences be? Despite everything, there appears to be a vague expectation that things will gradually return to business – and consumption – as usual. We will of course need to learn from our mistakes and deal with the excesses, but what if this is not enough, and a somewhat changed world awaits us?

It is not difficult in hindsight to point to serious mistakes before and after the crisis. Alan Greenspan, formerly declared the best Fed leader ever, has fallen from grace and is now regarded as a “serial bubbler”. Inadequate regulation, above all of the so-called shadow banking system, has certainly been contributory to the crisis, as have the incentive schemes inviting excessive risk-taking that the finance sector in particular has featured.

However, the focus on regulation and debatable risk-taking tends to cloud the issue of what are the real causes and extent of the crisis, asserts the American economist Thomas I. Palley in *America's Exhausted Paradigm: Macroeconomic Causes of the Financial Crisis and Great Recession* (June, 2009; New American Contract).<sup>1</sup> Palley, known to a wider readership among other things through *Atlantic Monthly* and *The Guardian*, is among the select collection of economists who for some time have been warning that the American economy would implode due to low pay increases and a high level of indebtedness. In *After the Bust. The Outlook for Macroeconomics and Macroeconomic Policy* (2009), Palley goes head to head with mainstream economists.<sup>2</sup> The neo-liberal policies to which they have given legitimacy have favoured only the financial markets

and the uppermost strata. The world of economics is proficient in marginalising dissidents, says Palley. Whoever is of a different opinion is simply “wrong” and not worth bothering about.

In *America's Exhausted Paradigm*, Palley further pursues his argumentation. The basic cause of the global crisis is the paradigm that has governed above all the American economy in the past 25 years, which incorporates the way in which the USA has related to and shaped globalisation. In Greenspan's defence, one should point out that the USA needed its bubbles to maintain growth. Neo-liberal economic policy concentrates income to the top percentiles and diminishes the buying power of large groups. To keep demand high there is a need for debt-taking and bubbles.

The paradigm of what we now call the thirty golden years from the end of the Second World War to the end of the 70s aimed to create a prosperous middle class that with its income could sustain a healthy demand. The economic policy focused on full employment, and productivity and pay rises went side by side, which created a virtuous circle. Higher salaries increased demand, which in turn contributed towards employment, and full employment created incentives for investments for increased productivity.

When President Ronald Reagan came into office, the target of full employment was abandoned, since it was considered to generate inflation.

<sup>1</sup> See New American Contract's website: [http://www.newamerica.net/publications/policy/america\\_s\\_exhausted\\_paradigm\\_macro\\_economic\\_causes\\_financial\\_crisis\\_and\\_great\\_recession](http://www.newamerica.net/publications/policy/america_s_exhausted_paradigm_macro_economic_causes_financial_crisis_and_great_recession)

<sup>2</sup> See The Levy Economics Institute's website: <http://www.levy.org/vauthdoc.aspx?auth=211>

Productivity continued to increase, but salaries did not increase correspondingly. It was prerequisite to this that the employees' position should become weaker. Trade unions, the guaranteed minimum wage and work protection were attacked, at the same time as globalisation exposed wage-earners to competition from low-income countries and the threat of outsourcing. Instead of relying on pay to generate demand growth, the neo-liberal model was built on debt and asset price inflation. Consumption has been maintained through reduced saving and increased borrowing. Financial booms provide consumers with collateral to support debt-financed spending. Financial innovations and

deregulation have enabled increased leverage and a broader flora of assets that can be collateralized. American household borrowing increased dramatically during the period 1981–2007. (See Table 1.) The neo-liberal model has also led to growing income differentials. Between 1979 and 2006, the income share of the bottom 40 per cent of US households decreased significantly, while the income share of the top 40 per cent increased significantly. (See Table 2.)<sup>3</sup> Cheap imports have to some extent neutralised dissatisfaction among the broad masses.

This paradigm included a relatively cavalier attitude towards trade deficits. They were in fact seen

as semi-virtuous because they helped to check inflation and because they reflected the choices of consumers and business in the marketplace. This era featured a flawed engagement with the global economy, says Palley. Globalisation as it was formed favoured corporations at the same time as it weakened the USA as a nation. It is however reasonable to wonder whether the corporate sector in the long run sawed off the branch it was sitting on. In its cost-cutting efforts it has kept down wages and thereby reduced demand for its own products. It is significant, incidentally, that the consumption boom in China that everyone is waiting for is being hampered by the fact that salaries are too low. There is a perception in the

West that Chinese wage-earners are saving instead of consuming, whereas the fact is, they do not have much money to consume with, as Palley points out in “External Contradictions of the Chinese Development Model: Export-led Growth and the Dangers of Global Economic Contraction”.<sup>4</sup> It is above all companies in China that are saving.<sup>5</sup>

The American economy has been bled in three ways during the prevailing economic regime. Household incomes have been spent on imports, generating revenue outside the USA. Furthermore, outsourcing has led to the relocation and loss of well-paid manufacturing jobs, mostly to

**Table 1. Household Debt/GDP and Non-Financial Corporate Debt/GDP Ratios by Business Cycle Peaks, 1948–2007**

Year	GDP (\$ billions)	Household debt (H) (\$ billions)	H/GDP	Non-financial Corp debt (C) (\$ billions)	C/GDP
1960	526.4	215.6	0.41	201.0	0.38
1969	984.6	442.7	0.45	462.0	0.47
1973	1,382.7	624.9	0.45	729.5	0.53
1981	3,128.4	1,507.2	0.48	1662.0	0.53
1990	5,803.1	3,597.8	0.62	3,753.4	0.65
2001	10,128.0	7682.9	0.76	6,954.0	0.69
2007	13,807.5	13,765.1	1.00	10,593.7	0.77

Source: FRB *Flow of Funds Accounts* and author's calculations. (Reproduced from *America's Exhausted Paradigm*.)

**Table 2. Distribution of Family Income by Household Income Rank 1947–2006**

Year	Bottom 40%	Next 40%	Next 15%	Top 5%
1947	16.9%	40.1%	25.5%	17.5%
1973	17.4	41.5	25.6	15.5
1979	17.0	41.6	26.1	15.3
1989	15.2	40.2	26.7	17.9
2000	14.1	38.1	26.6	21.1
2006	13.5	38.0	27.0	21.5

Source: Lawrence Mishel, Jared Bernstein, and Heidi Shierholz, *The State of Working America 2008/2009* (Ithaca, NY: ILR Press, forthcoming).

(Reproduced from *America's Exhausted Paradigm*.)

3) See also Gary Burtless, “Globalization and the American Income Polarization”, in *Towards an Hourglass Society?*, eds Kay Glans and Johanna Laurin, Glasshouse Forum, 2008.

4) *Journal of Contemporary China*, Vol.15 (46), 2006.

5) See *The Economist*, August 1, 2009, “The spend is high”.

China. Lastly, companies have been encouraged to move investments abroad, which has reduced domestic spending and denied the American economy modern industrial capacity. Instead of striving for a global market in which American companies might sell their products, the economic policy has aimed at a global production zone for companies. They manufactured products overseas that were then imported to the USA. Transnational companies in particular have lobbied for an economic policy that created a strong dollar, since a favourable dollar rate makes it cheaper for them to do business abroad. This has increased the American consumer's capacity to buy imported goods, but has not helped exports. In the last thirty years, the USA has, in the words of historian Charles Maier, been transformed from an "Empire of Production", into an "Empire of Consumption". How long does an "Empire of Consumption" remain an empire?

In Palley's analysis, the present crisis differs in two ways from the previous crises in the USA, for example the dot.com bubble in 2001. When previous bubbles burst, the consequences were not so serious, since their debt footprint was not so deep. This time it is not possible to increase demand –

neither by further reducing saving nor by finding new ways to raise money through loans. Both these strategies have run their course and the US households now need to get their finances in order. However, if they are over-thrifty, it will prolong the crisis, since demand will be stifled. The cause of the crisis is quite simply that the neo-liberal paradigm is obsolescent, says Palley. The focus on regulation leads to the macroeconomic problems being overlooked. If the neo-liberal model loses its opportunities to blow bubbles, it will find it even harder to create demand. It is striking how dependent growth has been on the housing bubble in recent years.

A new paradigm is needed, but all attempts to approach this are dismissed as protectionism, says Palley. The most important thing is to re-establish the relation between pay and productivity, and this is done by strengthening the position of wage-earners. The threefold bloodletting must be stopped, and companies must be made to work for the nation's well-being. As yet, however, there is little to indicate that the Obama administration is prepared for such fundamental change, Palley states. It appears rather that it is trying to create an interest-rate bubble in Treasury bonds.



Dr. Thomas I. Palley is an economist living in Washington DC. He holds a B.A. degree from Oxford University, and a M.A. degree in International Relations and Ph.D. in Economics, both from Yale University.

He has published in numerous academic journals, and written for *The Atlantic Monthly*, *American Prospect* and *Nation* magazines.

Dr. Palley has recently started a project, Economics for Democratic & Open Societies. The goal of the project is to stimulate public discussion about what kinds of economic arrangements and conditions are needed to promote democracy and open society.

Dr. Palley was formerly Chief Economist with the US – China Economic and Security Review Commission. Prior to joining the Commission he was Director of the Open Society Institute's Globalization Reform Project, and before that he was Assistant Director of Public Policy at the AFL-CIO.

# INTERVIEW WITH THOMAS I. PALLEY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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**“Politically, my fear is that this decade could turn out a lot like the 1930s. Deep prolonged economic stagnation releases political demons.”**

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

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

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

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

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

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

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

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

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

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

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

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

profits but it may lower national income and growth.

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**"Globalisation weakens the over-lap of interest between corporations and countries. What can be good for corporations can be bad for country."**

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

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

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

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

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

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**"What we need are policies that address the mobility of production and ensure that the mobility of production does not create a race to the bottom."**

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

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

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

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

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

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

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

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

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

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

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

## INTERVIEW

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

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

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

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**“...we lost our understanding of capitalism and forgot our history. In place, we bought into an idealised version of capitalism.”**

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

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

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

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